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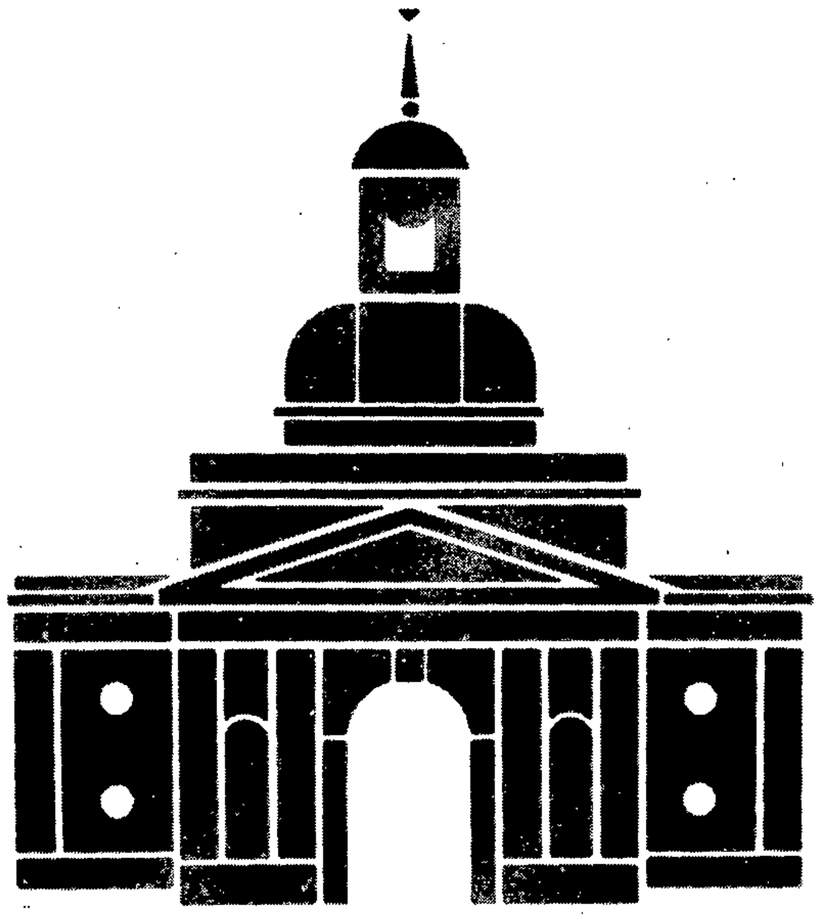

Bulletin 1988

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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:

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. 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 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.

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 five 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.*

The compact disc (CD-ROM) comprises virtually all of the world's effective tax treaties, including protocols and model treaties (846 in total, covering 130 countries).

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

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INCOME TAX COMPLIANCE AND SANCTIONS IN DEVELOPING COUNTRIES – AN OUTLINE OF ISSUES **3**

The author concludes that too much attention has been directed to the type and size of penalties and too little attention directed to catching violators and enforcing the penalties. It is far better to restrict the scope of the legislation and enforce more limited rules rather than rely on broad, but unenforceable law.

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Carrie Meyer et John F. Due:

République Dominicaine: Taxe sur la valeur ajoutée *13*

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INHALTSVERZEICHNIS

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Der Verfasser kommt zu dem Schluss, dass man zu viel Aufmerksamkeit auf Art und Höhe von Steuerstrafen gelenkt und dabei zu wenig die Verfolgung von Gesetzesübertretern und Durchführung von Steuerstrafen beachtet hat.

Carrie Meyer und John F. Due:

Die Mehrwertsteuer in der Dominikanischen Republik *13*

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Dr. Erwin Spiro:

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Li Jinyang:

Die Mehrwertsteuer in der Volksrepublik China 17
In diesem Artikel werden die verschiedenen Aspekte der Mehrwertsteuer in einer Planwirtschaft untersucht. Die Verfasserin geht davon aus, dass eine ideale Mehrwertsteuer universell angewandt werden sollte, um eine wirklich neutrale Besteuerung durchführen zu können und um die Schwierigkeiten bei der Verwaltung der Steuerbefreiungen und der verschiedenen Steuersätze zu minimieren. China wäre unter den Entwicklungsländern bezüglich der universellen Anwendung der Mehrwertsteuer in einer vorteilhaften Position, wenn das System der Preiskontrolle abgeschafft würde, was aber eher unwahrscheinlich ist. Trotzdem ist vorauszusehen, dass das System der Mehrwertsteuer in China in zunehmendem Masse angewandt wird.

P. Nagarajan:

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Der Verfasser untersucht das Wachstum Kenias öffentlicher Finanzen in der Periode 1965-1983. Er stellt fest, dass der relative staatliche Anteil sich während dieser Periode vergrössert hat. Das Steuersystem hat sich aufgrund der Besteuerung der einheimischen Produktion und der internen Geschäfte elastisch gezeigt. Es ist jedoch nicht möglich, Anhaltspunkte zu finden für die Stellungnahme, dass Kenias Steuersystem progressiver geworden sei.

Mahesh C. Purohit:

Indien: Die Besteuerung von Dienstleistungsverträgen – Bedingungen für ein Verkaufssteuersystem in einem Entwicklungsland 31
Dieser Artikel bespricht die Änderungen in der Verkaufssteuerstruktur in Indien, dessen Bereich ausgedehnt worden ist und heutzutage auch die Vergütungen für bestimmte Dienstleistungsverträge umfasst. Der Verfasser kommt zu dem Schluss, dass diese Änderung die Effizienz der Steuererhebung weitgehend verbessert.

Prof. Ali Ahmed Suliman:

Sudan: Erfahrungen mit Zakat – Das Verhältnis zwischen Zakat und der Einkommensteuer 34
Die Einführung von Zakat im Jahre 1984 im Sudan hat das Steuersystem, das sich in den vergangenen 80 Jahren entwickelt hatte, vollkommen verändert. Der Verfasser erläutert, dass die Anwendung der Zakat-Bestimmungen durch die Regierung weder den Vorschriften des Korans entspricht noch von wirtschaftlicher Bedeutung ist, weil die geleisteten Zahlungen abzugsfähig sind.

Dr. Erwin Spiro:

Republik Südafrika: Der Margo-Bericht 37
Im August 1987 veröffentlichte die "Steuerstruktur-Kommission der Republik Südafrika" (Margo-Kommission) einen ausführlichen Bericht mit neuen Vorschlägen für Änderungen im südafrikanischen Steuersystem. Der Verfasser untersucht einige der wichtigsten Empfehlungen.

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Income Tax Compliance and Sanctions in Developing Countries

An Outline of Issues

By Richard K. Gordon, Jnr.

There has been considerable discussion and writing concerning taxpayer sanctions and their effect on income tax compliance. In the United States, where the income tax provides almost all of the federal general revenues (excluding income security), most government officials agree that non-compliance has become a major problem. Numerous studies have indicated considerable taxpayer non-compliance, perhaps even equal to over half of the $ 200 billion plus deficit.[1] It has been argued that if compliance with existing law were improved, statutory tax increases would not be necessary.[2] In enacting the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[3], Congress intended to effect improved compliance, primarily through tougher sanctions against avoidance and evasion, as a major tool in raising substantial new revenues.[4]

Unfortunately, TEFRA, which both toughened existing sanctions and added new ones,[5] appears to have had little effect on the rate of taxpayer compliance.[6] A major motivation behind the passage of the Tax Reform Act of 1986 (TRA) was also to improve compliance.[7] Although TRA toughened some TEFRA sanctions and added some new ones,[8] TRA's principal method for improving compliance was to remove loopholes, reduce rates, and in general make the Code appear fairer to the average taxpayer.[9]

Improving taxpayer compliance has also been regarded as one of the most important ways of raising needed revenues in developing countries.[10] Though estimates often differ, most experts agree that in most developing countries, often more than one-third, and frequently more than half, of all income escapes tax.[11] While it is generally agreed that civil and criminal sanctions are needed to enforce the income tax laws, there seems to be little empirical evidence regarding how and why people underpay taxes, and how and why sanctions function to reduce that underpayment.

INITIAL QUESTIONS

Income vs. estimate

Before examining the issue of income tax compliance in poor countries, one should first know the revenue importance of the income tax relative to other forms of taxation in those countries. While developed coun-

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1. One estimate reported $170 billion in lost tax revenues. 72% came from unreported income (legal income, 48%; illegal income, 27%), 13.3% from unjustified deductions, exemptions and credits, 9% from non-filing, and 5.6% from non-payment of assessed taxes. U.S. General Accounting Office, *Further Research into Non-compliance Is Needed to Reduce Growing Tax Losses* 28-9 (1982). Estimates differ. See J. Henry, "Non-compliance with U.S. Tax Law – Evidence on Size, Growth, and Composition", in *Income Tax Compliance, A Report of the ABA Section of Taxation Invitational Conference on Income Tax Compliance* 33, 34 (1983).
2. At least since Congress enacted withholding on wages, better income tax compliance has been seen as a way of improving government resources. Wage withholding was introduced in 1942 with Pub. L. No. 77-753, and information reporting on interest and dividends in 1963 with Pub. L. No. 87-834.
3. Pub. L. No. 97-248.
4. See Staff of the Joint Committee on Taxation, *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982* (1982). Specific sections will be discussed infra. For a detailed description of the tax compliance legislation enacted by TEFRA, see J. LeDuc, "The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Compliance", 18 *Tax Notes* 363 (1983), and H. Mansfield, "The Role of Sanctions in Taxpayer Compliance", in *Income Tax Compliance,* note 2 at 217.
5. The major U.S. taxpayer sanctions can be found in Chapters 67, 68 and 75 of the United States Internal Revenue Code of 1954 (as amended) (I.R.C.).
6. Some members of the staff of the Joint Committee on Taxation of the United States Congress have concluded that the TEFRA sanctions have had no discernable effect on income tax compliance.
7. Pub. L. No. 99-514.
8. See Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (1986). Specific sections will be discussed infra. A brief description of these changes can be found in "Important Developments During the Year: Civil and Criminal Tax Penalties", 40 *The Tax Lawyer* 963 (1987). While a few changes in taxpayer sanctions were enacted between the passage of TEFRA and TRA, TRA made perhaps the most substantial changes since TEFRA.
9. *Senate Report* No. 313, 99th Congress, 2nd Session, 714 (1986). Perhaps one of the best indicators of the relative importance of different sections of a tax bill is the degree to which tax lobbyists discuss these provisions. While much of the talk heard by this author in "Gucci Gulch" (the corridor outside the House Committee on Ways and Means hearing room) during the Conference Committee meeting on TEFRA was about new taxpayer compliance provisions and sanctions, this author never heard any lobbyist discuss the sanctions changes in TRA.
10. For an overview, see generally A. Radian, *Resource Mobilization in Poor Countries* (1980).
11. See S. Richupan, "Income Tax Evasion: A Review of the Measurement Techniques and Some Estimates for the Developing Countries", *IMF Fiscal Affairs Department Document* 15-25 (1984).

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tries rely heavily on income taxes, most developing countries tend to rely far more on indirect forms of taxation, particularly *in rem* taxation.[12] A survey of 62 developing countries showed that less than one-quarter of all government revenues were raised by income and profits taxes.[13] It might be that the best way of combatting income tax evasion is further to reduce reliance on income taxes.

In 1951, Richard Goode enumerated those qualities he saw as essential if an income tax is to be useful and effective:
(1) the existence of a predominantly monetary economy; (2) a high standard of literacy; (3) the prevalence of honest and reliable accounting; (4) a large degree of voluntary compliance on the part of taxpayers; (5) a political system not dominated by wealthy groups acting in their self-interest; (6) an honest, reasonably efficient administration.[14] While some of these qualities might be directly related to the existence of tax compliance mechanisms, most are intimately tied to the country's stage of social and political, as well as economic, development. Countries in earlier stages of development might do well to avoid general income taxes and concentrate on the easier to administer in rem taxes such as excise, sales, import and export, and property taxes. Redistributive and other equity goals could then be achieved by non-tax fiscal measures.[15]

Another way would be to rely on those in personam taxes, such as the forfait system in France, which only approximate the income of an individual or entity but do not measure actual income.[16] The exact boundary between estimation of income and determination of actual income is not easily defined. This becomes increasingly true as estimation systems become more refined, and as the actual fixing of tax due becomes rebuttable.[17] It may be beneficial for developing countries to depend more on estimates and less on actual income as a tax base.[18]

Even if it is decided that an income tax is necessary, enforceable statutes need to be designed. Complex laws which permit the manipulation of tax liability through avoidance, or which tax transactions which are particularly difficult for the income tax service to discover or verify, will make enforcement of compliance difficult. It is careful consideration of these issues which may be the most important factor in fashioning sanctions for those laws eventually adopted.[19]

Avoidance vs. evasion

The line between tax avoidance, or the using of laws so as to minimize payment of taxes, and tax evasion, the breaking of laws, is difficult clearly to define. In addition, it is often difficult to decide where along the continuum of avoidance and evasion sanctions should be applied.[20] For example, taxpayers may seek to take the most favorable interpretation of existing law so as to take advantage of the use of money temporarily saved on taxes. Sometimes the taxpayer will win, sometimes not. Because not every return will be audited, the taxpayer will not only benefit from the time-value of money, but from those instances in which she or he is wrong but not found out. As the taxpayer's interpretations become increasingly far-fetched, and as she or he relies more and more on the "audit lottery" to escape tax, the avoidance of tax comes closer to the evasion of tax. But before this point is reached, the tax administration may wish to penalize the taxpayer so as to encourage her or him to adhere more closely to a "reasonable" interpretation of the tax law.

The issue of the time-value of money can in theory be dealt with by ensuring that market interest rates are charged. But this solution generates a number of difficulties. Even in developed countries there is no single "market rate" of interest; for the poor person without credit, a chosen "market rate" of interest will be too

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12. Economists often divide taxes in two different ways. The first division is between personal taxes (paid at the individual or household level and adjusted to the taxpayer's personal ability to pay) and in rem taxes (paid on activities or objects, independently of the characteristics of the owner or transactor). The second division is between income taxes (paid on total accretion to wealth plus consumption) and consumption taxes (paid only on actual consumption). In rem taxes, because they tax transactions and not individuals, are usually seen as easier to collect. See e.g. O. Oldman and L. Woods, "Would a Value-Added System Relieve Tax Compliance Problems?" in *Income Tax Compliance,* note 2 at 317.
13. From a study of 62 developing countries; the highest 15 countries collected on the average 37% of total revenues from income and profits taxes, and 3% from social security taxes. The middle 32 collected 24% and 3% respectively, and the bottom 15 collected 22 and 2%. Arithmetic, unweighted means, countries selected on basis of per capita GNP. A. Tait, W. Graetz, and B. Eichengren, "International Comparisons of Taxation for Selected Developing Countries, 1972-1976", 26 *IMF Staff Papers* 154-156 (1979).
14. R. Goode, "Reconstruction of Foreign Tax Systems", *Proceedings of the Forty-Fourth Annual Conference on Taxation, National Tax Association* 213-15 (1951), quoted in R. Goode, *Government Finance in Developing Countries* 102 (1984).
15. This might include a greater reliance on expenditures in effecting a policy of income redistribution, or adopting more easily collected indirect taxes in a way which would bear more lightly on the poor.
16. See Harvard Law School (M. Norr and P. Kerlan), *World Tax Series: Taxation in France* 345-368 (1966).
17. Carl Shoup defines six types of tax administration related both to the degree of taxpayer participation and to the nature of the tax. See "Economic Aspects of Tax Administration", in R. Bird and O. Oldman, *Readings on Taxation in Developing Countries* 500-513 (1975).
18. Personal taxes may be the least progressive, but can be modified to exclude the poorest. See E. Arowolo, "The Taxation of Low Incomes in African Countries", 15 *IMF Staff Papers* 322-41 (1968), quoted in R. Goode, *Government Finance in Developing Countries* 110 (1984). Taxes approximating expected revenue can be used either as an actual tax assessment, an irrebuttable presumption (essentially the same thing), or a rebuttable presumption or "best guess". See e.g. R. Goode, "Some Economic Aspects of Tax Administration", 28 *IMF Staff Papers* 250-274 (1981), A. Lapidoth, "The Use of Estimation for the Assessment of Taxable Business Income", 13-29 (1977), and I. Malik, "The Use of Presumptive Assessment Techniques in Taxation of Small Traders and Professionals in Africa", 33 *Bulletin for International Fiscal Documentation* 162 (1979), and references cited.
19. See also discussion in A. Radian, *Resource Mobilization in Poor Countries,* note 10 at 67-83. See also O. Oldman, "Controlling Income Tax Evasion", in *Problems of Tax Administration in Latin America* 296, 374 (1965). See general discussion below.
20. A good encapsulated description of the difference between evasion and avoidance can be found in S. Richupan, "Income Tax Evasion: A Review of the Measurement Techniques and Some Estimates for the Developing Countries", *IMF Fiscal Affairs Department Document,* note 14 at 1-3.

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low, while it will be too high for a large corporation.[21] But it is the second issue, the interpreting of laws as loosely as possible so as to play the audit lottery, that causes the most difficulty, especially where audits are scarce. It may be impossible to draw the line exactly between reasonable and unreasonable interpretations, and perhaps even between avoidance and evasion.

The United States Senate attempted to address this problem in TEFRA. TEFRA imposed a 10% "substantial understatement of tax" penalty, if the unreported amount is greater than 10% of the total correct tax, with a $ 5,000 floor ($ 10,000 for corporations). The amount may be reduced by the Internal Revenue Service (I.R.S.) to the extent that the taxpayer discloses all relevant facts, and that she or he relies on "substantial authority" for the under-reporting.[22] Apparently because the penalty seemed insufficient to improve compliance, TRA increased this amount from 10% to 20% of the underpayment.[23] In theory, such a penalty would encourage taxpayers to flag returns when a doubtful factual or legal interpretation is made, which theoretically would make the selection of returns for audit easier. Also because of the failure of the TEFRA provisions, TRA added yet another penalty. New Code §6653(a)(3) allows the I.R.S. to assess a negligence penalty against those taxpayers who fail to make a "reasonable attempt" to comply with the Code.[24] New Code §6653(a)(3) also allows the I.R.S. to assess negligence penalties for any "careless," "reckless," or "intentional disregard" of rules and regulations.[25] While such sections may help compliance by creating a sort of middle ground between avoidance and evasion, they cause two problems. First, assuming that the taxpayer is playing an audit lottery, the provisions will only work to the extent that the probability of audit times the penalty assessed is greater than the amount saved. Second, such penalties give a great deal of discretion to the revenue administration, something that may not be desirable from the taxpayer's (fear of arbitrariness), the revenue administrator's (difficulty in developing and enforcing standards), or the general public's (corruption of administration), point of view.[26]

Given these problems, perhaps the most effective way of dealing with tax avoidance, and thereby reducing the need to draw lines between reasonable and unreasonable avoidance, or between avoidance and evasion, is to design laws which leave relatively less room for interpretation.

A good example is provided by the United States I.R.S. and its battle against tax shelters. Tax shelters have usually consisted of limited partnership interests which provide deductible business losses to partners, losses often far in excess of actual amounts invested. Because of the global nature of (at least) the pre-1986 U.S. income tax, these losses could be used to offset other income. Loss deductions were created through the use by the partnership of heavy (often non-recourse) leveraging, accelerated depreciation, tax credits, and asset overvaluation.

The United States I.R.S. attempted to crack down on the most abusive of these shelters (usually those with grossly overvalued assets) through intensive auditing of tax shelter promotions. The problem was that the underlying statutory law did permit at least some types of tax shelters. Whether a deduction was allowable or not usually could be determined only after careful audit.

Congress attempted to control the most abusive forms of tax shelters without altering the underlying statutory law. As noted above, TEFRA, passed in 1982, included a provision for a 10% "substantial underpayment of tax" penalty.[27] The U.S. Internal Revenue Code (I.R.C.) §6700 provides for a penalty of 20% (or $ 1000, whichever is greater) of the tax shelter promoter's gross income from the scheme if a "gross overvaluation statement" had been made, or if there had been a fraudulent misrepresentation of the tax treatment of the shelter. While §6661 applies to tax shelter investors, the disclosure escape clause available in other instances of substantial underpayment of tax does not. A tax shelter investor can escape the penalty only if the taxpayer reasonably believed that the treatment taken was more likely than not correct.[28]

Unfortunately, the TEFRA penalties seemed to do little to deter the spread of abusive tax shelters. By 1985, over half of all audits performed by the United States I.R.S. were of tax shelters.[29] The continuous proliferation of shelters demonstrated that the audit lottery, even with the TEFRA provisions, was still worth playing.

Finally, in 1986, Congress solved the tax shelter audit difficulties of the I.R.S. Instead of trying to deal with the problem simply by adding more penalties and more audits,[30] Congress changed the underlying statutory law which had allowed tax shelters to exist in the first place. TRA carved out a type of exception to the global nature of the U.S. income tax and created a

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21. It should bother a government less if those with relatively fewer resources were able better to take advantage of imperfections in the administration of a tax system. Hence, it is recommended here that interest be charged at a (compounded) rate appropriate for the wealthier taxpayers.
22. U.S. I.R.C., §6661. The disclosure provisions do not apply in the case of tax shelters (limited partnerships which sell paper tax losses), one of the prime targets of this provision. See the discussion below.
23. TRA §1504(a).
24. U.S. I.R.C. §§6653(a) et seq.
25. Id.
26. The I.R.S. never requested such discretionary authority. It has encountered numerous problems in developing and implementing standards by which to enforce it. H. Mansfield, "The Role of Sanctions in Taxpayer Compliance", in *Income Tax Compliance,* note 2 at 222-224, 231. The less honest the tax administration, the greater the problem. It appears that, due to problems with pay, organization, and other issues, tax administrations in developing countries often experience greater problems with corruption than do tax administrations in developed countries.
27. See note 22.
28. U.S. I.R.C. §6661(b)(2)(c).
29. See Statement of Senior Associate Director for General Government J. Finch, General Accounting Office, before the House Ways and Means Oversight Subcommittee Hearing on the Budget of the I.R.S., quoted in "Unpopular Spending: IRS Budget and Tax Administration", 28 *Tax Notes* 821 (1985). For general coverage of the hearing, see 28 *Tax Notes* 570, 571 (1985).
30. Although Congress also did this. See discussion infra.

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schedular type "passive activity rule." New U.S. I.R.C. §469 generally prevents taxpayers from deducting losses and credits from passive business activities against income from other activities.[31] This, along with other new provisions regarding at-risk rules and non-recourse financing,[32] has essentially put an end to tax shelters – not through sanctions or increased audits, but through a change in underlying statutory law.[33]

Not all problems in tax avoidance or evasion can be solved by changing the underlying law. In those instances where they cannot, it might be wise to experiment with penalties similar in type to the TEFRA and TRA penalties, but without a sliding scale, and with criteria as clearly defined as possible. Because no detailed studies exist in developing countries concerning the extent to which unjustifiable avoidance occurs, it might make sense simply to experiment with different penalty levels. It would at all times be necessary not to raise the levels too high if the number of audits gets too low; otherwise taxpayers will feel that the system is arbitrarily singling out individuals for punishment.[34]

Non-compliance vs. evasion

In addition to making use of the "audit lottery" in cases where the taxpayer's position is essentially untenable, Boidman defines three different types of non-compliance: (1) failure to file a tax return of any kind; (2) failure to declare earned income on the tax return; and (3) reducing taxable income by incorrectly reporting tax deductions, exclusions or credits.[35]

First, each of the above failures could be due not to an intention to avoid, but to an error on the part of the taxpayer. If the error is unreasonable or due to negligence, it once again begins to approach fraud, and should subject the taxpayer to a special penalty in addition to interest.[36] Somewhere between negligence and unavoidable delays lies a middle ground, where the taxpayer is not playing some kind of audit lottery, but is simply making a mistake. A penalty needs to be applied here to encourage the taxpayer to take greater care.[37]

In both of these instances, even assuming that the taxpayer has no ulterior motive, the effect of the penalties will be felt only if they are applied. As is the case with the audit lottery, it is the actual audit and the application of sanctions which determine their effectiveness.

THE COMPONENTS OF TAX EVASION

It is in the area of willfully evading tax laws that the issue of sanctions normally receives the most discussion. Before understanding tax evasion, it is necessary to know something about how much evasion there is and how it is executed. Unfortunately, even in the United States, which has a large, relatively efficient revenue administration, estimates concerning non-compliance are not very reliable.[38] The problem is even greater for developing countries, where resources to study the problem are far more scarce.[39] While accurate studies are lacking, some general observations can be made. Looking back to Boidman's definition, it is clear that all tax avoidance can start with failure to file a return.[40] Simply getting income earners registered as taxpayers is the first step in effective tax administration; therefore, using all possible sources to establish a taxpayer master list has to be the most important task of a developing country's tax administration. Obtaining relevant information (particularly business and professional licenses, land records, and tax records from other jurisdictions) from regional and local governments, as well as the more traditional information from national departments, can be very helpful in finding missing taxpayers. This technique has been of particular help to tax administrators in Tanzania and Zimbabwe.

In the United States, almost half of lost revenue is estimated to come from illegal activities, though most taxpayers with illegal income file some kind of return.[41] This is probably due less to a desire to evade paying taxes (in fact, some income from illegal activity is declared as miscellaneous income on tax returns so as to escape the possibility of conviction in a tax evasion case), than simply to avoid prosecution under the substantive law.[42] This problem might be relieved some-

31. U.S. I.R.C. §469.
32. U.S. I.R.C. §465.
33. But see note 6.
34. Proposed initial levels of monetary fines can be found in Oldman, "Controlling Income Tax Evasion", note 19.
35. N. Boidman, "What Can Be Learned from the Experience of Other Countries with Income Tax Compliance Problems", 37 *Bulletin for International Fiscal Documentation* 415, 454-455 (1983).
36. Section 6653(a) of the U.S. I.R.C. provides for a 5% penalty on the total amount of deficiency if any part is due to negligence, and an additional 50% on the interest payable with respect to the part of the understatement due to negligence. TRA amended §6653(g) to allow the I.R.S. to assess a negligence penalty if the taxpayer fails to claim income reported as paid to her or him on an information return.
37. The U.S. I.R.C. provides a 5% penalty per month (up to 25%) for unjustifiably failing timely to file a return, and a 1% monthly penalty (up to 25%) for failure to make a payment of the amount due. Id. at §6651(a). TRA had increased these penalties.
38. The General Accounting Office has criticized the U.S. Internal Revenue Service for underestimating the extent of tax evasion primarily through the overuse of Taxpayer Compliance Measurement Program statistics (which only examine filers) and its failure to use national income account statistics. See generally U.S. General Accounting Office, *Further Research into Non-compliance Is Needed to Reduce Growing Tax Losses* (1982), especially Chapter 2, "Taxpayer Compliance, a Massive Problem About Which the IRS Knows Too Little". Oddly enough, the U.S. I.R.S. has consistently produced higher estimates than the Commerce Department. See Joint Committee on Taxation, *Analysis of Proposals Relating to Broadening the Base and Lowering the Rates of the Income Tax* (1982), quoted in LeDuc, "The Legislative Response", note 5 at 367.
39. See generally S. Richupan, "Income Tax Evasion: A Review of the Measurement Techniques and Some Estimates for the Developing Countries", note 12 at 15-21.
40. In the U.S., where information reporting is so extensive, it is difficult for most taxpayers to avoid filing any type of return; hence a low estimate in the 10% range of revenues lost due to failure to file compared to all revenues lost. See U.S. General Accounting Office, *Further Research into Non-compliance*, note 2 at 29. The less extensive the information reporting, the easier for a taxpayer to fall through the net.
41. Id. See also Internal Revenue Service, Office of the Assistant Commissioner of Planning and Research Division, *1983 Income Tax Compliance Research – Estimates for 1973-81* (1983).
42. See "The Underground Economy", Hearings Before the Subcommittee on Oversight, House Committee on Ways and Means, 96th Congress,

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what if tax return information were withheld from law enforcement personnel investigating or prosecuting non-tax related cases.[43] In some developing countries, that portion of tax evasion due to unreported illegal activity is probably smaller, as so much perfectly legal activity goes unreported.[44] In some countries with relatively greater amounts of economic regulation, however, this problem would still be substantial. This is often true in those developing countries which have elaborate laws concerning price controls, resource allocations, foreign investment, and currency convertibility. Briefly, the fewer the activities deemed illegal, the less the incentive for individuals not to report; the greater the confidentiality of returns, the less the incentive not to report.

Besides the obvious motive of saving money, there are other, fundamental questions regarding why some people do not pay their taxes. At first lies the issue of whether a particular culture, or a group within that culture, feels compelled to obey the law. Upandra Baxi, writing on the increased acceptance of lawlessness in India, attributes much of the problem to over-regulation (too much law) and a separation between those who need not follow the law because of special status, and the rest of the population which is expected to follow the law (law applied unequally).[45] As laws get more complex and far-reaching, people know that they cannot effectively be followed, and respect for all law fails. As the general population sees some individuals (whether members of a governing or economic elite) disobey the law, lawlessness increases; if elites can disobey, why can't we?[46] Second, and almost as important, is the issue of relative compliance; in some cases, only certain laws might be ignored if the proscribed activity does not fall afoul of social norms.[47] Each of these hypotheses may apply to revenue laws, depending on the general legal climate, the type of example set by elites, and the degree of seriousness with which society views paying taxes. In at least the second two cases, the seriousness with which the government enforces the revenue laws will have a profound effect on public attitudes. In the first instance, the extent to which the government overreaches in trying to tax income may effect overall compliance. In short, saying that you are trying to collect relatively less, and then trying relatively harder to collect that reduced amount, may foster better overall compliance.

There is some evidence which indicates that decreasing levels of compliance in the United States may be due in part to a growth in the perception that large numbers of individuals do not comply with the tax laws and a growth in the belief that the tax system does not treat all individuals in comparable ways.[48] This was a constant refrain among taxpayers in India, and was a motivating force behind Indonesia's recent tax reform. Related to these issues is whether the public believes that the laws themselves are substantively unfair on their face – either by favoring certain groups over others, or by taxing everyone too much. Opinion polls indicate that the U.S. electorate views the tax code as being fraught with unfair special-interest provisions, while many believe that taxes simply are too high.[49] To the extent that evasion is due to these factors, sanctions should have relatively less effect.

According to the Senate Finance Committee Report to the Tax Reform Act of 1986, an important motivation for tax reform was the perception by the average taxpayer that the proliferation of loopholes meant that only the naive and unsophisticated paid any taxes.[50] If that were so, why should the taxpayer be honest? No one else was paying taxes. The same report also concluded that high marginal rates of taxation were causing an increasing loss of confidence in the tax system by the average taxpayer.[51] It is too soon to tell if the reduction in loopholes and in individual rates wrought by the Tax Reform Act of 1986 will have any real effect on taxpayer compliance. Revenue officials in India, however, have claimed that a major reduction in individual tax rates, coupled with increased enforcement, was responsible for an increase in direct tax revenue of over 25%.[52]

1st Session (1979), and V. Tanzi, "Underground Economy and Tax Evasion in the United States: Estimates and Implications", in V. Tanzi, ed., *The Underground Economy in the United States and Abroad* 69 (1982). While there is some confidentiality of returns, law enforcement officers outside of the I.R.S. may share information on returns in prosecuting non-tax evasion cases. There may often be conflicting interests when a taxpayer wishes to avoid a tax evasion charge and wishes not to be caught in the underlying illegal activity.

43. Hence the conflict between tax administration and the enforcement of non-tax laws. In the past, the Organized Crime Strike Force has used tax evasion statutes to convict criminals whom it could not convict on other charges, and has used tax return information to track down illegal operations.

44. See generally S. Richupan, "Income Tax Evasion: A Review of the Measurement Techniques and Some Estimates for the Developing Countries", note 12.

45. See U. Baxi, *The Crisis of the Indian Legal System* (1982), Introduction, and sources cited.

46. Id. See also P. Dean, T. Keenan, and F. Kenney, "Taxpayers' Attitudes to Income Tax Evasion: An Empirical Study", 1980 *British Tax Review* 28.

47. In some developing countries, the general level of non-compliance is so great that, if the laws were ever enforced, one would have to put nearly the entire country in jail. In such instances, the public would think of the laws as having no seriousness and little moral power, and would view instances of isolated enforcement as unfair or arbitrary. See O. Oldman, "Controlling Income Tax Evasion", in Joint Tax Program, *Problems of Tax Administration in Latin America* 296, 318 (1965).

48. A. Witte and D. Woodbury, "What We Know about Factors Affecting Compliance with the Tax Laws", in *Income Tax Compliance,* note 2 at 142. See also studies cited, id., at 142-148.

49. See "Americans View Tax Code as Unfair", *New York Times* (1985), and M. Spicer and L. Becker, "Fiscal Inequity and Tax Evasion", 33 *National Tax Journal* 171 (1980). The increasing prevalence of tax protesting (refusing to pay any tax) may also be related to this phenomenon. But see Hansson, "The Underground Economy in a High Tax Country: The Case of Sweden", in V. Tanzi, ed., *The Underground Economy in the United States and Abroad* 125 (1983). Though Sweden is a high tax country, there is considerable tax compliance.

50. *Senate Report No. 313,* note 10 at 714.

51. Id.

52. This claim has been made by numerous Finance Ministry officials, including the former Minister, Mr. V. P. Singh. Though this author is unaware of any convincing studies supporting this claim, a completely unscientific survey of a number of advocates (lawyers) in New Delhi conducted by this author shows a remarkable 100% agreement that lower rates have encouraged "a greater feeling of fairness" (to quote one respondent) and a much higher level of tax compliance.

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High absolute levels of taxation, besides having an effect on the perceived fairness of the taxation system, might have additional effects due to the increased monetary value of evasion. One would expect that the higher the marginal rate, the more gain to be received by understating income or overstating deductions, and hence the greater the amount of evasion. If one were to compare two countries of equal wealth, one would expect the country with the lower marginal rates (other things being equal) to experience less evasion. Within a single country, one would expect those taxpayers with higher marginal rates to cheat more.

Working against these assumptions, however, is another tendency. One might also expect lower income taxpayers to cheat more, as each tax dollar would for them have greater utility. Which of these two conflicting forces is dominant is not clear.[53] Nonetheless, it may be less troublesome to tax administrations if poorer people are cheating because of a relatively higher marginal utility for each dollar collected. In addition, one would expect "bracket-creep," an increase in taxes due to inflation, to result in diminished compliance, as there would be no offsetting decrease in marginal utility. This is borne out in Witte's and Woodbury's review of the literature.[54] Sanctions may affect the wealthier if their tax brackets are sufficiently high that the benefits from evasion are simply too good to miss. Once again, substantial sanctions enforced only rarely will be seen as arbitrary.

Not entirely separate from the issue of respect for law is the fear of getting caught. Not surprisingly, studies tend to indicate that this is one of the most important determinants.[55] Witte and Woodbury found that the perceived probability that non-compliance would not be detected was the most important factor in increasing non-compliance.[56] In the case of monetary fines, one paradigm would consider the taxpayer as a rational, economic actor maximizing her or his utility by multiplying the perceived chances of detection and successful prosecution by the amount of money to be saved by evasion, and comparing that to the amount of potential fines. In fact, there is some empirical evidence of this happening.[57] However, there is also some indication that the fear of fines may be greater than the statistical likelihood of being caught might indicate.[58]

PENALTIES

While almost every developing country has enacted penalties for both negligent and intentional failure to comply with revenue laws, few civil, and virtually no criminal, penalties are ever assessed and collected.

The reasons given by different developing country tax administrations are usually the same: the penalties have no clear rationale and are therefore too severe (and seem unfair); they are hard to assess because under-reporting itself is difficult to discover; and, given the fact that it is the underlying tax liability which is more important, penalties can be bargained away in the process of securing the tax deficiency. The last point is an interesting one – even if penalties are never collected, they could be an important compliance tool (though this cannot be done in most instances in the U.S., as most penalties are assessed by statute).

The first point, the rationale regarding penalty amounts, is also a good one, and leads to the basic questions, how large should penalties be, and under what circumstances can tax administrators hope to discover (and prove) underpayment so that penalties can successfully be assessed? Even in the United States there seems to be little attempt to correlate penalties with a probability formula; an amount is picked which *seems* right.[59] The U.S. I.R.C. does tie fines to dollar amounts evaded (the greater the amount evaded, the greater the fine), which at least in part results in an increased amount of discounted fine for each increase in dollar benefit. The U.S. I.R.C. used to tie the amount of fines not to the deficiency due to the fraud, but to the total deficiency, a total penalty of 50%. This seemed unfair, and did not serve in a logical way to increase the disincentive to commit fraud. TRA changed this to 75% of the deficiency due to fraud.[60]

The U.S. I.R.C. also imposes very stiff criminal penalties for tax evasion for "any person who willfully attempts in any manner to evade or defeat any tax". The

53. One of the reasons that empirical regression studies of each of these factors are difficult to perform is that, on average, lower and middle income taxpayers often have less opportunity to cheat. This is particularly true in developed countries, where the vast majority of lower and middle class income comes from wages subject to withholding. It is therefore difficult for these taxpayers to understate income or to overstate deductions or exclusions. This is, of course, full of exceptions. Domestic workers in the United States are not subject to wage withholding, and until recently, waiters and waitresses were not subject to withholding on tips. Lower and middle income small business proprietors have myriad opportunities for manipulating income and expenses.

54. A. Witte and D. Woodbury, "What We Know about Factors Affecting Compliance", in *Income Tax Compliance,* note 2 at 142. See also studies cited at 142-148. See also the review article by A. Blumstein, "Models for Structuring Taxpayer Compliance", in *Income Tax Compliance, id.* at 159-172 (particularly 162).

55. See generally Mason and Calvin, "A Study of Admitted Income Tax Evasion", 13 *Law & Society Revue* 73 (1978).

56. Other factors included increases in marginal tax rate due to bracket-creep, growth in perception that others no longer comply, growth in perception that the laws treat different people differently and are therefore unfair, increased levels of education, and increases in unemployment and decreases in real income associated with periodic recessions. A. Witte and D. Woodbury, "What We Know about Factors Affecting Compliance", in *Income Tax Compliance,* note 2 at 142. See also studies cited, id. at 142-148. See also H. Mansfield, "The Role of Sanctions in Taxpayer Compliance", id. at 217-233. See especially bibliography on sanction studies, id. at 233.

57. See the review article by A. Blumstein, "Models for Structuring Taxpayer Compliance", in *Income Tax Compliance,* note 2 at 169, and studies cited.

58. See the model of N. Friedland, S. Maital and A. Rutenberg, "A Simulation Study of Income Tax Evasion", 10 *Journal of Public Economics* 107 (1978).

59. A good general outline of suggested penalties and methods of application based on a general sense of fairness can be found in O. Oldman, "Controlling Income Tax Evasion", in *Problems of Tax Administration,* note 20. Given the lack of useful empirical studies in most poor countries, Oldman's numbers can serve as a useful starting-off point. Increases or decreases in these figures could be made with regard to other relevant issues discussed as well as with the success of compliance.

60. TRA §1503(b), U.S. I.R.C.

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penalty for tax evasion includes a fine of not more than $ 100,000 ($ 500,000 in the case of a corporation) and/or imprisonment for not more than five years, plus prosecution costs. Other criminal penalties are assessed for willful failure to collect or pay over tax, willful failure to file returns or information, the making of fraudulent statements, and the filing of fraudulent returns.[61]

Of course, only if the people believe that they will be caught and that fines will be imposed will there be any deterrent (or what psychologists call "Pavlovian") effect. There are a number of issues involved here. First is the ability of the administration to discover underpayment, second is the will and ability to see to it that fines are imposed, and third is the public's perception that this is in fact happening. The most important of these is probably the first.

Once again, the first and most important task is to get a complete taxpayer master list, and then to fine heavily those who do not file returns. This is effective for three reasons. First, once a master list is completed, it is relatively easy to cross-check and see if each taxpayer has filed a declaration. If the taxpayer has not, it would be a relatively simple task to levy the fine. The second reason is that, by implementing this easily-enforced sanction, the tax administration helps instill in the public a healthy respect for all sanctions. Third, such a sanction helps coax recalcitrant would-be taxpayers onto the rolls. In the United States, there is a penalty of 5% of the amount of tax due for each month in which a taxpayer fails to file a required declaration, not to exceed 25% in the aggregate. Criminal penalties include a fine of not more than $ 25,000 ($ 50,000 for a corporation) and/or one year in jail. This is in addition to other penalties.[62]

Income subject to withholding and subject to reporting is relatively more impervious to evasion than other types of income.[63] All major studies carried out in the United States confirm this fact. Wages and salaries (on which there is withholding as well as easily matched information returns) by far show the lowest percentage of unreported to reported income, with self-employed income and rents and royalties having the highest.[64] Over the past 35 years, the income actually reported as a total percentage of income in a particular category has improved steadily for wages, interest and dividends, while there has been little or no improvement for business and professional income or for rental income. This makes intuitive sense, as withholding, information reporting and matching have been extended and improved for the former, but not for the latter.[65]

Withholding means either that the tax administration gets at minimum the amount withheld, or requires the taxpayer to explain why some money should be returned. Wage withholding is clearly the most important. Information returns can only be effective if matching is done and if the money is then collected.[66] If there were an efficient method of matching information returns, following up delinquencies, and collecting taxes due, withholding would not be necessary; many have suggested that this has been achieved in the United States.[67] The difficulty of actually remitting the withholding, as well as the possibility that some people will wind up being overwithheld, has added to the debate in the United States, and has served to defeat proposals to withhold on interest and dividends.[68] Such a problem would be eliminated by replacing withholding with a PAYE system, but that in itself would engender considerable administrative difficulties.[69] Overwithholding also requires the processing of refunds, which can create a substantial additional workload for tax administrations, particularly in developing countries.

While in a wealthy country like the United States there may be little difference between withholding and information reporting, in poorer countries matching paper and then trying to collect taxes due could be prohibitively expensive where there is information reporting but no withholding. Penalties should be increased to the point where going through each report

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61. U.S. I.R.C. §§7201 through 7207. See discussion of criminal sanctions, infra.
62. U.S. I.R.C. §§6651(a)(l), 7203.
63. In the United States, over 90% of all personal income tax liability is collected through withholding via a third party. See U.S. Department of Commerce, *National Income and Product Tables (1984).*
64. See Department of the Treasury, Internal Revenue Service, *Estimates of Income Unreported on Individual Income Tax Returns* 7-9 (1979), quoted in D. Holland and O. Oldman, "Measuring and Controlling Income Tax Evasion", *15th General Assembly of Inter-American Center of Tax Administrators* (1981). These estimates agree with those made by T. Parke in connection with his work on the reconciliation of personal income with I.R.S. adjusted gross income. Id. There is some disagreement over estimates of absolute dollar unreporting. The I.R.S. has estimated that unreported wages and salaries are the second largest source of unreported income, while the Department of Commerce has suggested that this amount is minimal. Id.
65. Id., and sources cited. This basic trend is confirmed in Professor Parke's examination, with some nuances. See id. at 28-37.
66. This sentiment has been expressed in the United States. "This is because an ADP information return system in itself will not collect one penny in taxes. All it can do is identify possible discrepancies which then must be followed up through ordinary collection and enforcement procedures available to the Internal Revenue Service" (regarding the substitution of information reporting for withholding on interest and dividends). Minority Views of Senators Douglas and Gore, *Senate Report No. 1881, 87th Congress, 2nd Session* 119 (1962), quoted in J. LeDuc, "Improving the Self-Assessment of Federal Income Tax: Recent Legislative Developments", 19 *Tax Notes* 1030-1031 (1983).
67. See R. Doenberg, "The Case Against Withholding", 6 *Texas Law Review* 61 (1982). See also a 1975 study which showed that 61% of all tax return filers receiving interest and dividend income covered by information returns reported the income correctly; in terms of dollars, 96.7% of the income received was voluntarily reported. T. Vitez, "Information Reporting and Withholding as Stimulants of Voluntary Compliance", in *Income Tax Compliance,* note 2 at 191-216. See generally the graph on page 295, relating withholding, information reporting, auditable records and cash levels of compliance. G. Feffer, R. Timbie, A. Weiner, and M. Ernst, "Proposals to Deter and Detect the Underground Cash Economy", in *Income Tax Compliance,* note 2 at 293-313.
68. There was a tremendous cry against enacting withholding on interest and dividends, with banks taking out full page ads urging depositors to write to their Congressmen and Senators. See Joint Committee on Taxation, *Description of Proposals Relating to Withholding on Interest and Dividends,* 96th Cong. (1980). Although there was a hue and cry against enacting withholding on interest and dividends, there has been some indication that Americans prefer over-withholding to under- withholding, most likely as a kind of enforced savings. See the brief discussion in N. Barr, S. James and A. Prest, *Self-Assessment for Income Tax* 61-62 (1977).
69. See L. Yudkin, *A Legal Structure for Effective Income Tax Administration* 32-40 (1971).

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and collecting on each discrepancy would be financially rewarding. Unless this were feasible, both politically and administratively, it would make more sense for poorer countries to enact withholding on those payments most easily made amenable, namely wages, dividends, interest, and government contracts.[70] Stiff sanctions then could be used to concentrate on those third parties who fail to remit withholdings or who misstate them. The numbers of taxpayers and information remittors would be far smaller, and the earnings potential for each investigation far greater than they would be for audits of individuals without withholding.[71]

Information reports are also less likely to be subject to understatement, as companies benefit from deducting wages paid from their company returns. Pakistan, for example, has reported success by disallowing deductions for unreported wages. Simple checking of wage information returns and wages deducted for income tax purposes can help keep wage reporting honest. With relatively fewer companies to audit, and with an economic reason for accurately preparing some information returns, it is likely that the number of violations will be relatively less, and subject to relatively simple discovery. For this reason (the likelihood of being caught) and because of the importance of reporting as a tax enforcement tool, relatively high penalties can be used further to encourage compliance without subjecting the tax administrators to charges of arbitrary enforcement.

Income not subject to withholding can be given the lion's share of audit attention.[72] Without a large number of audits, there will never be a credible threat, and without such a threat, the imposition of sanctions is not only a paper tiger, but undermines the entire legitimacy of the system. The decline in audit coverage in the United States is credited with much of the decline in (or failure to improve) compliance.[73] If the audit level were not brought up to a reasonable amount, the fines would have to be raised to levels unacceptable to those rare individuals unlucky enough to be caught, if the value of cheating were to be kept below the potential fines multiplied by the chances of being caught. Once again, too few audits would delegitimize the entire system. But audits are the most important component of tax compliance work, if often insufficiently supported by governments.[74] In the United States, a computer selection system assists auditing by selecting returns statistically likely to be incorrect.[75] While it might be far too difficult to replicate such a system in a poor country, a very limited use of automatic data processing, along with the correlation of a very limited number of factors, may assist auditors. The main effort must nevertheless be fieldwork.

Auditing deductions is undoubtedly one of the more difficult and time-consuming administrative activities. Preferably, the number of deductions should be limited as much as possible, and deductions should, when related to business, be subjected to some kind of reporting requirements. Standard deductions should be used whenever possible for individuals, and the auditing of deductions should be left primarily to the larger business establishments.

While audits may point out discrepancies, little overall deterrent effect will be accomplished if only interest or nominal fines are collected. The public must witness the serious attempts of the administration to punish tax evasion. In the United States, it was until recently the position of the I.R.S. that there was a very high level of tax compliance.[76] Recently, however, there has been a considerable amount of attention paid, both in Congress and in the media, about the de-

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70. See P. Griffith, "Current Payment of Taxes on Income", study prepared for the Harvard-Chile Tax Project (Revised 1970) in P. Kelley and O. Oldman, *Readings on Income Tax Administration* 347 (1973), and R. Musgrave and M. Gillis, *Fiscal Reform for Colombia* 325-330 (1971).

71. Richard Bird recommends that a special withholding enforcement section be created within the tax administration, that compliance be made as easy as possible, and that serious financial penalties be enacted for failure to collect or turn over withholding or PAYE amounts. R. Bird, "Income Tax Reform in Developing Countries: The Administrative Dimension", 37 *Bulletin for International Fiscal Documentation* 5-7 (1983). TRA added §§6721-6724, raising the maximum penalty for failure to file an information report (it had been $ 50,000), and providing a new $ 5 penalty for each failure to include correct information (with a maximum of $ 20,000 per calendar year). Maximum amounts do not apply to information reports on interest and dividends. In addition, the person responsible for withholding and remitting any tax can herself or himself be subjected to a penalty equal to 100% of the liability if she or he willfully fails to collect the tax or to remit it to the I.R.S. U.S. I.R.C. §§6671(b), 6672. Other penalties apply for certain taxpayers. See §6652. There is also now a $ 1,000 penalty ($ 10,000 if corporate) for a person who knowingly prepares a false information return or document. Id. at §6701.

72. Note the I.R.S.'s use of the "Gompertz" curve, which indicates that different classes of taxpayers respond differently to higher audit coverage; those with income subject to withholding or to information returns have their compliance rate little affected by a higher audit coverage than those not subject to such withholding or reporting. U.S. General Accounting Office, *Further Research into Non-compliance Is Needed to Reduce Growing Tax Losses,* note 2 at 17.

73. It is estimated that the 1986 individual audit coverage will equal a mere 1.2%, down from 5% in 1965. "Unpopular Spending: IRS Budget and Tax Administration", 28 *Tax Notes* 821 (1985). According to a former I.R.S. Commissioner, the reduction in general audit coverage is gravely damaging the U.S. system of voluntary compliance. See Letter of Sheldon Cohen to Commissioner Egger, reproduced in 28 *Tax Notes* 1269 (1985).

74. For example, it was proposed that the potential revenue shortfalls anticipated in the passage TRA could be avoided simply by requiring the I.R.S. to conduct more audits. This suggestion was rejected by the Chairman of the House Ways and Means Committee and the Chairman of the Senate Finance Committee because it would have required either an increase in appropriations for the I.R.S. (something deemed politically impossible, as the reform bill was to have no additional outlays), or a shift in resources within the I.R.S. to auditing activities (also deemed politically impossible, as this would have probably required the shifting of funds from data processing, which would itself have resulted in intolerable time lags in processing returns and refunds). See J. Birnbaum and A. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* 266-267 (1987). However, at the time of this writing, both the House and Senate are considering a sizable increase in appropriations for the I.R.S. in order to increase the number of audits, improve compliance, and reduce the deficit.

75. For a general description of this system, see A. Sze, "Audit ADP Applications, Featuring the Discriminant Function System" (1979) 45-46, 53-58 (unpublished I.R.S. working paper, on file with the author) and I.R.S., Office of the Assistant Commissioner, *Discriminant Function Handbook* 1-27 (1979).

76. Until the I.R.S. released its 1979 report, *Estimates of Income Unreported on Individual Income Tax Returns,* there was a reluctance to admit even that a significant compliance problem existed. See J. LeDuc, "The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Compliance", note 5 at 367.

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teriorating level of taxpayer compliance, as well as the declining audit rate.[77] The position was dropped publicly, not only because of existing evidence to the contrary, but as a legislative strategy to secure more funding for the agency. In general, however, it is important that the tax administrators present the image, to the greatest extent possible without losing credibility, that compliance is substantial. Recent, well-publicized cases of tax levying in Massachusetts have played an important role in improving general compliance.[78] This also appears to be the case in India, where a major new enforcement effort was begun in 1985, resulting in seizures of property in lieu of back taxes, as well as in arrests.[79] In the cases of both Massachusetts and India, arrests of tax cheats and the vigorous enforcement of revenue laws have been very popular with the public, if not always with the special interests.[80] But, as suggested earlier, serious fines provided for in the statutes but not levied can have a reverse effect on compliance, by making the statutes appear substanceless. Serious fines for non-compliance actually levied in those areas where the non-compliance is more likely to be discovered may have a powerful deterrent effect.

Sanctions which result in jail sentences seem to have some deterrent effect, although it is very difficult to measure.[81]Impressive jail sentences make the newspapers, and no doubt can have an effect on the average taxpayer. In the United States, very few criminal convictions are secured relative to the total number of returns investigated – less than 0.04%.[82] Once again, if sanctions are too severe, or if they are enforced too rarely, they might actually reduce compliance.

Practically speaking, very few developing countries ever use the criminal law to enforce income tax sanctions. The reasons are myriad. First, criminal penalties require, or should require, a higher standard of proof than civil penalties.[83] In civil fraud cases, the U.S. I.R.C. uses the phrase "due to fraud" without describing fraud.[84] Unlike in criminal fraud cases, where guilt must be proven beyond a reasonable doubt, the I.R.S. need in civil fraud cases only show "clear and convincing evidence", a tougher standard than the normal civil requirement of preponderance of the evidence, but less stringent than the criminal standard.[85] Second, and perhaps more importantly, criminal sanctions can appear grossly unfair. If income tax evasion is rampant, as is the case in many developing countries, singling out individuals for criminal sanctions can appear persecutory. While civil fines may seem a slap on the wrist, jail terms may seem too harsh. Also, if almost everyone is evading tax, tax prosecutions can be used as a way of punishing political enemies while leaving friends untouched.[86] Third, criminal sanctions are sometimes too unpopular politically to enforce, although both the Massachusetts and Indian experiences suggest otherwise. For some combination of these reasons, developing countries, and even many developed countries, very rarely enforce criminal sanctions against tax evaders.

Depending on the level of mass evasion, and on the degree of severity, civil sanctions may become subject to the same criticisms leveled against criminal sanctions.[87]

Recently, some have suggested that the existence of criminal sanctions or punitive civil sanctions on the statute books of developing countries is actually pernicious. Rather than make serious efforts to improve compliance through tax reform and better tax administration, governments simply pass increasingly stringent criminal penalties, which themselves are rarely used.[88]

If criminal penalties are to be enacted, they should be reserved only for the most egregious types of tax evasion, evasion of an extent far greater than the typical, evasion which would shock even the most cynical taxpayer. Once a statute exempts most typical evaders, it must be enforced.

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77. See e.g. "Cheating Uncle Sam: IRS is Losing Battle Against Tax Evaders Despite its New Gear. Aided by Law's Complexity, More People Underpay; Audit Coverage Declines. The Best Place to Borrow". *The Wall Street Journal,* April 10, 1981 p. 1.

78. See generally R. Behn, *Case Study: Massachusetts Department of Revenue* (Center for Excellence in Government) (1986), especially *Sequel,* pp. 18-33.

79. See e.g. "Business in the Dock", *India Today,* November 30, 1985, pp. 38-51. Most of the crackdown has dealt with excise and customs violations, not with direct tax violations.

80. While the revenue enhancement program in Massachusetts has been so popular that it has helped Governor Michael Dukakis in his bid for the United States presidency, some have alleged that arrests of powerful business figures in Indian tax evasion cases have (along with other causes) led to the dismissal of the instigator of the crackdowns, former Finance Minister V.P. Singh. There is little doubt, however, that Singh has benefited from enormous popularity due to his role in prosecuting tax offenders. See e.g. "V.P. Singh: Making Waves", *India Today,* 15 July 1987, pp. 34-35.

81. See D. Nagin, "General Deterrence: A Review of the Empirical Evidence", in A. Blumstein, J. Cohen and D. Nagin, eds., *Deterrence and Incapacitation: Estimating the Effect of Criminal Sanctions on Crime Rates: Report of the Panel on Research on Deterrent and Incapacitative Effects* (1978).

82. In 1982, there were over 9,280 criminal investigations. Fewer than 2,000 cases were filed, while the government succeeded in less than 1,500; less than half resulted in any jail sentence. This amount looks particularly small when it is compared to the nearly 2 million returns examined. I.R.S., *Annual Report of the Commissioner of Internal Revenue, 1981* 16 (1982), cited in H. Mansfield, "The Role of Sanctions in Taxpayer Compliance", in *Income Tax Compliance,* note 2 at 218. See generally S. Long, *The Internal Revenue Service: Measuring Tax Offenses and Enforcement Response* (1980).

83. See O. Oldman, "Controlling Income Tax Evasion", in Joint Tax Program, *Problems of Tax Administration in Latin America* 296, 318-320 (1965).

84. U.S. I.R.C., §6653(b).

85. For techniques in proving evasion, see I.R.S., IV *Internal Revenue Manual (Audit)* (see especially 7245-22-7247-21 [1985]); J. Potvin, "Tax Evasion in Canada", 25 *Canadian Tax Journal* 229 (1977); R. Meldon and T. Mountin, *Federal Taxation: Practice and Procedure,* 450 et seq. (1983); Directorate of Inspection, Income Tax Department, India, *Handbook of Summary Assessment Under the Income Tax Act* (1976); Harvard Law School, International Tax Program, *Materials on Comparative Tax Administration, Policy and Practice,* Part IV, "Verification and Auditing" (1985-86).

86. It is alleged that the Finance Ministry in India is using allegations of tax evasion to justify raids on a prominent and vocal newspaper which has lately been publishing an exposé of alleged corruption in the government. See e.g. "All the News Gandhi Doesn't Want to Hear", *The Economist,* 5 September 1987, p. 36.

87. See H. Mansfield, "The Role of Sanctions in Taxpayer Compliance", in *Income Tax Compliance,* note 2 at 219-220.

88. The Tax Administration Division at the International Monetary Fund has sometimes recommended against enacting criminal tax evasion penalties.

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Tax amnesties

Tax amnesties, or the forgiveness of sanctions, have been used, and probably overused, in the past. The 1967 tax amnesty in Israel, for example, may have had a deleterious effect on the public's perception of the serious, criminal nature of tax evasion.[89] When followed by a major improvement in the administration and prosecution of tax evasion, a single amnesty might work. This has been the experience in the Commonwealth of Massachusetts in the United States, where not only a genuine improvement followed a tax amnesty but, during the promulgation of the amnesty, political events convinced the public that a real improvement *would* follow. While successes have been reported in other American states, the experience in developing countries has been less successful than was hoped for. Often, the only time that criminal tax evasion penalties are taken notice of is when they are suspended for a tax amnesty.[90]

TAX COMPLIANCE AND TAX PENALTIES: A CONCLUSION

Too much attention has been paid to the type and size of penalties, while not enough attention has been paid to the likelihood of the taxpayer being caught and being forced to pay the penalties. If there exists a reasonable chance of being caught, then sanctions can become effective. As compliance increases, so can the threat of sanctions.

In some limited areas, where compliance is already sufficiently high, major sanctions can be of great use, such as against companies which fail to withhold or report wages, or against individuals who evade taxes to exceptional extremes. High interest rates and penalties on amounts assessed but not yet paid can make the collection process more profitable. Penalties high enough to militate against the audit lottery can be useful, but only when the chance of audit is reasonable. The severity of sanctions should match not only the extent of the avoidance or evasion, but also its degree of uncommonness and its chance of being discovered.

In each of these areas, the statutes should reflect the practice. It is far better to restrict the scope of the statute and then enforce the more limited law than it is to have a broad, but unenforced, law.

Briefly, then,

1. in rem taxes or best-estimate taxes should be used to reduce the scope of income taxes and hence of evasion, thereby freeing up resources for policing an income tax more limited in scope;
2. the tax code should be made simpler or easier to understand and administer, and should be made to appear fairer;
3. a complete taxpayer master list should be established, and stiff penalties for failure to file should be enacted and enforced;
4. withholding and reporting of wages, interest and dividends should be strengthened;
5. audits should be restricted to those limited areas where evasion is likely to be caught, e.g. to check on withholding and information reporting;
6. special audits should be made of the most egregious and obvious cases of individual tax fraud;
7. by statute, simple penalties like interest plus an additional percentage should be left to those areas where the law is nebulous and the line between evasion and avoidance is not clear;
8. by statute, more substantial penalties should be made for failure to remit tax owed;
9. by statute, heavy civil penalties should be concentrated on those areas where fraud is clear, where discovery is possible, and where enforcement is likely, such as against companies and individuals subject to withholding and reporting, and
10. by statute, criminal penalties should be reserved only for the most heinous and obvious cases of evasion; even in those instances, the statutes should be enacted only if they will actually be enforced.

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89. See H. Wilkenfeld, *Taxes and People in Israel* 248 (1973). Pakistan, however, has reported varying success with its tax amnesties, though a noted lack of success in the fifth and latest one.
90. For a brief overview of successes and the more numerous failures in the United States, see "Good Amnesty or Poor Enforcement", *Forbes*, 4 June 1984, p. 174.

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DOMINICAN REPUBLIC:

Value Added Tax[1]

By Carrie Meyer and John F. Due[2]

While the value added tax has become the dominant form of sales tax in Latin America, its introduction into the Caribbean has been much slower; in fact the Caribbean has been one of the last areas in the world to move to any form of general sales taxation. In 1983, however, the Dominican Republic introduced the value added tax, called Impuesto a Las Transferencias de Bienes Industrializados or ITBI, the Tax on the Transfer of Industrial Goods.

The Dominican Republic is located on the eastern half of the island of Hispaniola (the western portion is Haiti) in the Caribbean. The population is estimated to be about 6 million; it is thus larger than such Latin American countries as El Salvador, Costa Rica, Paraguay and Uruguay. Its per capita GNP, expressed in dollars, is $1,370 (1983), and thus is comparable to that of neighbouring Jamaica, and to those of Ecuador and Colombia. It is primarily dependent on agriculture and mining for exports – about 25% of the population is employed in agriculture. One-third of the population is employed in commerce and services.

INTRODUCTION AND NATURE OF THE TAX

The tax was enacted in January 1983, effective in November. The country had not previously used a sales tax, the new levy being designed to supplement the income tax, shift the tax structure toward increased use of domestic levies in lieu of heavy reliance on customs duties, and increase total revenue. In part this change reflected IMF pressures for strengthening the tax structure. A further motive was the belief that information provided by the tax would be useful as a bsis for a cross check on reported incomes.

Preparatory to the introduction of the tax, the Government provided substantial information to the taxpaying firms, in the form of clearly worded pamphlets, including *Instructivo para el Contribuyente del Impuesto a las Transferencias de Bienes Industrializados,* Octubre 1983, and *Impuesto a las Transferencias de Bienes Industrializados, Guía de Aspectos Basicos,* Agosto 1983.

The law provided for essentially a value added tax with the usual tax credit method, where firms apply the (5%) tax rate to total sales of taxable goods, and subtract tax paid on purchases. Tax paid on purchases of capital goods, however, cannot be subtracted. The tax was intended to apply to all firms in the manufacturing, wholesale and retail sectors with annual gross sales in excess of 60,000 DR pesos (equal to about US$ 18,000 at current exchange rates).

Opposition from firms in the commercial sector was so great that when the tax took effect it was confined to the import and manufacturing sectors by a decree by the executive power, to be extended to the wholesale and retail sectors on November 1984. When that time came, however, renewed pressure forced further modifications. Only those commercial firms with receipts in excess of 300,000 DR pesos a year were required to register as taxpayers. Furthermore, the basic value added principle was abandoned, at least temporarily, for this sector. Firms in the commercial sector, instead of paying tax on their value added, were required to pay as tax a percentage of the tax they paid on their purchases during the year, with rates as follows:

4%: wholesalers and retailers with at least 90% of their purchases consisting of "provisions"-food, drink, cigarettes, and some household supplies.
12%: supermarkets, and all establishments with between 50 and 90% of their sales consisting of "provisions".
20%: all other retailers and wholesalers.

Thus the levy in the commercial sector became essentially a tax on gross purchases, to which the value added tax paid on purchases was directly related, equal to 0.24, 0.72 and 1.2% of the amount of their purchases, not a percentage of sales or of value added. This curious provision was introduced as a simplification measure; it is presumed to be temporary, but an effort of the Government in November of 1986 to commence to apply the law as it was planned failed because of strong opposition from the commercial sector.

THE COMMODITY COVERAGE

The tax applies to all commodities except those specifically exempted or zero-rated.

Exemption

The exemptions are somewhat different for domestic and imported goods:

Imported and domestic:
Articles subject to excises or special levies: cigars, cigarettes, alcoholic beverages, beer, matches, soft drinks, petroleum products
Medicines
Processed milk, edible oils
Books, newspapers, magazines
Major farm inputs: livestock feed, seeds, fertilizer, fungicides, herbicides insecticides

Domestic only:
Unprocessed farm, livestock, forest and mineral products. This has the effect of excluding farmers, per se, from the tax.

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1. This paper is based on research conducted by Ms. Meyer in the Dominican Republic in the summer of 1987. We are greatly indebted to Lic. Florencio A. Lorenzo Silva, Director, and the staff of the Dirección General del Impuesto sobre la Renta for their assistance.
2. Ms. Meyer is Research Assistant in Economics and Mr. Due is Professor of Economics, Emeritus, at the University of Illinois, Urbana-Champaign.

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Basic food items: bread, flour, processed grains, legumes, ground coffee, rice, tomato paste, condiments, fish, poultry, meat, fruit, vegetables, eggs, cheese, processed meat, water, salt, sugar, syrup
Charcoal
Art work and handicrafts.

These items are taxed when imported, and thus the provision creased some protection.

Imported only:
Salt cod, herring
Corn, wheat
Paper for use in publishing books, newspapers, and magazines
Imports by various organizations: the public sector (unless used in taxed goods); diplomatic missions and international organizations; religious, educational, cultural and welfare organizations
Imports by firms in industrial duty-free zones and firms exporting more than 70% of production (to avoid substantial refunds)
Machinery, equipment, tools, packaging materials and parts for use in exempt industrial and agricultural activities

Zero-rated commodities
(and thus full refund of tax paid on inputs)

Exports
Domestic production of exempt goods.

Service coverage

Initially the tax applied only to commodities, but on 29 September 1985 it was extended to hotels, motels, cables, telex and television, and on 4 April 1986 to telephone service.

Real estate is not subject to the tax.

TAX RATE

A uniform rate of 6% is, by provision of the Act, applied to all taxable transactions. As noted above, however, at least temporarily, this rate applies only to the import and manufacturing sectors; commercial enterprises are subject to rates of 4, 12 and 20% of the tax paid on purchases.

REVENUE FROM THE TAX

Revenue from the tax has been as follows:

Year	Total revenue from the tax (millions of DR pesos)	Revenue from tax as % of total tax
1984	96.6	8.8
1985	165.0	10.5
1986	189.3	9.3
1987	161.9 (est.)	—

Source: Secretaría de Estado de Finanzas, Dept. de Estudios Económicos, *Boletín Estadistico,* Año VII, Julio-Diciembre 1986. No. 20, Santo Domingo, R.D., pp. 5, 30-31. Estimate from Dirección General del Impuesto sobre la renta.

Thus the revenue is a significant but not a major source of the total tax revenue of the country, but of course the rate is relatively low, 6%, and it is recognized that enforcement is by no means complete.

Almost equal amounts are obtained at importation and from domestic transactions, as follows:

Year	% of revenue from imports	% of revenue from domestic transactions
1984	50.9	49.1
1985	50.2	49.8
1986	47.3	52.7

Source: Secretaría de Estado de Finanzas, Dept. de Estudios Económicos, *Boletín Estadistico,* Año VII, Julio-Diciembre 1986, No. 20, Santo Domingo, R.D., pp. 5, 30-31.

In 1986, income taxes yielded 21% of total tax revenue, property taxes, 2%, import duties 25%, export duties, 5%, excises and domestic special consumption taxes, 33%, the value added tax 9%, other taxes, 5%.

ADMINISTRATION OF THE TAX

As is typical in Latin America but not in British Commonwealth countries, the tax is administered by the income tax department, Dirección General del Impuesto sobre la Renta, although the tax applying on imports is collected by the Customs Administration. When there are any questions on the tax paid at importation, the matter is resolved by the income tax administration. In the income tax administration, the operation of the tax is integrated in part with that of the corporate income tax. When firms are entitled to refund of the tax, they may receive a credit for this against future ITBI or income tax liability, but not as a monetary payment.

The tax returns are filed and the tax paid in the 29 regional offices, one in each province. One copy of the return is kept in the collection office, where it is checked for correctness, and against the list of registered firms in the district as a bsis for determining non-filers. The original of the return is sent to the headquarters for entering into the data processing system.

The tax is essentially administered, except for collection, at headquarters in Santo Domingo, with all audit and enforcement work handled from headquarters. There are currently 20 auditors involved in audit and enforcement of the tax. New audit personnel must have a bachelor's degree in accounting, economics, or business administration. Technical training is provided by the Instituto de Capatación Tributaria, which offers short courses, lectures and seminars, and new employees receive on the job training with senior personnel. There is no formal civil service or personnel

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system. Salaries in revenue administration are much lower than for equivalent work in the private sector, and thus constant recruiting and training of personnel for tax audit and compliance are necessary, with substantial loss of personnel to the better paying private sector once they are trained.

OPERATION OF THE TAX

In many respects operation of the tax is relatively standard for value added taxes.

Registration

All firms subject to the requirements of the tax are required to register, filing an application in the local collection office, together with their general tax registration (Registro Nacional de Contribuyente). Each registered firm is then given a registration number for ITBI purposes, the same number as for all taxes. Farmers and firms below the specified minimum sales are not required to register. Producers of zero-rated goods, however, are given the option to register so that they can recover tax paid on inputs.

The master file for the tax is in computer system in headquarters, and lists are kept in each collection office. As of July 1987 there were 3,300 registered firms. While an attempt is made by enforcement personnel to ensure that all firms subject to the requirement register, it is generally believed that many do not; the penalty for not filing is so low, 100 DR pesos (about US$ 30) that little incentive is given to file.

Returns

Filing of returns and making of payment are required on a monthly basis due not later than the 20th of the month following the month involved. Three copies of each return are required. The return form is very simple and easy to prepare.

Blank return forms are provided to the firms semi-annually, pre-printed with the firm's registration number, name, period, and the appropriate collection office. The returns must be filed in person together with the payment.

Delinquency and penalties

The returns filed are checked in the collection offices against the list of registered firms in the jurisdiction. The administration reports that about 5% of the firms do not file by the due date – an extremely low figure by comparison with other countries. A 15% penalty is applied to the amount due for failure to file on time; 3% is added each month until the tax is paid. In addition, 1% interest per month is applied.

Other infractions of the law are subject to penalties between 100 DR pesos (US$ 30), and 10,000 DR pesos (US$ 3,000). The operation of the control system is by no means perfected, largely because of shortage of personnel. While legal action can be taken against firms, little has been done beyond application of fines. Criminal action is not used, and the administration has no power to close firms.

Audit

Approximately 100 firms are audited each year, the auditor going to the firm's place of business and inspecting records of purchases and sales. It is recognized that audit coverage is inadequate, because of lack of personnel and a limited information system.

Record keeping by firms; invoices

Firms are required to keep records, including invoices, of all purchases and tax paid on them, and of all sales. Invoices must be issued on all sales, and the firms are encouraged to show the tax separately on sales to registered firms, but this is not mandatory. On sales to final consumers the tax is not shown separately, except on services.

REACTION TO THE TAX

The general reaction to the tax when it was intrduced was negative – in part because it was a new levy, not a replacement for an unsatisfactory form of sales tax, as has occurred in many countries. The strong resistance by the industrial and commercial sectors resulted in the modifications noted above, which prevented, to date, the implementation of the value added technique beyond the industrial sector. Labour unions opposed the tax, as did major political parties.

Much of the complaint from the business sector centers around the increased record keeping necessitated by the tax. The commercial sector of the country is completely dominated by the small and medium sized businesses, and these firms lack the technical capacity to implement the tax properly and resist the upgrading of their accounting systems that would be required. There is also some fear of the cross checking mechanism.

The other major objection to the tax is the belief that it has been responsible for increased inflation. The period since the introduction of the tax has been one of relatively severe inflation, as shown in Table 1; between 1973 and 1983 the rate averaged 8.5%.

Table 1
Annual rate of inflation
Dominican Republic

Year	Price index	% change
1982	158.02	7.64
1983	168.97	6.93
1984	210.27	24.44
1985	289.18	37.53
1986	317.35	9.74

* Base 1 May 1976 – 30 April 1977
Source: Banco Central de la R.D., *Boletín Mensual,* Enero de 1987, vol. 41 (no. 1), 0.137.

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While this has resulted primarily from the decline in the value of the DR peso and the removal of food subsidies to meet IMF demands, consumers have tended to place much of the blame on the tax.

There is general agreement that the enforcement of the tax has not been adequate, mainly because of lack of personnel. Apparently many firms fail to register, and evasion is believed to be widespread among the firms that do register. Failure to implement the tax as originally planned has largely eliminated the potential gains of the cross check mechanism.

The private sector would prefer limitation of the tax to the import and manufacturing sectors as occurred during the first year, though some persons argue for a retail sales tax, on the grounds that it would be much simpler to operate. The retail tax is without question simpler, but it is difficult to see how it could function effectively, given the nature of retailing in the Dominican Republic.

The overall evaluation of the tax in the country today therefore remains rather negative. While the tax has brought in additional revenue, the inadequate enforcement and the failure to extend it to the commercial sector as planned and the use of a makeshift, distorting system in the latter have resulted in serious failure to attain the advantags of a complete value added tax.

CONCLUSIONS

The experience of the country with the tax provides a warning to other developing countries not to attempt to use a value added tax extending beyond the import and manufacturing sectors without careful consideration of the ability of the wholesale and retail sectors to operate the tax, and the general attitude of these sectors toward the tax. Confining the tax to the import-manufacturing sector for several years, with gradual extension beyond this is greatly preferable to attempting to extend the tax to the commercial sector soon after the tax is established leading to makeshift, distorting alternatives which may be difficult to eliminate.

The tax as originally designed had many desirable features: use of a single rate, limited exemptions, broad coverage, simple returns – but politically at least it could not be implemented adequately under the circumstances. Failure to allow credit for tax paid on the purchase of capital equipment, however, is unusual, and a detriment to real investment.

C nference Diary

JANUARY 1988

Internationales Steuerseminar. St. Moritz, 11-15 January (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postfach, CH-8022 Zürich, z.H. Frau Fleischmann, Switzerland.

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. Bougival, 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 1988

Compensation planning '88. Lake Buena Vista, Florida, 7-10 February (English):
Tax Management Educational Institute, Suite 400, Att.: Ms. Patty Korenoski, Conference Registrar, 1231 25th Street, N.W., Washington, D.C. 20037, U.S.A.

International partnerships. London, 10 February (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

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.

MARCH 1988

Doing business in China. Brussels, 7-8 March (English):
Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Netherlands.

Current developments in German Taxation. London, 24 March (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.

APRIL 1988

8th National Convention; consolidation or change. Sydney, 12-15 April (English):
Executive Director, The Taxation Institute of Australia, 7th Floor, 64 Castlereagh Street, Sydney, NSW 2000, Australia.

International Taxation Management Techniques. Strasbourg, 21-22 April (English):
Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, The Netherlands.

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PEOPLE'S REPUBLIC OF CHINA:

Value Added Tax

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Over the course of the last three decades the patterns of sales taxes throughout the world have undergone tremendous changes. Value added tax (VAT) has become the most important type of sales tax in most developed countries and a number of developing countries have also substituted VAT for other forms of indirect taxes.[1] VAT, under one name or another, has been recently introduced in such countries as Indonesia and New Zealand, and proposals for adopting it have been made in Canada and the United States.

The People's Republic of China adopted VAT in a restricted form in 1984[2], this being the first example of its application in a socialist country.

EVOLUTION OF CHINA'S INDUSTRIAL AND COMMERCIAL TAX SYSTEM

Like most developing countries, and like most socialist countries, China has traditionally relied heavily upon indirect taxes, rather than upon income taxes, to provide the revenue needed by the State. In 1950, soon after the founding of the People's Republic of China, a new tax system was established. The most important of the new taxes (some of them based on taxes which had existed under the previous Guomindang regime) was the industrial and commercial tax comprising five separate taxes, the chief among which being a turnover tax, or circulation tax (liutong shui). A transaction tax (jiaoyi shui) was levied on transactions in cotton, handwoven cloth, grains, medicines and livestock. A commodity tax (huowu shui) was imposed on manufacturers, or in some cases on transporters of non-manufactured goods, and on a variety of commodities not subject to the turnover tax. A stamp tax, a salt tax, a special consumption tax and a cotton monopolies sales tax were also levied on various commodities and transactions.

In 1953 the multiplicity of the system was modified. The commodity tax was expanded to include part of the transaction tax and stamp tax. A new commodity transaction tax (shangpin liutong shui) was introduced to tax 22 items of commodities which were effectively controlled by the State at the wholesale level. Once a commodity transaction tax was levied, the commodities were exempt from the turnover tax; whereas commodities subject to commodity tax at the wholesale level would still be taxed under the turnover tax at the retail level.

In 1958, another reform took place. A new consolidated industrial and commercial tax (CICT)[3] was introduced to replace the commodity tax, the commodity transaction tax (which disappeared after this reform), the stamp tax and the turnover tax. The new tax essentially took the form of a turnover tax imposed on supplies of goods and services and it retained certain excise elements of the previous commodity tax.

A further simplification occurred in 1972; the CICT was merged with the salt tax, urban house and land tax, vehicle licence tax and slaughter tax (where paid by State enterprises) into a new industrial and commercial tax (gongshang shui). The industrial and commercial tax (ICT) was obviously an integrated tax, its main components being the previous commodity tax and the turnover tax. Other taxes were independent and not imposed on supplies of commodities and services. The reason for combining the various taxes into a single ICT was to suit the then political situation under which the existing tax system was criticized as "capitalist" and too complicated.

1. These include Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Guatemala, Haiti, Honduras, Indonesia, Israel, Ivory Coast, Korea, Madagascar, Mexico, Morocco, Niger, Nicaragua, Panama, Peru, Senegal, Turkey and Uruguay.
2. Draft Regulations on Value Added Tax (hereinafter referred to as 1984 Draft VAT Regulations), issued by the State Council on 18 September 1984.
3. For discussion of this tax, see E. Jehle, "Taxation in the People's Republic of China: A brief introduction", (1985) *Bulletin for International Fiscal Documentation* 405 at 413-14; A.J. Easson and Li Jinyan, "Taxation of Foreign Business and Investment in the People's Republic of China", (1986) 7 *Northwestern Journal of International Law & Business* 666 at 668; D.R. Simon, "Taxation of Joint Ventures in the People's Republic of China: A Legal Analysis in the Context of Current Chinese Economic and Political Conditions", (1982) 15 *Vanderbilt Journal of Transnational Law* 513 at 531-537; P.D. Reynolds, "Doing Business with the People's Republic of China: Tax Considerations", (1980) 14 *International Lawyer* 49 at 54-59; R.D. Pomp et al., "The Evolving Tax System of the People's Republic of China", (1981) 16 *Texas International Law Journal* 11 at 12-32.

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The ICT was basically a cascade-type tax. The problems of cumulative taxation, however, were not seriously considered at that time because profit was of no concern. In particular, State enterprises conducted their production strictly according to the State plan. All products would be purchased by the State at planned prices regardless of the quality of the products. Enterprises accounted for all their profit and loss to the State. It made little difference to them whether their payments to the State were made in the form of profit or tax.

The economic reforms, which commenced in the late 1970s and are still in the course of being implemented, have changed the whole picture. The profit-delivery system for State enterprises was replaced by an income tax payment system in the reform commonly referred to as "li gai shui". Enterprises were given more autonomy to run the business and a "management responsibility" system was introduced. After-tax profit was allowed to be reinvested by enterprises or applied for a variety of purposes, such as the payment of bonuses or establishment of social and welfare funds for employees. The unfair tax burden caused by the cascading ICT then became an important issue between vertically-integrated enterprises and specialist enterprises. It also became a serious obstacle in readjusting the industrial structure by breaking up unnecessarily integrated enterprises into separate enterprises engaged in specialized production and by merging specialist enterprises into "cartels" in order to enjoy economies of scale. Under the existing ICT, the tax burden in the former case would be increased and would be decreased in the latter case. Considerations of encouraging exports, reducing imports and securing and increasing fiscal revenue made the reform of the ICT urgent and necessary. From 1979 to 1982, a value added tax was introduced on a trial basis in some industrial cities including Shanghai, Liuzhou and Xian. From 1 July 1982 VAT was experimented with across the country.[4] During this period, VAT only applied to five chosen items: farm implements and their spare parts; machines, machinery and spare parts; sewing machines; bicycles and electric fans. Each item was taxed at a separate rate ranging from 6% to 25%. Two methods of calculation of VAT were tried: the sales subtractive (value deduction) method for agricultural implements and for machines and machinery, and the tax subtractive (invoice) method for the other items.

With the development of economic reform, the entire tax system needed to be revised. Between 1983 and 1986, new income taxes were promulgated to apply to State enterprises, collective enterprises and private businesses respectively. The ICT was broken up into four taxes: product tax (chanpin shui), value added tax (zengzhi shui), business turnover tax (yingye shui), and salt tax (yan shui).

SPECIAL FEATURES OF CHINA'S VAT

All other countries adopting VAT have been market economies or capitalist countries. They have introduced VAT because of its advantages over other forms of sales tax. China is a State-planned economy, which makes Chinese VAT different both in operation and function.

1. The scope of VAT is restricted

The nature of VAT normally requires a broad tax base including most products and services. In China, however, only twelve industrial products are covered in the 1984 Draft VAT Regulations. These are: (a) machines, machinery and their spare parts covering mechanical equipment for general and specified use, motor vehicles, motorized ships, bearings and farm implements and their spare parts; (b) steel products, billet, bicycles, sewing machines, electric fans, printed and dyed silks, and western medicines (both raw medicinal materials and made up medicines). Category (a) products are broadly defined and the structure of the products covered is relatively more complex than those of Category (b).[5]

In a recent Notification of the Ministry of Finance, entitled "Several Regulations regarding Methods of Perfecting the Collection of Value Added Tax", the number of taxable items was increased to include chemical fibre, textile products, clothing, carpets, enamel products and glass ware heat preservation containers. Thus, at present, there are 13 categories of taxable products under the VAT.[6]

Another characteristic of the Chinese VAT is that it is levied only on importers and manufacturers of the taxable products. VAT applies principally to the manufacture stage largely due to price control policy. Pricing and taxation are the two economic regulators used in China to control the demand and supply of goods. Prices of most commodities are fixed by the State based on the cost of producing the goods, the appropriate profitability of the producer and the importance of the goods to the economy. The profit level of enterprises is consequently influenced to a great extent by the price-fixing system. If the goods are considered to be very important, such as grains, edible oils, energy and basic industrial materials, the price is set low and strictly controlled by the State. Where the Government plans to increase the demand for certain goods, a dilemma often exists. If it simply fixes a lower price for these goods in order to stimulate demand, the profit margin of producers will be lowered as well, which will discourage them from increasing production. Similarly, if it is wished to reduce demand a simple price increase will produce higher profits and encourage enterprises to increase production. As a

4. This was done in accordance with the Provisional Measures on Value Added Tax, promulgated by the Ministry of Finance in 1982.
5. Article 2 of the 1984 Draft VAT Regulations, supra note 2.
6. Notification of the Ministry of Finance No. 042(87) of 20 March 1987 (hereinafter referred to as the "Notification") published in No. 15, 1987 *Zhongguo Shuiwu* 29. An interpretation of the scope of taxable items was given by the General Tax Bureau of the Ministry of Finance on 26 March 1987 in Notification No. 013(87). A table of VAT items and rates is provided by the writer in the Appendix at the end of this article.

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partial solution to the problem the Government uses taxation to regulate the profit level of enterprises. Thus, for example, where the demand and production of a product need to be decreased, the State would fix a higher price and also increase the tax rate. The rate consequently can be set to adjust average profit levels for each type of product. That explains why there were as many as 82 tax rates under the ICT.

To effectively use these two regulators to control production, sales taxes are imposed at the manufacturing level because almost all industrial manufacturers are State enterprises. The wholesale sector, which formerly was almost entirely State-owned and was tax exempt under the ICT, is now taxed at a uniform rate of 10% to enable private and cooperative wholesalers (who appeared mainly after the 1978 economic reform) to compete with State-owned ones on fair conditions. Retailers were taxed at a single rate of 3% under the ICT and continue to pay the new business turnover tax at that rate.

If VAT were to be applied to the retail stage, given the present price system, the traditional allocation pattern of economic benefits would be altered since the distribution sector is allowed a very thin margin of profit. Prices would have to be readjusted accordingly, causing disturbances to the economy as a whole. Multiple rates would also have to be applied to the retail level, replacing the present single rate retail system, thus further complicating tax administration.

2. Multiple rates are applied

A central technical lesson of European experience is that multiple rates can be used to eliminate the regressivity of the value added tax, but that penalties in administrative complexity, increased compliance costs and distortions in consumption decisions have been high and are probably not justified. Thus a single rate structure is suggested by most commentators, while using other taxes and transfer payments to alleviate the undesirable distributional consequences generated by a VAT levied at a uniform rate.[7] In varying degrees, however, practically all countries which have adopted VAT employ differentiated rates to pursue distributional objectives and make the distributional pattern of the VAT resemble that of the taxes it replaced.

Because of the multirate structure of the ICT and the desire to maintain as nearly as possible the original tax burden, thus avoiding corresponding price adjustments, there were 6 rates applied separately to the 12 items under the 1984 Draft VAT Regulations.[8] The Notification added one more rate to suit the increased number of taxable items. The rates range from 8% to 43%.[9]

At present, VAT is used together with product tax and business turnover tax. It is a transitional measure and of experimental nature. The multirates of the product tax predetermine the rate structure of VAT since VAT only replaces it in part. The Chinese industrial and commercial tax system has always been multiple-rated so that society is used to it and a similar VAT, at least so long as it is not applied at the retail level, does not unduly complicate tax compliance and administration. A single rate would not suit China's current situation.[10]

3. Two methods are used for calculating VAT

The invoice method (or tax credit method) is generally regarded as superior in a number of respects to the sales subtractive method and is widely used in other countries. China's VAT law, again, provides differently: both methods are used.[11] The sales subtractive method is used for products such as machines and machinery, motor vehicles, motorized ships, bearings and farm implements and spare parts. These items are broadly defined, and each type can be subdivided into different kinds of products. For example, the term "machines and machinery" may include mechanical equipment, medical equipment, meters, etc. Materials and parts used to manufacture these products are numerous and they were taxed at a variety of rates under the ICT. For instance, motor vehicles were taxed at 5%, whereas tyres and steel were taxed at 15% and 8% respectively. Before including all the materials and parts into VAT, the sales subtractive method provides an easier means to calculate the amount of value added. Manufacturers simply deduct all deductible purchases (at the tax-inclusive price) from their sales and apply the VAT rate to the difference. They do not have to determine the amount of tax paid on the purchases. It can be very difficult, if it is possible at all, to calculate taxes charged on materials and parts since they would have been taxed at different rates and tax would have been included in the price. Under the sales subtractive method, the same amount of value added by the manufacturer is taxed

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7. See H.J. Aaron, ed., *The Value Added Tax: Lessons from Europe* (Washington: The Brookings Institute, 1981), at 16; S. Cnossen, "What Rate Structure for a Value-Added Tax?", (1982) 35 *national Tax Journal* 205; W.J. Turnier, "Designing an Efficient Value Added Tax", (1984) *Tax Law Review* 435.

8. Article 2 of the 1984 Draft VAT Regulations, supra Note 2. The rates of VAT were determined according to the following formulae:

(a) If the VAT liability of a product is calculated under the "sales subtractive" method, the VAT rate is

$$\frac{\text{price} \times \text{ICT rate}}{\text{sale price of the product} - \text{cost of purchase}} \times 100\%$$

(b) If the "invoice method" is used, the VAT rate is

$$\frac{\text{sale price} \times \text{ICT rate} + \text{cost of purchase} \times \text{ICT rate}}{\text{sale price}} \times 100\%$$

ICT rates, for example, for farm machinery were 3%, sewing machines 10% and bicycles 15%. The rates for these items under the above formulae are 6.9%, 12.31% and 16.7% respectively. See further Guo Hongde, Wang Wending and Han Shaochu, *Zengzhi Shui Gaishuo (A General Introduction to Value Added Tax)* (Beijing: China's Finance and Economic Press, 1984), at 109-112

9. See Appendix.

10. See Wang Kun, *Guojia Shuishou Gailun (An Introduction to the Nation's Taxation)* (Wuchang: Huazhong Engineering College Press, 1985), at 115-128; Liu Longheng, *Zhongguo Shuifa Gailun (An Introduction to China's Taxation* (Beijing: University of Beijing Press, 1986), at 166-172.

11. Article 4 of the 1984 Draft VAT Regulations, supra note 2.

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equally although the tax burden on two products of the same category may not be uniform.[12]

The tax credit method applies to products which are "simple structured" goods, such as steel products, billets, bicycles, sewing machines, electric fans, printed silk and Western medicines. Taxes on materials and parts for these goods would normally have been levied at a single rate or at a higher rate than that of the VAT on the manufactured item. The tax credit method is therefore feasible, making administration much simpler. The total tax burden on a product is uniform regardless of whether it is produced in a vertically-integrated factory or by a number of specialist factories. The tax liability of manufacturers on the same amount of value added is, however, not equal.[13] The tax credit method was adopted in the Notification to calculate VAT liabilities.

4. Deductible items are limited

Only specifically provided items can be deducted by taxpayers in calculating VAT. Cost of purchases and taxes paid on materials, fuels, power and packaging materials purchased from outsiders and used to manufacture taxable products are allowed to be deducted.[14] Capital goods are not deductible because capital investment is planned by the State, the Government encourages labour-intensive investment and the unbalanced existing capital structure of enterprises makes it difficult to set a uniform level of depreciation. The purpose of introducing VAT in China is to eliminate the unfair tax burden caused by cumulative taxation. Capital inputs are not considered a contributing factor.

5. Exemptions and deductions are specifically provided

Since VAT is levied at the manufacturer's stage, all taxable products are taxed, whether they are manufactured for the domestic or overseas market, in the absence of specific exemptions. In order to encourage exports and to pursue certain public policies, the 1984 Draft VAT Regulations provide some tax exemptions and deductions.

Taxable products for export are exempt from VAT if they are exported directly by the manufacturer. If they are exported by exporting corporations, exporters can apply for a tax rebate on goods on which VAT has already been paid. Contraceptive medicines are also exempt from VAT to better implement the national family planning policy.

New products under trial production listed in the State Plan can enjoy a tax reduction or exemption for a fixed period. Other products which require a period of exemption or reduction due to special circumstances can also be exempt from VAT if so decided by the tax collection authorities.[15]

6. VAT is used together with product tax and business turnover tax

Since VAT at present applies only to a limited range of products and its extension to the retail sector is not feasible under China's current conditions, VAT coexists with the product tax and business turnover tax. Product tax is imposed on enterprises engaged in the production and importation of 270 listed taxable commodities. Except that the tax on a few farm products is collected from State or collective commercial enterprises when they purchase them, or from sellers if sold to private entities or individuals, all industrial products are taxed at the manufacturing level. Levying the product tax when products are sold by producers makes this tax an efficient regulator to be used in conjunction with pricing control. The limited number of taxpayers also simplifies tax administration. As explained above, VAT has already replaced part of the product tax for a number of items. To substitute VAT for this tax is a general tendency. Recently, the Ministry of Finance has promulgated provisions to

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12. E.g. assuming Product A and Product B are both under the category of "machines and machinery" and taxed at a 10% rate. To manufacture A and B, Enterprise X and Enterprise Y both purchased inputs for 1000. X's inputs were taxed at 6% and Y's inputs taxed at 8%. The sales of products A and B are 2000. The value added is 1000. Under the sales subtractive method, both X and Y pay VAT of 100 = 1000 × 10%. The total tax on product A is 160 = (1000 × 6%) + (1000 x 10%) = (60+ 100). The total tax on product B, however is 180 = (1000 × 8%) + (1000 × 10%) = (80 + 100).
13. Using the same facts as in note 12, under the tax credit method, enterprise X is liable for VAT at the amount of 140 = (2000 × 10%) – (1000 × 6%) = (200 – 60); whereas Y's VAT liability is 120 = (2000 × 10%) – (1000 × 8%) = (200 – 80).
14. Articles 5 & 6 of the 1984 Draft VAT Regulations, supra note 2.
15. Article 11 of the 1984 Draft VAT Regulations, supra note 2.

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apply VAT to certain textile products[16] and it is probable that the scope of VAT will be increasingly expanded in the coming years.

The business turnover tax is not a cascade tax as was the case with the old Spanish or German turnover taxes. It applies to enterprises and individuals engaging in retail, wholesale, transportation, construction and installation, finance and insurance, post and communications, printing, public utilities, entertainment, service and temporary business. Most of these business activities are taxed at a 3% or 5% rate, only rail and pipe transportation being taxed at 15%. Wholesalers are taxed at 10% on the mark-up at this stage. Nevertheless, when products which are subject to the product tax are taxed again at the retail or wholesale level, cumulative taxation arises. The total structure of China's indirect tax system consequently has a "cascade" nature.

THE ROLE OF VAT IN A PLANNED ECONOMY

Indirect taxes have traditionally served a number of purposes in China. As in many other countries they have been an important source of State revenue. Before the recent economic reforms this importance was exaggerated: up to then the greatest part of the industrial and commercial tax was collected from state enterprises, which eventually would account to the State for their profits anyway, so that the collection of the ICT really represented little more than a bank transfer from the enterprise to the tax office at the time that sales receipts were realized.[17] Nevertheless they possessed the advantage of being simple to administer and of ensuring a prompt and regular cash flow into the State Budget. This advantage has become all the more important with the introduction of management responsibility and replacing profit delivery with income taxation for State enterprises.[18]

Moreover, as explained above, indirect taxes operate as a form of "buffer" between the cost of production and the eventual price paid by the consumer.[19] That, of course, is true with most tax systems, but in free market economies it is normally assumed that the tax burden will be shifted forward to the consumer in the form of higher prices. Where prices are controlled, however, as in China, the tax may in fact have a greater effect upon the level of profit of the enterprise, since it cannot be passed forward and must therefore be shifted back to the supplier.

Since the official promulgation of the State Enterprise Income Tax Law in 1983, some special regulatory taxes have been introduced to compensate for the effects on profitability of enterprises caused by differences in plant and machinery, previous capital investment, location and other similar factors. Indirect taxes play a complementary role by regulating the effect upon profits of "irrational" pricing.[20] Pricing policy itself is, of course, also in the process of being reformed, but sudden major price changes are to be avoided so that, in the meantime, the tax system has an important economic role to play.

A COMPREHENSIVE VAT FOR CHINA?

An ideal VAT should be universal, extending to the retail stage and to virtually all sectors of the economy including services, with as few exemptions as possible. Only with a comprehensive and uniform coverage is it possible to obtain the full benefit of a truly neutral tax and to minimize the administrative complexity of the VAT. This ideal, however, is likely to remain a dream in most countries. The principle of neutrality is compromised by considerations of equity and efficiency. None of the VAT systems in European countries is perfect, let alone those in developing countries.

Unlike many other developing countries, China is probably technically able to adopt a comprehensive VAT. More than 75% of adults are literate. Accounting systems are quite sophisticated and even in the agricultural sector the previous production brigades and communes were obliged to keep good records. The existence of product tax and business turnover tax makes the extension of VAT feasible: the wholesale sector is already being taxed on its value added under the business turnover tax, so that the effect is the same as it would be under a sales subtractive method VAT. The further development of the economic reform will require less State control of the economy and a relatively more neutral tax system. Above all, the advantage of VAT as a large and secure revenue-raiser will make it attractive to the Government.

Nevertheless, a comprehensive VAT would probably only be feasible if price controls were removed. Although existing controls are likely to be substantially modified and relaxed, and market forces can be expected to become more important in the future, the complete abolition of price controls is most unlikely. As mentioned earlier, pricing and taxation are considered to be the main economic regulators, without which there would be no way to implement State plans and, therefore, the multirate structure of the existing

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16. Regulations concerning Application of VAT to Textile Products on an Experimental Basis, promulgated on 4 February 1986. See also Notification of the Ministry of Finance No. 009 (87) of 27 January 1987.
17. G.N. Ecklund, *Financing the Chinese Government Budget* (Chicago: Aldine Publishing Co., 1966), at 69.
18. See Du Pingqin, "Step Up the Pace of Overall Tax Reform Using Product Tax as the Main Levy", *Jingji Guanli (Management of Economy)*, No. 1, 1984, 25; Jia Kecheng, "Views on the Relationship between Prices and Tax Revenue", *Caizheng Yuanjiu (The Study of Finance)*, No. 5, 1985, 48.
19. Jap Kim Siong, "China: China's Recent Tax Experiments to Revive the Industrial and Commercial Tax System of State Enterprises" (1982), 36 *Bureau of International Fiscal Documentation* 66, at 68; Chen Gong et al., *Caizhengxue Jiaocheng (A Course in Finance)* (Beijing: China's Finance and Economic Press, 1985), at 154-164.
20. See further, Wang Zhenzhi and Wang Yongzhi, "Epilogue: Prices in China" in L. Wei and A. Chao, eds. *China's Economic Reforms* (Philadelphia: University of Pennsylvania Press, 1982), 220; Luo Gengmo, "Some views on the Laws of Socialist Commodity Pricing in China", (1984) *Social Sciences in China* 152. The reform of the price system is considered the key to reform of the entire economic structure. The core of price reform is to relax State control and let the market mechanism regulate demand and supply of goods and services. See Xue Muqiao, "Readjust Prices, Reform Controls" *Jingji Yanjiu (The Study of Economy)*, No. 1, 1985, 3; Yuan Mu, "On Price Reform", *Liaowang (Observation)*, No. 43, 1985, 18.

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product tax is likely to be maintained, although it may be simplified, in order to effectively control the production and supply of goods and services according to the State plan. As experience in other countries has shown, a multirate system complicates VAT administration considerably.

Nevertheless, VAT does have advantages over other types of sales tax and it is probable that the next few years will see a steady expansion of VAT in China. Eventually, the overall indirect taxation picture might be as follows:

(a) A number of special excise taxes, on luxury products such as tobacco, alcohol, cosmetics, etc. As in the EEC, these taxes could be in addition to a VAT.
(b) A widely-based VAT, replacing the existing product tax, imposed at the manufacturer and wholesale stages. The tax would probably have from three to five separate rates. This would greatly simplify the existing rate structure while having a relatively small impact upon most prices. Where necessary, to control excess profits resulting from reduced tax rates and to ensure adequate profits where taxes were increased, minor adjustments could be made in prices.
(c) A separate business turnover tax, as presently used, applied to the retail sector and other sectors such as transportation. The rates might vary, from about 3% to 7%, but each business would normally be taxed at a single rate on total turnover.

A system such as that described would represent a major simplification of China's indirect tax system, but would still be consistent with the objectives of the recent economic reforms.

APPENDIX

TABLE OF VAT ITEMS AND TAX RATES

Category	*Taxable item*	*Rate %*
1	Chemical fibre	14
2	Textiles	
	(i) woollen textiles products:	
	woollen strips	14
	woollen knitwear, reproduced woollen products, man-made fur	20
	other woollen textile products	23
	(ii) other textile products	14
3	Clothing	
	(i) woollen clothing	20
	(ii) other clothing	14
4	Carpets	14
5	Enamel products	20
6	Glass-made heat preservation containers	
	(i) bamboo-shelled, plastic-shelled, meshed metal-shelled thermos	14
	(ii) other glass-ware heat preservation containers	20
7	Medicine	14
8	Daily-use machinery	
	(i) mechanical watches, stop watches	43
	(ii) pocket watches	14
	(iii) electronic clocks, watches	14
	(iv) mechanical clocks	20
	(v) bicycles	20
	(vi) sewing machines	14
	(vii) cameras	14
	(viii) parts and components of above items	14
9	Daily-use electric products	
	(i) refrigerators	14
	(ii) electric fans	20
	(iii) washing machines	14
	(iv) vacuum cleaners	14
	(v) air conditioners	14
	(vi) electric heaters	14
	(vii) bulbs	14
	(viii) other daily-use electric products	20
	(ix) parts and components of above items	14
10	Electronic products	
	(i) television sets	16
	(ii) videorecorders	16
	(iii) computers	16
	(iv) tape recorders, record players	16
	(v) radios, megaphones	16
	(vi) gramophones	16
	(vii) telephones	16
	(viii) electronic game machines	16
	(ix) other electronic products	14
	(x) parts and components of above items	14
11	Machines and machinery	
	(i) motorized ships	12
	(ii) farm implements	12
	(iii) other machines and machinery	14
	(iv) parts and components of above items	14
12	Steel billet	8
13	Steel products	14

Note: This table is adapted from Notification of the Ministry of Finance No. 042 (87) of 20 March 1987.

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Kenya's Fiscal Stance in the Course of Development, 1965-83

By P. Nagarajan

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This paper* examines public sector development in Kenya during 1965-83. The tendency of the government's relative share in the economy to rise is consistent with Wagner's Law of increasing governmental activity.

Analysis shows that it was the expansion of taxes on domestic production and internal transactions, not direct taxes, which enabled the tax system to be buoyant, the result of mostly discretionary, rather than automatic, changes. There is no evidence to suggest that the tax system has been moving towards progressivity.

Tax revenues contribute an average of 60% of the total public expenditure, and the growth rate of tax/GDP ratio has tended to keep pace with the growth of expenditure/GDP. The rate of growth of the Government's gross fixed capital formation, however, has not kept pace with the latter ratio and this trend, if left unchecked, will result in low productivity, a lower rate of return for private capital, and generally poor economic performance.

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INTRODUCTION

Government's role in less developed countries (LDCs) in the areas of resource expansion, resource allocation and resource management has been well recognized. In particular, the importance of Government finance, among other things, in generating economic fusion in LCDs has received wider attention (Prest, 1962; Hicks, 1965; Kaldor, 1965; Rani, 1971; Goode, 1984). The enlargement of public surpluses through a well designed fiscal system is regarded essential to the accelerated capital formation leading to a "big push" in development.

But the ability of an expanding public sector in LDCs to restrain non-productive expenditures, and thus transform increased tax revenues into capital formation promoting economic growth, has been seriously questioned (Please, 1967, 1972). Interestingly, major empirical studies recently have come up with divergent results concerning the impact of public sector on economic growth. For example, Rubinson (1977) and Ram (1986) have found a positive relationship between the growth of Government, indexed by Government revenue share in national income, and economic growth in LDCs. On the other hand, inverse relationships between larger Government and economic growth have been found in other studies (Landau, 1983, for example).

Notwithstanding the contradictory results, increasing reliance on taxation to finance growth public expenditure is absolutely essential.[1] Clearly, the causal nexus between Government revenue share in national income and economic development is not direct and straightforward; complex "fiscal behaviour" rather than the aggregate tax ratio or expenditure ratio, among other things, determines the level of economic growth.

* It is based on research while the author was a visiting Professor at the University of Nairobi in 1984-85. The study was supported by grants from the Ministry of Finance and Planning, Kenya, and the Senate Research Committee of the University of Prince Edward Island. The author acknowledges gratefully the research facilities provided by the Department of Economics at the University of Nairobi. An earlier version of this paper was presented at the Twenty-Third International Atlantic Economic Conference held at Munich, Federal Republic of Germany, 20-27 April 1987.

1. Due to increase in population growth, urbanization, and changed conception of the role of the State, the LDCs are under heavy pressure to expand the size of the public sector. See, for example, A.R. Prest, *Public Finance in Underdeveloped Countries* (London, Weidenfeld and Nicholson, 1962). It has been contended that for LDCs it is necessary to focus on taxation because public expenditures are held far below their optimal level as a result of bottlenecks associated with the mobilization of domestic resources. See J.R. Lotz and E.R. Morss, "Measuring 'Tax Effort' in Developing Countries", *IMF Staff Papers,* Vol. 14, June 1967.

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A close interaction exists between a country's tax system and the stages of economic development (Hinrichs, 1966; Musgrave, 1967). Whilst economic growth tends to bring about changes in the tax base and structure of taxation, the nature and speed of the development process is largely dependent, among other things, on the overall fiscal performance of a country. Changes in the tax level and tax-mix, combined with expenditure level and expenditure-mix, obviously affect virtually all major economic aggregates, and have widespread implications for stabilization policies and improved economic management. A continued assessment of the changing fiscal behaviour pattern in LDCs, particularly through case studies, is important for designing appropriate development strategies and macro-policies.

This study examines the fiscal activities of the public sector in a developing African country by analyzing the changing levels and composition of taxes and expenditures in Kenya during economic development from 1964-65 to 1982-83.

GROWTH OF TAX RATIOS

Changes in the Kenyan tax system can be gauged from the following indicators[2]: tax ratios, composition of tax revenues, marginal propensity to tax (MPT) and tax buoyancy ratios, as shown in Tables 1 to 3.

Table 1 shows that overall tax revenues relating to GDP (at factor cost) rose from an average level of 12.60% in 1965-69 to 22.63% in 1980-83, an 80% growth in the T/GDP ratio over the long-term period.[3] Thus, it may be presumed that, in Kenya, the relative share of Government in the economy, indexed by T/GDP, has expanded with economic development during 1965-83.

In terms of broad categories, the ratio of direct taxes to GDP (T_d/GDP) increased from an average level of 4.70% in 1965-69 to 7.32% in 1980-83, about 56% growth in the direct tax revenue share. In comparison, the share of indirect taxes in GDP (T_i/GDP) increased from an average level of 7.90% to 15.31%, approximately 94% growth in the T_i/GDP ratio.

Table 1 brings out a noticeable shift within indirect taxes, away from taxes on international trade (T_{xm}) and towards increased reliance on indirect taxes on domestic production and internal transactions (T_{ipt}/GDP). Whilst the T_{ipt}/GDP ratio tripled, from an average level of 3.12% in 1965-69 to 9.85% in 1980-83, the T_{xm}/GDP ratio increased marginally from an average level of 4.78% to 5.46%.

Long-term growth of tax ratios can be deceptive, because they can mask changes in the tempo of growth. As Table 2 makes clear, the growth of tax ratios was anything but steady and continuous throughout the 19-year period. The T/GDP ratio growth rate was 27.2% over the period 1965-69 to 1970-74, and thereafter its growth rate decelerated and grew only by 16.87% during 1975-79 to 1980-83. A deceleration in the growth rate of direct tax revenue share is rather striking; its growth rate dropped from 44.89% during

2. Tax ratios refer to the tax revenue and its major components expressed as a percentage of GDP; it is commonly used as a measure of "tax effort". Tax revenue category expressed as a percentage of total tax revenue is referred to as the composition of tax revenue. The marginal propensity to tax (MPT) is a ratio between an absolute change in tax revenue and an absolute change in GDP (i.e. $\Delta T/\Delta Y$). The MPT is estimated by regressing tax revenue on GDP, using annual data for the period 1965-83, $T = a+by$, where $b = dT/dy$ = MPT. The tax buoyancy is a ratio between a percentage change in tax revenue, resulting from both automatic and discretionary changes, and a percentage change in GDP. The buoyancy ratio is estimated from a double log linear function of the form: $\log T = \log\alpha + \beta \log y$, where β is an estimate of constant buoyancy ratio.

3. At the aggregate level, the observed tax performance in Kenya seems to satisfy Sir Arthur Lewis's famous definition of proper fiscal performance of developing countries.

Table 1
Tax ratios and composition of tax revenues; Kenya, 1964-65 to 1982-83

	1964-65 to 1968-69 (Average)		1969-70 to 1973-74 (Average)		1974-75 to 1978-79 (Average)		1979-80 to 1982-83 (Average)	
Categories	% of GDP @ factor cost	% of total tax revenue	% of GDP @ factor cost	% of total tax revenue	% of GDP @ factor cost	% of total tax revenue	% of GDP @ factor cost	% of total tax revenue
Income taxes	4.64	36.65	6.75	42.21	7.37	38.01	7.27	32.10
Property taxes	0.06	0.53	0.06	0.40	0.03	0.19	0.05	0.22
Direct taxes (1)+(2)	4.70	37.18	6.81	42.61	7.40	38.20	7.32	32.32
Sales tax	—	—	—	—	4.71	24.24	6.59	29.09
Excise duties	2.07	16.32	2.43	15.28	2.04	10.48	2.35	10.36
Taxes on specific services	1.05	8.34	1.45	9.13	0.67	3.53	0.90	4.00
Taxes on production & internal transactions (4+5+6)	3.12	24.65	4.67	28.88	7.43	38.25	9.85	43.45
Export duties	0.16	1.37	0.08	0.51	—	—	0.20	0.90
Import duties	4.61	36.76	4.49	28.09	4.53	22.98	5.29	23.35
Taxes on international trade (8+9)	4.78	38.13	4.55	28.50	4.53	22.98	5.46	24.26
Indirect taxes (7+10)	7.90	62.78	9.12	57.38	11.98	61.23	15.31	67.72
Total tax revenue	12.60	—	16.03	—	19.36	—	22.63	—

Source: Kenya, Central Bureau of Statistics, *Statistical Abstract,* 1968, 1973, 1976, 1979, 1981, 1983.

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Table 2
Percentages increase in key tax ratio, different sub-periods
Kenya, 1964-65/1982-83

	Percentage increase in ratio			
	1964-65/1968-69 to 1969-70/1973-74	1969-70/1973-74 to 1974-75/1978-79	1974-75/1978-79 to 1979-80/1982-83	1964-65/1968-69 to 1979-80/1982-83
$\frac{T}{GDP}$	22.72	20.77	16.89	79.60
$\frac{T_i}{GDP}$	15.44	31.14	28.00	93.79
$\frac{T_{xm}}{GDP}$	(–) 4.81	—	20.52	14.22
$\frac{T_{ipt}}{GDP}$	49.67	59.10	32.57	212.00
T_d	44.89	20.77	(–) 1.08	55.74

* T = overall tax revenues; T_i = total indirect taxes; T_{xm} = taxes on international trade; T_{ipt} = taxes on domestic production and internal transactions; T_d = direct taxes; GDP = gross domestic product at factor cost.

Source: Calculated from data in *Table 1.*

1965-69/1970-74 to 20.77% during 1970-74/1975-79 and subsequently registered a negative growth rate of 1.08% during 1975-79/1980-83. In comparison, the growth rate of indirect tax revenue share sharply accelerated from 15.66% to 31.44% over the same period, followed by a mildly decelerated growth rate of 28.00% during 1975-79/1980-83. Within indirect taxes, as seen from Table 2, the T_{ipt}/GDP ratio grew by 32.57% during 1975-79/1980-83, compared to its growth rate of 59.10% during 1970-74/1975-79, a significant deceleration in the growth of the T_{ipt}/GDP ratio.

COMPOSITION OF TAX REVENUE

The differential growth rates of the tax levels of the sub-components are reflected in the changing composition of tax revenues over the period 1964-65/1982-83. The share of direct taxes in total tax revenues (T_d/T) increased from 37.18% in 1965-69 to 42.61% in 1970-74. But thereafter its share steadily declined and dropped to an average of 23.32% in 1980-83. Correspondingly, the average share of indirect taxes in total tax revenues (T_i/T) declined in the first half of the period, and in later years the T_i/T ratio steadily increased and rose to an average of 67.72% in 1980-83 (Table 1).

The share of taxes on international trade in total tax revenues (T_{xm}/T) has tended to decline from 38.13% in 1965-69 to 24.26% in 1980-83, followed by a substantial increase in the share of taxes on domestic production and internal transactions (T_{ipt}/T), from 24.65% to 43.46% over the same period.

The relative share of excise duties and taxes on specific services has tended to decline during 1965-83. Thus, within taxes on domestic production and internal transactions, sales tax has become the single largest source of revenue accounting for nearly two thirds of T_{ipt}, and 30% of the total revenues in 1980-83. This shows that a marked increase in the relative share of T_{ipt} in total tax revenues was brought about by the adoption and widespread use of sales tax since 1972-73.

BUOYANCY OF THE TAX SYSTEM

Table 3 shows the marginal propensity to tax (MPT) and buoyancy of the overall tax system and of major components for the period 1965-83. The overall MPT

Table 3
Marginal propensity to tax and buoyancy of major taxes, and of the total system

Kenya, 1964-65 to 1982-83

Category	MPT	Buoyancy ratio
1. Income taxes	0.07534	1.21801
2. Property taxes	0.00038	0.66722
3. Sales tax*	0.07909	2.18873
4. Excise duties	0.02285	1.02422
5. Taxes on specific services	0.00810	1.18492
6. Export duties	0.00221	1.15946
7. Import duties	0.05504	1.05972
8. Taxes on domestic production & internal transactions (3 + 4 + 5)	0.10699	1.59803
9. Taxes on international trade (6 + 7)	0.05725	1.06261
10. Direct taxes (1 + 2)	0.07555	1.21085
11. Indirect taxes (3 to 7)	0.16241	1.34364
12. Total tax system (10 + 12)	0.23979	1.29276

* Sales tax was introduced in 1972-73; the MPT and buoyancy ratio are for the period 1972-73 to 1982-83.

Source: Kenya: Central Bureau of Statistics, *Statistical Abstract*, various issues.

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was estimated to be 0.24 during 1965-83; i.e. a one shilling increase in GNP resulted in 24 cents of tax revenue. The estimated buoyancy of the tax system was 1.29276, which means the tax system yielded a 1.29276% change in tax revenues, resulting from both automatic and discretionary changes, for every one percent change in GDP during 1964-65/1982-83.

The responsiveness of the major tax components, with respect to changes in GDP, was rather divergent. For example, the MPT of direct taxes was 0.07554, with a buoyancy ratio of 1.21085. In comparison, the MPT of indirect taxes was 0.16241, reflecting that more than two thirds of the absolute changes in tax revenues came from indirect taxes. The buoyancy of indirect taxes was 1.34364, higher than the buoyancy of the total tax system.

Within indirect taxes, the estimated MPT of domestic production and internal transactions was 0.10699, with a buoyancy ratio of 1.59803, as compared to MPT of 0.05725 for international trade with a buoyancy ratio of just 1.06261. The MPT of sales tax, a major component of indirect taxes, was 0.07907 with a buoyancy ratio of 2.18873. This reflects that it is the expansion of taxes on domestic production and internal transactions, not direct taxes, which enabled the overall tax systems to be buoyant with a ratio greater than unity (1.29276) during the period 1964-65/1982-83, resulting mostly from discretionary changes rather than automatic changes.

DIRECT AND INDIRECT TAXES: MARGINAL RESPONSE

The relative marginal response of direct and indirect taxes to the changes in overall tax ratio during 1965-83 was estimated by regressing the sub-components tax ratios against the overall tax ratio. The derived equations are as follows (numbers in parentheses are t-values):

$$\text{(Eq. 1)} \quad \frac{T_i}{GDP} = -2.52714 + 0.76695 \frac{T}{GDP} \qquad R^2 = 0.95 \quad (3.4905) \quad (19.1106)$$

$$\text{(Eq. 2)} \quad \frac{T_d}{GDP} = 2.51680 + 0.23370 \frac{T}{GDP} \qquad R^2 = 0.68 \quad (2.7880) \quad (6.4670)$$

$$\text{(Eq. 3)} \quad \frac{T_{ipt}}{GDP} = -5.12603 + 0.66258 \frac{T}{GDP} \qquad R^2 = 0.94 \quad (4.8365) \quad (7.6792)$$

$$\text{(Eq. 4)} \quad \frac{T_{xm}}{GDP} = 3.16396 + 0.09571 \frac{T}{GDP} \qquad R^2 = 0.23 \quad (4.1116) \quad (2.2237)$$

As seen from the estimated equations, the ratio of indirect taxes to GDP increased by more than three fourths percentage point for every one percentage point increase in the overall tax ratio, compared to an increase of less than one fourth percentage point in direct tax ratio. The result also shows that for every one percentage point increase in the overall tax ratio the ratio of taxes on domestic production and internal transactions to GDP increased by two thirds, and the ratio of taxes on international trade to GDP increased by less than one tenth during this period.

The negative constant term in equations 1 and 3 implies that the marginal ratio exceeded the average ratio, and this led to a faster increase in the T_i/GDP ratio, particularly the T_{ipt}/GDP ratio during 1965-83. In case of positive constant term in equations 2 and 4, the marginal ratio is less than the average ratio, and this pulled down the T_d/GDP and T_{xm}/GDP ratios over time.

TAX RATIOS, ECONOMIC DEVELOPMENT AND INFLATION

The response of the critical tax ratios (T/GDP, T_d/GDP, and T_i/GDP) to development, indexed by per capita GDP (GDP/POP), and inflation, measured by the changes in GDP deflator (Π), was estimated by regressing the tax ratios against GDP/POP and Π respectively. Annual data for the period 1964-65/1982-83 were used in the analysis. The estimated linear regression equations are as follows (numbers in parentheses are t-values):

$$\text{(Eq. 5)} \quad \frac{T}{GDP} = 10.08009 + 0.07568 \frac{GDP}{POP} \qquad R^2 = 0.82 \quad (12.7128) \quad (8.8618)$$

$$\text{(Eq. 6)} \quad \frac{T}{GDP} = 14.62407 + 0.3806\,\Pi \qquad R^2 = 0.58 \quad (6.5830) \quad (4.7538)$$

$$\text{(Eq. 7)} \quad \frac{T_d}{GDP} = 5.42286 + 0.01376 \frac{GDP}{POP} \qquad R^2 = 0.40 \quad (11.8740) \quad (3.3396)$$

$$\text{(Eq. 8)} \quad \frac{T_d}{GDP} = 6.08229 + 0.07940\,\Pi \qquad R^2 = 0.32 \quad (14.9403) \quad (2.8750)$$

$$\text{(Eq. 9)} \quad \frac{T_i}{GDP} = 5.77070 + 0.05912 \frac{GDP}{POP} \qquad R^2 = 0.87 \quad (3.3790) \quad (10.6609)$$

$$\text{(Eq. 10)} \quad \frac{T_i}{GDP} = 8.56006 + 0.30196\,\Pi \qquad R^2 = 0.45 \quad (8.8766) \quad (3.5119)$$

The overall tax revenue ratio has responded positively to both per capita GDP and inflation, as seen from the estimated equations. But the response of direct tax ratio to both these variables has been rather small in magnitude, as compared with the response of direct tax ratio. It is rather interesting to note that nearly 80% of the inflation-induced tax revenues, as well as development-induced tax revenues, have resulted from indirect taxes over the period 1964-65/1982-83.

As a consequence of weak response of the direct taxes with respect to both per capita GDP and inflation, as compared to indirect taxes, the ratio of direct to indirect taxes has tended to decline over time. The ratio of direct to indirect taxes (T_d/T_i), an indicator of the degree of elasticity of the tax system, was regressed on per capita GDP. The estimated equation is as follows:

$$\text{(Eq. 11)} \quad \frac{T_d}{T_i} = 77.25134 - 0.17087 \frac{GDP}{POP} \qquad R^2 = 0.50 \quad (17.5801) \quad (3.9433)$$

A negative relationship is found between the T_d/T_i ratio and GDP/POP. The R^2 is somewhat low but the slope coefficient is statistically significant at the 0.01 level. The empirical results confirm a relatively sluggish growth in direct taxes, as compared to indirect taxes, and the apparent lack of built-in flexibility in the

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tax system. This implies that a growing public expenditure has to be financed by rising tax revenues by introducing very frequent discretionary changes which may lead to a lopsided development of the tax system.

GROWTH OF PUBLIC EXPENDITURE: SOME EMPIRICAL RESULTS

Table 4 shows the changing level and structure of public expenditure over the period 1964-65 to 1982-83. The total Government expenditure (combined current and capital) as a percent of GDP increased from an average level of 20.94% in 1965-69 to 37.50% in 1980-83, a 79% growth in the total expenditure ratio (G/GDP) over time. Wagner's Law which states that the size of public expenditure share in the economy increases with income is confirmed by the following estimated equation:

$$\text{(Eq. 12)} \quad \frac{G}{GDP} = \underset{(14.8730)}{17.38362} + \underset{(10.6160)}{0.12474}\ \frac{GDP}{POP} \qquad R^2 = 0.87$$

As seen from the equation, the expenditure ratio is positively related to per capita GDP, and the slope coefficient (0.12474) is statistically significant at the 0.01 level. The estimated expenditure ratio elasticity with respect to per capita GDP is 0.3861 (calculated at the mean values). Thus, on average, a 1% increase in GDP/POP leads to an increase in the G/GDP ratio by 0.3861%. This confirms that demand for Government expenditure is income elastic, particularly during the early stages of "economic transformation" of the developing countries.

Government expenditure on gross fixed capital formation as a percent of GDP (G_{fc}/GDP doubled during 1965-74, from an average of 2.43% in 1965-69 to 4.92% in 1970-74. But thereafter the G_{fc}/GDP ratio increased very marginally and averaged just 5.52% in 1980-83. Its share in total public expenditure (G_{fc}/G) also followed a similar trend, which initially increased from 11.48% in 1965-69 to 18.82% in 1970-74, and subsequently the G_{fc}/G ratio tended to decline and averaged 14.80% in 1980-83.

While it has been observed that the level of public expenditure, as a percent of GDP, has been rising, along with an increasing tax ratio over time, the empirical results tend to show that the rate of growth of capital formation in the public sector has not kept pace with it, as shown by the following equations:

$$\text{(Eq. 13)} \quad \frac{G}{GDP} = \underset{(0.7983)}{1.67912} + \underset{(12.9824)}{1.52770}\ \frac{T}{GDP} \qquad R^2 = 0.91$$

$$\text{(Eq. 14)} \quad \frac{T_{fc}}{GDP} = \underset{(0.4607)}{-0.49803} + \underset{(3.7562)}{0.17411}\ \frac{G}{GDP} \qquad R^2 = 0.48$$

$$\text{(Eq. 15)} \quad \frac{G_{ds}}{GDP} = \underset{(2.61184)}{-2.8208} + \underset{(5.5523)}{0.20677}\ \frac{G}{GDP} \qquad R^2 = 0.65$$

The total expenditure ratio increased, on average, by 1.52 times of any increase in the tax ratio over the period 1965-83 (Eq. 13). But for every one percentage point increase in the total expenditure ratio, the expenditure on gross fixed capital formation as a proportion of GDP (G_{fc}/GDP) increased less than one fifth, as seen in Eq. 14. In comparison, for every one percentage point increase in the G/GDP ratio, expenditure on interest and loan repayments (i.e. debt services) as a percent of GDP (G_{ds}/GDP) has increased at a higher rate than the G_{fc}/GDP ratio.

Expenditure on wages and salaries (G_{ws}), goods and services (G_{gs}), gross fixed capital formation (G_{fc}) and debt services (G_{ds}), all expressed as proportion of total Government expenditure, were regressed against per capita GDP to determine the relationship between the structure of expenditure and development. The estimated equations are as follows:

Table 4
Expenditure ratios, by economic categories, and structure of expenditures
Kenya, 1964-65 to 1982-83

Categories	1964-65 to 1968-69 (Average)		1969-70 to 1973-74 (Average)		1974-75 to 1978-79 (Average)		1979-80 to 1982-83 (Average)	
	% of GDP	% of total expenditure	% of GDP	% of total expenditure	% of GDP	% of total expenditure	% of GDP	% of total expenditure
1. Wages & salaries	6.64	31.72	9.25	35.45	6.97	22.45	7.12	18.90
2. Goods & services	3.37	16.08	4.46	17.08	7.28	23.82	10.22	27.28
3. Gross fixed capital formation	2.43	11.48	4.92	18.82	5.07	15.90	5.52	14.80
4. Exhaustive expenditure (1 + 2 + 3)	12.44	59.28	18.63	71.35	19.32	62.26	22.86	60.98
5. Subisidies & transfers	4.68	22.36	2.85	11.06	5.22	17.00	6.62	17.60
6. Interest	1.08	5.98	1.33	5.10	1.67	5.50	3.06	8.10
7. Loan repayments	0.84	4.04	1.08	4.08	1.06	3.44	2.55	6.65
8. Total debt services (6 + 7)	1.92	10.02	2.41	9.18	2.73	8.94	5.61	14.75
9. Investment in govt. enterprises	0.34	0.33	0.66	2.54	0.58	2.26	0.27	0.70
10. Lending to other sectors	1.68	7.98	1.53	5.92	3.08	9.32	2.21	5.93
11. Lending & investment (10 + 11)	2.02	8.31	2.19	8.46	3.66	11.58	2.48	6.63
12. Total govt. expenditure	20.94	—	26.08	—	30.54	—	37.5	—

Source: Kenya, Central Bureau of Statistics, *Statistical Abstract*, and *Economic Survey*, various issues.

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(Eq. 16) $\frac{G_{ws}}{G} = 39.37167 - 0.13453 \frac{GDP}{POP}$ $R^2 = 0.76$
(21.68066) (7.28346)

(Eq. 17) $\frac{G_{gs}}{G} = 12.05420 + 0.09905 \frac{GDP}{POP}$ $R^2 = 0.87$
(13.14224) (10.74295)

(Eq. 18) $\frac{G_{fc}}{G} = 13.80979 + 0.00835 \frac{GDP}{POP}$ $R^2 = 0.01$
(6.43120) (0.38675)

(Eq. 19) $\frac{G_{ds}}{G} = 7.16856 + 0.03824 \frac{GDP}{POP}$ $R^2 = 0.35$
(5.69389) (3.02053)

As seen from the above equations, while the expenditure on wages and salaries, in relation to the total expenditure, has tended to decline, the expenditure on goods and services has trended upward in course of development. The relationship between the G_{fc}/G ratio and GDP/POP was not found to be statistically significant, reflecting that the expenditure allocated to gross fixed capital formation did not increase in course of development (Eq. 18). In comparison, the expenditure on debt services has tended to increase over time, as a result of increasing reliance on borrowing to finance the growing public expenditure.

SOURCES OF FINANCING PUBLIC EXPENDITURE

Table 5 shows the various sources of funds, expressed as a percentage of total Government expenditure and of GDP, during 1965-83. Whilst tax revenues, as a percent of GDP, increased from an average level of 12.61% in 1965-69 to 22.63% in 1980-83, its contribution to total expenditure has remained virtually the same around 60% in all the periods except 1970-75, reflecting that the rate of growth of public expenditures tended to equal the rate of growth of tax revenues over time.

However, the contribution of budgetary revenues (combined tax and non-tax revenues) to total expenditure declined from an average of 79.10% in 1965-69 to 69.27% in 1980-83, as a result of decline in non-tax revenues over this period. This has led to increasing budgetary deficits, and borrowing has emerged as an increasing source for financing public expenditures.[4] For example, borrowing (internal and external) as a percent of GDP increased nearly three-fold, from 3.67% in 1965-69 to 10.22% in 1980-83; and its contribution to total expenditure increased from 17.51% to 26.84%.

As a result, public debt has been building up over time; it increased as a percent of GDP from an average of 30.30 in 1965-69 to 46.27 in 1980-83. Consequently, expenditure on debt services as a percent of GDP nearly tripled, from 1.922 in 1965-69 to 5.61 in 1980-83, with an accelerated growth in the latter period. Its share in the total public expenditure increased from an average of 8.96% in 1975-79 to 16.75% in 1980-83 (Table 4).

THE IMPACT OF THE PUBLIC SECTOR

To investigate whether relative public sector growth in Kenya has exerted any influence on certain magnitudes, the following linear regression equations[5] were estimated using the time-series data for the period 1965-83:

(Eq. 20) $\frac{I_p}{GDP} = 15.47300 + 0.22199 \frac{G}{GDP}$ $R^2 = 0.14$
(3.2985) (1.6052)

(Eq. 21) $\frac{\Delta GDP}{GDP} = 9.62814 + 0.12872 \frac{G}{GDP}$ $R^2 = 0.02$
(1.3743) (0.5406)

(Eq. 22) $\frac{\Delta GDP}{GDP} = 4.40234 + 1.70645 \frac{G_{fc}}{GDP}$ $R^2 = 0.20$
(0.9326) (1.9703)

4. It has been maintained that increasing Government deficits in LDCs pose a serious problem for stabilization policy, particularly it leads to destabilizing monetary accommodation and inflation. For details see, for example, Aghevli, B.B. and Khan, M.S., "Government Deficits and the Inflationary Process in Developing Countries" in Warren L. Coats and Deena R. Khatkhate (eds.), *Money and Monetary Policy in Developed Countries*, Pergamon Press, 1980.

5. We concentrate more on the statistical significance of the slope coefficient rather than the size of the R^2, given the nature of our inquiry.

Table 5
Sources of revenue as percent of GDP and total Government expenditure
Kenya, 1964-65 to 1982-83

Categories	1964-65 to 1968-69 (Average)		1969-70 to 1973-74 (Average)		1974-75 to 1978-79 (Average)		1979-80 to 1982-83 (Average)	
	% of GDP	% of total expenditure	% of GDP	% of total expenditure	% of GDP	% of total expenditure	% of GDP	% of total expenditure
1. Tax revenue	12.61	60.10	16.04	61.65	19.49	63.90	22.63	60.55
2. Non-tax revenue	3.96	19.00	3.84	14.92	3.06	10.06	3.25	8.72
3. Total borrowing	3.67	17.51	5.25	20.18	7.18	23.36	10.22	26.84
A. Internal borrowing	1.54	7.19	3.13	12.07	4.57	14.90	5.19	13.51
B. External borrowing	2.13	10.31	2.11	8.10	2.60	8.45	5.02	13.32
4. Capital transfers from abroad	0.06	0.31	0.14	0.59	0.59	1.98	0.98	2.60
5. Loan repayments	0.49	2.33	0.49	1.91	0.20	0.73	0.09	0.25
6. Others	—	—	—	—	0.36	1.15	0.16	0.45
7. Capital revenue	4.51	21.46	5.89	22.70	10.33	33.83	11.56	30.39

Source: Kenya: Central Bureau of Statistics, *Statistical Abstract*, 1968, 1973, 1976, 1979, 1981, 1983.

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(Eq. 23) $\frac{X}{GDP} = 39.23592 - 0.21357 \frac{G}{GDP}$ $R^2 = 0.17$
(11.2774) (1.8063)

(Eq. 24) $\frac{M}{GDP} = 28.66043 + 0.22827 \frac{G}{GDP}$ $R^2 = 0.17$
(4.8835) (1.4305)

As seen from the Eq. 20, a positive relationship is found between the public expenditure ratio and the ratio of private investment to GDP (I_p/GDP), and the slope coefficient is significant at the 0.10 level. This suggests that a rising G/GDP ratio did not adversely affect the I_p/GDP ratio over time.

The relationship between the G/GDP ratio and economic growth rate, indexed by the changes in per capita GDP ($\triangle$GDP/GDP), is found to be inconclusive as shown by the non-significant slope coefficient (Eq. 21). But a positive relationship is established between the ratio of Government's gross fixed capital formation to GDP and economic growth, and the slope coefficient is significant at the 0.05 level.

It is somewhat surprising to find an inverse relationship between the public expenditure ratio and the ratio of exports to GDP (X/GDP). Whereas the ratio of imports to GDP (M/GDP) is positively related to the public expenditure ratio, and the slope coefficient is significant at the 0.10 level.

On the whole, the tentative results lead one to suspect that and increasing scale of public intervention in the economy over the period 1965-83 has apparently failed to increase the relative level of exports (or decrease the relative level of imports) which is generally accepted as crucial to economic growth. As a result, a growing foreign exchange gap has probably acted as a major constraint on growth. Since a rising G/GDP ratio has not adversely affected the relative level of private investment expenditure in the economy, we have found no conclusive evidence whether the growth of the public sector promoted or depressed economic development.

SUMMARY AND CONCLUSION

The overall conclusions from our analysis of the Kenyan fiscal data for the period 1964-65/1982-83 can be summarized as follows. The tendency of the Government's relative share in the economy to rise with economic development is consistent with the widely recognized Wagner's Law of increasing governmental activity.

Tax revenues contribute an average of 60% of the total public expenditures, and the growth rate of the tax/GDP ratio has tended to equal the expenditure/GDP ratio over time. But significant changes in both tax-mix and expenditure-mix have occurred during 1965-83.

The proportion of direct tax revenues in total tax revenues tended to decline, which is contrary to the hypothesis of rising share of direct taxes in course of economic development (Thorn, 1967). Direct taxes have been relatively less responsive to inflation and economic growth, compared to indirect taxes. As a result, the ratio of direct to indirect taxes, an indicator of the elasticity of the tax system, has trended downward in course of development, reflecting the lack of built-in elasticity of the tax system.

As expected, taxes on foreign trade have tended to decline with the growth in the economy (Chenery, 1966; Hinrichs, 1966). The expansion of indirect taxes on domestic production and internal transactions has contributed the lion's share in raising the overall tax/GDP ratio and enabled the overall tax system to be fairly buoyant (1.29) during 1965-83. The direct tax system has been less buoyant (1.21) compared to the buoyancy of indirect taxes on domestic production and internal transactions (1.60).

There is no evidence that the Kenyan tax system has been moving towards progressivity (or becoming less regressive) in the course of economic development during the period studied.[6] With an increasing monetized and market-oriented economy, and decreasing in-kind income, heavy reliance on indirect taxes, particularly in the absence of large mass consumption of luxury goods, would make the tax system less progressive over time (Yukon Huang, 1976).

One reason for declining progressivity is possible growing evasion of direct taxation, especially with the

6. The ILO mission (1972) and the World Bank (1975) found that the Kenyan structure in the beginning of the 1970s was not very progressive and lacked redistributive elements. Over the years apparently this has not changed very much.

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rapid growth of the informal sector. Another possible reason for the relative decline recently in the growth of income tax revenue is that the public sector grew more rapidly in the 1970s, and was able to tax its own employees. This was not the case in the 1980s, when the Government reduced the growth in the civil service, and lowered real levels of remuneration.

Public expenditure has increased on average by 1.52 times of any increase in the tax/GDP ratio during 1965-83. Although it is widely asserted that increased capital formation requires greater reliance on taxation in LDCs, the rate of Government's gross fixed capital formation failed to keep pace with the growth of public expenditure and economic growth.[7] This is largely due to an increasing expenditure on debt service, and failure to restrain the growth of public consumption expenditures in the course of development.

The empirical evidence on the impact of the public sector on economic growth is inconclusive. But the results tend to show that an increasing scale of public intervention in the economy over the period 1965-83 has apparently failed to increase the level of exports (or decrease the level of imports) which is generally accepted as crucial to economic growth in LDCs.

In the second half of the period the growth rate of the expenditure/GDP ratio has accelerated, whereas the growth rate of the tax/GDP ratio has decelerated. Given the low degree of built-in elasticity of the tax system, with predominance of indirect taxes on domestic production and internal transactions, it will be extremely difficult to mobilize adequate resources to finance the growing public expenditures without introducing a high degree of built-in elasticity to the tax system.

The declining trend of the Government's gross fixed capital formation, if left unchecked, will result in low productivity, a lower rate of return to private capital, and generally poor economic performance.

7. This tendency seems to lend support for Please's hypothesis which maintains that when developing countries find more tax revenues, the tendency is to spend more for non-productive form of public consumption expenditure than investment expenditures. There is a danger that those who recommend increased taxation for promoting development in LDCs might be looking at a mirage. For details see Please (1967).

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INDIA:

Taxation of Contracts for Work:

Policy Imperatives for a Sales Tax System in a Developing Country

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The structure of sales tax in India is far more complicated than the existing sales tax structure of any other country.[1] To add further to the complexities, the Forty-Sixth Constitution Amendment Act[2] has opened a Pandora's Box by empowering the states to levy sales tax on contracts for work.

Hitherto, a contract for work was not considered a sale because the term "sale" is defined as a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price.[3] In other words, a contract of sale is a contract, the main object of which is the transfer of property in, and the delivery of the possession of, a chattel to the buyer. Where the main object of the work undertaken by the payee is not the transfer of a chattel qua chattel, the contract is one for work and labour.[4]

The expression of contract for work, on the other hand, is used in respect of labour, skilled or otherwise, and for the construction of buildings, bridges, factories, etc., including supply of all materials, machineries and other requirements in setting them up. In some of the contracts there may be an implied agreement for sale of some or all materials used as and when they are bought at the site, or at some other point in time, or there may be only an agreement that the contractor will supply all the materials, and the person who places the order will pay for the work as a whole. It is not the form of the contract, but the substance which has to be looked into when deciding the question of whether or not it is a contract for work and labour with materials supplied.

In a contract for work in the form of a building contract, requiring specified work to be executed for a lump sum, there is no contract of sale for the materials, unless there is an implied contract to that effect. In fact, the agreement in such contracts is that the contractor should construct a building according to the specification contained in the agreement. He receives payment in consideration thereof. Accordingly, there is no contract to sell the materials nor does the property pass therein as movables.[5] However, this does not prevent the parties entering into distinct and separate contracts, one for the transfer of materials for money considerations and the other for the payment of remuneration for services rendered and work done.[6]

DEFINING CONTRACTS FOR WORK

In view of the difference in the definition of sale and contract for work, the latter concept has not so far been included under the purview of Indian sales taxation. Some of the states have nevertheless defined the term even before the Forty-Sixth Constitutional Amendment. Andhra Pradesh, for example, defined it as "any agreement for carrying out for cash or for deferred payment, or for other valuable consideration, the construction, fitting out improvement or repair of any building, road, bridge or other immovable property or the fitting out, improvement or repair of any movable property".[7] However, subsequent to the passage of the Forty-Sixth Constitutional Bill, the states are empowered to levy "tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a contract for work".[8] By virtue of this amendment, many more states have defined contract for work. Kerala has inserted in the Kerala Finance Act, 1984 the definition of contracts for work as including any agreement for carrying out, for cash or for deferred payment or other valuable consideration, the construction, fitting out improvement, repair, manufacture, processing, fabrication,

1. See for details, Purohit, Mahesh C. (1987), *Structure and Administration of Sales Taxation in India.* Reliance Publishing House, Ranjit Nagar, New Delhi-8.
2. Government of India (1983), *The Constitution (Forty-Sixth Amendment) Act, 1982.* New Delhi.
3. Government of India (1974) *Sixty First Report on Certain problems connected with powers of the States to levy a Tax on the Sale of Goods and with the Central Sales Tax Act, 1956, Law Commission of India.*
4. Halsbury's Laws of England (Third Ed.), Vol. 34, at 6. Sarvodaya Motor Works v State of Gujarat (1966) 17 STC 261; State of Madras v Richardson and Guddas (1981) 21 STC 245 (SC); Richardson and Guddas v State of Madras (1965) 16 STC 243, affirmed.
5. State of Madras v Gannon Dunkerley & Co.; Nenuram v State of Rajasthan (1967) 20 STC 551; AIR 1967 Raj 50 (DB).
6. State of Madras v Gannon Dunkerley & Co., supra.
7. A.P. Sales Tax Act, Section 2(t).
8. Clause 29A(b) to the Article 366, Government of India Constitution of India, New Delhi.

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erection, installation, modification or commissioning of any movable or immovable property.[9]

Similarly, many other states have also defined contract for work. For example, Tamil Nadu has defined contract for work to include "any agreement for carrying out for cash, deferred payment or other valuable consideration, the building construction, manufacture, processing, fabrication, erection, installation, fitting out, improvement, modification, repair or commissioning of any movable or immovable property".[10] Bihar has defined contract for work as an "agreement for carrying out for cash or deferred payment or other valuable consideration the construction, fitting out improvement or repair of any building, road, bridge or other immovable properties".[11] Karnataka has also defined contract for work to include "any agreement for carrying out for cash, deferred payment or other valuable consideration the building construction, manufacture, processing, fabrication, erection, installation, fitting out improvement, modifications, repair or commissioning of any immovable or movable property".[12] Maharashtra includes in the definition of contract for work "the transfer of property in goods involved in the execution of contracts for work for fabrication and installation of plant and machinery for fabrication and erection of structural works including fabrication and erection of trusses or turbine, for fabrication and installation of cranes or hoists, elevator or escalators or rolling shutters or collapsable gates, for civil works like construction of building, bridge or roads and their repair thereof; for installation of doors, windows, frames or grills, for fixing tiles, slabs, stones or sheets; for installation of air-conditioning equipment including deep freezers, cold storage plants, humidification plants or dehumidifiers, for installation of air-conditioners; for electrical fittings or for installation of electrical equipments for furniture and fixtures, partisans including contracts for interior decoration; for construction of bodies or chassis of motor vehicles including three-wheelers, construction of railway coaches or under carriages supplied by railways; for shipbuilding including construction of barrages, ferries, tugs, trawlers or dredgers; for sanitary fittings; for plumbing; for drainage or sewerage; and for laying underground or surface pipelines, cables or conduits".[13]

These definitions suggest that the states have tried to define contract for work in such a way that the scope of the tax could be made as vast as possible. All types of agreements, be they for supply of goods and services or for construction, have been included under the purview of taxation.

THE BASE OF THE TAX

Notwithstanding the uniformity in the approach of the states in including contracts for work under the purview of taxation, there does not seem to be a common approach to the basis on which the tax is levied. States like Maharashtra have defined the taxable turnover under contract for work to include "the aggregate of the amount of sales price, received or receivable by dealer in respect of any transfer of goods involved in the execution of any contract for work whether executed fully or partly during a given year and includes any advance received by a dealer as a part of sale price".[14] This definition does not provide for any concession for the tax paid byt the contractor on the inputs used in the execution of the contract. That is to say, the tax on raw materials, components as well as inputs is not allowed to be set off against the liability arising from the execution of the contract for work. Consequently, the tax is low and varies for different projects depending upon the nature and the type of contracts. In such a case the contractor is not required to submit accounts for the purchase of inputs and satisfies his tax liability by making a lump-sum payment on the basis of the prescribed rate. However, under another approach the tax would be on the value added through the execution of the contract for work. As it is proposed in Bihar, the law would allow deduction of tax for all the bills/invoices of the contract for work submitted by the contractor. That is to say, the tax paid by the contractor in executing the contract for work would be set off against the tax liability arising out of it. In Kerala, the turnover in respect of contracts for work is the aggregate amount of the contract minus labour charges. In Tamil Nadu, the total turnover is the amount payable for the execution of the contract for work. This includes the value of all goods and the labour and other charges involved in the execution of the contract. However, in determining the taxable turnover, some deductions are allowed. These deductions are:

(a) Where the transfer of property takes place in the form of finished goods or the contractor is required to build, construct, manufacture, process, fabricate or otherwise procure or supply any finished goods: the charges for freight and delivery of the finished goods are deductible; and
(b) Where the transfer of property does not take place in the form of goods but takes place in some other form, the labour and other charges would be deducted as follows: for electrical contracts of H.T. transmission line, the labour or other charges would be equivalent to 15% of the value of the contract, but for the contract for work of substation equipment and all other electrical contracts the labour charges would be 10 and 20%, respectively.

Thus, the intention of taxation of contracts for work is not to include labour charges; the basic idea is that the contractor should not go scot-free, and while executing the contract, if he has purchased things "as dealer",

9. Government of Kerala (1984), *Kerala Gazette (Extraordinary)* 28th July, at 4.
10. Government of Tamil Nadu (1984), *Act (Amendments)*, at 3.
11. Government of Bihar (1984), *Bihar Gazette (Extraordinary)* 7 April, at 4.
12. Government of Karnataka (1985), *The Karnataka Sales Tax (Amendment) Bill*, 1985, at 4.
13. Government of Maharashtra (1985), *Maharashtra Government Gazette*, at 155-156.
14. Ibid, at 151.

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either he should have paid the tax on inputs or he should pay on the final product, i.e. on the value of the contract.

VIEWING TAXATION OF CONTRACTS FOR WORK AS AN ANTI-EVASION MEASURE

The above analysis of the base of the tax suggests that a tax on contracts for work could be viewed from two different angles. One approach could be to consider this tax as a new source of raising revenue. For example, Maharashtra levies such a tax at a very low rate without giving a set-off for the payment of the tax on raw materials or other components. Taxing contracts for work in this way would imply that the state is interested in raising more revenue from this new base. And, in fact, this approach of taxing the contract for work might not have any resistance from the dealers either. The dealers would conversely shift the tax on contracts for work to the contractee. The second approach of taxation of contracts for work is to consider this base as a means to controlling the existing loopholes for avoiding and evading the tax. Accordingly, the tax is levied at a slightly higher rate of tax but a complete set-off is given for the amount of tax paid by the contractor on the inputs as well as raw materials and components bought by him. In this approach the tax is primarily on the final product and that too on the value added by the contractor. The contractor is required to submit his accounts to the tax department to show that the tax has been paid on the inputs purchased by him. Failing the submission of accounts, the contractor is denied the facility of set-off. This approach, therefore, views the taxation of contract for work as an integral part of the enforcement of sales tax.

From among the above two approaches it is important that in the present stage of evolution of the sales tax system in India, we adopt the second approach and view the taxation of contracts for work as an integral part of the anti-evasion activity which would automatically make the contractors abide by the taxation laws. In fact, the present state of affairs in most of the states is such that it is not very difficult for a contractor to buy goods without payment of tax. When a tax is levied on the contracts for work and the contractor is entitled to claim a set-off for the amount of tax paid on inputs, he would either pay the tax to the (selling) dealer at the time of purchasing the inputs or forgo the set-off facility and pay the tax to the Government at the time of receiving the consideration for the contract.

Thus the direct yield of the tax on contracts for work may not be substantial but the existence of tax per se would have an indirect effect on the tax yield. The total sales tax revenue would go up partly due to the direct yield of this tax and partly but more importantly due to synergy effect of the existence of such a tax.

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ADMINISTRATION OF THE TAX ON CONTRACTS FOR WORK

The taxation of contracts for work would not create insurmountable problems. In fact, many of the states already have tax laws which require the Government departments to withhold the amount of tax when a dealer supplies goods to the department. When a tax is levied on contracts for work, a similar practice could be adopted. Whenever the money is paid to the contractor (be it a seed money for commencing the contract for work or any other money) the amount of sales tax on that consideration could be withheld by the Government department. Finally, assessments must be made every year on the contractors. An assessment order must be passed for the contracts completed during the financial year; any contract being carried over to the next financial year should not be finally assessed.

CONCLUSION

The problem of taxation of contracts for work in the states can be seen both from the view of the stage of economic development and from the angle of the efficiency in the administration of tax. The taxation of contracts for work in any state should, however, be better viewed from the latter point of view. That is, the inclusion of contracts for work in the sales tax base is of great importance in closing the loopholes in the administrative organization for the tax administration and for better enforcement of the tax. It is possible that the yield in the initial years of the levy will not be large but its synergy effect on the efficiency of tax administration may have far-reaching consequences.

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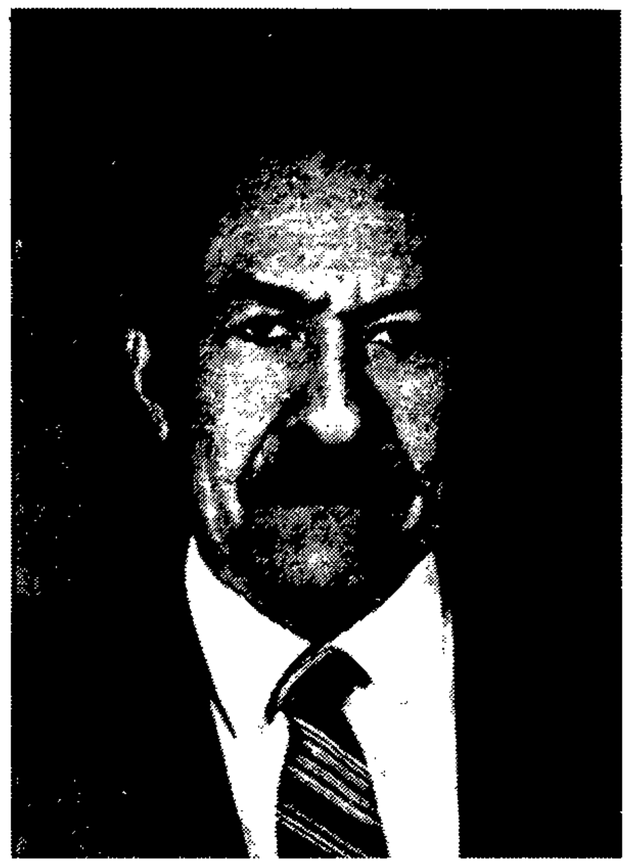
THE SUDAN:

Experience with *Zakat**

The Relation between *Zakat* and Income Tax

By Prof. Ali Ahmed Suliman



The author is Professor of Economics and Dean, Faculty of Economic and Social Studies. He has acted as a consultant to many organizations including the UNIDO, ECWA, ILO and the Arab Council for Economic Unity. Professor Suliman is also the author of several books and articles for both Arab and English language journals.

INTRODUCTION

The main objective of this article is to evaluate the experience of the Sudan with *Zakat* and to draw some lessons from it. Such lessons may be of help to other countries which may be considering the possibility of introducing *Zakat* or making it compulsory, or of developing income taxation together with a system of *Zakat* which is already in existence.

Though the basic principles of *Zakat* are the same, their application may vary; as we shall see, different Islamic countries can have different approaches to *Zakat*. No attempt will be made to evaluate *Zakat* in general, as such a discussion can be – at least as regards certain points – very controversial and would require a large number of references to religious texts and quotations in Arabic. Therefore, such an evaluation would require more than one article to deal with it fully. Furthermore, a large number of articles and books which deal with the subject of *Zakat* have already been published.[1]

The experience of the Sudan is interesting because it has raised the question of the relation between *Zakat* and income taxation in a dramatic manner. The important and inevitable question of the relation between *Zakat* and income taxation has been dealt with neither adequately nor in depth in previous writings – mainly because attention has been focused on *Zakat* as such and its merits as a religious levy.[2]

In the Sudan, the experience of *Zakat* has been rather short and it is therefore not surprising to find that some important issues have not been discussed or dealt with in the Sudanese context. On the other hand, in the countries which have had long experience with *Zakat* and where *Zakat* has been applied seriously, such as Saudi Arabia, Kuwait, the United Arab Emirates and Oman, income taxation has not so far been developed to any great extent.

HISTORICAL BACKGROUND

A very short description of how income taxation has been developed in the Sudan and how *Zakat* was introduced may help to create a better understanding of the interaction between *Zakat* and income taxation in the Sudan and its implications.

The Sudan was reconquered by Egyptian and British forces under Kitchener in 1899, and in the same year the Anglo-Egyptian Agreement, which laid the foundations of the new regime in the Sudan, provided for a new tax structure to finance the Government. Between 1899 and 1925, a number of taxes on huts, land, crops, houses, animals and date-palms were introduced in lieu of income taxes. After 1924, taxes on imports and exports were developed. In 1913, a tax was introduced on business profits (BPT) which represented a major development in income taxation in the Sudan. In 1964, a personal income tax (PIT) was introduced on wages, salaries, commissions and allowances and in the same year a land rent income tax was also introduced.

* *Zakat* is a religious levy. It is one of the corner-stones of Islam. It may also be written '*Zakah*'.

1. E.g. Nicholas P. Aghnides, *Mohammadan Theories of Finance,* Lahore, Premier (1961); Muhammad Hameedulah, "Budgeting and Taxation in the Time of Holy Prophet", *Journal of the Pakistan Historical Society* (January 1955); Frede Lokkegaard, *Islamic Taxation in the Classical Period with Special Reference to Circumstances in Iraq,* Copenhagen, Branner and Korch (1950); S.A. Siddiqi, *Public Finance in Islam,* Lahore, Sheikh Mohammad Ashraf (1975); Shaykh Ahmad (ed.) *Some Socio-Economic Aspects of Zakat,* Karatchi, Pakistan Institute of Arts & Design. Sheikh Ataullah, *Revival of Zakat,* Lahore, Rippon Printing Press (1949); Mirza Hussain, *"Zakat – A Scheme of Social Insurance in Islam and Socialism,* Lahore (1947); Farishta G. de Zayas, *The Law and Philosophy of Zakat,* Damascus, Al-Jididah Press (1960).

2. E.g. M.M. Metwally, "Fiscal Policy in an Islamic Economy" in *Fiscal Policy and Resource Allocation in Islam,* Islamabad (1983), at 59-63.

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Thus by 1964, income taxation was well developed and covered all the main sources and types of incomes in the Sudan. It is true that the administration of these income taxes was not very effective. However, in the 20 years that followed, income taxation in the Sudan witnessed a continuous improvement in terms of both yield and equity. By 1984, income taxation had become highly developed in terms of legislation and administration as well, when judged against the standard achieved in several African states. But instead of developing income taxation and its administration further, President Nimeiri abolished income taxation and replaced it with *Zakat* under the *Zakat* and Taxation Act, 1984. This new Act repealed all direct taxes,[3] totalling seventeen in all, including income taxes and capital gains tax, as well as taxes collected by local governments in lieu of income taxes. Income taxation is the main component of all direct taxes, and it usually amounts to more than 90% of the total revenue of direct taxes collected by the Central Government. *Zakat* replaced all income taxes, while a tax equivalent to *Zakat* (2½%), known as the social equality tax, was imposed on non-Muslims. In the view of some people this implied that non-Muslims should pay *Zakat* but under a different name! President Nimeiri, in his drive to win the political support of the Muslim majority in the Sudan, introduced *Zakat* along with other Islamic legislation. According to the *Zakat* and Taxation Act, 1984, *Zakat* was levied on wages and salaries (a point which may raise controversy among Muslim Scholars)[4], gold and silver, agricultural produce, animal wealth and trading stock at the rate of 2½%.

After the popular uprising which led to the downfall of President Nimeiri in April 1985, the *Zakat* and Taxation Act, 1984 was repealed by the Income Tax Act, 1986. However, the Income Tax Act, 1986 allows the taxpayer (except in the case of PIT) to deduct *Zakat* paid as expenses from taxable income. Also in 1986 *Zakat* was reintroduced separately and as a compulsory levy by the *Zakat* Act, 1986.

ZAKAT AS A SUBSTITUTE FOR INCOME TAXATION

Obviously, one way to solve all the problems involved in the interaction between *Zakat* and income taxation is to completely replace income tax by *Zakat*. This approach was adopted by the Sudan in 1984 under the *Zakat* and Taxation Act which abolished all taxes, except import and export duties at the Central Government level and most of the taxes at the regional and local government level. However, *Zakat* has always been conceived of as a religious levy which is one of the corner-stones of Islam, whether by Muslim philosophers or governments. It has never been regarded at any time throughout the history of Islam as an Islamic tax which can be collected to finance government activities. The enactment of *Zakat* as a tax by law in the Sudan in 1984 may be the first time that this has occurred in the history of Islam.

Furthermore, the same *Zakat* of 2½%, under the name of the social equality tax, was levied on non-Muslims who make up about a quarter of the population of the Sudan. This approach to *Zakat* and taxation raised serious problems, especially in a country like the Sudan which is in particular need of national unity and peace.

Another problem which resulted from this replacement is the inadequacy of the *Zakat* yield. Though *Zakat* as a religious levy of 2½% is adequate for its purposes, which are clearly laid down in the Koran (i.e. to assist the poor and the needy in the community), it is not adequate as the sole source of revenue in place of income taxes. On the basis of the performance of *Zakat* over the first few months, it was estimated that its yield as legislated by the 1984 Act would not be more than 50 million Sudanese pounds. Therefore, *Zakat* could not bring in revenue amounting to more than a quarter or a fifth of that of income taxes. However, it may be argued that the low yield of *Zakat* could have resulted from the drought, and that *Zakat* as a new levy needed time for the administration to cope with it adequately. However, although this may be true, *Zakat* by its very nature cannot be expected to bring in a large revenue to the public treasury. Firstly, the rate is low. Secondly, it has an exemption level called in Arabic *Al-Nisab;* Muslims are to pay *Zakat* only if the zakatable base reaches *Al-Nisab*. Thirdly, it is not intended to be a revenue raiser for the Government, but to be spent on the poor and needy of the community. Furthermore, it can be very costly to administer as a large part of it is collected in kind – crops and animals.

In fact, the limited yield of *Zakat* is inherent in it. For example, in Saudi Arabia the yield of *Zakat* has made up only 0.01% of GDP in recent years. It has always been much less than 1% of GDP.[5]

As soon as the *Zakat* and Taxation Act, 1984 was applied in September of that year it became clear that the revenue was very limited. Also the Government could not use all of it for its various activities as only a small part of total Government expenditure was actually spent on the needy and the poor. In fact, the concept of *Zakat,* if understood properly, its revenue should be outside the Government Budget and kept in a special fund. In 1985, local committees[6] were formed in rural areas to oversee the collection and disbursement of *Zakat*. Local committees spend 62½% of the

3. Taxes collected by the Department of Taxation are classified as direct.
4. There is wide agreement among Muslim Scholars that *Zakat* is not payable on wages and salaries, but only on such part as is hoarded or saved for a whole year. The part of wages and salaries which is used to meet the basic needs of any family is not zakatable at all. For example, in Saudi Arabia, wages and salaries are not subject to *Zakat*.
5. Mohammed Ariff (ed.) *Monetary and Fiscal Economics of Islam,* International Centre for Research in Islamic Economics, Jeddah (1982), at 355.
6. *Zakat* is basically local in nature and its basic objective is to help the needy and the poor in the community. A *Zakat*-payer is supposed to start by helping his poor relatives and neighbours, which is why in Saudi Arabia 1% of *Zakat* is left to the *Zakat*-payer to pay to those who are near to him. However, in Kuwait, *Zakat* is given a national dimension and supported by Government assistance.

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collected *Zakat* and 37½% is sent to the central *Zakat* fund. In this respect, Pakistan has developed a detailed and comprehensive system of *Zakat* committees and funds,[7] which other countries can learn from.

When it became evident that income taxes had been abolished without *Zakat* actually replacing them, a new income tax was introduced in November 1984, as an amendment to the *Zakat* and Taxation Act, 1984. The old BPT was reintroduced with lower rates, ranging between 5 and 30%. BPT is the main income tax, yielding about 60% of the revenue from income taxation. By 1986 the inadequacy of tax revenue had become even clearer and so a new Income Tax Act 1986 was introduced with higher tax rates, especially at the highest marginal rates for insurance companies and banks. However, the new Act allows the taxpayer (with the exception of PIT) to deduct *Zakat* as an expense from taxable income.

DEDUCTION OF *ZAKAT*

According to the Income Tax Act, 1986, except in the case of personal income tax, *Zakat* can be deducted from taxable income as an expense. With a progressive income tax, *Zakat* will mean a greater tax reduction the higher the income of the taxpayer. Though *Zakat* is to be paid by all Muslims at an equal rate of 2½%, this provision means that the amount of tax reduction obviously varies with the level of income. Such treatment of *Zakat* raises the question of the equity of this deduction and whether *Zakat* should continue to be compulsory although it is a religious levy.

Moreover, according to the *Zakat* Regulations of 1986, *Zakat* on personal income (wages and salaries) should be deducted from personal income tax itself. Such deduction of *Zakat* from income tax in effect makes the Government pay *Zakat*. Under such a system, the total Zakat and personal income tax paid by a Muslim is equal to the amount of income tax paid by a Christian (at the same level of income), though a Muslim is supposed to pay *Zakat* personally. Again, such treatment of *Zakat* raises questions about the logic behind making it compulsory under the present conditions of Sudan. Also the deduction and collection of *Zakat* by employers through the system of P.A.Y.E. places an unnecessary burden on them, while the yield of *Zakat* on personal income cannot be significant because of its low rate and the exemption level *(Al-Nisab)*.

Furthermore, if we consider the most serious current economic problems of the Sudan, we find that the inadequacy of public revenue and the resulting, significant, dependence on deficit finance constitute a major factor in the inflation of the Sudanese economy, which is estimated to have a rate of not less than 30% per annum. Deficit financing in the Sudan is continuously growing at a catastrophic rate. For example, in the fiscal year 1982/83, deficit finance amounted to 144.1 million Sudanese pounds, making up 13.5% of current expenditure in that year, while in the fiscal year 1984/85 it was 792.9 million Sudanese pounds, or 35.3% of annual public expenditure.[8] Under such economic conditions, every effort should be made to increase revenue and any measures which adversely affect public revenue should be carefully re-examined.

Finally, it may be worthwhile to question whether, if *Zakat* on personal income is to be deducted, it is more appropriate to deduct it from the tax itself (though it is not a tax, but a religious levy) or to deduct it from the taxable income. In Pakistan, according to the Income Tax Ordinance, 1979, total income is reduced by the amount of *Zakat* paid to a *Zakat* Fund. Also according to the Wealth Tax Act, 1983, the amount of *Zakat* on wealth is deducted from taxable wealth.[9]

CONCLUSION

Though the Sudan has experienced *Zakat* for less than 3 years – from the introduction of *Zakat* as a compulsory levy in September 1984 to the present (July 1987) – a number of changes have been made both in *Zakat* and in income taxation. These changes reflect a serious misconception of *Zakat*, inadequate research and studies of Sudanese problems and potential, and the fact that there was no attempt to learn from the actual experience of other countries. The *Zakat* and Taxation Act, 1984 was hurriedly drawn up and passed.

It has been shown in this article that the Sudan in 1984 moved towards the integration of *Zakat* and income taxation, and when the weaknesses and problems inherent in the *Zakat* and Taxation Act, 1984 became clear, *Zakat* was separated from income taxation, but continued to be compulsory. However, even this new separation of *Zakat* and income taxation is in need of reform under the prevailing conditions of the Sudan. *Zakat* should neither be compulsory nor deductible. The deduction of *Zakat* from taxable income is partially shifting *Zakat* to the Government, while the deduction of *Zakat* from PIT is completely shifting *Zakat* to the Government. This shifting of *Zakat* to the Government has serious implications both for finance and equity.

An effective and separate administration should be established for *Zakat* as a religious levy among Muslims of the Sudan and to oversee its distribution as stipulated in the Koran, thus leaving the Department of Taxation free to develop the administration of direct taxes.

7. *The Zakat Manual,* Central Zakat Administration, Ministry of Finance, Islamabad (June, 1982).
8. *Bank of Sudan Annual Reports,* 1982 and 1985.
9. *The Zakat Manual,* Central Zakat Administration, Ministry of Finance, Islamabad (June 1982), at 32.

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REPUBLIC OF SOUTH AFRICA:

The Margo Report

By Dr. Erwin Spiro

The tax structure of South Africa is currently under review. A report was published in August 1987 detailing new proposals, and some of the major recommendations included in the report are covered by this article.

HISTORY

The Margo Report is the "Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa", completed, under the chairmanship of Judge C.S. Margo, on 20 November 1986. Government expenditure is outside the Commission's terms of reference (§ 1.12) and the Commission accordingly made no specific findings thereon (§ 1.13). The Report runs into 516 pages and was made accessible to the public on 20 August 1987. There was to be a meeting between the private sector and the Government on 22 October 1987. The Government may be expected to pronounce its intentions by February 1988. In addition to Chapters 2 and 29 most Chapters end with a Summary of Recommendations. Para. 2.276 provides for the creation of a small tax reform Committee to carry on the Commission's work of research and study. There are 300 Recommendations, providing also for a new tax, the so-called Comprehensive Business Tax (CBT), which will not all be dealt with in this brief outline. It is unlikely that the Recommendations will be accepted by the Government in their totality.

The Minister of Finance, Mr. Barend du Plessis, pointed out that there was no possibility of any measures being meaningfully implemented before the 1989/1990 Budget.

GENERAL

According to § 1.23 of the Report there is no magic, no touchstone, no cure-all by which all the problems and burdens of taxation can be made to disappear.

THE MAIN RECOMMENDATIONS

Introduction

It seemed prudent to the Commission to formulate 2 separate packages of proposals, the first on the assumption that detailed investigation of the CBT would confirm its suitability as a national tax and the second, considerably less ambitious, on the assumption that it would not (§ 29.5). This article will concentrate on the proposals based on the former assumption.

Income tax

Bands and marginal rates. The proposal is to slowly move back towards a simpler income tax structure with fewer, broader bands and lower marginal rates (§ 6,110(t)).

Husband and wife. Fulfilling a long-felt need, the joint taxation of husband and wife should be changed to the separate taxation of individuals (§ 29.12).

Fringe benefits and tax expenditures. The ideal would be for all remuneration to be paid in cash (§ 29.13), and tax expenditures should be eliminated as far as possible (§ 29.14).

Dividends, if paid to residents by resident companies are to be exempt from tax in the hands of shareholders, but a small extra tax should be made on company profits (§ 29.15). Under what the Commission calls "Neutrality", the inference is drawn that if both the company tax rate and the rate of tax on close corporations are, as far as possible, kept in line with the maximum marginal rate for individuals, the exemption of dividends from further taxation will go a long way towards achieving neutrality to business form (§ 29.16). Such neutrality will be carried a stage further by the taxation of business trusts as companies, and by the imposition of a branch profits tax on remittances to parents by local branches of foreign companies, provided in the latter case, that the rate is set equal to that of the non-resident shareholders' tax (§ 29.17).

Depreciation. Plant and machinery in all sectors of the economy, farm improvements and capital expenditure are, as a general rule, to be written off over a uniform period (at current rates of inflation, say 3 years), thus reducing the favoured tax treatment that certain sectors have enjoyed (§ 29.18).

PAYE. The effectiveness of the PAYE system would be greatly enhanced by the expansion of Inland Revenue inspection teams which should conduct more regular and intensive inspections of employers' records (§ 8.59(a)). See also § 8.59(h). Consideration should be given to introducing a standard income tax on employees (SITE), thereby virtually eliminating refunds and raising the threshold of the final deduction system (§ 8.59(f)(aa)(bb)).

Husband and wife. Despite the considerations that support taxing husband and wife as a unit, the Commission recommends that the individual replace the couple as the unit; its decision was reached after a thorough evaluation of previous South African investigations into the subject, of trends in other Western jurisdictions, and of local and international criticisms of joint taxation (§§ 7.128 and 7.159(a)).

General sales tax (GST)

There should be a return to a lower rate of sales tax and a move towards a more clearly defined base. That base should be retail sales, eliminating all elements of double taxation, and it should include food as there

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are more effective methods of helping the poor than subsidizing food which would also prove to benefit the wealthy (§ 29.8).

(National) comprehensive business tax (CBT)

To finance the gradual lowering of tax rates throughout the system, the radical reform of GST (to be converted into a retail sales tax) and the change from joint to separate taxation of husband and wife, resort must be had to a comprehensive business tax as described in Chapter 22. It should be introduced rapidly with a minimum of legislative change (§ 29.22).

Capital transfer tax

A capital transfer tax, at a flat rate of about 15%, should replace the present estate duty and donations tax; to prevent abuse, certain trusts should be taxed every 15 years as though a transfer of their assets had occurred (§ 29.26).

Regional taxation

The two bases for regional taxation – which as such the Commission supports – established by current legislation, but not yet in operation are turnover and payroll: the former is unfair, cannot be consistently applied, leads to cascading and, in the view of the Commission, provides an incentive to the integration of firms that is contrary to policy (§ 29.24 and 25). The latter may be represented as a tax on employment (which it is not) (§ 29.25). The subtractive form of the CBT base replaces "turnover" with sales less purchases; the additive form adds "profit, interest, royalties, rent and depreciation" to "payroll" (ibid.).

International aspects of taxation

In Chapter 26 the Commission deals with the international aspect of taxation or rather with what, in its view, falls thereunder. The following items may be mentioned:

Citizenship of taxation. None of the representations received by the Commission called for the adoption of the citizenship basis of taxation, and the Commission does not recommend that that basis be adopted (§ 26.11).

Source of proceeds of sale. The provisions deeming the source of the proceeds of a contract of sale of goods concluded in the Republic to be located in the Republic should be revoked (§ 26.57(c)).

Transfer pricing. Action should be taken immediately to counter transfer pricing abuse (§ 26.57(n)).

Tax avoidance

Abnormality. The test of abnormality in S. 103 of the Income Tax Act should be qualified so that commercial acceptance of an avoidance practice does not defeat the operation of that section (§ 27.51(a)).

Interest should be charged, with retroactive effect, on the amount of tax where a taxpayer has been successfully challenged in terms of S. 103, provided that the total liability for interest should not exceed the amount of tax involved (§ 27.51(b)).

Tax avoidance provisions in all fiscal legislation. Tax avoidance provisions should be inserted in all fiscal legislation (§ 2.51(c)).

Names of defaulting taxpayers to be published. The names of defaulting taxpayers should be published (§ 27.51(e)).

Unresolved problems

The Commission was well aware that a number of problems have been left untouched as well as that the recommendations may create new ones. In this regard it referred to interest income of individuals, business income and inflation, life insurance companies, farming and gold mining, not without pointing out that the list was "certainly" not exhaustive (§§ 29.38 and 29.39).

Guides to European Taxation – Vol. I

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Lee Fook Hong, MBA, FCIS, FAIA, ACIArb

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Adolfo Atchabahian:

Argentinien: Der Steuerreformprozess: 1983-1987 65

Der Verfasser gibt einen Überblick der Steueränderungen, die seit der Inauguration der Regierung Alfonsíns durchgeführt worden sind. Dieser Zeitraum kann, was die Steuerangelegenheiten anbelangt, in zwei Perioden aufgeteilt werden, d.h. Dezember 1983 bis einschliesslich Juni 1985 und Juli 1985 bis einschliesslich September 1987. Während der ersten Periode wurde eine neue Steuerpolitik konzipiert und dem Urteil des Parlaments unterworfen, nur wenige

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Antonio Mendes:

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William T. Cunningham:

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David O'Reilly:

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William T. Cunningham:

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K.A. Gofran:

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Tax Reform in Industrial Countries and the Impact of the U.S. Tax Reform Act of 1986*

By Vito Tanzi

Vito Tanzi, a naturalized American citizen, was born in Italy. He received his Ph.D. from Harvard University. Before joining the International Monetary Fund, where he is now Director of the Fiscal Affairs Department, he was Professor and Chairman, Department of Economics, at the American University. He has also been on the faculty of the George Washington University and a consultant for the World Bank, the United Nations, the Organization of American States, and the Stanford Research Institute. He has worked as a fiscal expert in a large number of countries. He has published 5 books, and written a large number of articles in leading journals. His major interests are public finance, monetary theory and macroeconomics. In recent years Mr. Tanzi has written several papers on the underground economy, the role of fiscal deficits, and the determination of interest rates. He has had a continuous interest in fiscal problems of developing countries.

I. INTRODUCTION

There is no question that the tax reform movement in the United States that started in 1981 and culminated in the U.S. Tax Reform Act of 1986 has sent shock waves to other countries. Because that movement represented in part the political expression of a powerful Government, and, perhaps equally important, because it appeared to be built on a foundation of discontent with various aspects of existing tax systems, it provided the officials of other countries with both a challenge and an opportunity to introduce changes in their own tax systems. One does not exaggerate in stating that very rarely has the world seen so much interest in tax reform as in the past couple of years; and very rarely has there been such a convergence of views on at least some of the aspects of the tax systems that needed to be modified.

Some foreign experts have referred to a "fascination effect" with the U.S. tax reform (OECD, 1987, pp. 35-36; see also Wingert, 1987; and Solal, 1987). Others have worried about a possible "brain drain" toward the United States if other countries did not respond to the American challenge by reducing the marginal tax rates on the incomes of highly skilled and presumably highly mobile professionals. Others still have worried that the lowering of the corporate income tax rates, as well as the lowering of the marginal tax rates on the returns to the savings of individuals, would increase the attractiveness of the American economy to foreign companies (especially for knowledge-intensive firms that would benefit from the lower tax rates), thus inducing a "capital drain" from other countries (see Nakatani, 1987).

The argument of a capital drain toward the United States was often made after the 1981 U.S. tax reform. The changes in U.S. tax rules introduced in 1981 and 1982 implied a considerable reduction in the net cost of capital compared with what that cost would have been under 1980 tax laws.[1] It was argued by some foreign officials that, by increasing the net of tax rate of return to real investment, the United States had created an artificial pull for foreign capital. However, while after 1981 this argument applied mainly to capital-intensive firms, that benefited from the sharp increase in depreciation allowances, now it applies to profitable firms that use little capital (i.e. knowledge-intensive firms).

I will anticipate some of the conclusions of this paper by stating that it would probably be an unproductive effort to attempt to identify the response of other countries to the U.S. Tax Reform Act of 1986. For one thing, very little time has passed since that Act was enacted into law. Secondly, the Tax Reform Act of 1986 represented the conclusion of a discussion that went on for several years. Treasury I[2] may have had as much influence on other countries as the final Act. More importantly, that Act as well as the tax reforms that have taken place or have been proposed in other countries have been political responses to accumulating evidence on the effects of tax systems on the economy. For example, the Hon. R.O. Douglas, Minister of Finance of New Zealand, in a *Statement on Taxation and Benefit Reform* presented to the House of Representatives of New Zealand on 20 August 1985 in which he announced ". . . the most far-reaching reform of taxes and benefits in New Zealand's recent history" declared that (p. 1):

> The tax system . . . has failed to keep up with changes in our society. It is unfair and is seen to be unfair. Ordinary wage and salary earners on moderate incomes are paying too much of their incomes in tax. High marginal tax rates create a drag on economic growth by penalising innovation, efficiency, hard work and saving, and by diverting people's attention towards tax avoidance.

* This is a revised and expanded version of a paper presented at the Spring Symposium of the National Tax Association-Tax Institute of America, Washington, D.C., 18 May 1987. The earlier version was published in the September 1987 issue of the *National Tax Journal*. The paper is based on information from many sources. In several cases, the sources were secondary ones so that the full reliability of the information could not be checked. The author hopes that the mistakes have been kept to an acceptable minimum and he definitely internalizes all the remaining mistakes. Assistance received from several colleagues in the International Monetary Fund is highly appreciated. The views expressed are those of the author and do not necessarily represent those of the Fund.

1. This increase was estimated differently by different observers, but it is likely to have raised, at least temporarily, the rate of return on new investments by several percentage points.
2. See U.S. Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth*, Three Volumes (November, 1984).

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SUMMARY

Over the past couple of years the world has seen an explosion of interest in tax reform. Many industrial and developing countries have either carried out important tax reforms or have proposed to do so in the near future. This paper focuses on industrial countries. It begins with a technical survey of major findings related to the effects of taxes on economic efficiency. It also discusses taxpayers' changing perceptions about the fairness of particular taxes. Another section of the paper attempts to identify elements common to the various reforms and discusses the extent to which these were influenced by the tax reform experience of the United States.

One feature found in many of these reforms is the lowering of the highest personal income tax rate. For a group of 12 industrial countries the average of these rates fell by 10 percentage points. In none of the countries, however, did this rate fall as much as in the United States since the beginning of the Reagan administration. Another major preoccupation of the current tax reform movement has been the reduction in the number of brackets for individual income taxes. For ten countries the average number of brackets fell from 11 to 4. This reduction is normally justified on grounds that it would make the tax systems simpler. Still another feature is the reduction in the normal corporate income tax rate. Broadening the tax base for the corporate income tax through the removal of incentives to investment often meant, however, that the tax revenue collected from corporations would increase in spite of the rate reduction. This aspect of the reform has been controversial.

The paper provides concise descriptions of the reforms in ten countries before drawing some general conclusions. One important conclusion for the role of the International Monetary Fund is that when large countries undertake major tax reforms, they should be aware of, and concerned about, the effects of their reform on other countries. Tax structure changes, even when they are revenue neutral, can have as powerful effects on other countries as changes in monetary and fiscal policy. Therefore, they need to be coordinated just as those other policies. The time may come one day when these reforms are jointly discussed and carried out in order to maximize their beneficial effect on the world at large.

Similar though less concise statements can be found in all of the documents describing the tax reforms of this period. Equity (both objective *and* subjective), efficiency, and simplicity are the catchwords of this tax reform movement. The Minister's statement was made a full year before the U.S. Tax Reform Act was passed by Congress.

One could argue that new technical findings, as to the negative effects of existing tax systems on the economies of the industrial countries, combined with increasing doubts about the fairness of these systems, were the real forces behind the tax reform movement. If this interpretation is correct, then the role of the U.S. tax reform process must not be seen as one that initiated the process but, rather, one that accelerated it by providing the needed political support and publicity.

This interpretation, however, is based on the assumption that technical work is not itself influenced by political developments. Another possibility is that, at least in part, technical work responds to political currents. To put it bluntly, one must not dismiss the possibility that, perhaps subconsciously, economists are more likely to reach technical conclusions that are in tune with evolving political trends than conclusions that are out of step with them. In recent years, a more conservative world-wide political environment may have in part generated technical results that made politically-attractive tax reforms appear to be in tune with recent technical findings. According to this interpretation, political developments may influence technical discoveries; in return, technical discoveries may themselves influence political choices.

II. SOME TECHNICAL BACKGROUND

Before discussing the recent reforms, it may be worthwhile to summarize very briefly some of the major findings that raised questions about the existing tax systems and that pointed the way toward reform. As industrial countries have relied to a large extent on income taxes, much of the recent research has inevitably focused on these taxes.

Over the years there has been a progressive disenchantment with the objective of vertical equity; on the other hand, horizontal equity, to which legislators had previously paid only lip service, has gained in importance. For decades equity had been almost synonymous with vertical equity, and vertical equity had meant highly progressive statutory tax rates. The empirical studies on the incidence of the tax system, which were so popular in the 1960s and early 1970s, concentrated on measuring the *average* tax burden by income classes. They did not worry about the dispersions around those averages. However, as the marginal tax rates became very high even at relatively low income levels, the differential burden between those who could escape paying those rates and those who could not became a major issue. In the United States, the marginal personal income tax rate for a 4-person family with twice the median income rose from 22% in 1965 to 43% in 1980 and was still 38% in 1986 (Council of Economic Advisers, 1987, p. 80).[3] McKee, Visser and Saunders (1986) have estimated that in 1983 the total marginal tax rate on labor use for an average production worker (calculated as a percent of total compensation, including payroll taxes) approached 60% in Europe. This rate was above 70% in Denmark, the Netherlands and Sweden and around 45% for non-European OECD countries. It was 42.6% for the Unit-

3. See also (Minarik, 1985, p. 37).

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ed States. Feldstein has estimated that the effective rate on investment income rose from 55% in the mid-1960s to 67% in the second half of the 1970s (see Feldstein, 1987, p. 390).

The high rates themselves prompted taxpayers to search for ways (legal, quasilegal, and illegal) to avoid paying taxes. The complexity of the laws, largely a reflection of the many objectives that tax legislators had tried to achieve through the tax system, facilitated the search for loopholes, for those who had the means to hire good lawyers and accountants, and contributed to the spreading feeling that the tax systems had become unfair and arbitrary. The fast growing literature on the underground economy and tax evasion is a testimony to the importance of the issue at this time. Some of the estimates of the size of tax evasion and of the underground economy are worrisome indeed (see Pyle, 1987, and Cowell, 1985, for tax evasion, and Tanzi, 1982, for the underground economy). This literature was almost nonexistent two decades ago.

Literature on this issue has propagandized the inequities of the tax system and may have helped to change taxpayers' attitude toward taxation. Annual surveys by the U.S. Advisory Commission on Intergovernmental Relations over the past 15 years provide some concrete evidence of this change in attitudes. For example, the percentage of the U.S. public that considered the U.S. federal income tax the "least fair" rose from 19% in 1972 to about 30% in 1973-78, and to about 37% in 1979-86 (see Table 1). We have thus come a long way from the time when this tax was generally seen as "the nation's fairest . . . source of revenue" (Pechman, 1971, p. 52; see also Goode, 1964, pp. 11-12). The view that lower tax rates levied on broader bases would lead to a fairer tax system has gained wide acceptance.[4] This idea is so well accepted today that we may tend to forget how radical it would have been considered 20 or even 10 years ago.[5] It is one of the ideas on which there is now a growing convergence of views among countries.

Although the issue of fairness may have been the prime mover behind several of the recent tax reforms, it was also assisted by progressively more convincing technical studies that called attention to the efficiency costs of existing systems. At a time when the growth rate had slowed down in many countries, leading to high and rising unemployment, and growth had become again the central objective of economic policy, the possibility that the tax system might be putting obstacles to the growth potential of these countries could no longer be ignored. The relationship between taxes and the labor supply, taxes and the rate of saving, and taxes and the allocation of capital has attracted the attention of economists and policymakers both within and outside the United States.

Take the relationship between taxes and labor supply: For a long time studies of this relationship had found very little evidence that the labor supply was affected in any significant way by income taxes. Writing in 1971, Pechman could conclude that "the evidence suggests that income taxation does not significantly

Table 1

Which Do You Think Is the Least Fair Tax?

	March 1972	May 1975	May 1979	May 1983	May 1986
Federal income tax	19	28	37	35	37
State income tax	13	11	8	11	8
State sales tax	13	23	15	13	17
Local property tax	45	29	27	26	28
Don't know	11	10	13	15	10

Source: Advisory Commission on Intergovernmental Relations, *Changing Public Attitudes on Governments and Taxes* (Washington, D.C.: annual).

reduce the amount of labor supplied by workers and managers" (Pechman, 1971, p. 66). A similar conclusion was reached in an OECD survey of this issue (OECD, 1975, Chapter 6, pp. 122-128). Thus, according to these so-called "first generation studies", there was no ground for concern that high marginal tax rates on labor income would reduce the supply of labor.

In more recent years, however, using new econometric tools, better and different data, and, perhaps, different motivations, economists have been obtaining, with increasing consistency, results that seem to indicate that high marginal tax rates discourage work participation by significant amounts (Killingsworth, 1983). Some of these results come from studies of the behavior of the working poor. These so-called "second generation studies" find that, although the whole labor force participation is reduced by high marginal tax rates, the effect on women, and particularly on married women, is striking. One recent study (Hansson and Stuart, 1985) calculated at 0.4% the median weighted average wage elasticity of the total labor force derived from recent studies. For female workers alone the elasticity would be much higher. Even in the United States, where the marginal tax rates on labor use are relatively low by comparison with European countries, it has been estimated that the U.S. labor supply has been reduced by as much as 5-12% (Burtless and Havemann, 1985). These new results are not beyond controversy, yet their impact on policy has been substantial.[6] As a recent OECD study has put it:

> Though it is difficult to draw clear-cut conclusions from the studies . . . on the effects of taxation on labour supply, there appears to be a widespread consensus among politicians and taxpayers that high rates of income taxes are adversely affecting work effort . . . This is probably one

4. The covers of the recently released reports on the Canadian tax proposals show arrows with the indications: "lower rates" (for the arrow pointing south), "fairer system" (for the lower arrows, pointing east and west).

5. In the United States this idea resulted in proposals aimed at making the income tax a proportional one imposed with one relatively low rate on the widest base possible. This rate ranged between 12% and 18% depending on whether a personal exemption would be allowed (see Hall and Rabushka, 1983). Various bills along these lines were submitted to Congress.

6. Against these results one must mention the fact that in the United States the percentage of adults in the labor force has been increasing over the past 2 decades and especially in periods when the marginal tax rate was rising fastest.

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> of the main reasons why many governments have recently implemented or announced reductions in the schedule of rates of taxes . . . (OECD, 1986, p. 59).

The extent to which taxes on capital income reduce the rate of saving is much more controversial than the effect of taxes on the supply of labor. Here both theoretical discussions and empirical studies have led to ambiguous conclusions. Some studies (Boskin, 1978; Gylfason, 1983; Summers, 1983) have concluded that the rate of saving is positively affected by the rate of return; others have not found any relationship (Howrey and Hymans, 1978; Friend and Hasbrouch, 1983) or they have even argued in support of a *negative* relationship (Tanzi and Sheshinski, 1984).

One aspect emphasized in the paper by Tanzi and Sheshinski is that since there is statistical evidence that in the United States a large share of all financial assets is owned by individuals over 65 years of age,[7] and since these individuals, in conformity with Modigliani's life-cycle theory of the consumption function, can be expected to have much higher marginal propensities to consume than the rest of the population, a policy change that increases the share of total income going to this group is likely to result in a fall in the saving rate. Therefore, an increase in the net-of-tax rate of interest is likely to result in a decrease in the saving rate. The behavior of the saving rate in the United States in the 1980s, when after-tax real interest rates were very high, is consistent with this expectation. Be that as it may, the prevalent view seems to be that high marginal tax rates on interest income reduce the rate of saving. Therefore, tax reform should reduce those marginal tax rates to stimulate individuals to save more. The recent reforms have reflected that view.

There has also been quite a lot of analysis and concern about the fact that various incentive schemes (such as accelerated depreciation, investment tax credits, and other similar incentives), especially when combined with significant rates of inflation, and the possibility of taking a deduction for nominal interest payments, lead to an allocation of investment that may be far from optimal and may imply significant efficiency costs (see King and Fullerton, 1984, and Fullerton and Henderson, 1986). The effective marginal tax rates on various types of assets and industries have been shown by several studies to be highly divergent.

Recent tax reform proposals have aimed at reducing the differences in these effective tax rates in order to achieve a tax system more neutral vis-à-vis the various categories of investment.[8] This objective has come to be referred to as "levelling of the playing field". For example, a study by Melvyn King presented estimates of the effective marginal tax rates for the United States and the United Kingdom before and after the reforms enacted in 1984 in the United Kingdom and proposed in Treasury I and II the United States. He concluded that the reforms would indeed dramatically reduce the variation in effective tax rates (King, 1985). A similar conclusion was reached in recent studies of the U.S. reform (see Steuerle, 1987, pp. 294-95). This "levelling of the playing field" would presumably make investment more productive.[9]

III. MAJOR ELEMENTS OF RECENT TAX REFORMS

It would not be possible in this paper to give full details of all the reforms now under way in industrial countries. Rather, in this section I will attempt to show the extent to which the various reforms could be assumed to reflect common principles. In Section IV, summary descriptions are provided for several recently enacted or proposed tax reforms. The essential elements of the 1986 U.S. reform are the following:

Individual income tax

The 1986 Tax Reform Act:

(a) sharply reduced the number of tax brackets from 15 to 2;
(b) reduced the highest marginal tax rate from 50% to 28% (or to 33% for some taxpayers);
(c) raised the lowest rate from 11 to 15%;
(d) increased the standard deduction and the personal exemption to reduce the number of taxpayers required to file;
(e) expanded the tax base by limiting or eliminating various deductions;
(f) retained indexing provisions for adjusting some nominal figures for the effect of inflation.

Corporate income tax

The 1986 Tax Reform Act:

(a) reduced the basic (or highest) rate from 46% to 34%;
(b) made the depreciation allowances much less generous;
(c) repealed the investment tax credit and imposed severe limitations on many other deductions and exclusions.

The Act introduced also many provisions aimed at increasing compliance by individuals and enterprises. The revenue impact of the Act was expected to be neutral. However, there would be a major shift of the tax burden from the individuals to the corporations.

In both the individual and the corporate income tax,

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7. Individuals over 65 years of age receive more than 50% of all interest income reported to the U.S. Internal Revenue System.
8. As the Honourable Michael H. Wilson, Minister of Finance of Canada, stated in his speech to the House of Commons on 18 June 1987:
> [The tax reform] will encourage investment decisions to be based far more on the imagination and creativity of research, engineering and marketing experts, and far less on the advice of tax specialists.
9. The empirical significance of this improvement in economic efficiency has been challenged by a few economists who have argued that the benefit to the economy from these efficiency gains will be swamped by the losses associated with the cut in investment due to the elimination of investment incentives (see, inter alia, Summer, 1987).
10. See House of Commons Paper 341: *Fourth Report from the Treasury and Civil Service Committee* – Session 1983-84. The 1984 Budget, Appendix

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the predominant objectives were a reduction of the statutory rates and a broadening of the taxable base. These objectives are found in many but not all of the recent reforms.

The countries where the most significant tax reforms have been recently enacted – say, in the past couple of years – or are in the process of being carried out are Australia, Canada, Japan, Denmark and New Zealand. Important changes have been introduced, or are being contemplated in several other countries including Belgium, France, Germany, Italy, the Netherlands, Norway, Sweden and a few others. It should be recalled that in 1984 the British corporate income tax underwent a major reform[10] and in 1979 the British marginal tax rates for the personal income tax were substantially reduced.

Table 2 provides information on the minimum and maximum personal income tax rates for 12 countries where have occurred or have recently been proposed. The information is first provided for 1985 and then for 1986 or later years if announcement of a change has already been made. If attention is first focused on the maximum rate, it will be noticed that the rate has fallen in all but one of the countries shown. The exception is the United Kingdom where the maximum rate remains at 60% after having been reduced in 1979 from 83% for earned income and 98% for investment income. On the average the maximum rate has fallen by about 10 percentage points – from 61% to 51%. However, the fall is much higher for some of the countries and particularly for the United States (22 points), Japan (20 points) and New Zealand (18 points). It remains above 50% in many of the countries shown. Of the G-7 countries 2 (United States and Canada) have reduced or are in the process of reducing the highest rate to less than 30% while the remaining 5 will have rates equal to or above 50% even after the proposed changes are carried out.

Since the beginning of the Reagan administration, the U.S. maximum personal income tax rate has fallen by 42 points, clearly a record. The new level of the U.S. rate is dramatically lower than that of the other countries and especially of Japan and the United Kingdom for which the differences in 1988 will be 22 and 32 points, respectively. Whether this difference will persist or will in time be eliminated and whether it will be eliminated by cuts in the other countries' rates or by increases in the U.S. rate, remains to be seen. While these differences persist, they will represent a challenge to those countries, and especially to the United Kingdom in view of its close cultural affinity with the United States. These differentials will surely provide an inducement to highly skilled and highly mobile professionals to migrate.

One could argue that the importance of the maximum rate should not be overplayed since the taxpayers who fall into that rate usually represent a small proportion of the total. Table 3 shows some readily available information with respect to this point. Unfortunately, the information is not as recent as one would like. Recent figures would undoubtedly show larger percentages. The percentage of taxpayers at the highest rate was very small except for Denmark in which it was 4.2% and had risen to 7% by 1985. However, a significant "brain drain" is not likely to require large numbers. It is sufficient that a few highly visible and productive professionals move to make a political and, perhaps, even an economic difference.

Table 2 does not show much of a trend with respect to the lowest rate. The average fell from 22% in 1985 to 21% in the later period. From a revenue point of view it is, of course, the lowest rate that is the important one. The impact on revenue of a percentage point change in the minimum rate is normally many times larger than that of a similar change in the maximum rate. The reason is obviously that there are relatively few taxpayers exposed to the highest rate. Therefore, in terms of revenue losses it is easier for governments to be generous with changes in the maximum rate. As long as income taxes remain a major source of revenue, and as long as the level of taxation of these countries needs to remain high, it is unlikely that the lowest rate can be reduced significantly unless the tax base is considerably widened or unless the rate structure is substantially modified. From an efficiency point of view, there may be a lot to be gained by paying for the reduction in the highest rates through an increase in the lowest rate as the United States has done since welfare costs are positively and increasingly related to the size of the marginal tax rates.

Table 2

Recent and proposed changes in lowest and highest personal income tax rates (national levels)

(Percentages)

Country	*Tax rates in 1985*	*Tax rates in 1986 or later*
Belgium	-72	-60 (Unspecified)
Australia	30 -60	24 -49 (From 1987)
Canada[a)]	6 -34	17 -29 (From 1988)
Denmark[b)]	50 -73	50 -68 (From 1987)
France	5 -65	5 -50 (From 1988)
Germany	22 -56	19 -53 (From 1990)
Ireland	35 -65	35 -58 (From 1986)
Italy	18 -65	11 -56 (From 1988)
Japan	10.5 -70	10 -50 (From 1988)
New Zealand	20 -66	15 -48 (From 1986)
United Kingdom[a)c)]	30 -60	27 -60 (From 1987)
United States	11 -50	15 -28 (From 1988)
Average	22[d)]-61	22[d)]-51

Source: Based on information obtained from country sources.
a) If provincial taxes are taken into account, the top marginal rate averaged about 53% before the changes proposed by the tax reform of 1987.
b) Includes tax to primary and county authorities and church tax.
c) Up to 1979 the top rate had been 83% for earned income and 98% on investment income.
d) Without Belgium.

10. For a critical review of that reform, see (Edwards, 1984).

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Table 3

Taxpayers at the highest rates and revenue from highest rates – selected countries[a]

Country	*Percentage of taxpayers at the highest rate*	*Percentage of tax yield from taxpayers*
Australia	0.8	7.7
Belgium	0.1	1.8
Canada	0.2	4.2
Denmark	4.2	24.5
France	0.8	7.9
Germany	0.0[b]	1.8
Italy	0.0[b]	0.0
Japan	0.0[b]	n.a.
Netherlands	0.2	7.0
Sweden	0.6	4.4
United Kingdom	0.2	4.8
United States	0.1	1.8

Source: Tables 3 and 5 of OECD, *Income Tax Schedules Distribution of Taxpayers and Revenues* (Paris, 1981).
a) The data refer to various years between 1975 and 1981.
b) Less than 0.05% but greater than 0.0.

Table 4

Changes in numbers of rates and brackets: implemented or proposed

Country	*Before change*	*After change*
Australia	5	4
Austria	11	5
Belgium	14	4
Canada	10	3
Italy	9	8
Japan	15	6
Netherlands	9	3-4
New Zealand	5	3
Sweden	16	3
United States	15	2
Average	11	4

Source: Based on information from various countries.

A major preoccupation of the current tax reform movement has been a reduction in the number of brackets (and of statutory rates) for the personal income tax. This was an important aspect of the U.S. Tax Reform Act that resulted in a reduction from 15 to only 2 taxable brackets. Other countries have followed the U.S. lead and have also reduced, or have proposed to reduce, the number of brackets in their income tax (see Table 4).

These reductions in the number of brackets are often justified on the grounds that they will simplify the income tax. They are, in other words, a consequence of the widespread demand for "simplicity". However, it is not clear why a reduction in the number of brackets should make the preparation of tax returns simpler when taxpayers generally rely on tax tables to make their calculations. Once these tables are available, it does not matter how many brackets there are.

There may be, however, a more important economic objective that is at times achieved through the reduction in the number of rates. It is an objective that has been emphasized in the recent Japanese reform as well as in in the reforms of some other countries. Specifically, the reduction in the number of brackets results in the widening of their size. If the first taxable bracket becomes very wide, and if its limits are adjusted for inflation, then the result might be that, for all practical purposes, a large number of taxpayers will be faced by what for them becomes de facto a proportional income tax with the obvious efficiency advantages that such a tax has compared with a highly progressive tax. The Japanese tax reform has gone so far as to make the size of the first taxable bracket wide enough to accommodate the income of many taxpayers over their entire career. Thus, the problems that arise because of the fact that the earnings of many individuals change with their age become much less serious. A reform proposed in the Netherlands by the Tax Reform Commission would also have a rate structure with a maximum of 4 brackets, the first of which would cover 88% of the taxpayers.

Table 5 provides some comparative information on the effect of the tax reform movement on the basic rate of the corporate income tax.[11] Starting around 1984 there has been substantial change in these rates. This movement, however, did not start in the United States but in the United Kingdom and in the Netherlands. In the United Kingdom the rate was reduced from 50% in 1984 to 35% in 1986. In the Netherlands, it fell from 48% in 1984 to 42% in 1986. For the 14 countries shown in Table 4, the average is scheduled to fall from 46% in 1985 to 41% in 1988-89. If an earlier year than 1985 had been considered, the reduction would appear even more significant. On present schedule, by 1988 Canada, Finland and the United States will have the lowest rates among the countries shown in the table.[12]

The reduction in the rate is not, however, general. There are some countries (Australia and New Zealand) where the rate actually increased over the period, and some countries (Denmark, Italy and Sweden) where it did not change. In Denmark, the rate had been increased from 40% to 50% in 1985. In the countries where the rate was reduced, the authorities generally took steps to widen the base in order not to lose revenue or even to gain additional revenue to pay for reductions in individual income taxes. Depreciation schedules were revised to make them less liberal and investment credits and similar other incentives were reduced or eliminated. This process may have been carried farthest in the United Kingdom and the United States. Similar changes are taking place in other countries.

11. Because the announcements on tax reforms available were not always very clear about timing, and because some of the changes applied to fiscal rather than calendar years, it was not always easy to allocate the expected changes to specific calendar years.
12. However, especially in Canada and Finland there are substantial local taxes on corporations.

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Table 5

Scheduled changes in corporation income tax rates in countries undergoing significant reforms

Country	*1985*	*1986*	*1987*	*1988*	*1989*
Australia	46.0	46.0	49.0[a)]	49.0	49.0
Canada	36.0	36.0	36.0	28.0	28.0
Denmark	50.0[b)]	50.0	50.0	50.0	50.0
Finland[a)]	43.0	33.0	33.0	33.0	33.0
France	50.0	45.0	44.0	42.0	42.0
Germany[d)]	56.0	56.0	56.0	50.0	50.0
Ireland	50.0	50.0	50.0	36.0	36.0
Italy	43.37	43.37	43.37	43.37	43.37
Japan	43.3	43.3	42.0[e)]	40.0[e)]	37.5[e)]
Luxembourg	40.0	40.0	38.0	36.0	36.0
Netherlands[f)]	43.0	42.0	42.0	42.0	42.0
Sweden	52.0	52.0	52.0	52.0	52.0
New Zealand	45.0	48.0	48.0	48.0	48.0
United Kingdom[g)]	45.0	35.0	35.0	35.0	35.0
United States	46.0	46.0	40.0	34.0	34.0
Average	46.0	44.0	44.0	41.0	41.0

Source: Based on information from the various countries.

a) From 1 July 1987.
b) Rate increased from 40 to 50% in March 1985.
c) Excludes local and church taxes which average about 17%.
d) A 36% rate applies to distributed profits.
e) Fiscal years. These are national rates only. Including local rate the decline will be from about 53% to just below 50%.
f) The rate was 48% in 1984.
g) The rate was 50% in 1984.

Let us turn now to a brief description of some of the ongoing or proposed reforms in other industrial countries. There is also a great deal of activity in many developing countries but a discussion of reforms in those countries will be left for another paper.

IV. BRIEF SYNOPSES OF TAX REFORMS ENACTED OR PROPOSED IN INDUSTRIAL COUNTRIES OTHER THAN THE U.S.A.

Australia

In October 1984 the Prime Minister called for a complete review of the tax system. The review was to be based on 9 principles and should lead to a fairer, simpler and more efficient tax system. The new system should (a) generate the same revenue, (b) reduce personal income tax rates, (c) reduce evasion and avoidance, and (d) have widespread community support. The Prime Minister's call resulted in June 1985 in a *Draft White Paper* which provided a working document for a July 1985 summit involving representatives from cross-sections of the Australian community. The Government's tax reform package was announced on 19 September 1985. Even though the reform had been intended to be revenue neutral, the final package involved some revenue loss. It also did not contain a major change in the sales tax which the *Draft White Paper* had contemplated, i.e. replacement of the wholesale sales tax by a broad-based retail sales tax levied at a uniform rate of 12.5%.

The major elements of the tax reform are the following:

1. Cuts in the marginal tax rates of the personal income tax; these cuts were particularly significant for taxpayers with higher incomes. The top rate was reduced from 60% to 49%. The two lower rates of 46% and 48% were both reduced to 40%. The 2 lowest rates were only reduced by one percentage point, i.e. 30% to 29% and 25% to 24%.

2. A comprehensive capital gains tax, which would apply to gains realized after 19 September 1985, was introduced. For assets held more than 12 months only inflation-adjusted gains are taxed. The taxable capital gain is included in the taxpayer's income in the year when the gain is realized but a 5-year averaging is allowed.

3. Deductions for entertainment were disallowed.

4. *A fringe benefits* tax was introduced from 1 July 1986. This tax is imposed *on employers* on the value of non-cash fringe benefits provided to employees. The tax rate is equal to the company rate which, in turn, is equal to the highest personal marginal tax rate (49%). The tax paid is not a deductible expense for companies.

5. A foreign tax credit system which took effect on 1 July 1987 and which allows a credit for taxes paid abroad on income taxable in Australia.

6. As of 1 July 1987 the "classical system" for taxing companies was replaced by a system of full imputation.[13] The new system credits to the resident individual shareholders the tax paid by the company so as to avoid the double taxation of dividends. If the shareholder's own income is subject to a lower rate than the top tax rate, he can apply the credit to other income.

7. The corporate income tax rate was increased from 46% to 49% on 1 July 1987 to bring it in line with the maximum rate on the income of individuals.

8. Most tax shelters were abolished.

Austria

The new Austrian Government has announced that it intends to introduce a major tax reform to take effect on 1 January 1989 and on 1 January 1991. With respect to the personal income tax, the reform would (a) reduce the rates by about 6%; (b) cut the number of tax brackets from 11 to 5; and (c) simplify the tax by abolishing many exemptions and deductions. The corporate income tax would also be reformed.

13. The "classical system" taxes corporate income when it is produced and then it taxes dividends when they are received by shareholders without any credit for the taxes paid by the corporations.

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Belgium

Early this year the Royal Commission for the standardization and simplification of the Belgian tax system made various proposals to the Minister of Finance. These proposals were discussed by the Government in October 1987 and to be submitted to Parliament sometime in 1988.* If approved, they would come into effect in 1990. The main elements of this reform would be: (a) a reduction in the number of tax rates from 14 to 4; the new rates would be 30, 40, 50 and 60%, respectively; (b) a reduction in the overall average rate on taxpayers from 66.7% to 50%; (c) an increase in the size of the personal exemption; (d) abolition of the aggregation of the income of spouses to reduce the burden on married women; (e) replacement of the progressive rates on corporate income by one rate; (f) introduction of a full imputation system; (g) restructuring the indirect taxes, i.e. higher taxes on alcohol, tobacco and fuel, elimination of other excises, and changes in the rates of the value added tax.

Canada

On 18 June 1987 the Honorable Michael Wilson, Minister of Finance, announced a major tax reform for Canada. The factors leading to the reform were similar to those mentioned in other countries. Quoting from the Minister's speech to the House of Commons, they include the fact that the tax system (a) "allows many profitable corporations to avoid paying a fair share of tax, year after year"; (b) "allows some people with very high incomes to pay less than the average Canadian wage-earner, year after year"; and (c) "allows those who are able to use special tax breaks to shift the burden to others less able to carry it". The Minister went on to state that:

> Canada needs a tax system that raises revenue in a fair reliable way; a system that supports our national effort to promote economic growth and create more and better jobs. Over the years, our tax system has become a crazy quilt of special incentives, special deductions and special write-offs. Each incentive gives a break to someone. But each special tax break means that taxes have to be higher for everyone else. Special breaks have made the income tax more and more complicated, and less and less fair.

Major changes have been proposed for the personal income tax, the corporate income tax, and the sales tax. As in other countries, the changes in the personal income tax include rate reduction and base broadening. As a consequence of the reform, individuals will pay less income taxes while corporations will pay more. The reduction in federal personal income taxes will be $ 2 billion in 1988, the first year of the reform, and more than $ 11 billion over the next 5 years. 80% of Canadian households would pay less personal income tax. The tax will replace the current 10 rates of federal income tax with 3 rates: 17% on the first $ 27,500 of taxable income, 26% on the next $ 27,500, and 29% on taxable income over $ 55,000. The highest federal rate is thus reduced from 34% to 29% falling in line with the highest federal rate in the United States where it is 28%. The reform restricts and removes many tax deductions and exemptions and converts the remaining one to tax credits. Capital gains taxes are increased.

The major declared objectives of the corporate income tax reform are the following: (a) to improve the overall competitive position of Canadian business and industry, particularly vis-à-vis the United States; (b) to return the profit motive to investment by rewarding success; and (c) to ensure that profitable corporations carry a bigger share of the total tax burden. Overall, corporations will pay more taxes in spite of a reduction in the corporate tax rates (from 36% to 28% for general business and from 30% to, eventually, 23% for manufacturing business). This result will be achieved through an expansion of the base due to reductions in capital cost allowances and in the investment tax credit rates, and through other provisions aimed at restricting deductions.

No final decision has yet been reached in relation to the sales tax reform. The Government is considering three alternative forms of the new sales tax, including a national sales tax which would combine the present federal sales tax and provincial sales tax, a goods and service tax, and a value added tax.

Denmark

Denmark has recently undergone a major tax reform. This reform was announced in early 1986 and became effective on 1 January 1987. It reflected an Agreement reached in June 1985 between the Government Parties, the Social Democratic Party and the Radical Liberal Party. According to a Government publication the purpose of the reform was (a) to counteract tax speculation, (b) to promote private savings, (c) to lower the marginal rate of taxation, (d) to improve the conditions of families with children, and (e) to provide a fairer distribution of the tax burden.

Denmark has the heaviest taxation of income in the world: the taxation of personal income has been generating an extraordinary 24% of GDP in recent years. In 1985, the marginal tax rate was 0% for 21% of the taxpayers, 73% for 7% of the taxpayers, and 50-60% for the remaining 72% (Foighel, 1986, p. 5). It is, thus, no surprise that ". . . individuals as well as companies [became] very conscious of the tax effects of their actions – and they have acted accordingly" (ibid., p. 6.). One major problem reported by Isi Foighel, the Minister of Taxation of Denmark, is associated with the deductibility of interest payments. Given a relatively high rate of inflation until recently, and the fact that owners of real estate could easily

* *Editor's Note:* In fact, the Government discussed the Commission's proposals in July during the negotiations over the 1988 Budget, and announced in August its own plan for tax reform. The Government's plan differed substantially from the proposals of the Royal Commission. The Commission thereafter resigned (September 1987). Whether the Government's plan will be submitted to Parliament is questionable because of the Government crisis in October. A general election was held on 13 December 1987 and negotiations on the forming of a new Government are continuing.

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mortgage their real estates, there was a substantial amount of borrowing and thus a substantial erosion of the tax base. This situation was aggravated by the fact that interest received, which could have increased the tax base, was received mostly by tax-exempt pension funds.

One interesting feature of the reform is the separation of income into two schedules: *personal income* (wages and salaries, pensions, incomes from independent business activities, etc.) and *capital income* (interest, dividends, imputed rent for owner-occupied houses, etc.). All income is first taxed with a basic rate of 50%. Deductible expenses have a value of 50%. In addition, *personal* income over 200,000 Dkr. is taxed with a surtax of 12%. Another surtax of 6% applies to the total of personal income and positive net income from capital which exceeds 260,000 Dkr. for married persons. The marginal tax rate on interest income (as well as the value of interest deductions) is thus limited to 50% or 56% as compared to the earlier maximum of 73%. This change has decreased the top marginal tax rate from 73% to 68%. In 1985, the rate of the corporate income tax had been increased from 40% to 50%. The net effect of these changes is essentially to remove progressivity from the taxation of capital income and to tax it at a flat rate of about 50%.

Still concerned by excessive consumption and, thus, as a measure to stimulate personal saving, in October 1986 the Danish Government announced a new tax measure aimed at reducing even more the attraction of borrowing by households. A 20% tax on net interest expenses of household was introduced. Loans raised for business and educational purposes as well as loans for the acquisition of owner-occupied dwellings granted by mortgage associations were exempt. The new measure reduces the value of an interest reduction to about 30%.

Germany

An agreement was reached in 1987 among the Government's coalition partners on the basic content of a reform that would go to parliament in the autumn and would become fully effective in 1990. The package would include the following changes:

1. The basic personal exemptions would be increased from 4,536 DM for single taxpayers and 9,072 DM for married couples to 5,666 DM and 11,232 DM, respectively. The general children's allowance would be raised from 2,484 DM to 3,024 DM.

2. The lowest marginal tax rate would be reduced from 22% to 19%. However, the size of the first bracket to which this rate applies would be considerably reduced (to less than half its present value).

3. The tax schedule will be flattened to make it linear. Unmarried individuals with taxable incomes between 20,000 DM and 120,000 DM would experience reduction in their marginal tax rates. These reductions would be particularly significant for taxable incomes between 40,000 DM and 80,000 DM.

4. The highest marginal tax rate would be reduced from 56% to 53%. However, the income level at which this rate applies would be reduced by 10,000 DM for single taxpayers (to 120,000 DM) and by 20,000 DM for married taxpayers (to 240,000 DM).

5. The corporate tax rate on undistributed profits would be reduced from 56% to 50%.

6. Depreciation allowances for medium-sized enterprises would be increased.

Questions have been raised as to whether these changes, although significant in terms of revenue reductions and possibly in terms of incentive effects, add up to what one could genuinely call a major reform. As a German public finance expert has recently written: "The measures which have been and shall be taken in the field of tax policy don't deserve the term "tax reform". They are in substance . . . not a reform in the sense that important taxes are fundamentally changed or that the tax system as a whole has undergone a substantial revision" (Schmidt, 1987, p.1). Professor Schmidt continues: "A broadening of the tax base has not yet been decided upon, and my guess is that only modest success can be expected here" (ibid.). He concludes that: ". . . a tax reform in the proper sense remains to be done" (ibid., p. 15).

Japan

In September 1985, Prime Minister Nakasone entrusted a Tax Commission with the task of conducting a thorough review of the Japanese tax system and to make proposals for a tax reform. In April 1986 the Commission published an *Interim Report* and in October 1986 it published the *Final Report on the Overall Review of the Tax System*. The Final Report recommended the largest change in the Japanese tax system in 37 years. The October report was widely discussed both within and outside the Government and in December it resulted in specific bills which were submitted to the Japanese Diet in February 1987. The following description is based on those bills. However, the reform met strong opposition on some of its aspects. The final result is still uncertain at this moment.

It was generally agreed that the tax system of Japan, established after World War II, was out of step with the present Japanese economy. The Government was hoping that the revised system would be consistent with expected economic changes through the 21st century.

The guiding principles for the reform were the following:

1. revenue neutrality;
2. a greater reliance on consumption and wealth as tax bases;
3. the spreading of the tax burden more evenly over economic activities;
4. the need to consider international implications of taxation; and
5. finally, the reform should be guided by principles of "equity, fairness, simplicity, choice and economic vitality".

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The major changes proposed are: (a) a substantial reduction in individual income taxes; (b) an almost as substantial a reduction in corporate income taxes; (c) the introduction of a value added tax; and (d) a major reform of the present system of saving incentives.

Individual income taxes

The reform would reduce the revenue from individual income taxes by about 0.8% of GNP. This would be achieved by a drastic reduction in the progressivity of these taxes. The number of the tax brackets would be reduced from 15 to 6 over a 2-year period. The rates for the national income tax would be reduced from the current range of 10.5% to 70% to a range of 10% to 50%. For the local income tax, the current 14 brackets, with rates ranging from 4.5% to 18%, would be reduced to 4, with rates ranging from 5% to 15%. For both taxes combined, the highest marginal tax rate would be cut from the current level of 88% to the still very high level of 65%.

One major objective of the reform of the individual income taxes was the reduction of their progressivity and their burden especially on middle-income workers. Another important goal was to subject a large share of employed individuals to a constant marginal tax rate *over most of their careers*. As a consequence, the bracket to which the "basic rate" of 15% would apply is very wide (from ¥ 1,200,000 to ¥ 5,000,000). The reform also proposes a new special exemption for spouses without income.

Corporate income tax

The reform would reduce the revenue from the corporate income tax by about 0.5% of GNP. In 1985, taxes on corporate income as a percentage of GDP were close to 6%. After Norway and Luxembourg this was the highest among industrial countries. The basic national tax rate on corporate income would be reduced to 37.5% from the current level of 43.3%. The transition period would be 3 years for this change. Taking into account the local taxes on corporations, the effective tax rate would be reduced from about 53% to about 50%. The current lower tax rate of 33.3% on dividends paid will disappear over a 3-year period. To compensate for some of the revenue losses associated with the lower corporate income tax rates the reform proposes reviewing the system of tax-free reserve for bonus payments and other special measures. Depreciation schedules are also expected to be brought in line with the economic life of assets.

Reform of the tax-exempt system

This system was introduced many years ago as an incentive to small savings but, as the country became richer, this incentive lost its main justification (see Tanzi, 1969, pp. 114-115). Furthermore, due to difficulties in its administration, the system was widely abused and created inequities among different income sources. Around 70% of the total personal savings are now in tax-exempt deposits. A consequence of this is that most interest income escapes taxation and the personal income tax has become largely a tax on labor income.

The reform proposes that (a) tax-free savings deposits be abolished except for special cases such as individuals over 65 years of age, fatherless families, handicapped, and a few others; and (b) that a final, schedular income tax be withheld at the source on interest incomes at the rate of 20% (15% for national tax and 5% for local tax). The Tax Commission also recommended that capital gains be fully taxed. However, the legislation that went to the Diet in January 1987 did not contain any major recommendation to that effect.

Sales tax

Indirect taxes, although still very important, have been losing ground in Japan over the years. The share of indirect taxes in the total has fallen from 45% in 1950 to 26% in 1986. There is no general sales tax so that the existing indirect taxes are levied on specific items and therefore are highly discriminatory. The Government proposed to introduce a broadly-based value added tax at the rate of 5%. The base would exclude sales of foods, supplies of educational services, medical services, and a few other items. Small enterprises (with annual sales less than ¥ 100 million) would also be exempted. The value added tax would replace several of the existing excises. This proposal has encountered strong political resistance and has been withdrawn for the time being.

The Netherlands

A commission for simplification of wage tax and income tax was instituted on 20 September 1985 by the Minister and State Secretary of Finance. The commission's final, unanimous report, entitled *A Step Towards Simplicity*, was submitted to the Minister of Finance on 28 May 1986. The report provided the main outline of a reform but left the translation of the Commission's proposals in terms of specific laws, regulations and procedures to the Government. The commission "assumed the viability of the income tax"; it also assumed that, given the revenue requirements of the Netherlands, high rates were unavoidable even if deductions could be substantially reduced. Its proposals aimed at a neutral revenue impact.

The main recommendations of the commission were:

(a) Replacement of the existing scale for the personal income tax, which consists of 9 brackets, with one that would have only 3 rates (40, 55 and 65) or alternatively 4 rates (40, 55, 65 and 70);
(b) The first rate at 40% *would integrate the contributions for the 5 general social insurances*. Thus, individuals would no longer pay separate social security taxes. This first rate would extend over 45,000 Dfl. which would mean that about 88% of all taxpayers would face just this rate. The higher rates would consist only of taxes and therefore not include contributions;
(c) The "exceptionally complicated and incomprehensible" system of standard exemptions and personal

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allowances would be abolished and replaced by a uniform standard deduction of 4,250 Dfl. for everyone; and

(d) Other special provisions related to family circumstances.

New Zealand

New Zealand's tax reform was announced on 20 August 1985 and came into effect on 1 October 1986. In the words of the Minister of Finance, its objectives were "to introduce a greater degree of equity into the tax . . . system; to minimize the distortionary impact of the tax system on resource allocation, by reducing anomalies and concessions, widening the tax base, and lowering marginal tax rates; and to make the tax system more certain and simple" (Hon. R.O. Douglas, 1985, p.3). A major concern about equity was that "At present people in similar economic positions often pay vastly different amounts of tax" and that ". . . the tax burden has increasingly been shouldered by the ordinary wage and salary earner" (ibid.).

The basic document on the reform refers to the fact that high marginal tax rates have encouraged taxpayers to avoid and evade paying taxes; have diverted the most talented professionals into activities aimed at designing schemes to minimize tax liability; have discouraged work effort; and have induced investors to make investment decisions based mainly on tax considerations. As the United Kingdom had done in 1979, and as Japan intended to do in 1987, New Zealand's reform would shift the burden away from direct taxes and into indirect taxes. The main changes are the following:

1. *Personal income tax*

The personal income tax scale that had 5 taxable brackets with rates ranging from 20% to 66% was changed to one with 3 brackets with rates of 15%, 30% and 48%.

2. *Business taxation*

The tax on companies was increased from 45% to 48% starting on 1 April 1986. As for Australia, the rate of the corporate income tax is thus brought into line with the maximum rate of the personal income tax. This change was made to remove tax considerations from decisions on ways of doing business. The tax on fringe benefits was also increased to 48% from 1 April 1986. The Government proposed to introduce a full imputation system in 1988/89 but no details were provided.

3. *Indirect tax reform*

The main reform here is introduction of the "goods and services tax" on 1 October 1986. This is essentially a value added tax levied at the single rate of 10% on a very wide base including imports. Exports would be zero-rated and would get a rebate for taxes paid on their inputs. The "goods and services tax" would replace most of the other indirect taxes except some specific ones such as those on tobacco products, alcoholic beverages, fuels and a few others.

4. Other measures include a proposed withholding tax on interest to be introduced in 1987 and some others to reduce tax avoidance.

Sweden

The Minister of Finance has recently published broad proposals for major tax reform but these proposals have not yet been submitted to Parliament.[14] These proposals would replace the four current personal income tax rates (which under current legislation would be 35, 50, 64 and 75%) by three lower rates: 33, 45 and 60%. The revenue loss would be compensated by a broadening of the bases of the personal and corporate income taxes and the net worth tax, and by higher indirect taxes. Tax rules would be simplified and a more uniform treatment of income from capital would be legislated. It should be mentioned that income taxes had already been reformed in 1983-1985 when marginal tax rates had been considerably reduced from the very high levels they had reached in the early 1980s when almost half of the population faced a marginal tax rate exceeding 50%.

Proposals for the reform of the corporate income tax have been made in recent months by the Federation of Swedish Industries. These proposals would sharply reduce the corporate tax rate from 52% to 25% while they would substantially broaden the base. The Government's reaction to these proposals has been reported to be favorable.

V. CONCLUDING REMARKS

In the previous pages I tried to survey as concisely as possible very recent tax reforms in a variety of contries. In conclusion I would like to address several questions. First, were the tax reforms in other countries a response to the U.S. Tax Reform Act or a response to common preoccupations? Second, was the response from the other countries uniform in the sense that one finds the same changes across countries? Third, and more specifically, will the U.S. Tax Reform Act of 1986 have a specific impact on other countries? Finally, has the time come when large countries ought to coordinate major tax reforms to minimize possible negative impacts on other countries?

The first of these questions was addressed at some length at the beginning of this paper. To repeat the basic argument made earlier, a change in the political environment, combined with different technical findings, pointed toward reforms for certain aspects of the tax system. These reforms were promoted by concerns with equity, efficiency and simplicity of the tax systems. The paper emphasized that the present equity

14. See *Tax Reform in Sweden: A Proposal* (April 1987). This is an English translation, with a foreword by Kjell-Olof Feldt, Minister of Finance.

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concept is somewhat different from that of earlier times. In the past *vertical* equity was the main preoccupation; currently it is *horizontal* equity. A major recent preoccupation is the differential burden of taxation on wage earners and on those who receive incomes from other sources. The concern with efficiency may have been promoted by the low growth rate of many of these countries and by the increase in the unemployment rate. This concern has been heightened by the results of various studies which appear to indicate that efficiency costs of high marginal tax rates may be significant. The objective of simplicity is perhaps not an independent one but is closely linked to the concern with equity. However, there has been concern with the size of resources allocated to the "tax industry".

Dealing with the second question, of whether the response of various countries was uniform, the answer could be non-committal since tax reform is always country specific. Nevertheless, there are many common trends. Among these one could perhaps mention the following:

(1) The increasing dissatisfaction with the high marginal tax rates of the personal income tax. Many countries have reduced or are in the process of reducing those rates. This reduction is often facilitated by the fact that the revenue loss associated with the rate reduction is much less at the high rate than at the low rate.

(2) Many countries have tried to restructure the tax base. One finds a wide agreement on the need to increase the standard deductions and/or the personal exemptions but this increase is accompanied in many but not all cases by the elimination of many other "tax expenditures". The increase in the personal exemption and standard deduction may be a response to the demand for simplicity and may also reflect a concern for relatively poor taxpayers; the elimination of the other tax expenditures may be a reaction to the quest for horizontal equity. It may also reflect a growing dissatisfaction with excessive governmental intervention in resource allocation.

(3) There is a fairly broad concern about problems created by the deductibility of interest payments.[15] In several countries, including Japan, Denmark, Norway, the United States and a few others, the deductibility of tax payments has been challenged and this challenge has resulted in some countries in what is de facto a schedular personal income tax system since interest incomes are taxed separately with a flat rate. A schedular system is more acceptable when tax rates are not very progressive. As a consequence, we may see in future years less general preoccupation with the concept of a global income tax than in the past.

(4) Many of these reforms have tried to reduce the taxpayers' arbitrage related to (a) present and future income, (b) different types of income, and (c) different forms of business organizations. Countries have become keenly aware that when tax rates are high and progressive, taxpayers will try to shift income from periods when they would be subject to high rates to periods when they would be subject to low rates. They will try to channel income toward activities that are taxed at lower rates and they will try to carry out their business through organizational forms which provide the greatest tax benefits. A lowering of the progressivity, combined with a schedular taxation of interest income and a top personal income that is close to the corporate income tax rate reduces these possibilities. In many countries the highest personal income tax rate and the basic corporate rate are now much closer than they used to be. This is a major change from the past when at times there was a difference of 30-40 percentage points between the 2 rates.

(5) There is a lot of concern about abuses connected with fringe benefits and 2 countries (Australia and New Zealand) have introduced specific taxes on those benefits. Other countries have introduced limitations to the fringe benefits that could be taken as deductible expenses.

(6) There is also a movement toward the elimination of the distinction between capital gains and other forms of income. Again the lowering of the marginal tax rates facilitates the integration of capital gains with other incomes. However, the problems created by gains connected with inflation have not been universally dealt with.

(7) For the corporate income tax, there is a trend toward lowering the basic rate and broadening the base. However, this trend is less universal than for the personal income tax. This trend is also more controversial among tax experts, especially in the United States. Governments seem to be losing their enthusiasm for the possibility of influencing investment decisions in ways that they consider beneficial to society. Thus, investment credits have been abolished in a variety of countries and depreciation allowances are being redefined to bring them closer in line with economic depreciation. At the same time the "classical system" of taxing corporations is being challenged and imputation has been introduced, or is in the process of being introduced, in a few countries.

(8) There is a movement toward a greater reliance on indirect taxes. This movement was perhaps started by the United Kingdom but it is spreading to other countries, including the United States, where some increases in excise taxes have already occurred.

(9) Finally, many of these reforms seem to be revenue-neutral in intentions if not in results. One important exception is Germany, where, perhaps, the major objective of the reform was revenue reduction to provide some fiscal stimulus to the economy. Governments do not seem to have accepted the theories of some economists that rate reductions would automatically generate more revenue in the future. Perhaps the experience of the United States after the 1981 reform provided a useful lesson to others.

As to the third question, it is difficult to speculate on

15. For studies dealing with this issue, see (Steuerle, 1985; and Tanzi, 1984).

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the *direct* impact of the 1986 U.S. Tax Reform Act on other countries. The Act will inevitably affect some important decisions, especially with respect to foreign investment flows. Some international corporations may decide that it is more convenient, for example, to have their legal residence in the United States than, say, in Japan. There has been a lively discussion in Japan whether the United States might become a kind of tax haven for Japanese corporations. The same considerations are relevant to the movement of some highly skilled and internationally mobile individuals. For example, with the internationalization of the capital market, bond traders may be as effective in New York as they would be in Tokyo. Thus, tax consideration may play a role for some of these people.

In this connection, one must raise the question of whether these potential movements respond to what are seen as permanent or temporary levels of tax rates. Given the current size of the U.S. fiscal deficit and the fairly general agreement among policymakers that it needs to be reduced, a logical question to ask is whether foreigners will see the current income tax rates in the United States as permanent or whether they will see them as temporary. Of course, the more they think that these rates are permanent, the more likely it will be that they will respond to the U.S. Tax Reform Act.

Finally, given the fact that we now live in a world that has become highly interdependent, it would seem desirable if countries became fully aware of (and more concerned about) the effects of their tax reforms on other countries. These external effects can be substantial, especially when the countries are large. The size of these effects increases as the countries become more interdependent. These effects may relate to movements of capital and other factors of production. It must be recognized that just as it is possible to have competitive devaluations, it is possible to have competitive tax reforms. So far there is no evidence to suggest that competitive tax reforms have been pursued. However, there is evidence to suggest that the external effects of tax reforms, whether positive or negative, were not taken into account. Tax reforms have responded mainly to domestic requirements and political concerns. The effects on other countries were given low weight.

Perhaps the time has come for policy coordination among major countries to extend to tax reforms. These reforms, even when they are revenue neutral, can be as powerful in their effects on other countries as changes in monetary or fiscal policy. Therefore, they need to be considered in policy coordination just as other policies now are. Some international organization could play a role in making countries aware of the impact on other countries of their tax reform actions (see also Tanzi, 1987). As the institution entrusted with the task of surveillance, and as the one with considerable expertise in public finance matters, the IMF would seem to be the logical institution to assume this role. The time may come when industrial countries could jointly discuss ways in which their tax systems could be reformed in a manner to maximize both domestic and world welfare.

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ARGENTINA:

Tax Reform Process: 1983-1987

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IV. CONCLUDING REMARKS

I. INTRODUCTION

The 4 years which have elapsed since the inauguration of Mr. Alfonsín's administration (on 10 December 1983) can be divided into 2 periods as far as fiscal events are concerned. This article overviews the changes in taxation during the periods December 1983 to June 1985 and July 1985 to September 1987.

The first period consumes almost 2 years during which time a fiscal policy was defined and several bills designed to implement the policy were presented to Congress. The policy objective, at that time, was to adjust certain aspects of the taxation system at the federal level without making profound changes in the system itself. In other words, even though some tax amendments wrought important changes and the expression "tax reform" was used to describe the entire package, in reality there was no tax reform, i.e. no new taxes were created in lieu of other taxes, no taxes were eliminated and existing taxes were not substantially amended. Rather, the government's main concern was to direct its attention to the effects of inflation in determining tax liabilities. The significance of the amendments to the tax system should not be underestimated, however. The number and scope of the amendments may, in the long run, actually deserve the label "tax reform" because it will take a long time to assimilate the impact of the amendments.

During the first period, very few of the proposed bills were approved by Congress; those which were passed had immediate effects on revenue. However, the Executive Branch of the central government took a far-reaching decision in June 1985[1] when it instituted a monetary reform in Argentina, changing the name of the Argentinean currency from peso to austral (one thousand of the former was converted to one unit of the latter). Other measures were also adopted to reduce the fiscal deficit and diminish the rate of inflation, which was very close to hyper-inflation.

The second period of the Alfonsín administration witnessed the enactment of the most important bills integrating the above-mentioned package. It culminated in the enactment of a tax amnesty (blanqueo) in March 1987. The amnesty was the sixth amnesty approved during the last 3 decades. By virtue of Law 23,495, tax evaders pay a small amount (in comparison with the actual unpaid tax liability) in substitution for the taxes evaded.

II. PART I

A. The President's Inaugural Speech

During his inauguration speech before the Congress on 10 December 1983, Mr. Raúl Alfonsín outlined a detailed set of policies to be followed during his 6-year administration.[2] A major part of the message dealing with economic policy was devoted to the need to control and reduce the galloping inflation which had prevailed, in one form or another, for the last 40 years.[3]

1. This measure was embodied in Decree 1,096 of 14 June 1985.
2. See "Diario de Sesiones, Diciembre 10 de 1983, Asamblea Legislativa", at 77-108. The President read only a brief part of the speech printed in the Congressional Records.
3. Since the middle 1970s the rate of Argentinean inflation has been among the highest in the world. Moreover, during the period 1977-1986, the monthly average increase in the level of prices was almost 11%.

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The President described the multifarious causes and pervasive unfair consequences of inflation on the economy, the society and the political situation in Argentina. He enumerated various measures to be taken to recover the country's economy; in particular, Mr. Alfonsín focused on the need to assist the agriculture, cattle-raising, mining, industry and fishing sectors. On the whole, the President manifested an attitude favouring private sector activities with respect to the economic policy. To that end, he pointed out that public enterprises would be transferred to the private sector.

As far as fiscal policy was concerned, the assumption underlying the Presidential speech was that the Argentinean tax system, at least at the level of the federal government, was highly regressive; to combat this characteristic, more equitable principles needed to be introduced into the system. Accordingly, the President committed his government to the pursuit of several priority objectives: improve the structure of public expenditures, rationalize such expenditures and strive to reduce them, return functions to the private sector which had been improperly undertaken by the government and substantially reduce the fiscal deficit from 13% of GNP in 1983 to a maximum of 5% by the end of 1984.[4]

The President recognized that the best approach to reduce the fiscal deficit was to reduce public expenditures. He felt that no further tax effort could be demanded from the taxpayers and that tax revenues could be increased by a better tax administration as opposed to an increased tax burden. Fulfilment of these goals, i.e. reduction of public expenditures and redistribution of the tax burden, would permit a broadening of the available margins for private sector activities.

Two sectors of the economy received special attention in the speech. The President proposed that taxes imposed on the rural sector (i.e. agriculture and cattle-raising) be simplified and that an effort be made to achieve progressivity as well as fairness with respect to these taxes. The land tax would be the primary tax imposed on the rural sector. Another area referred to in the Presidential speech was cooperatives, which have significance in some sectors of the Argentinean economy.

B. Tax bills submitted by the Executive Branch to Congress in December 1983

In accordance with the announcements made in his inaugural speech, in December 1983 the President submitted several bills dealing with tax matters to the Congress.[5] Although the administration expected that the tax package would be passed (either for equity reasons or for revenue reasons) during the extraordinary session, the Congress did not approve the bills.

These tax bills were not, strictly speaking, intended as a tax reform but rather as technical adjustments to existing laws.The predominant purpose of the proposed bills was to rapidly increase tax revenue; however, the underlying purpose was to reduce the regressive nature of the tax system as a whole by emphasizing reliance on direct taxation and thereby improving the redistributional effect of the tax structure.

The regressive nature of Argentinean taxation can be illustrated by the chart below. With respect to the most important taxes, the federal government's tax structure in 1983 can be grouped conceptually. The significance of each group in relation to the GNP of market prices is shown in percentages.

Income taxation		0.97
Net worth taxation		0.86
Taxes on goods and services		6.77
– value added tax	3.23	
– excise taxes	1.29	
– fuel tax	2.25	
Customs duties		2.25
– import duties	0.85	
– export duties	1.40	
Social security contributions		6.07
Taxes on economic circulation (stamp tax, foreign exchange transactions)		0.36
Other tax revenue		1.96
Total		19.24[6]

The tax package included separate bills to amend the following laws:

(a) income tax (this bill contained a proposal for an amendment to the tax on the transfer of securities);
(b) capital tax liability of business enterprises;
(c) net wealth tax on individuals and undivided estates;
(d) excise taxes.

Certain other bills were also proposed, i.e. a special tax on cattle revaluation, export promotion legislation and a reinstatement of earmarked taxes.[7] Most of these

4. As a percentage of the GNP, the actual fiscal deficit for 1984 was 12.8%; for 1985, 5.9%; for 1986, 3.6%. At the beginning of 1987, it was expected that the fiscal deficit would be 2.5%. However, estimates set the current deficit at approximately 7% to 8% of the GNP.

5. Art. 55 of the Argentinean Constitution provides that both the House of Representatives (the Cámara de Diputados) and the Senate hold their ordinary sessions from 1 May to 30 September. However, the same article also empowers the President to convene Congress for extraordinary sessions to be held outside of the ordinary period. During extraordinary sessions, the Congress can only debate bills specifically indicated by the Executive Branch.In December 1983, President Alfonsín exercised his powers under Art. 55 and convened Congress. He submitted the tax bills to the House of Representatives which has prerogative for the initiation of that type of bill (Art. 44 of the Constitution).

6. This total percentage increased to 22.9% for the fiscal year 1986 as estimated in the budget message for 1987. That increase was parallel to the drastic reduction in inflationary financing of public expenditures.

7. These bills are mentioned here as taxes which are usually applied at low rates with a limited base. They are usually intended to finance certain governmental agencies' budgets. Since the scope of these taxes is restricted and hardly affect tax planning aspects, they will not be further elaborated.

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bills had been abrogated in October 1980. The most important bills which were enacted during 1984 were the excise taxes, the special tax on cattle revaluation and the export promotion legislation. The bills listed in "a" through "c" were approved in October 1985, i.e. during the second period and will be further discussed in Part II of this article.

1. Excise taxes

The reform of the excise taxes approved by Law 23,047, in February 1984, did not include new products under the tax nor did it broaden the base for products already taxed. The amendments increased revenue by imposing a higher tax burden on consumers of certain luxury goods. The obvious purpose of the amendments was to reduce the regressive nature of excise taxes.

The amendments generally concerned rate increases for certain products, as follows:

- ethyl alcohol: from 30% to 32%;
- alcoholic beverages:
  - whisky: from 37% to 47%;
  - cognac, brandy, gin, vodka, rum, tequila: from 24% to 32%;
  - fine wines: from 10% to 12% (the tax on common or regular wine remained the same, i.e. 5%);
- toilet articles and cosmetics: from 22.5% to 24.5%;
- luxury goods: from 10% to 17%;
- cameras, articles for photography, televisions, firearms (except those firearms sold to the police or the armed forces): from 5% to 9.5%;
- automobiles, motorbikes (on a scale depending on the gas consumption of the vehicle): the former rates were almost doubled;
- imported automobiles: from 13% to 21.5%.

It is almost impossible to ascertain the impact of the increases on the consumption of related goods because of the inflationary conditions prevailing in Argentina where the monthly increase in the cost of living is much higher (i.e. in the 18 months between January 1984 and June 1985, inflation rose from 17% to 42% per month). In other words, the effects of the tax rate increases on prices were totally diluted by the rate of inflation.

2. Special tax on cattle revaluation

Law 23,079 of September 1984 introduced a special tax to be paid by breeders who, for income tax purposes, value their cattle (not subject to depreciation) under the estimated cost criterion or the fixed price criterion. The tax base resulted from the difference between that cost or the price previously taken into account, and its indexation, computed in accordance with the law. The law applies to cattle owned in the taxpayer's business at the beginning of the fiscal year in which Law 23,079 was published in the Official Bulletin (7 September 1984).

A certain amount was exempt from tax, but above this amount, the tax ranged from 2% to 8%. The tax was 40% lower with respect to cattle owned by businesses located in certain geographic areas of the country.

It must be noted that this tax was enacted during a difficult economic period for the cattle-raising sector. The condition of cattle raisers had been progressively deteriorating primarily because European Common Market competition drastically reduced the demand for Argentinean meat and related by-products, but also because of the unsatisfactory rates of exchange for meat exporters.

3. The Export Promotion Law

One of the most important aspects of the Alfonsín administration was to design a coherent export promotion policy in order to generate savings in foreign currency, pay the foreign debt and attempt to locate new markets for Argentinean goods and services. The export promotion bill contemplated a full range of measures designed to achieve these objectives. It was presented to the Congress in December 1983 and culminated in promulgation of Law 23,101 in October 1984. The law provides for the reimbursement and credit of value added tax and excise taxes which may have been paid on exported goods and services or on input used to supply goods and services.

Several decrees, approved in January and February 1985, implemented Law 23,101. Decree 173/85 grants a special deduction for income tax purposes which benefits exporters of certain goods listed in an annex to the Decree and is equivalent to 10% of the F.O.B. value of the export. Decree 174/85 authorizes the formation of trading companies. They will be identified as *consorcios de exportación o cooperativas de exportación*. Another measure adopted (Decree 177/85) provides for implementation of the drawback regime as contemplated by the Customs Code (Law 22,415, Arts. 820-824).

C. The fiscal situation at the end of 1984 and the first semester of 1985

As mentioned above, the bills concerning income tax, the capital tax liability of business enterprises and the net wealth tax were not approved during 1984. During this time, however, the financial situation of all levels of government deteriorated tremendously.[8] The public sector's financial picture worsened as high rates of inflation persisted while the fiscal deficit continued to feed the inflation. The increase in the cost of living in 1984 was 688%, whereas for the first semester of 1985 the figure for that index was 323%. This latter trend made the projected 222% in the cost of living (for 1985) impossible.[9]

8. For instance, in lieu of the initially projected 5% of the GNP as the fiscal deficit for 1984, the final result for the federal government alone was 12.8%. See footnote 4.

9. This was the figure taken into consideration when preparing the annual budget for the national administration. The budgetary period for the federal government is prepared in accordance with the calendar year.

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The revenue-sharing legislation (under which the federal government collects most of the important national taxes and part of the resulting revenue is distributed among the provinces, the municipality of Buenos Aires and the national territory of Tierra del Fuego) expired on 31 December 1984. The provinces were claiming larger portions of the total revenue involved in the revenue-sharing system and the central government's proposal to maintain the revenue-sharing system with minor changes to improve the percentage of the revenue received by the provinces proved unacceptable.[10]

At the time of this article, the revenue-sharing legislation in effect (since 1 January 1988) is Law 23,548. In practice, however, from 1985 to 1987 the provinces receive funds from the federal government approximately along the same lines as under the previous legislation. Due to the lack of sufficient financing, some provinces have increased their taxes more rapidly than the rate of inflation while others have issued bonds which are used as soft money in ordinary transactions. In accordance with the provisions of Law 23,548, the provinces as a whole will receive a percentage higher than the federal government of the total revenue from national taxes.

The Congress felt that the federal tax system was unable to provide sufficient funds to cover the financial needs of the parties interested in the revenue and that distribution of the tax burden was unfair. Consequently, both houses of Congress decided to create a joint committee to carry out a major revision of the federal tax structure: revamp the tax system to make it more efficient to achieve the objectives of financial sufficiency and equity among taxpayers and achieve an equitable tax burden both horizontally and vertically.

III. PART II

A. Tax bills announced by the Economics Department in April 1985

The Executive Branch of the federal government was sensitive to the situation described above, i.e. the increasing fiscal deficit, the justified claims from the provinces (sometimes they could not afford to provide basic public services because of lack of funds) and the need to scrutinize the existing national tax system more closely. A decision was taken to form a special committee (at the Treasury Department), composed of highly competent members with long-time expertise and technical background in taxation.[11] The Committee prepared several drafts of legislation which were submitted to the President for his consideration. The President made general policy suggestions on certain aspects of the drafts and they were subsequently redefined.

The subject matter of the new bills (some of which focused on revenue and some of which strived to correct inequities in the tax system) were as follows:

(1) tax on debits in checking accounts (Law 23,213);
(2) tax on the interest and adjustment of fixed term certificates: exemption if the term of maturity was equal to or more than 120 days (Law 23,243);
(3) tax on the transfer of securities (Law 23,257);
(4) federal stamp tax (Law 23,258);
(5) tax on capital gains (Law 23,259);
(6) income tax (Law 23,260);
(7) tax on enterprises' capital (Law 23,296);
(8) net wealth tax on individuals and undivided estates (Law 23,297);
(9) value added tax (Law 23,349);
(10) excise taxes (Law 23,350).

Three other laws were also enacted, which, even though they have no direct effect on the tax burden are significant mechanisms to assist tax audit activities and improve the tax administration at the federal government level. These laws were as follows:[12]

(1) elimination of banking and stock exchange secrecy with respect to the Tax Board, the national agency responsible for collecting internal taxes (Law 23,271);
(2) shares issued by private corporations must be registered shares and non-endorsable (Law 23,299);[13]
(3) procedures for applying, auditing and collecting national taxes (Law 23,314).

Finally, the tax package contained 2 other items (as yet unenacted):

(1) inheritance tax: the bill was approved by the Chamber of Deputies on 26 September 1985 but the Senate has not yet taken any action on the matter;
(2) emergency tax (for a period of 5 years) on rural land, excluding improvements; this proposal represents a new approach to the tax treatment of taxpayers involved in agriculture and cattle-raising activities. The bill was submitted by the Executive Branch to Congress in April 1986 but no decision has been taken by the Chamber of Deputies.

As the Economics Department stated in March 1985 when the tax package was announced, the measures "arise from the need to correct the tax structure's inequity". On the same occasion, high Treasury officials stated that this tax package tends to establish a system which permits a better distribution of the tax burden[14] as well as attempts to eliminate tax evasion.[15]

10. In actuality, the proposal was designed as an interim measure while a study was conducted to develop a new scheme.
11. The committee acted for several months under the chairmanship of the Undersecretary on Tax Policy and Administration.
12. The scope of these provisions is based on legislation already in effect.
13. Bearer shares no longer exist. Previously, only shares of corporations in the banking industry were required to be registered.
14. In illustrating the objective of the tax reform, officials mentioned that the goal should be an income tax collection equivalent to 2% of GNP. Compared with the percentage indicated in Part I, it would seem to duplicate tax collection.
15. These fundamental objectives have been linked with the goal of reducing the fiscal deficit and its inflationary consequences.

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1. Tax on debits in checking accounts

The only redeeming merit to this tax is that it easily produces significant amounts of revenue. The tax on debits in checking accounts had previously been in effect but was abandoned. The law was reinstated, at a rate of 0.1%, on 19 October 1983 (Law 22,947). In August 1985 (Law 23,213) the rate was doubled to 0.2%. The tax expired on 31 December 1986 but was again reinstated on 20 February 1987 and will be in effect until 31 December 1988 (Law 23,496).

However, Law 23,549 (Title II) enacted in January 1988 has adopted new provisions. These provisions will replace the previous legislation on this tax and will be in effect until 31 December 1992. The general rate of tax has been increased to 0.7% and there is a tax credit against the income tax liability (i.e. the credit is up to 70% of the payment as tax on debits in checking accounts).

2. Tax on the interest and adjustment of certificates (either in local or foreign currency)

This tax, imposed at the rate of 2%, entered into force in September 1983 (Law 22,916) and was valid until 31 December 1986. The law was reinstated on 20 February 1987 (Law 23,497) and now remains valid until 31 December 1988. The purpose of the exemption granted by Law 23,243 is to stimulate certificates having a maturity period of at least 120 days. Adjustments related to certificates for a shorter period of time are taxable. After expiration of the 120 days, the interest on the certificates is taxable.

3. Tax on the transfer of securities

The amendments to the law taxing the transfer of securities aimed to fill a gap in existing legislation. The purpose was to clarify the scope of the law, which had been interpreted as only being applicable to transfers of securities taking place within Argentina, i.e. when the actual physical transfer of the securities took place within the Argentine boundaries.

Law 23,257 effectuates the territorial principle[16] with respect to this tax. Upon transfer of securities, the tax will be due regardless of the place where the actual transfer takes place, regardless of where the contract is entered or regardless of where the securities are deposited. Taxation depends on the place where the goods or assets (i.e. the capital of the issuing entity) represented by those securities are located.[17]

The tax rate was increased from 0.5% to 0.75%. However, for transactions of securities effected through the stock exchange, the rate is 0.5% (Law 23,469 effective 5 December 1986). Certain transfers of capital contributions are excluded from this tax, i.e. those involving shares in limited liability companies, those in ordinary silent partnerships and those in silent corporate partnerships. This exclusion is consistent with the tax treatment accorded to these types of transfers under the income tax law and the tax on capital gains.

4. Federal stamp tax[18]

The stamp tax is imposed on contracts, promissory notes and other legal instruments. The taxable matter must be formally identified by the law because of the difficulties in interpreting the provisions of the law. The primary justification for maintaining this tax (which is anachronistic, cumbersome and irrational) is the importance of the revenue collected from this source.

One of the purposes of the amendments to the federal stamp tax is to include certain types of contracts which had previously been outside the scope of the stamp tax (for example, insurance contracts, contracts concerning obligations to do or to refrain from doing something and contracts for temporary mergers between enterprises). In addition, the new provisions increase several of the tax rates and clarify certain aspects of the law (i.e. the definition of "contract by mail" or lease contracts).

5. Tax on capital gains

The attempt to eliminate some loopholes inspired the approach taken in the amendments to the capital gains tax and the income tax. The reform reinforces the coordination between the 2 laws, and in that sense, contributes to a simplification of the taxation system in this area.

The income tax law includes as taxable matter periodic or recurrent income obtained from a permanent source which is actively used or enables the production of income. The concept underlying the law on capital gains is to include in its scope any kind of gain or income not taxed under other provisions of the law.[19]

The tax on capital gains is only levied on individuals and undivided estates. Gains or benefits derived from the sale of any real property owned by a corporation, partnership or sole proprietor of an enterprise does not fall under the law on capital gains but rather is considered ordinary income for purposes of the income tax law.

The criteria for calculating the cost of the property sold, and consequently the taxable base, are made compatible with the criteria provided for income tax and the net wealth tax on individuals and undivided estates.[20] The 15% tax rate remains the same as previously.

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16. This is the usual and prevailing principle in the Argentinean tax system.
17. The law now considers the following as located within Argentina: all government bonds (either federal, provincial or municipal) and securities issued by domestic corporations.
18. A separate chapter of Law 23,495, enacted in March 1987, deals with amendments to the federal stamp tax law. This new chapter primarily deals with a higher rate of tax on "monetary transactions" made by entities not included in Law 21,526 on financial institutions and a lower rate on the transfer of real property.
19. This attitude appears justifiable because some gains or income were not taxed at all.
20. This form of tax on capital gains simplifies the tax system because a certain income constituted ordinary income or capital gains.

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6. Income tax[21]

The main objective of the amendments to the income tax law[22] was to impose tax on dividends (other than stock dividends) in the hands of the shareholders to the extent that such dividends were previously excluded from taxation. Under the old law, resident individual shareholders were not obliged to include dividends in their taxable income. The new law abolishes this exemption and instead grants a tax credit in favour of resident shareholders.[23] If the shareholder is an individual, the amount of the tax credit depends on the average tax rate imposed on his total annual taxable income. If the average general tax rate is equal to or higher than 27.50%, the maximum tax credit is this percentage of the total dividends received during the year. If the general tax rate is lower than 27.50%, the credit is equal to the increase of the tax liability due to the inclusion of the dividends as taxable income up to the maximum limit of 27.50% of those dividends. As a result of this dividend-taxing provision, corporations (as well as commercial entities treated like corporations for tax purposes) tend to pay only stock dividends so as to avoid the higher tax burden on their shareholders or partners.

With respect to the income of domestic enterprises, the tax treatment which was in effect until 1976 was reinstated and amended by Law 21,286, i.e. only domestic corporations and silent corporate partnerships[24] are still subject to a 33% flat rate tax on their annual taxable income. Limited liability companies and ordinary silent partnerships are not recognized as independent taxpayers. They are treated like trading partnerships and capital and industry partnerships whose partners are subject to income tax on their proportional shares of the profits of the enterprise. This same treatment is given to general partners (i.e. those who have unlimited liability for the firm debts) in a silent corporate partnership.

The taxable income of enterprises has been broadened to include income which theoretically is capital gains, such as the benefits derived from the sale of real property owned by the enterprise. The adjustment for inflation (a measure approved in 1978 by Law 21,894) was amended to solve problems of implementation.[25] The carry-forward of losses provision was amended to allow only a 5-year carry-forward as opposed to the previous 10 years. Furthermore, in accordance with Law 23,549 (enacted in January 1988) this loss carry-forward allowance has been limited to 50% of the taxable income obtained in each fiscal period.

Non-residents receiving Argentine-source income are now subject to a higher tax burden because of a considerable increase in the fixed percentages to be applied to gross income in order to arrive at the net income (a non-rebuttable presumption). This net income represents the taxable base to which the 45% rate (imposed on non-residents) is applied.[26]

The provisions concerning minimum non-taxable income and personal and family allowances have been reformulated to measure more accurately the effects of inflation in determining the amounts of these deductions. The income tax exemptions for interest have also been amended by adjustments and limits, i.e. the exemptions are not applicable to interest derived from transactions related to adjustable capital or from deposits in a foreign country.

7. Tax on an enterprise's capital

The law concerning the tax on the capital of an enterprise contains changes in the valuation methods applicable to different kinds of assets. The objective is to value the assets on the closing date of the taxpayer's fiscal period taking into account the most up-dated value of the asset. In addition, the law eliminates the 50% reduction on the valuation of real property used for agricultural enterprises as well as the tax exemption for savings deposits. Cooperatives have been specifically excluded by the law. However, a later law (Law 23,427 effective December 1986) establishes a special levy on the capital of cooperatives which is structured along the lines of the general tax on the capital of an enterprise, i.e. the rate is 1.5% of such capital at the end of the fiscal period.

8. Net wealth tax on individuals and undivided estates[27]

Law 23,297 provides for:

(a) elimination of exemptions formerly granted on behalf of different kinds of banking deposits and stocks and shares in corporations, companies or partnerships as well as bonds and debentures;
(b) new criteria for the valuation of those stocks and shares; and
(c) a new method for taxing non-resident individuals and non-resident undivided estates.

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21. For a more complete study on Law 23,260, see Pedro Massone "The Argentine Income Tax Reform", 40 *Bulletin for Fiscal Documentation* 6 (1986) at 237.
22. These amendments confirm the government's intention to rely more on direct taxation.
23. Corporate shareholders are not subject to tax with respect to dividends received.
24. With respect to the silent corporate partnership, the law only applies to partners with limited commercial liability.
25. Implementation difficulties arose in application of the inflation adjustment because certain changes (which had taken place during the fiscal year) with respect to assets, liabilities and net wealth structures of the taxpayer had not been taken into account.
26. For example, the net income to be taken into account, as a taxable base, is 60% of the amount paid as fees for technical assistance, engineering or consulting services provided it is impossible to obtain these services in Argentina and provided that the services were duly registered and effectively rendered. Previously,the income tax law provided that the net income would be 40% of the gross amount paid for the services.
27. The revenue effect of the changes in the tax on an enterprise's capital and the tax on the net wealth on individuals and undivided estates has been almost immediate because taxpayers must compute the taxable base in broader terms than previously, and, in addition, they must apply more updated indexes for the valuation of goods. The double taxation effects discussed in the text also mean higher revenue. There is no information available with respect to the expected attempts to avoid an increase in the tax burden, in particular the tax burden resulting from double taxation (for instance, individuals with a large portfolio attempting to transfer the portfolio to third parties or establishing different entities to hold the portfolio in order to take advantage of the credit allowance, i.e. 1.5% of the portfolio, as often as necessary to avoid any net wealth tax due because of the portfolio).

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Abolition of the exemptions for stocks and shares results in a double taxation of these securities, i.e. once as part of the issuer's equity and again as part of the net wealth of the shareholder or partner. To diminish this cumulative effect, a limited tax credit is granted (to taxpayers residing in Argentina) up to 1.5% of the taxpayer's portfolio on stocks and shares.

The law also provides for (1) the exclusion from the tax base of shares owned in cooperatives; (2) a minimum valuation to be accepted in the case of real property included in the tax base; (3) new methods for valuation for several types of goods as part of the net wealth (i.e. special attention is paid to the valuation of jewelry, paintings, carpets and antiques); and (4) a new scale for the tax rates which are higher than the previous rates (the new scale includes a marginal rate up to 2%, in lieu of the former 1.5% rate.

9. Value added tax

The value added tax has been amended so many times that the entire text has now been changed. Although the most recent amendments did not change the substance of the law, the amendments are significant because they foster the objectives of simplifying the collection of taxes and combating tax evasion.

The simplification objective is achieved primarily by imposition of a new method of taxing small taxpayers, i.e. those enterprises having less than a certain amount of capital and no more than 7 persons (including the owner, partners and employees) working in the business. These taxpayers are divided into 3 categories: those who render services, those engaged in industrial activities and those engaged in commerce. The tax liability of each category depends on a classification made in accordance with the actual amount of capital and the number of persons involved in the enterprise.

The law indicates, in detail, the presumed monthly "output tax" for each category and classification (the highest amount is for commerce and the lowest for services). The law also states which percentages of "input tax" are deductible from the "output tax" .The "input tax", in connection with investments on fixed assets, is (as previously) deductible in 3 consecutive annual instalments.[28]

The rate structure has also been simplified by eliminating the previous differential rates (5% and 25% below and above the standard 18%). Currently, only one rate applies, i.e. 18%. An exception to the standard rate applies to goods and services used in housing construction; these goods and services are taxed at one-half the standard rate, i.e. at 9%.[29]

The number of services subject to the value added tax has been reduced to a minimum number of transactions. The tax on construction and similar work, with respect to real property owned by the taxpayer or third parties, is maintained as previously. The tax return for the value added tax must be filed on a monthly basis as opposed to an annual basis. A special chapter of the law is devoted to the tax treatment of exports and its provisions are coordinated with those contained in Law 23,101, i.e. the Export Promotion Law.

10. Law on Excise Taxes

As an example of the government's policy to increase the tax burden on those taxpayers with a greater ability to pay, the Law on Excise Taxes increases the tax rates on goods designated as luxury goods and reduces the rates for certain products (such as wine) of mass consumption among low income people.

Coordination of the excise tax rates and the value added tax rates is an important development. The approach adopted in the reform is to establish one value added tax rate (i.e. no differential rates, either above or below the standard rate). Consequently, discriminatory tax treatment is left to the excise taxes because the excise tax law contains a list of goods which were previously subject to the value added tax at the highest differential rate (25%). Toilet articles and cosmetics are taxed at a rate of 29% (previously 24.5%) and for other luxury goods, the rate is 20% (previously 17%) imposed on each stage of the commercial process.

A tax on soft drinks (whether or not carbonated), syrups and the like has been reformulated to include other kinds of beverages (non-alcoholic beverages, low alcohol beverages, certain juices, etc.). The tax rate on these products has been reduced from 27% to 24%.

A new addition to the excise tax law is the use of the Brussels Tariff Nomenclature to identify the goods which are taxed.[30] In particular, the Brussels Tariff Nomenclature is used in the chapter dealing with goods which are deemed goods for selective consumption. Two tax rates are contemplated by the law, i.e. 9.5% and 17% to be applied to goods listed. Law 23,549 has increased the tax rates on gasoline, gas oil and fuel oil.

11. Banking and stock exchange secrecy

Law 21,526 (enacted in 1977) provides for the regime to be applied to banks and financial institutions in general. Title V deals with the secrecy requirements which those entities must comply with in connection with their activities. Art. 39 of Law 21,526 provides that neither banks nor financial institutions may reveal information concerning transactions they enter into or information received from their customers.[31] Art. 39, however, contains exceptions to the secrecy require-

28. The government intended to authorize the immediate and total deduction of the "input tax" in the period in which the investment was purchased. Revenue considerations, however, precluded that idea from coming to fruition.
29. Certain products previously taxed at the 5% rate are among those exempted while others are subject to the standard rate.
30. The Brussels Tariff Nomenclature has been used since 1975 with respect to the value added tax.
31. Law 21,526 also stipulates that personnel of the financial institutions are obligated to maintain total confidentiality with respect to information received in the course of their employment.

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ment. Among the exceptions is one related to tax collection agencies (federal, provincial and municipal) which may request information from the financial institution.[32] If the following conditions are satisfied, the bank or financial institution may reveal the information:
(1) the request concerns a particular taxpayer;
(2) the tax administration is in the process of auditing the particular taxpayer; and
(3) the request is made formally.

Law 23,271 abolishes the above conditions with respect to the Tax Board. In other words, notwithstanding the provisions of Law 21,526, which allows confidential information to be disclosed under certain conditions, the new law prevents any restrictive interpretations under which Law 21,526 would prevail (and therefore preclude disclosure of information) over the conditions contained in Law 11,683 concerning the application, auditing and collection of national taxes. Law 23,271 neutralizes the restrictive interpretation which would result in the Tax Board not having access to banking information.

Law 17,811 (enacted in 1969) created the National Securities Commission (Comisión Nacional de Valores), which currently, in accordance with Law 22,169 (enacted in 1980) is the competent, exclusive body controlling public corporations, i.e. those corporations whose shares are quoted on the stock exchanges.

Art. 8 of Law 17,811 provides that the information gathered by the Commission as a consequence of its inspections and investigative activities is secret. In addition, judges must deny any requests for information in the hands of the Commission concerning those activities except in criminal cases.[33] This impediment to information is no longer in effect with respect to the Tax Board.

The Tax Board is now authorized to request information from both financial institutions and the National Securities Commission regardless of the scope of the information, i.e. the request may be in general or directed toward a particular taxpayer, it may concern one taxpayer or several taxpayers and the taxpayer may or may not be undergoing a tax audit.

12. Shares issued by private corporations

Although Title III of Law 20,643 (promulgated in February 1974) provided that shares issued by private corporations must be registered, implementation of the measure was suspended by Law 20,954 (Art. 29) in December 1974.

In October 1985, by virtue of Law 23,299, the pertinent provisions (Arts. 22, 23, 27 and 61) of Law 20,643 were amended to provide that all bearer shares had to be converted into registered shares before 1 May 1986. The government deemed this measure to be an indispensible element to a successful application of the income tax on dividends.[34] Consequently, all serial stocks issued by private corporations in Argentina are registered stock and non-endorsable. Transfer of the shares must be indicated on the face of the certificate, it must be registered and the issuer corporation must be notified of the transfer.

13. Procedures for applying, auditing and collecting national taxes

Most of the provisions of Law 23,314 are aimed at facilitating the Tax Board's activities in the course of its relationship with the taxpayer. The power of the Tax Board to issue deficiency notes based on an estimated imposable base has been reformulated in this law. Art. 25 of Law 11,683 (which is the basic statute on these procedures) provides for the methods and approaches to be used by the Tax Board in calculating the imposable base in accordance with certain presumptions. This article has been extended in its scope and it includes new and more precise circumstances to compute the tax liability.

Art. 28 of Law 11,683, concerning payments on account of the annual tax, has been broadened and redefined. More precise wording and detail is given to the provision concerning taxpayer obligations as to the procedures he must follow for his accounting books, documents, deeds, etc.[35] This documentation must be available to the Tax Board inspectors at any time for the purpose of Tax Board controls and audits. The Tax Board is granted some new powers, i.e. the authority to temporarily close (up to 5 days) stores, warehouses or plants whenever the Board deems this measure indispensible for a tax audit procedure.

The minimum and maximum fines provided for in Law 11,683 have been increased. Although Art. 44 of this law provided for arrest in certain cases, this penalty was never successfully applied. Law 23,314 eliminates arrest as a sanction. The new text of Art. 44 authorizes the Tax Board to close the taxpayer's establishment, in certain cases, for a period between 3 and 10 days. The taxpayer may appeal this decision to the judicial system. A provision which was in effect until 1978 concerning presumptions of tax fraud unless evidence to the contrary is proved, has been reinstated.

The legal nature of the amount calculated as indexation for a given tax liability has been the topic of much discussion in the last years, i.e. is this amount part of the principal amount of tax or is it an accessory? The law takes the position that indexation has the same nature as the tax to which it corresponds.

Law 23,495 amends Law 11,683. The most relevant amendments for tax auditing purposes is the provision whereby (beginning 1 January 1988) no personal or

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32. The scope of Art. 40 of Law 21,526 is similar to that of Art. 39 but it specifically relates to the Central Bank of the Argentine Republic.
33. In addition, the information requested must directly relate to the investigated facts.
34. Law 23,299, the provisions of which were implemented by Decree 83 on 15 January 1986, and the Tax Board have approved general rulings 2,596 and 2,601 dealing with this matter.
35. The law also contains a provision for taxpayers who utilize computerized systems to maintain their accounting records.

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real property (such as automobiles or immovable property) which is required to be registered with public agencies in Argentina may be transferred without first obtaining a certificate issued by the Tax Board. The Board must certify that the property to be transferred has been included in the annual income tax return of the transferor. General ruling 2,774, approved by the Tax Board in December 1987 deals with this matter.[36]

V. CONCLUDING REMARKS

In the opinion of this author, the changes adopted in the Argentine tax legislation do not amount to a "tax reform" because the measures do not affect the basic tax structure but rather only focus on the effects of inflation in determining tax liability. Nevertheless, the changes do contain a feature common to tax reforms in all developing countries, i.e. the existing system is unfair and causes an undesirable distribution of the tax burden so a tax reform is justified.

Admittedly, the Argentinean tax structure contains some built-in inequities; however, these deficiencies in the system are much less important than those which derive from lack of a sound tax administration.[37] It is also true that the untenable burden of the rate of inflation offers an additional excuse to evade taxes but this does not absolve the tax administration's poor performance in general and its laxity in detecting tax evaders.[38] The tax administration's recent activities have primarily focused on determining tax differences consisting of indexation and interest as a result of delayed tax payments. There is more political appeal and impact in talking about redesigning the tax structure than plunging into the intricacies of a reform of the tax administration. It is even easier to arrive at conclusions to amend the tax laws than to remove weaknesses and inefficiencies within the tax administration. On the whole, the tax reform in Argentina has failed to direct requisite attention to the need to strengthen the tax administration with respect to its operational abilities. The government's increase in revenue should be derived from this sector.

It must also be noted that another factor has played a role in diminishing voluntary taxpayer compliance, i.e. the expectation (during the last years) that a tax amnesty would be enacted, granting an instalment plan for payment of tax debts in arrears and pardoning fines and other types of sanctions which were being litigated. Tax amnesty measures have been enacted on an annual basis since 1981.[39] It is a mistake to believe that more severe sanctions (as contained in Law 23,314 enacted in May 1986) will discourage tax evasion. Experience, thus far, indicates that this is a permanent illusion in Argentina. Before seeking to impose severe penalties, an effort should be made to collect the taxes from all taxpayers who are required to pay.[40]

It is a well-known fact in Argentina that taxpayers have become more and more sophisticated and audacious in their manoeuvres to avoid an audit by the Tax Board. Accordingly, to prevent this type of activities, the Tax Board must exercise its auditing powers to the full extent allowed by law. In other words, the impelling need for increased revenue from national taxes is much more dependent on Tax Board performance than on the outcome of the changes in the tax laws. The Tax Board must utilize an effective information system as the main source of data on which to base a meaningful audit program. The anachronistic and sporadic audit procedures now in effect will preclude any real increase in the government's tax revenue.

Nevertheless, it must be admitted that, to some extent, the objective of increasing the relative share of revenue from income tax vis-à-vis the revenue from taxes on goods and services was achieved. At least in accordance with the most recent information the significance of income tax has increased in 1986 to 2.5% of the GNP (it was 0.97% of the GNP in 1983). It can be inferred that the increase in income tax revenue was basically due to the dramatic reduction in the inflation rate (from 385% in 1985 to 82% in 1987) but direct taxation in Argentina remains far from being the main source of public sector financing. Consequently, the predominance of regressive taxes has not yet been seriously penetrated and the preoccupation with equity issues and fair distribution of the tax burden appears in vain when the inflation rate increases and becomes difficult to control (which has happened since July 1987, i.e. the average monthly rate of inflation in the third quarter of 1987 was 11.83%).

The government's anxieties as to how to finance the fiscal deficit is another issue. Unlike previous administrations, the central government is now commmited to avoid inflationary financing. The government is determined to reduce and control the fiscal deficit, basically through taxation measures. To that end, in November 1987, new proposals were submitted to Congress by the Executive Branch. These proposals were designed to provide revenue as quickly as possible by taxing goods and services. In addition, the government intended (i) to broaden the tax base for the tax on the net wealth of individuals and undivided estates as well

[continued on page 77]

36. It should be noted that, in accordance with Argentinean income tax legislation, individual taxpayers must declare, in their tax return, a complete list of their assets and liabilities which are located either in Argentina or abroad. A comparison of this list with the taxpayer's net wealth allows a certain degree of control.
37. As a crude example of the Tax Board's functional weakness,it is sufficient to mention the unsatisfactory use the Board makes of automatic data processing equipment as a tool for tax audits, along with its use of tax statistics and taxpayer registers. In all fairness, however, this situation has improved in the last year or so.
38. Tax evasion refers not only to those taxpayers who evade 40%, 50% or even more of their tax liabilities but also to those who have never registered as taxpayers although obligated to do so.
39. Law 22,490 of 9 January 1981; Law 22,681 of 24 November 1982; Law 23,029 of 12 September 1983; Decree 2,364 of 8 March 1984. The most recent and acute example of a tax amnesty was Law 23,495 in March 1987. See text above.
40. The National Constitution (Art. 16) states that the equality principle applies as to taxes.

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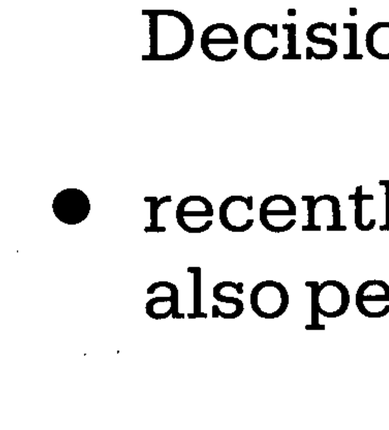

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BRAZIL:

The Debt-Equity Conversion Programme

By Antonio Mendes

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The long-awaited Brazilian rules on debt-equity conversion have now been issued. The proposal developed by the Central Bank of Brazil was approved by the National Monetary Council on 17 November 1987, and on the same day the Central Bank issued its Resolution No. 1416, setting forth the applicable rules.

A. KEY POINTS OF THE RULES

1. A distinction is made between credits of foreign financial institutions as follows:
(a) those consisting of deposits at the Central Bank, in respect of payments of principal and interest on medium and long-term (more than 360 days) external obligations, whether or not already covered by the external renegotiation process (hereinafter referred to as "Debt Renegotiation Funds");
(b) those consisting of credits not yet matured, whose debtors are entities of the public sector, i.e. the Union, states, municipalities and legal entities controlled by the Union, states and municipalities (hereinafter referred to as "Unmatured Public Sector Debt");
(c) those consisting of credits not yet matured, whose debtors are entities of the private sector (hereinafter referred to as "Unmatured Private Sector Debt"); and
(d) those consisting of voluntary deposits made by Brazilian debtors with the Central Bank for hedging purposes under Resolution No. 432/77 and Circular No. 230/74 (hereinafter referred to as "432/230 Deposits").

2. All funds converted must remain in Brazil for a minimum period of 12 years from the date of conversion.

3. The Central Bank may impose restrictions on remittances of profits generated by funds so converted during a period of 4 years from the date of conversion.

4. Conversions which cause, either directly or indirectly, the transfer of control of companies to foreign investors shall not be allowed.

5. The assignment of credits abroad for the purpose of conversion is permitted.

6. In order to obtain approval of each conversion[1], the original creditor of the amounts being converted must formally agree with the contractual provisions required to be included in the external debt restructuring agreements for the purpose of permitting the issuance of securities by Brazil and the implementation of the debt-equity conversion programme.

7. Finally, once securities are, in fact, issued by Brazil, it will also be a condition for the approval of each conversion[2] of Debt Renegotiation Funds and 432/230 Deposits that the original creditor of the amounts being converted have acquired such securities.

8. The debt-equity conversion of amounts of loan principal granted to Brazilian borrowers or of Central Bank deposits does not result in any tax consequences to either party, as no taxes or fees are due. The conversion of interest amounts due to foreign creditors, however, is subject to payment of the same withholding tax which would otherwise be due if the interest was paid in cash to the foreign creditor because the interest will be deemed to have been paid to the foreign creditor immediately prior to its conversion into equity.

B. CONVERSION OF DEBT RENEGOTIATION FUNDS

The conversion of Debt Renegotiation Funds for investments in the private sector shall be made pursuant to an auction system still to be devised by the Central Bank. The auction system will be subject to a periodically-established ceiling. Two ceilings will be utilized, i.e. one for investments in any project selected by the interested party and one (of equal amount) for investments in projects located in the SUDENE, SUDAM, Espírito Santo and Vale do Jequitinhonha areas.

Debt Renegotiation Funds which are converted under the auction system may be invested in the stock market in Brazil through the so-called "Fundos de Conversão – Capital Estrangeiro" (Conversion Funds-Foreign Capital), subject to the following rules:
(1) The Conversion Funds-Foreign Capital may not acquire shares in excess of 5% of the voting capital and 20% of the total capital of any given company.
(2) They will be subject to the tax and foreign capital registration rules determined by Law 4131/62, as amended. This means that the Conversion Funds-Foreign Capital will not enjoy the tax advantages recently given to similar funds which may be created with new money investments in Brazil.[3]

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1. Approval is granted by the Central Bank of Brazil.
2. Id.
3. Both types of funds, namely Conversion Funds-Foreign Capital and new money investment funds, enjoy tax exemption from withholding income tax or corporate tax as to the investment made by them in Brazil. This means that no tax is paid by either fund on income earned or on capital

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(3) They will be subject to the operational rules applicable to similar new money funds.
(4) Quotas or units of Conversion Funds-Foreign Capital must be in registered form and will be non-transferable for a period of 5 years.

Once the securities programme has been launched, the Central Bank may impose a limit on credits that can be converted. The limit may be imposed on a "per creditor basis", taking into consideration the amount of securities acquired by the creditor.

Debt Renegotiation Funds which are converted pursuant to the auction system for investment in private sector projects must be applied to new investments or to the expansion of existing investments. Therefore, they cannot be utilized for acquisition of equity participations in already-existing projects other than through Conversion Funds-Foreign Capital.

In the case of conversion of Debt Renegotiation Funds, the investor must obtain foreign capital registration of its investment in the amount proposed in the auction. For example: assume the conversion of a credit of US$ 1,000,000 acquired abroad from the original creditor for US$ 500,000, and which wins the auction with a bid of US$ 800,000. The following applies:
(a) the investor will, of course, spend US$ 500,000 abroad for payment to the original creditor;
(b) the investor will receive from the Central Bank local currency corresponding to US$ 800,000; and
(c) the foreign capital registration will be made in the amount of US$ 800,000.

C. PUBLIC SECTOR INVESTMENTS

Investments in the public sector, which would include privatization of companies presently controlled by the Government are subject to special rules:
1. The utilization of Debt Renegotiation Funds for investments in the public sector is not subject to the auction system.
2. Unmatured Public Sector Debt can only be utilized for investments in the public sector.
3. Funds earned with investments pursuant to "1" and "2" must be utilized to amortize loans previously granted by the Government to companies controlled by the Government.
4. Even though it is unlikely that investors will choose to avail themselves of this option, Unmatured Private Sector Debt and 432/230 Deposits may be utilized for investments in the public sector.
5. Any such investment will be subject to other applicable laws and regulations, and will require the prior approval of SEST ("Secretaria Especial de Controle das Empresas Estatais", i.e. the Special Secretariat for the Control of Government Companies) and of STN ("Secretaria do Tesouro Nacional", i.e. the Secretariat of the National Treasury).

The registration of conversion funds applied to investments in the public sector as foreign capital must be made at face value less the discount established by the Central Bank, taking into consideration the results of the auction system. Assuming that the Central Bank has determined that the appropriate discount is 15% (based on results of the auction system), the following applies:
(a) Debt Renegotiation Funds will be converted with a discount of 15%. If the investment is US$ 1,000,000, the investor will receive from the Central Bank local currency in the amount of US$ 850,000, and the registration of foreign capital will also be made in the amount of US$ 850,000.
(b) Other funds will be converted in local currency at whatever rate the investor may have agreed upon with the interested party. Again, if the investment is US$ 1,000,000, the investor will receive local currency as negotiated with the other party, which may be equivalent, in local currency, to more or less than US$ 850,000. However, the registration of foreign capital with the Central Bank will be US$ 850,000.

D. UNMATURED PRIVATE SECTOR DEBT

Utilization of Unmatured Private Sector Debt will be at the investor's discretion and the terms of the transaction will be negotiated among the parties involved. Registration of foreign investment will be granted by the Central Bank at the discount established for these transactions, having regard to the results of the auction system. For example, for an investment of US$ 1,000,000, which has been acquired abroad for US$ 500,000, where the Brazilian debtor has agreed to pre-pay with a 10% discount, and where the Central Bank discount for foreign capital registration purposes is 15%, the following applies:
(a) the investor will spend US$ 500,000 abroad to obtain the credit;
(b) the investor will receive in Brazil local currency equivalent to US$ 900,000; and
(c) the Central Bank will register the investment at US$ 850,000.

E. 432/230 DEPOSITS

The use of 432/230 Deposits will be subject to a ceiling to be established from time to time by the Central Bank. The investor may exercise his discretion as to the use of the corresponding funds. Applications will

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gains realized on their investment in Brazilian securities. There is a difference in taxation, however, with respect to the remittance of profits and capital gains to the foreign investor. New money investment funds may distribute profits upon the payment of a 15% withholding tax and capital gains made by the foreign investors on the redemption of their investments can be remitted tax-free. Distribution of profits by Conversion Funds-Foreign Capital is subject to withholding tax at the rate of 25% on profits up to 12% of the foreign investment, averaged over a 3-year basis. Any excess is subject to supplementary income tax at the following rates: 40% for excesses between 12% and 15% of the foreign investment, 50% for excesses between 15% and 25% of the foreign investment and 60% for excesses over 25% of the foreign investment. Remittance of capital gains on the redemption of investment in Conversion Funds-Foreign Capital is subject to withholding tax at the rate of 25%.

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be reviewed in the order they are filed. Registration of the investment will be made at the discount established by the Central Bank, having regard to the results of the auction system. The example given in the preceding paragraph also applies to the conversion of 432/230 Deposits.

F. RULES FOR THE FUNDS

Funds resulting from approved conversions may be deposited, in foreign currency, with the Central Bank, pending utilization of the funds for the purpose for which the conversion was approved. Such deposits must be made pursuant to rules still to be established by the Central Bank.

Funds resulting from debt conversions must always be applied to risk investments. In addition, they cannot be utilized for investments in projects which enjoy the guarantee of minimum profitability or of repurchase of the investment, whenever such guarantee is to be funded, directly or indirectly, by Government resources.

Whenever a party interested in the debt conversion has effected a repatriation of foreign investment or a remittance abroad of capital gain during the preceding 36 months, approval of the debt conversion will be conditioned on reinvestment in Brazil of the funds (in foreign currency) so remitted abroad.

Investors taking advantage of the debt conversion programme must deposit with the Central Bank[4] the amount so converted before they will be allowed to remit abroad any previous foreign currency investment made in the project in question.

The Central Bank may prohibit or impose limits for debt conversions for investments in given sectors of the economy for economic reasons or whenever such sectors already have sufficient installed capacity.

Resolution No. 1416/87 confirms that proposals for debt conversion submitted to the Central Bank up to 20 July 1987 will be processed pursuant to the rules contained in Carta-Circular No. 1125/84.

G. CONCLUSION

The debt-equity conversion programme is highly controversial in Brazil because a substantial number of Congressmen and Senators of the PMBD ("Partido do Movimento Democrático Brasileiro" – Party of the Brazilian Democratic Movement) oppose it. On the day the National Monetary Council approved the conversion programme, a number of these politicians made public announcements to the effect that the programme was contrary to national interests and indicated that the conversion programme should be prohibited by the Constitution which is currently being drafted.[5]

The vehement controversy, however, highlights the difficulties encountered by the Central Bank in drafting the proposal now approved by the National Monetary Council. The proposal is liberal in many respects but it can certainly be criticized in many others. Resolution No. 1416/87, despite its shortcomings, does provide a working basis where none previously existed. The supplementary rules to be issued by the Central Bank will indicate the direction the programme will take.

4. The conditions for deposit are still to be established.
5. The general expectation is that many of the extreme positions adopted by certain politicians with respect to the drafting of the new Constitution will not prevail, including the one on debt-equity conversion.

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as reshape the brackets for the net wealth tax (the objective is to increase the current 0.25% of the GNP as revenue from that source to 0.45% in 1988); (ii) impose a 3-year emergency tax on luxurious real estate; (iii) increase the rate for the tax on debits in checking accounts from 0.2% to 0.7%; and (iv) to limit the carry-over of losses within the income tax. The first 2 proposals were repealed by Congress. The other 2 were approved by Law 23,549 (see above).

Finally, another proposal to amend the income tax concerns the imposition of income tax (in certain cases) based on a presumption instead of being based on the taxpayer's real income. Such a proposal destroys the rationality and fairness upon which the income tax was founded. The proposal seems to be influenced by the inability of the tax administration to conduct a proper tax audit. Fortunately, this proposal was recently abandoned.

As has so frequently occurred in the arena of public financing, the search for a rational tax system has been sacrificed for the urgent need for public funds. The amendments to the tax legislation were made in a rather coherent fashion and paved the road for a rational tax system. The new provisions, however, will have the effect of undermining the possibility of achieving the above goals.

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Portuguese Tax Reform

By William T. Cunningham

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INTRODUCTION

Income taxes have existed in Portugal since 1641. The 10% tax or "décima" on income from properties, capital, trades or employments laid the foundations of the tax system which, with a 19th century reorganization into schedules, has survived with minor modifications in the system which Portugal has today.

There have been prior attempts at tax reform. The laws of 1845 and 1880 attempted to extend the tax to all types of income. The 1922 tax reform sought to extend further the concept of taxing actual, as opposed to imputed income, but ran into compliance and enforcement problems which were addressed by the introduction of the complementary tax prior to the next major reform in 1929. Tax reforms in 1962 and 1965 preserved the basic two-tier concept of taxation of income according to its source under the various schedules and according to its recipient by means of a complementary tax applied to total income.

CURRENT TAX REFORM

In July 1984 the Government set up a Commission on Tax Reform to study the possibility of a re-structuring of the income tax system and to recommend appropriate measures for achieving this re-structuring. No mention was made of indirect or gift and inheritance taxes. With remarkable speed, the Commission completed its work and presented its report in April 1987. This report incorporated the draft of an overall enabling law, which, with minor modifications, was presented to Parliament at the end of October 1987. Drafting of the new codes in anticipation of its approval by Parliament, in which the ruling Social Democrat Party has a comfortable majority, is already at an advanced stage, and the reformed system is expected to be in operation from 1 January 1989.

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The remainder of this article summarizes the basic outline of the new Portuguese tax system.

STRUCTURE OF THE NEW TAX SYSTEM

Three mutually exclusive taxes may apply to income as computed under the new rules:

The tax on individuals	–	"Imposto sobre o Rendimento das Pessoas Singulares" (IRS)
The corporate tax	–	"Imposto sobre o Rendimento das Pessoas Colectivas" (IRC)
The local government tax	–	"Contribuição Autárquica"

The tax on individuals (IRS)

For purposes of this tax, income is to be computed under 8 different headings, according to its source. These headings or categories are:

Category	*Scope*
A	Income from employment
B	Income from self-employment activities
C	Commercial or industrial profits
D	Income from farming
E	Investment income
F	Rental income
G	Capital gains
H	Pensions
I	Other income

The concept of income has been enlarged to include the income of civil servants and similar employees, capital gains and gambling winnings which previously enjoyed either complete or limited exemptions from taxation.

The taxable unit is the family (agregado familiar), with both spouses jointly liable for the tax of the family unit. Individuals resident in Portugal are liable to tax on their world-wide income. Non-resident individuals are liable only in respect of income derived from Portuguese sources. The draft legislation does not define residence, but this is expected to follow the 180-day rule currently in force, perhaps modified to the more widely-accepted 183-day rule found in tax treaties. The existing alternative test of residence, i.e. having an habitual place of abode available for occupation on 31 December of any year in which the individual visits Portugal, is expected to be abolished, to the relief of owners of holiday homes in Portugal.

New rules are to establish the deductions available against income in each of the above categories, taking into account the costs of generating the income, either on an actual or percentage basis.

Factors such as the age and marital status of the taxpayers and the age and number of his dependents are to be taken into account. Conditions and limits in respect of health, education and other expenses are also to be established. Provision is to be made for special treatment of windfall gains, allocation of income to years other than that in which it was received and for the carry-forward within income categories of losses or excess deductions.

Rate of tax

The law requires the new tax to be progressive. It does not establish the rates or tax tables to be applied. However, the Report of the Commission recommended that the maximum rate should not exceed 50%. It is understood that preliminary proposals envisage a maximum rate of 45%, although the draft law presented to Parliament contains no upper percentage limit.

Calculation of tax

A system of "income-splitting" is expected to be applied under which the income of a married couple is divided by 2 for purposes of applying the tax tables and the resulting tax liability is doubled. This results in a liability which does not vary where the income of one spouse differs from that of the other spouse and which treats a single-income family in the same way as a dual-income family.

Special rates may be established for some types of income arising under categories "E", "G" and "I", having regard to the nature of the income or to the impossibility of tracing it to an individual recipient.

The corporate tax

Corporate tax will apply to the world-wide income of companies having their headquarters or place of effective management and control in Portugal. Other companies will be liable in respect of income derived from Portuguese sources. Income of these companies attributable to the permanent establishment in Portugal of a foreign-controlled entity is liable to tax. Income not so attributable is also liable unless it has already been subjected to the tax on individuals. Co-operatives also fall within the scope of the new tax. Roll-over relief is to be introduced for the reinvestment of sale or insurance proceeds on the disposal of or damage to fixed assets.

The tax year is to remain the calendar year, except for entities managed and controlled outside Portugal and having income from Portuguese sources not liable to the tax on individuals, i.e. permanent establishments of foreign-controlled companies. These companies may opt for a tax reporting year corresponding to that of the head office entity. This flexibility may be extended to that of the head office entity. This flexibility may be extended to other taxpayers where economic realities justify such an extension.

In determining taxable profits, costs incurred wholly and exclusively in generating the profits and in maintaining the productive capacity are to be deductible. For long-term business activities exceeding one year, profits and costs may be allocated to accounting periods, taking into account the production cycle or the period of construction.

Rate of tax

The original report suggested a maximum rate of 38%. This maximum was removed in the version presented to Parliament. It is understood that yield projections are now being made with a view to establishing a rate which will yield neither more nor less revenue for the State than the old system would have provided. In view of the extension of the tax base and the present and proposed elimination of several tax incentives, it is expected that the rates will be a little below the present range of 41% (a combination of industrial tax, extraordinary tax and municipal surcharge) and 48% (these taxes increased by complementary tax on undistributed profits of Portuguese-resident companies).

The local government tax

This tax will be introduced simultaneously with the tax on individuals and the corporate tax. It will apply to the value of properties at a rate of 1% for rural and 1.2% for urban properties. The enabling legislation provides flexibility in relation to special rates for residential, professional, commercial or industrial property located in urban areas. The tax is deductible in computing income for purposes of the tax on individuals or the corporate tax. The Government will be obliged to review the valuation procedures to establish a more rigorous basis for application of this tax while keeping the costs of administration and collection under control.

Incentives

In response to a widely-held belief that the tax legislation contains too many incentives, the Government

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proposed the abolition of 53 incentives in its Budget for 1988. The Commission on Tax Reform has established the guidelines for continuation of this trend towards simplification. Only in cases of indisputable public interest will exemptions, rate reductions or other tax incentives be granted under the new corporate and personal tax systems. Entitlement will be on the basis of meeting generally defined criteria. This marks a departure from the present practice of granting specific exemptions by means of a Ministerial Order or Decree Law on a company-by-company basis.

The duration of any tax incentive may not exceed 5 years. Incentives already granted are to be left in place, subject to possible limitation to the 5-year maximum duration. Incentives already granted by specific contract with the State are to remain in force, with the necessary adaptations arising from abolition of the taxes on which they were based and their replacement by the IRC and IRS. Where exemption from either of these taxes is granted, the related legislation must state whether the exemption is total or is merely "exemption with progression", under which the exempted income may be taken into account in determining the rate of tax to be applied to other income of the same taxpayer. For control purposes, exempt income must be reported even if no tax is payable.

Entry into force

Parliament is currently analyzing the draft legislation in committee. It is expected that the full National Assembly will vote on the legislation in January 1988. Some changes may be expected in the course of its passage through Parliament, but the essential structure of the proposals is expected to remain unchanged. Within 240 days of the law being passed by Parliament, the Government must promulgate the detailed tax legislation implementing the tax reform proposals. It is expected that this and the necessary training and reorganization of the tax authorities' personnel (Direcção-Geral das Contribuições e Impostos – DGCI) will occur during 1988, and that the new tax system will, as mentioned above, be operative from 1 January 1989.

Conference Diary

FEBRUARY 1988

International Corporate Finance Conference 1988. London, 1-2 February (English):
Business Research International Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

2nd International Conference on Double Tax Relief for Corporate Activity and Ownership. Amsterdam, 4-5 February (English):
European Study Conferences Limited, Douglas House, Queen's Square, Corby, Northants NN17 1PL, United Kingdom.

Compensation planning '88. Lake Buena Vista, Florida, 7-10 February (English):
Tax Management Educational Institute, Suite 400, Att.: Ms. Patty Korenoski, Conference Registrar, 1231 25th Street, N.W., Washington, D.C. 20037, U.S.A.

Best Practice in Investment Management. London, 9 February (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA, United Kingdom.

De Nederlandse vestiging in Groot-Brittannië. Den Haag, 9 February (Dutch):
FENEDEX, Raamweg 14, 2596 HL Den Haag, Netherlands.

International partnerships. London, 10 February (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

Latin America – towards renewed growth. London, 11-12 February (English):
International Herald Tribune, Jenni Bielenberg, Conference Office, 63 Long Acre, London WC2E 9JH, United Kingdom.

European VAT Legislation. London, 12 February (English):
Centre for Commercial Law Studies, 339 Mile End Road, London E1 4NS, United Kingdom.

The Impact of U.S. Tax Reform on International Investment and Financing. Lausanne, 18-19 February (English):
International Bar Association, 2 Harewood Place, Hanover Square, London W1R 9HB, United Kingdom.

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.

European VAT Case Law. London, 26 February (English):
Centre for Commercial Law Studies, 339 Mile End Road, London E1 4NS, United Kingdom.

MARCH 1988

How to set up and operate Holding and Finance Companies in Switzerland, Liechtenstein, Luxembourg, Anglo-Saxon jurisdictions, Netherlands and Netherlands Antilles. Vienna, 7-8 March (English):
Seminar Services SA, Blvd de Pérolles 7a, CH-1700 Fribourg, Switzerland.

Unit Trusts and the Financial Services Act. London, 8 March (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA, United Kingdom.

Münchner 1988 Steuerfachtagung. München, 23 March (German):
Münchner Steuerfachtagung e.V., c/o Lehrstuhl Prof. Dr. Klaus Vogel, Ludwigstrasse 28 Rückgeb. 8000 München 22, Federal Republic of Germany.

Current Developments in German Taxation. London, 24 March (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

The 1988 European Bank Accounting Conference – Financial Controls for Europe's Changing Markets. London, 24-25 March (English):
Jan Holman, Lafferty Conferences Ltd., Axe & Bottle Court, 70 Newcomen St., London SE1 1YT, United Kingdom.

APRIL 1988

8th National Convention; Consolidation or Change. Sydney, 12-15 April (English):
Executive Director, The Taxation Institute of Australia, 7th Floor, 64 Castlereagh Street, Sydney, N.S.W.2000, Australia.

Recent Tax Cases. London, 19 April (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

International Taxation Management Techniques – Transfer Pricing, Currency Management, Mergers and Acquisitions. Strasbourg, 21-22 April (English):
To the Customer Service Department, Management Centre Europe, Postbus 95 – 3417 ZH Montfoort, The Netherlands.

MAY 1988

The Taxation of Government Personnel in Europe – Diplomats and Consular Officials. London, 9 May (English):
Miss Audrey Evelyn Bone, 606 Bryer Court, Barbican, EC2Y 8DE, United Kingdom.

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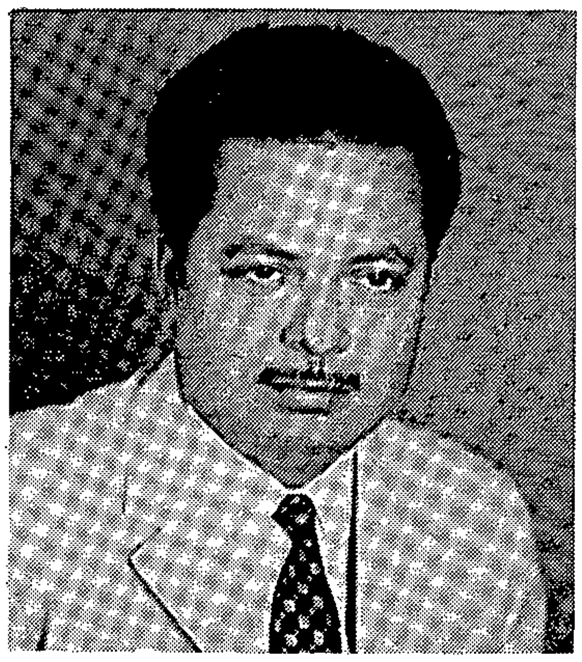

BANGLADESH:

Salient Features of the 1987-88 National Budget

By K.A. Gofran

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

The National Budget of the People's Republic of Bangladesh for the fiscal year 1987-88, as presented in Parliament by Mr. M. Syeduzzman, Minister of Finance, disclosed revenue receipts of 49,150 million Tk, and expenditure of 44,810 million Tk, giving a revenue surplus of 4,340 million Tk. The Development or the Capital Budget has been formulated at 50,460 million Tk with a foreign aid component of 43,040 million Tk (exclusive of food) and a Non-ADP Budget estimated at 7,980 million Tk. The deficit of 4,160 million Tk, required for the Annual Development Programme (Development Budget) will be met by new tax proposals relating to income tax, customs and excise duties and the enhancement of utility services and charges as detailed in the Finance Act 1987 and the Budget Speech.

As noted by the Finance Minister, the new Budget aims at strengthening the base of the economy, raising food stock and the overall growth of the national economy. This growth has been projected at 5% as compared to 5.2% last year although the net growth has been 4.2%. The Economic Survey accompanying the Budget showed that the deficit in food production, the import of food grains, the reduction in price of both tea and jute, resulted in fewer exports and a slump in industrial growth during the preceding financial year. The Minister stated that the rise in the international market for jute and increased production in jute, textile, fertilizer, paper and sugar sectors had partially offset the adverse economic growth prevailing up to December 1986. The Finance Minister stated that exports are US$ 1,200 million below the original target although compared to last year they are up 19%.

Similarly, import earnings have reached US$ 2,400 million. The foreign exchange reserve stood at US$ 300 million in December 1986, but due to increased foreign aid, export earnings and enhanced I.M.F. assistance this now stands at US$ 800 million. This is the highest reserve since independence.

THE FISCAL MEASURES: 1987-88

Considering that the bulk of Government revenue comes from various taxes several fiscal measures and a revenue projection have been embodied in the Budget for the year. Increases in tax revenue are imperative for the mobilization of additional internal resources. The Government is therefore pursuing a policy of raising more revenue and simultaneously encouraging investment and production. This year's fiscal policy seeks to make the tax system more dynamic by making the levy and collection of taxes easier and more rational. The proposals relating to indirect taxes, especially customs and excise duties, are in the nature of adjustments and rationalization to increase revenue in addition to widening the revenue base.

DIRECT TAXES: INCOME TAX

Apart from raising revenue the objectives of the new budgetary proposals relating to income tax are to (i) stimulate savings, (ii) encourage investment in productive sectors, particularly in industries, (iii) create employment opportunities, and (iv) provide some tax relief to low income groups. Some of the most significant changes relating to income tax are noted below:

(a) Considering the increase in the cost of living the exemption limit in respect of individual taxpayers has been raised from 30,000 Tk. to 36,000 Tk. Similarly, the exemption limit of registered firms has been raised to 36,000 Tk. and in both cases, the existing five tax brackets have been rationalized.

(b) In view of raising the exemption limit, the limit for the compulsory submission of statements of assets, liabilities and expenses has been raised from 80,000 Tk. to 100,000 Tk.

(c) In view of the increase in prices, the value limit, for the purposes of depreciation allowance on motor vehicles not plying for hire and used for the purpose of business and profession of the assessee has been raised from 250,000 Tk. to 300,000 Tk.

(d) As the time limit for the special depreciation expired on 30 June 1987, this time limit has been extended to 30 June 1990, in order to encourage investment in the communication sector.

(e) At present the law provides for lower rates of

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depreciation for agricultural equipment as compared to industrial implements. In order to encourage mechanization of agriculture, depreciation allowances on this type of equipment have been raised.

(f) Development banks and financial institutes pay tax on income computed on an actual basis. As a result unrealized interest is also included for income computation. In the context of the present problems faced by the Bangladesh Shilpa Bank and Bangladesh Shilpa Rin Shangstha in respect of the realization of loans, a provision has been made in the Income Tax Ordinance for deduction of a sum equal to 5% of overdue debt or the amount of the actual provision whichever is lower, for the purpose of computing total income. This measure will remain valid up to 30 June 1990.

(g) Salaried employees who do not receive allowances or perquisites will henceforth be entitled to deduct the following enhanced sum as expenses from total income:

(i) those who do not own any vehicle	3,000 Tk.
(ii) those who own any power driven vehicle other than a car	3,000 Tk.
(iii)those who own cars	6,600 Tk.

The previous sums were 2,400 Tk. 3,200 Tk. and 6,000 Tk. respectively.

(h) For the purpose of the Recognized Provident Fund, the definition of "employer" has been extended to foreign embassies and missions. As a result the Bangladeshi employees of these offices or missions will be entitled to the benefit of the Recognized Provident Fund.

(i) In the Income Tax Ordinance, 1984 there was no specific provision regarding "place of assessment" and this resulted in difficulties for all concerned. In order to remove the difficulties, specific legal provisions have now been made in respect of "place of assessment" in the I.T. Ordinance, 1984.

(j) The "investment allowance" which may be deducted by individual taxpayers (limit of one third of total income), has now been extended to donations to recognized charitable institutions, Zakat Fund, national level sports organizations and contributions to Benevolent Funds and Group Insurance Schemes.

(k) In view of the increase in the cost of living, particularly the house rent and conveyance allowance, the tax-free limit of each rent and conveyance allowance of salaried employees has been raised to 2,500 Tk. and 4,800 Tk. respectively.

(l) According to the provisions of Income Tax Rules, if an employee of a company is also a shareholder of that company, the amount of monthly contributions to his provident fund is restricted to 500 Tk. In partial relaxation of this rule, it has now been provided that this restriction shall not apply to employee shareholders who do not own more than 5% voting rights in the company.

(m)The limit for allowing distribution of free samples as expenses prescribed under the Income Tax Rules has now been raised as per revised Rules 65C.

SPECIAL MEASURES FOR INVESTMENT UNDER THE THIRD FIVE-YEAR PLAN

With a view to achieving the investment target as well as to encourage savings the following measures have been announced:

(a) If an assessee, other than a company, declares any income under the head "income from other sources" in his return of income for the assessment year 1987-88 and pays income tax at the rate of 20% on it, his/her return will be accepted without any questions being asked.

(b) At present, dividend income is exempt up to 15,000 Tk. but on fulfilment of certain conditions, dividends received from Public Limited Companies are exempt up to 25,000 Tk. Dividends received from companies located in the Export Processing Zone are entirely exempt from tax in the hands of foreign shareholders. Moreover, dividends from companies enjoying the tax holiday have also been exempted if certain conditions are fulfilled. Provisions now exist to exempt all dividends in respect of shareholders other than companies. This benefit will not, however, be available to shareholders of a private limited company if such private limited company is not converted into a public limited company within two years commencing 1 July 1987.

(c) In the past, tax rates for individuals were reduced substantially. To encourage investment in the productive sector, tax rates applicable to companies have also been reduced in each case by 5 percentage points. The present tax rates for companies are as follows:

(1) Publicly traded company	40%
(2) Industrial company other than a publicly traded company	45%
(3) Banks and other companies	55%

This reduction is expected to improve the investment climate in the capital market.

(d) The time limit for accelerated depreciation of machinery used for industries expired on 30 June 1987 (as was also the case for the special depreciation, see above). To encourage investment in the industrial sector this time limit has also been extended to 30 June 1990.

FOREIGN TRAVEL TAX

At present Bangladeshi passengers are liable to pay foreign travel tax which was introduced in 1980. There was legal provision for providing exemption from payment of travel tax for certain categories of passengers. This exemption resulted in considerable evasion with regard to payment of foreign travel tax. In consideration of this, the provision for exemption has now been deleted. This measure is expected to simplify collection of foreign travel tax and consequently payment of tax can be checked quickly. This will also result in substantial increase in revenue, the tax rates, however, remain unchanged.

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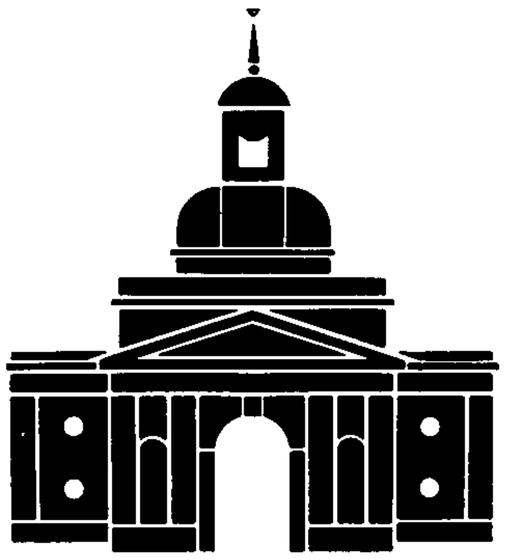
LAND DEVELOPMENT TAX

The rate of land development tax on agricultural land was last fixed in 1982-83. Almost half of GDP in Bangladesh arises in the agricultural sector but there is no significant contribution to government revenue from this sector. Considering the rise in price of the agricultural sector, land development tax on agricultural land has been revised from the 1st day of Bangla Calender year 1394, corresponding to 15 April 1987. Four progressive rate bands have now been introduced. This revision of the land development tax is expected to generate more land tax as well as to curb evasion by big land holders.

RATE OF INCOME TAX

The rates and schedules of income tax applicable for the fiscal year 1987-88 are as follows:

Taxable income	*Rates*
(1) On the first 55,000 Tk. of taxable income	10%
(2) On the next 55,000 Tk. of taxable income	20%
(3) On the next 55,000 Tk. of taxable income	30%
(4) On the next 55,000 Tk. of taxable income	40%
(5) On the balance of taxable income	50%



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An Australian Report*

Two taxation changes of particular international significance were introduced into the Australian Parliament in the latter half of 1987. The changes involve statutory rules against the thin capitalization of foreign investment in Australia and measures to encourage the development of offshore banking in Australia through a withholding tax exemption for interest paid to non-residents by offshore banking units. The general outline and intent of the amendments was given by the Minister Assisting the Treasurer, the Hon. Clyde Holding M.P., when presenting the proposed legislation to the Parliament.[1] This report summarises the Minister's speeches to the Parliament, and incorporates relevant press releases issued by the Treasurer and any subsequent amendment of the legislation as originally proposed.

THIN CAPITALIZATION MEASURES[2]

The thin capitalization rules contained in the Taxation Laws Amendment Bill (No. 4) 1987 were foreshadowed by the Treasurer on 30 April 1987[3] and apply to qualifying foreign investment in Australia with effect from 1 July 1987.

The legislation introduced into the income tax law rules against thin capitalization which are designed to prevent significant losses of revenue that can arise where foreign investors do not maintain an appropriate balance between debt and equity in respect of their income-producing activities in Australia. The appropriate balance, expressed in terms of a foreign debt to foreign equity ratio, is given in the legislation. The measures apply statutory debt:equity ratios to the funding of foreign investments from non-arm's length sources where a non-resident has a 15% or greater interest in an Australian entity or business.

The new rules replace administrative measures that had previously been imposed as a condition for approval of investments under foreign investment policy. While the amendments generally do apply from 1 July 1987, borrowings that had been approved under foreign investment policy and which exceed the new debt:equity ratios are freed from the new rules.

The rules are directed at foreign investments in Australia that are excessively geared up through the use of "in-house" loans made available by associated persons such as foreign parent companies and other related off-shore entities. Where foreign debt from such sources exceeds debt:equity ratios of 6:1 for financial institutions and 3:1 for other investors, deductions for interest payments will be reduced to the extent that the relevant ratio is exceeded. A debt: equity ratio between 6:1 and 3:1 may apply to an Australian entity or business which qualifies as a financial institution for the purposes of the new rules and which carries on other business.

The measurement of foreign debt and foreign equity is, of course, central to the operation of the rules. Special provisions apply in the initial period of operation of the legislation with respect to the measurement of foreign debt which is taken at its highest point during the year, and foreign equity which, on the other hand, is measured at the beginning of the year of income and takes into account any asset revaluation reserves. To ensure that foreign investors are not unduly disadvantaged by the new rules, affected taxpayers were allowed until 30 November 1987 to make adjustments to their financial arrangements to ensure that their "in-house" debts comply with the applicable debt:equity ratio, and for the first year of the new rules, equity is to be valued on 28 October 1987 rather than 1 July 1987.

These transitional measures were subsequently modified by the Taxation Laws Amendment Bill (No.5) 1987, which extended to 31 January 1988, the transitional year for taxpayers with an approved substituted accounting period ending after 30 November 1987 and before 31 January 1988 in lieu of 30 June 1988.

A detailed report of thin capitalization rules will appear in a future issue of the Bulletin.

OFFSHORE BANKING UNITS (OBUs)

The Taxation Laws Amendment Bill (No. 5) 1987 exempted from withholding tax interest paid to non-residents by Australian OBUs.

The Bill exempts from interest withholding tax interest and amounts in the nature of interest paid by OBUs on specified borrowings contracted for after 1 July 1986. It gave effect to the Government's decision, announced on 1 July 1986[4] and expanded on 9 April 1987,[5] to provide an interest withholding tax exemption to facilitate offshore banking in Australia, primarily for dealings in foreign currencies with non-residents.

An OBU is not permitted to purchase securities (whether denominated in Australian or foreign currency) issued by Australian entities or their associates on overseas markets. The restriction on lending to residents also applies to non-residents carrying on

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* This report was compiled by David O'Reilly of the IBFD, based on information received.

1. House of Representatives, Taxation Laws Amendment Bill (No. 4) 1987, 17 November 1987.
2. House of Representatives, Taxation Laws Amendment Bill (No. 5) 1987, 9 December 1987.
3. Treasurer Press Release No. 40, 30 April 1987.
4. Treasurer Press Release No. 64, 1 July 1986.
5. Treasurer Press Release No. 27, 9 April 1987.

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business in Australia through a branch or other permanent establishment. Interest withholding tax previously applied to interest paid by such a branch to a non-resident and this liability could have easily been avoided if a resident OBU were allowed to be interposed between the branch in Australia and the non-resident lender. In other words, an OBU is only permitted to on-lend borrowed funds to non-residents outside Australia.

The new arrangements do, however, cover transactions between non-residents in Australian dollars through an OBU, and borrowing/lending transactions between an OBU and its offshore branches or subsidiaries. However, special anti-avoidance provisions have been incorporated in the legislation to ensure that the exemption is confined to 'genuine' intra-group transactions. The interest withholding tax exemption is not available in respect of any back-to-back loans by an OBU or where non-arm's length transactions are structured to achieve the exemption. Additionally, any foreign tax credits generated by OBUs will be subject to appropriate quarantining arrangements, i.e. credits for foreign taxes incurred in pure offshore banking activities being part of an Australian financial institution will be allowed only up to the amount of Australian tax payable on the profits derived by an OBU, and, in the case of an OBU being a wholly-owned subsidiary in a company group, the transfer of an excess credit to any other member of the group will be denied.

Consistent with the basic concept of separate dealings by OBUs in foreign currency transactions, any foreign income tax losses incurred by OBUs from offshore banking business may be offset only against subsequent profits from that business.

For tax compliance purposes the Taxation Office is responsible for monitoring the activities of OBUs. Liability for income tax, at a penal rate, could apply if an OBU misapplies borrowings that qualify for the withholding tax exemption, for example, by on-lending to residents of Australia. Income tax is calculated under a formula, the penal rate of tax being 300% of the formula amount.

The Government has decided that exemption is to be confined to authorized banks subject to the Banking Act, State banks and other financial institutions authorized to deal in foreign exchange. The Treasurer is authorized, under the Income Tax Assessment Act, to specify the institutions or classes of institutions that would be eligible to establish an OBU for the purpose of obtaining an IWT exemption in respect of pure offshore business.

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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 1988 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Botswana

FINANCIAL ASSISTANCE POLICY
summary.
Gaborone, Coopers & Lybrand Services, 1987. 13 pp.
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Ghana

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Ghana Income Tax Law and practice.
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South Africa

REPORT OF THE COMMISSION OF
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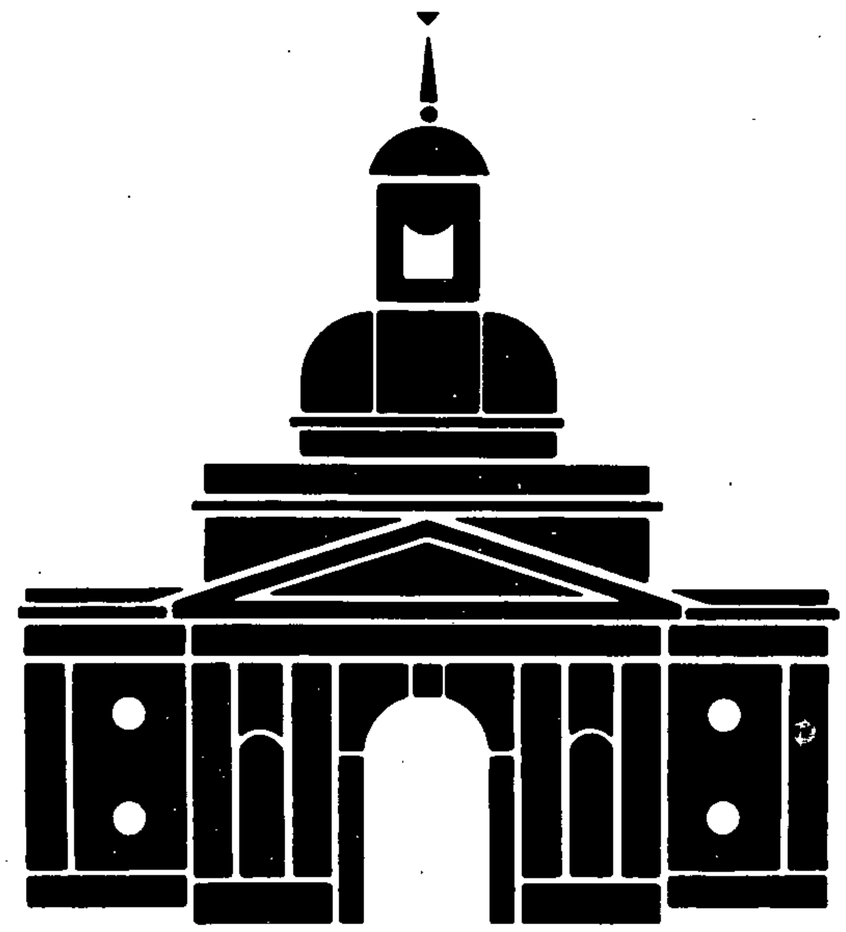

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In June 1987 on the occasion of its 35th anniversary, the Harvard Law School International Tax Program (ITP) held a weekend Reunion Conference. Former participants of the ITP, staff members and representatives of various organizations which support the program were invited to meet and confer on a few of the major issues in taxation and development. Three of the papers, as well as an introductory note, are published in this issue.

The introductory note, written by ***Oliver Oldman,*** *briefly outlines the points raised in the various papers and concludes with highlights from the final session of the Conference.*

The first paper, by ***Vito Tanzi,*** *entitled* ***Trends in Tax Policy as Revealed by Recent Developments and Research,*** *p. 97, highlights recent trends in taxation of industrial countries in a historical perspective. Two major trends are emphasized, i.e. the increase in the level of taxation and the prominent role of income tax.*

The second paper, by ***Stanford G. Ross,*** *is entitled* ***Developing Countries and the New International Aspects of U.S. Taxation,*** *p. 104. This paper discusses the fundamental changes made by the 1986 Tax Reform Act in the United States as well as the policy issues involved in the reform.*

The final paper, ***Some Observations on Relationships Between Tax and International Trade Law,*** *by* ***Greyson Bryan,*** *p. 110, focuses on international trade law and illustrates various ways in which tax law and trade law intersect.*

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Rapports distribués en 1987 à l'occasion de la réunion du "Harvard Law School International Tax Program" *95*

A l'occasion de son 35ème anniversaire, en juin 1987, le "Harvard Law School International Tax Program" (ITP) a donné un congrès au cours d'un week-end. D'anciens participants au ITP, des membres du personnel et des représentants de différentes organisations soutenant le programme y ont été invités et ont discuté de quelques-uns des problèmes importants posés en matière d'imposition et de développement. Trois de ces rapports accompagnés d'une note d'introduction sont publiés dans ce numéro.

La note d'introduction, rédigée par *Oliver Oldman,* résume brièvement les problèmes mentionnés dans les différents rapports et termine en indiquant les points importants retenus lors de la session de clôture.

Le premier rapport, de *Vito Tanzi, Tendances en politique fiscale telles qu'elles ressortent des développements récents et de la recherche,* p. 97, insiste sur les tendances quant à la fiscalité des pays industriels et ceci d'un point de vue historique. Il souligne deux courants essentiels, à savoir l'augmentation du niveau de l'imposition et le rôle prédominant joué par l'impôt sur le revenu.

INHALTSVERZEICHNIS

Während der Veranstaltung anlässlich des Treffens des „International Tax Program" der Harvard Law School im Jahre 1987 gehaltene Vorträge *95*

Das „International Tax Program" (ITP) der Harvard School feierte seinen 35. Geburtstag im Juni 1987 mit einem Treffen am Wochenende. ITP hatte ehemalige Teilnehmer des Programms, seine Mitarbeiter und Vertreter der Organisationen, die ITP stützen, eingeladen, an der Veranstaltung teilzunehmen, um über einige der wichtigsten Probleme betreffs Steuern und Entwicklungsfragen zu diskutieren. Drei Vorträge und eine Einleitung sind in diesem Heft abgedruckt.

Die von *Professor Oldman* geschriebene Einleitung skizziert im Kurzen die in den Vorträgen erwähnten Probleme und schliesst mit den wichtigsten Punkten, die bei der Abschluss-Sitzung der Tagung besprochen wurden.

Der erste Vortrag, von *Vito Tanzi,* über *Trends in der Steuerpolitik anhand der neuesten Entwicklungen und Erforschungen,* Seite 97, beschreibt die neuesten Trends in der Steuergesetzgebung der industriellen Länder in ihrer historischen Perspektive. Zwei der wichtigsten Trends sind: die Erhöhung der Steuerniveaus und die prominente Rolle der Einkommensteuer.

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Le deuxième rapport, de *Stanford G. Ross, Les pays en voie de développement et les nouveaux aspects internationaux de l'imposition américaine,* p. 104; ce rapport commente les modifications essentielles apportées par la Loi de la Réforme Fiscale de 1986 aux Etats-Unis ainsi que les solutions politiques impliquées dans la réforme.
Le dernier rapport, de *Greyson Bryan, Quelques observations sur les relations entre les législations fiscale et commerciale internationale,* p. 110, insiste sur la législation commerciale internationale et démontre comment, de différentes façons, les législations fiscale et commerciale se recoupent.

Ricardo Villarmarzo:

Uruguay: Evolution de l'imposition et programmes promotionnels . *116*
L'imposition indirecte a été la première source de revenus du gouvernement en Uruguay. Le gouvernement civil veut choisir un système qui repose plus largement sur l'imposition directe. Cet article analyse l'évolution de l'imposition en Uruguay depuis 1985, tenant compte des efforts faits par le gouvernement pour mettre en œuvre un système d'imposition directe, ainsi que tous les développements, lois promotionnelles et règlements applicables aux investisseurs locaux et étrangers.

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Le gouvernement de Grenade s'est attaqué à un programme de réforme du système fiscal. La réforme a été réalisée en deux phases, tout d'abord diminution du nombre des impôts de 20 à 7 puis tentative de resserrement du filet fiscal, de suppression de différentes échappatoires et de redressement des effets négatifs du système fiscal. Cet article analyse deux des impôts actuellement applicables, à savoir l'impôt professionnel et la taxe sur la valeur ajoutée. Ces deux impôts remplacent, respectivement, les impôts sur les sociétés et sur le revenu des personnes physiques. L'auteur considère que, bien que la réforme fiscale ait été entreprise au bon moment, l'ensemble des mesures prises ne réussira pas à atteindre les objectifs poursuivis par la réforme.

Torao Aoki:

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Après une année mouvementée au cours de laquelle se sont tenues les sessions ordinaires et extraordinaires du "Diet", une réforme fiscale de compromis a été finalement adoptée par la Chambre des Représentants et la Chambre des Conseillers. La réforme affecte aussi bien les impôts nationaux que les impôts locaux et contient une révision importante du système d'exemption de l'impôt "maruyu" pour les petits dépots. Cet article insiste sur les modifications les plus importantes acceptées en 1987 ainsi que sur les propositions d'autres révisions approuvées au cours d'une réunion de cabinet le 24 janvier 1988.

Nestor J. Belgrano:

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Der zweite Vortrag, von *Stanford G. Ross,* behandelt *Entwicklungsländer und die neuen internationalen Aspekte der amerikanischen Besteuerung,* Seite 104. Er beschreibt die Grundsatzänderungen, die vom „1986 Tax Reform Act" in den Vereinigten Staaten vorgenommen worden sind, ebenso wie die Probleme, die dieser Steuerreform inhärent sind.
Der letzte Vortrag enthält *Bemerkungen über die Beziehungen zwischen Steuern und internationalem Handelsrecht,* von *Greyson Bryan,* Seite 110. Er beschreibt insbesondere die verschiedenen Weisen, in denen Steuerrecht und Handelsrecht einander überschneiden.

Ricardo Villarmarzo:

Uruguay: Die Entwicklung des Steuersystems und der Massnahmen zur Förderung der Wirtschaft *116*
Indirekte Steuern waren immer die wichtigste Einnahmequelle für die uruguaischen Regierungen. Die heutige Bürgerregierung jedoch wünscht diese Lage zu ändern und plant, ein Steuersystem einzuführen, das sich auf direkte Steuern stützt. Dieser Aufsatz verfolgt den Entwicklungsprozess des uruguaischen Steuersystems ab 1985 und beschreibt die Anstrengungen der Regierung, ein direktes Steuersystem einzuführen, sowie die neuen Entwicklungen, Gesetze und Verordnungen zur Förderung der Wirtschaft und insbesondere für inländische und ausländische Anleger.

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Die Regierung von Grenada hat ein Programm zur grundsätzlichen Änderung des Steuersystems gestartet. Diese Steuerreform, welche in zwei Phasen ausgeführt worden ist, hat zunächst die Anzahl von Steuern von 20 auf 7 herabgesenkt und sich danach mit einer besseren Anwendung der Steuergesetze durch Verringerung der Möglichkeiten zur Steuerumgehung und Aufhebung von negativen Auswirkungen des Steuersystems befasst. Dieser Artikel untersucht zwei der heutigen Steuern, d.h. die Gewerbesteuer (business levy) und die Mehrwertsteuer (value added tax), welche die Einkommensteuer und die Körperschaftsteuer ersetzt haben. Der Verfasser betont, dass, obwohl die Steuerreform rechtzeitig vorgenommen wurde, der Inhalt der neuen Massregeln nicht zum Ziel der Steuerreform führen würde.

Torao Aoki:

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Nach einem stürmischen Jahr, in welchem gewöhnliche und aussergewöhnliche Sitzungen des Parlaments gehalten wurden, haben das Abgeordnetenhaus und der Senat eine Kompromisssteuergesetzgebung verabschiedet. Die Reform betrifft die nationalen und lokalen Steuern und enthält eine grundsätzliche Revision der „maruyu" – ein Steuerbefreiungssystem für kleine Depositen. Dieser Artikel beschreibt die wichtigsten Änderungen, über die 1987 Übereinstimmung erreicht wurde sowie die Vorschläge für andere Steuerreformen, welchen von der Regierung während einer Kabinettssitzung am 24. Januar 1988 zugestimmt wurde.

Nestor J. Belgrano:

Argentinien: Die Umstrukturierung und Konsolidierung der Auslandsschulden *136*
Die Zentralbank Argentiniens veröffentlichte kürzlich eine Mitteilung, in der das Verfahren für die Umstrukturierung und Konsolidierung von Argentiniens Auslandsschulden bekannt gemacht wurde. Dieser Artikel beschreibt die Einzelheiten dieses Verfahrens.

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The 1987 Reunion Conference of the Harvard Law School International Tax Program

By Oliver Oldman

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On the occasion of its thirty-fifth anniversary the Harvard Law School International Tax Program (hereinafter referred to as ITP) invited all former participants in its curriculum as well as staff members to return to Cambridge, Massachusetts, to meet with each other and to reflect and confer on a few of the major issues in the field of taxation and development today. The weekend Reunion Conference was also intended to bring forth suggestions for ITP's curriculum and research for the decade of the 1990s. Conference participants also included representatives of companies, law and accounting firms, and other organizations providing support to ITP.

The Conference agenda consisted of the presentation and discussion of 4 papers and a luncheon talk by Stephen E. Shay, then International Tax Counsel at the U.S. Treasury and now at Ropes & Gray in Boston. Three of the papers are reproduced below. The fourth, "The Experience of Developing Countries With the Value Added Tax" by Milka Casanegra de Jantscher (Director of the Tax Administration Division of the Fiscal Affairs Department of the International Monetary Fund) is not included here because it is being published along with a collection of other papers commissioned by the World Bank for a conference on value added taxation in developing countries.

The remainder of this introduction touches on some of the points raised during the presentation and discussion of the 4 papers and concludes with highlights from the final session of the Conference entitled "Relevance and Usefulness of Training at the International Tax Program: Future Directions for Training and Research at ITP".

The first Conference session set the stage of tax reform for the rest of the Conference. Dr. Vito Tanzi, Director of the Fiscal Affairs Department of the IMF, presented the main points from his paper "Trends in Tax Policy as Revealed by Recent Developments and Research". The discussion after the presentation focused on the extent to which tax reform trends in the developed countries are now affecting and can be expected to affect the developing countries in the coming decade. Dr. Tanzi reminded the conferees that the revenue neutrality objective in the reforms in developed countries could not be afforded by the developing countries which continue to need more revenue. To emphasize that the developing countries were not so far "behind" on tax reform he referred to the drastic changes in Indonesia during the past few years. The changes reduced income tax rates substantially and converted the structure to a 3-rate system, kept the top corporate and personal tax rates at the same level (35%), and established a value added tax at a single rate. The increasing attention being paid to tax administration was also emphasized during the discussion. One topic for which insufficient time was available either in the presentation or in the discussion was the emerging trends in taxation at subnational levels of government, particularly the renewed attention being given to the use of property taxes to finance local government. A final question, one that was raised several times during the Conference, was whether any correlation exists between tax changes and changes in the structure, if not the level, of public expenditure. No new insight on this question was developed at the Conference.

The second Conference paper was presented by Stanford G. Ross, now of Arnold & Porter in Washington, D.C., but also the author of ITP publications and the first occupant of the position now known as the Director of Training at ITP. "Developing Countries and the New International Aspects of U.S. Taxation" combined a descriptive analysis of what the 1986 U.S. Tax Reform did with a commentary on the policy issues

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raised. The discussion took 2 separate tacks. One dealt with objections to the international tax changes in the U.S. Tax Reform, objections based principally on difficulties in administration and in compliance. The other focused on the Reform's impact on developing countries and their reaction to the Reform. Concern was expressed that the lower U.S. corporate rates will stimulate investment away from developing countries to the U.S. rather than the reverse. High-tax developing countries were concerned about newly-generated excess foreign tax credits. Low-tax countries were concerned about the reduction in their relative tax advantages.

The next Conference session began with the presentation of an innovative paper, "Relationships Between International Tax and International Trade Laws and Policies" by Greyson L. Bryan of the Tokyo Office of O'Melveny & Myers. Relating tax concepts and practices to those in customs law and laws relating to unfair trade practices, dumping, countervailing duties, etc., led to a provocative discussion. Several conferees urged that ITP training curriculum develop the topic of this paper further. It was also suggested that the topic is one more reason why ITP should consider providing additional training in economics. The interrelationship between taxes and subsidies was also made clearer by the discussion, as was a wide range of possible subsidies that might be considered in trade laws, i.e. Medicare and defense budget items.

The final presentation at the Conference was made by Milka Casanegra de Jantscher on "The Experience of Developing Countries With the Value-Added Tax". This was supplemented by my comments before the general discussion. Mrs. Casanegra de Jantscher's paper, distributed at the Conference, was the revised version of a paper presented by her at a World Bank Conference on the value added tax some months earlier. Vigorous discussion followed about the role of VAT in developing countries. Where, as in Chile, the tax accounts for over 70% of government revenues because of its broad base and high rate, it is not possible for even the expenditure side of the budget to compensate for regressivity. Differing views appeared as to the likelihood of the VAT coming to the U.S., but no one expected the VAT, if and when it does come to the U.S., to dominate the revenue system. Mrs. Casanegra de Jantscher responded to questions about the multiplicity of taxes being a problem and about the proper balance among taxes with her view that developing countries can properly use customs duties for such protection as is necessary, income taxes for reasons of equity, and sales taxes, particularly the VAT, for revenue.

The final Conference session was held on the morning of the second day with the announced title: "Relevance and Usefulness of Training at the International Tax Program: Future Direction for Training and Research at ITP". A panel of former ITP participants gave their views and suggestions, and additional ones emerged from the general discussion. On the technical skills side, several people emphasized teaching the participants from the developing countries about everything from compounding and discounting at one end of the spectrum to expert systems at the other end. Certainly a solid introduction to computer technologies in the context of taxation is necessary. Integrating the teaching of tax policy with the teaching of tax administration, something we have tried to do in different ways, was urged; this proposal could be implemented in workshops involving small groups of participants focusing on a particular problem or assignment. Welcomed by many was the suggestion made by several conferees from both the public and private sectors that ITP expand its coverage of public expenditure as a regular part of the curriculum. All agreed that ITP should continue to encourage participants to question how and why things are done as they are at home and elsewhere, to provide a classroom forum and atmosphere in which participants are not put down for their ideas and comments, and to keep alive the vision of taxation as a broad subject encompassing many disciplines and requiring a world view of law, economy, and society.

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Trends in Tax Policy as Revealed by Recent Developments and Research

By Vito Tanzi

It is indeed a great pleasure for me to be a speaker at this important event. Although I did not have the privilege to be a participant in the International Tax Program, my indirect association with it goes back a long time and in many ways I feel very much like an alumnus of the ITP. Over the years I have seen the changing groups of participants come and go and I have been fortunate to work with several of them in the International Monetary Fund. In fact the heads of the divisions dealing with tax policy and tax administration in the Fiscal Affairs Department of the Fund have been associated with the International Tax Program and so have several other colleagues. I would like to take this opportunity to compliment Professor Oliver Oldman for his outstanding contribution to the field of taxation in developing countries and for having made the Tax Program such a success.

In my remarks today I shall highlight recent trends in taxation but I would like to place those trends in a historical perspective. I will, thus, go back in time for a bird's eye look at changes in tax levels and tax structure in order to sort out the factors that brought about these changes.

Vito Tanzi, a naturalized American citizen, was born in Italy. He received his Ph.D. from Harvard University. Before joining the International Monetary Fund, where he is now Director of the Fiscal Affairs Department, he was Professor and Chairman, Department of Economics, at the American University. He has also been on the faculty of the George Washington University and a consultant for the World Bank, the United Nations, the Organization of American States, and the Stanford Research Institute. He has worked as a fiscal expert in a large number of countries. He has published 5 books and written a large number of articles in leading journals. His major interests are public finance, monetary theory and macroeconomics. In recent years Mr. Tanzi has written several papers on the underground economy, the role of fiscal deficits, and the determination of interest rates. He has had a continuous interest in fiscal problems of developing countries.

I. HISTORICAL BACKGROUND

Tax levels and structures are strongly influenced, if not totally determined by (a) changing views about the role of the government; (b) the changing structure of the economy; and (c) technological developments in the field of taxation. Tax research is itself influenced by some of these changes and, in turn, it influences them to some extent. In particular, it influences them by inventing new ways of taxing individuals and by shaping attitudes toward the various tax alternatives that become available. Let me comment briefly on some of these aspects starting with the role that the government is expected to play and the implications of that role for taxation.

Society's and especially the economists' attitude toward the role of government has changed enormously over the years as a brief historical survey quickly reveals. This role can be assessed from statements made through the years by various economists or policymakers as well as through a few statistics. "The very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount." With these not too profound words, J.B. Say summarized, more than a century ago, his views of what the proper function of the public sector ought to be in a market-oriented economy.[1] Bastiat was more explicit; for him the government "cannot have any other national function but the legitimate defense of individual rights . . .". He went on to say that "beyond justice, I challenge anyone to imagine a governmental intervention which is not an injustice".[2]

On the other side of the English channel, the economists' attitude toward the role of the government in the economy was not much different. There too the belief that the best government is the one that governs the least led many economists of the eighteenth and nineteenth centuries to come to regard public expenditure with suspicion and even to conclude that often it is inherently unproductive. Given this belief, it was natural for them to recommend that public expenditure should be kept to a bare minimum, and, given the classical economists' faith in the market, that it should be financed by taxes with the highest degree of neutrality.

1. Cited by Hugh Dalton, *Principles of Public Finance* (New York: Augustus M. Killey, 1967) at 5. This quotation makes Say's views appear more extreme than they actually were. For a more complete view, see J.B. Say, *Cours Complet d'Economie Politique Pratique,* 3rd edition, Part. 7, Chapter XIV.
2. Frédéric Bastiat, *Harmonies of Political Economy* (Patrick Stirling translation), Part II, p. 458.

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Adam Smith, for example, was quite specific in outlining the functions of the state. For him the state had 3 basic functions:

(a) first, "that of protecting the society from the violence and invasions of other independent societies . . .";[3]

(b) secondly, "that of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice . . .";[4]

(c) and, thirdly, "that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals . . .".[5] These "public works" are mainly "those for facilitating the commerce of the society, and those for promoting the instructions of the people".[6] In other words, they are growth-promoting expenditures.

Of these 3 functions, the first 2 are basic to any organized society. They require expenditure for defense, police, administration, and so forth. The third function, however, being less specific, is more interesting because, with some liberality of interpretation, it seems to anticipate the modern concept of public good, which did not enter the public finance literature until recent decades. What is relevant here is that Adam Smith has nothing to say about the role of the government in redistributing income or in stabilizing the economy.

One may feel that the statements of these economists did not reflect the actual levels of taxation or public expenditure in the earlier periods in which they lived. However, this is not the case as a few references can quickly show.

Heavy and increasing taxes to finance high levels of public expenditure have become so much a part of our life that we might think that the world was never different. Yet, only a century ago a prominent French economist could write that the level of taxation is "moderate" when the ratio of all taxes (including provincial and local taxes) in the national income is 5 or 6%. Taxes become "heavy" when that ratio rises to 10 to 12%. Beyond 12% the level of taxation would be "exorbitant" and would have serious consequences for the growth of the country and the liberty of its citizens and its industry.[7] Leroy-Beaulieu, this early forerunner of the Laffer curve, mentioned Belgium, Great Britain and France as fitting into the 3 categories.

One might suppose that, perhaps, Leroy-Beaulieu was misinformed about the level of taxation in his time. This is not so, however. Seligman provided us with a careful comparative study of tax levels for the 4 major Western countries in 1900-1901, 1913-1914, and 1924-1925. Seligman's results have been reproduced in Table I together with OECD statistics for later years. Table I allows us to see how much tax levels changed in 4 major industrial countries during the first 85 years of this century. The changes are nothing short of remarkable.

Table I
Tax levels in four major Western countries, 1900-01 to 1985[8]
(Percent of national income)

	1900-01	1913-14	1924-25	1965	1975	1985
France	14.96	14.11	20.11	35.0	37.4	45.6
United Kingdom	9.99	11.29	24.77	30.6	35.4	38.1
Germany	7.99	10.51	29.21	31.6	35.7	37.8
United States	7.76	6.68	11.06	25.9	29.0	29.2

Note: For 1900-01; 1913-14; and 1924-25 the figures are percentages of national income. For later years they are percentages of gross domestic product. Therefore the table understates the rise in the tax levels.

The table confirms that the percentages used by the French economist were not invented but reflected closely the situation in his time. These percentages also support a conjecture made by Peacock and Wiseman that wars bring about permanent increases in the level of taxation and expenditure.[9] The levels for 1924-25 are substantially higher than those for the earlier periods; the main reason for this increase was probably World War I.

We cannot but smile at the realization that Leroy-Beaulieu considered "exorbitant" the level of taxation then prevailing in France – somewhere around 15%. If a tax level of 15% was exorbitant, how would he have reacted to the levels reached in France and in many other industrial countries in recent decades? For example, that level has exceeded 50% in Sweden in recent years. But even in Sweden, which now epitomizes the high tax countries, the ratio of tax revenue in gross national product was below 10% up to 1930 and below 20% up to 1950. It rose to 30% by 1960 and grew rapidly afterward to reach a record 51.1% in 1981.[10] After 1981 the Swedish level of taxation fell marginally until 1985 but then rose again to a new record in 1986.

It is equally amusing to read that the Professor of Public Finance at Harvard in 1913 considered "clearly excessive" the maximum rate of 7% to be applied to taxable incomes in excess of $ 500,000 in the just intro-

3. Adam Smith, *The Wealth of Nations* (New York: The Modern Library, 1937) at 653.
4. Ibid. at 669.
5. Ibid. at 681.
6. Ibid. at 681.
7. Paul Leroy-Beaulieu, *Traité de la Science des Finances,* Tome Premier, Des Revenus Publics (Paris: Guillaumin et Cie, Librairis, 1888) at 127-28.
8. Edwin R.A. Seligman, *Studies in Public Finance,* The Macmillan Co., New York, 1925, Ch. 1 for the period 1900-01 to 1924-25, and OECD *Revenue Statistics of OECD Member Countries* (Paris, 1987) for the later years.
9. Peacock, A.T. and Wiseman, J.A., *The Growth of Public Expenditure in the United Kingdom, 1890-1955,* Princeton University Press for NBER, Princeton, 1961.
10. See the paper by Krister Andersson on Sweden in *Comparative Tax Systems: Europe, Canada, and Japan,* Joseph A. Pechman, editor (Arlington, Va.: Tax Analysts, 1987).

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duced income tax[11] or to read that in that same year Cordell Hull, the Chairman of the Ways and Means Committee of the U.S. Congress, could state in a speech to the U.S. House of Representatives that the income tax rates from 1 to 6% then being proposed "would produce more money than the mind of man would ever conceive to spend".[12] Clearly, things have changed a great deal.

These low levels of taxation were not associated with stagnating or anemic economies. Quite the contrary! The period between 1870 and the First World War was a very dynamic period in terms of economic development. This, for example, is the period when a large portion of the Paris that most visitors so much admire, including the Paris subway system (the "metro"), was built. I am not using these statistics to argue that low taxes necessarily lead to faster growth. The jury on this issue is still out although I would guess that, when a final verdict is in, it will support the view that high tax levels do have significant efficiency costs. Rather, I am using them to argue that a vibrant, if not necessarily an equitable, society can exist with low tax levels. What is sacrificed is essentially the objective, if not necessarily the realization, of a more equitable income distribution and greater income stability. Even today nonredistributive expenditure by governments are not much higher, as shares of gross national products, than the levels of taxation prevailing at the turn of the century.

II. DEVELOPMENTS UP TO 1980

The growth of the tax levels in this century is largely a consequence of the changed perception about the proper role of the government in allocating resources, in redistributing income, and in stabilizing the economy. The allocative role was given greater legitimacy by the literature on public goods and externalities. If a market economy is unable to properly allocate resources because of the existence of public goods and externalities, the government must step in and fill the gap. That, of course, means more taxes. If the market economy does not bring about a distribution of income that is seen as equitable, then the government must step in and, by taxing some and subsidizing others, must ensure that the resulting distribution is closer to what society wants.[13] That again means more taxes. If the market economy is inherently unstable so that at various times the unemployment rate tends to be greater than desirable and the level of output lower than the full employment level, then the government must step in and try to promote full employment and a high level of capacity utilization. That, once more, means more taxes.

The growing importance of redistribution and stabilization inevitably led to the growth of the public sector and, consequently, to the growth of the tax level. It also led to the growing importance of the income tax. Given the perceived requirements of the times, the income tax was in many ways an ideal tax. Particular characteristics of this tax – its elasticity, its built-in flexibility, and its incidence – attracted a lot of attention on the part of tax experts and many research papers resulted from it.

Economists maintained that the income tax could help stabilize the economy given its considerable built-in flexibility. This automatic flexibility guaranteed that, during cyclical swings of the economy, disposable (i.e. after-tax) incomes would fluctuate less than before-tax incomes. As a consequence, consumption that was supposed to depend on current disposable income would fluctuate less than national income. Thus, the tax made the economy more stable. The income tax would also reduce aggregate saving since the tax fell disproportionately on those with higher incomes who, presumably, were also those who did much of the saving. Since too much saving was assumed to be a major factor in bringing about economic stagnation, a tax that encouraged consumption (and, thus, aggregate demand) was considered desirable. The income tax also made the income distribution more even by falling mostly on the rich. Finally, the tax lent itself, in a manner that other taxes did not, to become a tool for social engineering through the introduction in the tax code of special treatments for deserving activities or individuals (charitable and educational activities, the blind, the aged, homeowners, and so forth).

Income tax rates rose to reach very high levels in peace times. To top bracket rate in the United States, for example, exceeded 90% in the 1954-63 period before it was reduced by the 1964 tax reform. However, even when the rates declined, the levels of income at which they became applicable often fell even more so that revenue from personal income taxes rose.[14] In a few countries the percentage of taxes on personal income in gross domestic product exceeded 20% (Denmark, New Zealand, Sweden); in most it exceeded 10%.

Perhaps reflecting the widespread positive attitude toward the personal income tax, a tax that was widely regarded, at the time, as the fairest of all taxes, tax research failed to find any significant negative impact of the high tax rates on the response of factors of production.[15] Rather, as I have already mentioned, tax research concentrated on aspects of the tax that were considered desirable (built-in flexibility, incidence, etc.) and ignored those that might have cast a bad light on it. This is perhaps an example of research

11. See Richard Goode, *The Individual Income Tax,* The Brookings Institution, Washington, D.C., 1964 at 3.
12. Cited in a *Washington Post* article written by Wilbur D. Mills, former Chairman of the House Ways and Means Committee. It should be recalled that the income tax on individuals was permanently introduced in the United States in 1913.
13. In many industrial countries today the major redistributive function is between those who work and those who do not (children, elderly, unemployed).
14. For example, personal exemptions for single persons fell from $ 3,000 in 1913-16 to $ 500-$ 600 in 1942-69. The size of the first bracket fell from $ 20,000 in 1913-16 to $ 500 in 1964-78. The level at which the top bracket rate became applicable fell from $ 2,000,000 in 1916-17 to $ 200,000 after 1964.
15. A question worth asking is the following: how hard did researchers work on these issues?

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unwittingly setting out to find what the prevailing social and political winds expect it to find.

In addition to changes in attitude, structural changes in the economies also helped make the income tax the keystone of the tax systems of most industrial countries. Two important structural changes must be mentioned. The first is the increasing share of total income that individuals received from others either by leasing their real capital (as with houses and land) or by lending their financial savings through intermediaries or by finding employment (that is by hiring out their labor services). This development created income flows that could be assessed and taxed more easily than when much income occurs in subsistence activities or in activities connected with self-employment.The second trend was connected with the kind of technological development that characterized the period. Technological change in this period was largely associated with important economies of scale which led to the creation of huge enterprises especially in the industrial sector but also in the distribution sector. Giant enterprises came into existence (U.S. Steel, General Motors, Sears and Roebuck, etc.) which, when added to the much larger government entities than in the past, created income-generation centers that could easily be used by the tax authorities to tax incomes. Withholding at source, introduced in the United States in 1943, was facilitated by these developments. It should be recalled that tax evasion is lowest when income can be withheld at the source and when the payers are large establishments. Incidentally, these changes also facilitated the use of taxes on general consumption in those countries where these taxes were introduced.

The absence of some of these trends in developing countries helps explain why income taxes on individuals have remained much less important there than in industrial countries. In the former, subsistence activities and the activities of the self-employed remained very important. Wages and salaries, for example, are often a much smaller share of national income than in the industrial countries. Thus, in the developing countries, the share of personal income taxes in gross domestic product is only about 1.2% for the 20 poorest countries and 2.7% for the 20 countries with the highest income and much of this comes from wages and salaries.[16] For all developing countries combined that share is less than 2%. The average for the industrial countries is about 6 times larger.[17]

The income tax reached its apotheoses in the 1960s when it was considered by many to be the fairest tax in addition to exhibiting the various attributes described above. At that time both tax experts and the public at large seemed to approve of this tax having apparently forgotten Seligman's warning of more than 70 years ago that:

> Even if the income tax were the fairest of all taxes – which . . . is not necessarily true – the decision as to whether it ought to be utilized would depend largely upon whether this fairness which is predicated of it in the abstract, would ensure in actual practice. It is notorious, however, that of all taxes the income tax is perhaps the most difficult to assess with scrupulous justice and accuracy; so that what is conceived as justice after results is crass injustice.[18]

It was only in the late 1970s that Seligman's assessment came to be shared by many thus setting the stage for some of the recent tax reforms.

At this point I should perhaps say a few words about taxes on goods and services. These generate now on the average about 11% of the gross domestic products of the OECD countries and 5.2% of GDP in the United States. There has never been the same kind of professional, and one could say emotional, support for these taxes as there has been for the taxes on income, especially in the United States. Governments have always been slightly embarrassed in using these taxes and economists have been somewhat ambiguous about their attitudes vis-à-vis them. Of course the "sin taxes" (those on tobacco and alcohol) were generally justified especially after the links between consumption of tobacco and alcohol and illnesses and accidents were established. But when it came to other taxes on goods and services, it was different. The United States still does not have a national general sales tax and, as of now, there is no plan to introduce one. Soon this country may have the distinction of being the only major industrial country without a general sales tax if Japan should, as it seems likely, reintroduce the VAT tax bill in the near future and if that bill should be approved.[19] The proposal to introduce a VAT ran into strong political opposition in 1987 and the Japanese Government was forced to withdraw it. At present the United States and Japan raise the lowest share of revenue (as a percentage of gross domstic product) from these taxes among the industrial countries.

Taxes on goods and services now come mainly from 3 sources: (1) taxes on tobacco and alcoholic beverages; (2) taxes on petroleum products; and (3) taxes on general consumption. The taxes on tobacco and alcoholic beverages, the so-called "sin taxes", have been around for a long time and are of about equal importance in industrial and developing countries. Revenues from them are generally eroded by inflation (since these taxes are often imposed with specific rates) and enhanced by budgetary difficulties (that increase the need for additional revenue) and by changing perceptions about just how sinful or unhealthy it is to consume tobacco or alcohol. The taxes on petroleum products reflect the use of a relatively new and growing tax base. These taxes are now lowest, by far, in the United States. Taxes on general consumption have

16. See Vito Tanzi, "Quantitative Characteristics of the Tax Systems of Developing Countries" in David Newbery and Nicholas Stern, editors, *Modern Tax Theory for Developing Countries* (Oxford: Oxford University Press, 1987).
17. Similar relationships exist for taxes on general consumption. In developing countries these taxes yield about 1.6% of GDP while in industrial countries they yield about 6% of GDP.
18. See Edwin R.A. Seligman, *The Income Tax, History, Theory and Practice of Income Taxation* (New York: The MacMillan Company, 1914 at 18).
19. Canada has recently decided to introduce a national general sales tax.

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been growing in importance over the years among industrial countries. In some industrial countries they now generate revenues close to 10% of gross domestic product (Austria, Denmark, France). By contrast they raise only about 2% of GDP in the United States. Among the developing countries, the record goes to Chile which raises as much as 9-10% of GDP from the value added tax. But, as already indicated, general sales taxes still raise relatively little in developing countries (about 1.6% of GDP).

The most widely-used form of a general sales tax, the value added tax, has spread like wildfire in recent years. There are now close to 50 countries that either already have such a tax or are in the process of introducing one. The success of VAT is in part the result of the proven effectiveness of this tax in the real world. However, it has also depended on a set of favorable circumstances that paved the way for success and are unlikely to exist for other forms of taxation.

The establishment of the European Common Market created the need to eliminate artificial barriers to the movement of goods across member countries. The destination principle could not be easily applied to the turnover tax (which was the form of general sales tax common to Europe in the 1950s) since the tax content of the price of a product could not be precisely determined due to the cascading characteristic of the turnover taxes. This would create the possibility that countries would subsidize their exports by over-estimating the tax content of an export price and would restrict imports by imposing a higher import tax than might be justified by the cumulative effect of the turnover tax. In the mid-1950s, France introduced a value added tax. This tax seemed to be immune from the above-mentioned problems of the turnover tax. Thus, France succeeded in convincing the other members of the community to adopt a value added tax. But France had also much influence on French-speaking African countries, and, to a lesser extent, on Latin American countries. As a consequence, the tax found its way into the developing world.

As I have already indicated, the structural changes in the economy discussed above were also important for general sales taxes, especially the size of the establishment and, for the developing countries, the share of the tax base that was represented by imports. In the majority of developing countries much of the revenue from the value added tax comes from imports and from relatively few domestic enterprises. The popularity of the VAT also attests to the importance of technological development in the field of taxation. This tax was "invented" by tax experts. One cannot fully anticipate what other alternative tax possibilities are still to be uncovered and which of these may find a ground as fertile as that found by the VAT. Two relatively new "inventions" in the tax area, an expenditure tax and a tax on the cash flow of enterprises, have so far not found any takers. The expenditure tax was tried in India and in Sri Lanka. In both cases, it was eventually repealed. Some version of it has been recommended in important official or nonofficial reports (in Ireland, Sweden, the United States, and the United Kingdom). The tax on cash flow is now under consideration in a couple of Latin American countries.

III. DEVELOPMENTS IN THE 1980s

The decade of the 1970s saw the culmination of various developments in taxation. These trends were particularly important with respect to taxes on personal income.[20] The overall levels of taxation in the majority of industrial countries reached historical records. By 1979 8 industrial countries had a ratio of total tax revenue to GDP of over 40%. In the United States that ratio was "only" 30%. The importance of personal income taxes in total revenue became overwhelming, particularly if one adds social security taxes levied on wage incomes. While these trends were going on, several developments were taking place which were likely to have important implications for the tax systems of the 1980s and later. Some of these developments deserve mention.

First, there was the impact of inflation. Inflation had been relatively low in most industrial countries in earlier periods, but during the 1970s, a period when income taxes were particularly important, it reached relatively high levels. Inflation brought about various distortions of tax bases, often sharply raising the effective tax rates, especially on some incomes. For example, incomes from *real* interest payments were at times taxed at more than 100%. Inflation also distorted the measurement of capital gains and profits and pushed individuals towards higher effective marginal tax rates even when their real incomes did not change. A recent OECD study found that inflation was by far the most important factor in changing income tax liabilities between the mid-1970s and the early 1980s in the majority of industrial countries.[21]

Second, there was a growing perception that the high marginal tax rates, which were often accompanied by a proliferation of tax expenditures, had brought about major problems of horizontal equity.[22] The growing popularity of the literature on underground economic activities and on tax evasion reinforced this perception.[23] The perception began to set in that the income tax, far from being the fairest tax of all, was progressively becoming an inequitable tax. This changed attitude is reflected in surveys of taxpayers' preferences conducted in the United States over the years which indicate a sharp erosion in the percentage of taxpayers who continued to consider the personal income tax as a good tax (see Table II). By 1979, 37% of the taxpayers considered the income tax as the least fair tax.

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20. Taxes on corporate income did not show any consistent trend. They rose a little in all industrial countries; however, in several countries, including the United States, corporate taxes fell.
21. See OECD, *Personal Income Tax Systems Under Changing Conditions* (OECD: Paris, 1986), especially Ch. 4.
22. The work by the late Professor Surrey played an important role in the development of the concept of tax expenditure.
23. See on this Vito Tanzi, *The Underground Economy in the United States and Abroad* (Lexington, Mass.: Lexington University Press, 1982).

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Table II[24]
Which do you think is the least fair?

	March 1972	May 1975	May 1979	May 1983	May 1986
Federal income tax	19	28	37	35	37
State income tax	13	11	8	11	8
State sales tax	13	23	15	13	17
Local property tax	45	29	27	26	28
Don't know	11	10	13	15	10

Third, there was a change of political climate associated with a more conservative attitude vis-à-vis the role of the government, which also had implications for the level of taxation and for the structure of the tax systems. These conservative developments led to calls for the reduction of tax levels and tax rates. Research on taxation responded to these developments by putting the spotlight on those aspects of the tax systems which the prevailing political winds considered the least attractive.

There were 2 strands of writing which influenced developments in this period: one was the more politically-biased "research" originating from writers with strongly conservative views. For example, the work of Arthur Laffer, as well as the work of Wanniski,[25] Gilder[26] and some other writers, was especially influential. It was directed against the current role of the government and the presumed negative impact of taxes on growth and economic activity. Laffer popularized the view that a reduction in tax rates would bring about an increase in tax revenue. Wanniski and Gilder popularized the view that reducing marginal tax rates would have significant effects on rates of growth. This strand of research had a strong political impact on the United States.

At the same time a more academic strand of research re-analyzed some of the incentive effects of high marginal tax rates. Some of this research discovered relationships which had not been found in earlier studies. For example, several of these new studies concluded that work effort had been considerably reduced by the impact of high marginal tax rates. This was particularly true for married women and for second workers within families. At the same time, some studies claimed that taxes on capital income, by reducing the rate of return to capital, could significantly discourage saving.[27] By the late 1970s, the Keynesian negative view of saving (because of its impact on aggregate demand) was no longer popular; as a consequence, the negative impact of income taxes on saving was considered a worrisome result, especially in a period when the rate of growth of the economy had slowed down and, as a consequence, the unemployment rate had increased sharply.

There was also growing concern about distortions brought about by differential effective tax rates on different investments. Several studies had shown the widely diverging effective tax rates on different industries, assets and/or enterprises. These differences would imply that capital would not be allocated in the most efficient manner. The tax code rather than the market was determining the allocation of investment. The tax reform of 1981, by giving excessive but differential incentives to investment, had aggravated this problem. Tax economists started arguing about the need to "level the playing field" by reducing or eliminating tax incentives while reducing tax rates.[28]

Some of these tendencies were felt more strongly in the United States than in other countries. Therefore, it was the U.S. tax system that came to be affected most dramatically by these changes. Once the U.S. tax system was changed many other countries felt obliged to follow suit, if for no other reason than to protect themselves from the pull that they expected the U.S. economy would exert on some of their factors of production if their tax systems remained unchanged. Since current developments in tax reform have been described by the author in a recent paper,[29] I will mention just the main results.

There has been a major reduction in the tax rates of the income taxes in many countries; the marginal tax rates have especially been considerably reduced (i.e. in the United States and Canada but also in several other countries). In the United States the marginal tax rate has fallen from 70% in 1981 to 28% with the 1986 Tax Act. This may constitute a record reduction. The search for simplicity in the tax system has also brought about a reduction in the number of tax brackets. Legislators have come to believe that fewer brackets imply a simpler tax system. In many cases the tax bases have been widened through the elimination of many tax preferences in an attempt to (a) make the tax systems more equitable in a horizontal, if not a vertical, sense; (b) "level the field" in order to achieve a more efficient allocation of capital; and (c) compensate for some of the revenue losses associated with the rates' reductions.

The recent reforms have slowed down somewhat the rate of growth of the tax level; in the past several years those tax levels have changed only marginally for the average of the OECD countries. However, because of the difficulties in reducing public expenditure, and because of the existence of very high fiscal deficits in many of these countries, it has been difficult for governments to introduce reforms which actually reduced the level of taxation. Once again, the country that tried hardest to do this was the United States. Unfortunately, it ended up paying a heavy price in terms of

24. Source: Advisory Commission on Intergovernmental Relations, *Changing Public Attitudes on Governments and Taxes* (Washington, D.C.: annual).
25. Jude Wanniski, *The Way the World Works* (New York: Simon and Schuster, 1978).
26. George Gilder, *Wealth and Poverty* (New York: Basic Books, 1981).
27. See, in particular, Michael Boskin, "Taxation, Saving and the Rate of Interest", *Journal of Political Economy*, 86, 2, 2, 1978.
28. However, some economists who worry more about the low level of investment than about its inefficient allocation have continued to argue in favor of these incentives.
29. See Vito Tanzi, "The Response of Other Industrial Countries to the U.S. Tax Reform Act", *National Tax Journal*, Vol. XL, No. 3, September 1987.

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a fiscal deficit that was too high in the eyes of most observers. That deficit is now widely blamed for the problems that the United States is having with its balance of payments, and also for the high real interest rates which have prevailed throughout the 1980s.

IV. CONCLUDING REMARKS

The previous discussion has emphasized 2 major trends in the tax systems of industrial countries: first, the enormous growth in this century in the level of taxation; second, the prominent role played by the income tax in this growth. However, developments in the 1980s cast some doubts as to whether these trends are likely to continue. Although, by and large the tax levels, expressed as shares of GDP, are still rising, their rate of growth is now very slow and is largely explained by the need to reduce fiscal deficits rather than to finance additional public spending. For the first time there is evidence of countries (Canada, Germany, the Netherlands, New Zealand, Norway, United Kingdom, the United States) where the tax levels have actually fallen in recent years, although in all cases the falls are small.

The trend related to taxes on personal incomes is also changing. In recent years these taxes, as percentages of GDP, have not changed for the OECD countries taken as a group and, while they have risen in some countries, they have fallen in others. For example, since 1980 they have fallen in the Netherlands, Norway, Sweden, Turkey, the United Kingdom and the United States. There is also some evidence of a shift toward more reliance on taxes on goods and services and particularly on taxes on general consumption. I would be very surprised if by the middle of the next decade all industrial countries (including the United States and Japan) did not have a general sales tax. The role of taxes on general consumption is likely to grow also in developing countries. These countries will go through the process of structural changes in their economy experienced in past years by the industrial countries; this process will increase the feasibility of personal income taxes and of general sales taxes in those economies.

If one tries to look beyond the next decade the picture gets somewhat cloudier. Likely developments, such as the aging of the population, the process of integration of the world economy, the trend toward a service economy, and so forth will create new possibilities for the tax systems while at the same time reducing some of the existing ones. In general, it will become progressively more difficult to maintain the present levels and structures of taxation. For example, in a highly integrated world, where capital can move freely, it will become increasingly more difficult to tax capital incomes. And in a world where production has become more oriented toward customized products or toward services and it thus takes place in smaller establishments, it may become difficult to tax labor income. On the other hand, the tremendous increase in the amount of information that can be stored in computers is likely to create other options. One day we may have to come to think of taxation on a global basis and not just on a national basis. "Internal" Revenue Services may have to be supplemented by an "International" Revenue Service.[30]

30. For a look at the future, see Vito Tanzi, "Taxation and Changes in Economic Structure: Past and Future", paper presented at the Conference on *Tax Policy in the Twenty-First Century,* Washington, D.C., 5-7 October 1987. A conference volume edited by Herbert Stein will be published in 1988 by John Wiley and Sons.

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Developing Countries and the New International Aspects of U.S. Taxation

By Stanford G. Ross

I am pleased to have the opportunity to discuss with you recent U.S. international tax developments. I was a member of the faculty of the International Tax Program early in my professional career and have had the good fortune to participate in its activities from time to time subsequently. The Program has made great contributions to tax policy and hopefully will continue to do so. This conference and reunion is itself solid evidence of its past and present achievements and an indicator of its promise for the future.

The United States has provided leadership in many respects on important international tax issues. Thus, the major tax reform legislation that was enacted in the United States at the end of 1986 is of interest to everyone with a concern for tax policy. I will today try to outline what happened in the United States in 1986, emphasizing the international aspects of this development. I will discuss major issues raised by these U.S. developments, particularly for developing countries.

I. AN OVERVIEW OF THE NEW U.S. TAX REGIME

The Tax Reform Act of 1986 makes fundamental changes in the U.S. income tax treatment of both U.S. and foreign individuals and corporations. Whether the Act is truly revolutionary and destined to invigorate the American economy, as claimed by President Reagan and its leading political advocates in Congress, or whether it is essentially more of the same process of continual and complicating tax law change that has taken place over the past 10 years, remains to be seen. But it is undoubtedly the case that the basic tax planning considerations that are present with respect to business and investment activity in the United States have been significantly changed, at least for the time being.

The 1986 Tax Reform Act is traditional in the sense that it renews the federal government's commitment to relying on income taxes as the major source of its revenues. While economic thinking in the United States in the past 10 years has suggested that the federal government move more towards a consumption tax or at least moderate the federal government's reliance on the income tax with a new tax such as a value added tax, the new Act follows classic liberal reform philosophy by trying to restore a broad income tax base and attempting to renew public confidence in the income tax as the best way to finance government.

An unintended consequence of the 1986 Act is that many states will have significantly increased revenues from their own income taxes, which are based on the federal income tax regime. Most of such states can be expected to reduce their income taxes, but the federal reforms will require that they review their relative reliance on income taxes, sales taxes, and other revenue sources. Recent trends by the states away from following unitary tax methods with respect to state income taxation should not be affected by the federal reforms.

While the 1986 Act is supposed to raise only the same overall revenues as prior law (it is said to be "revenue neutral"), the revenue estimates must be regarded as uncertain at best. They are based in large measure on static assumptions about economic behavior and do not reflect the reality that

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individuals and corporations will adapt their activities in the light of the new law. Thus, the new tax law may well have unintended and unexpected economic repercussions. Some believe it is quite possible that it will worsen the deficit, lead to an economic slowdown generally or at least in some hard-hit sectors such as real estate, and generally cause a dislocation of existing economic patterns.

The individual tax rates, which for 1986 were as high as 50%, are reduced in 1988 to 2 rates, i.e. 15% and 28%, but a 5% surcharge produces a 33% effective rate for many high income persons. A blended rate structure with a maximum marginal rate of 38.5% is applicable for 1987. Accordingly, contrary to traditional liberal tax policy, progressivity has been significantly reduced. However, as noted, the tax base to which these lower rates apply is greatly broadened. Personal deductions and investment loss deductions are curtailed, capital gains preferences are eliminated, and strong minimum tax provisions are applicable. About one-fifth of all individual taxpayers will have a net tax increase, particularly those in higher income situations who have previously been able to shelter income and pay little tax.

For corporations, a top rate of 34% is scheduled for 1988, with a transitional rate of 40% in 1987. The corporate tax base is also broadened by a repeal of investment credits, some restriction of research and development credits, reduced depreciation allowances (particularly for real property), tighter tax accounting provisions, and reduced industry-specific tax preferences. In addition, a strong alternative minimum tax ensures that all corporations, including even some with operating losses and excess foreign tax credits, will pay some taxes. Corporate taxes are expected to increase by $ 120 billion over the 1987-1991 period, or about 22% on the average.

A number of restrictive changes were enacted to increase the taxes on the foreign income of U.S. corporations by several billion dollars annually. The basic structural elements of the U.S. tax treatment in the foreign income area generally were not changed, i.e. the foreign tax credit mechanism, the Subpart F controlled foreign corporation structure, the Sec. 367 tollgate, and the Sec. 482 reallocation safeguard were maintained. However, many new provisions were added that essentially transform the effect and application of these basic structural elements. Thus, while the general foreign tax credit limitation was left as an "overall" concept, in reality the new provisions create a "separate basket" system that requires many "per-item" calculations.

To take another dramatic example of the kinds of changes that were made, while Secs. 367 and 482 are left essentially unchanged, a new "super royalty" provision and accompanying Committee reports interpreting it, in reality, create a new allocation of income concepts that presumably will draw much more foreign income back to the United States regardless of the ownership and location overseas of the intangible assets generating that income. Many of these new provisions introduce totally new and unprecedented concepts, the meaning and application of which is uncertain and which will remain uncertain for a long period while interpretive materials are developed.

There will undoubtedly be major unintended consequences and unexpected responses to the new U.S. taxation rules affecting foreign income. However, the underlying philosophy of the provisions in 1986 is consistent with similar changes made in 1982 and 1984, namely to increase U.S. tax revenues by restricting foreign tax credits and expanding limitations on deferral. To the extent that such restrictive changes in combination with the new lower U.S. corporate tax rate encourage domestic as opposed to foreign investment, the U.S. tax changes are consistent with the increasing protectionist philosophy that seems to be present in the international trade area and other areas of international law and regulation.

II. ADAPTATION BY FOREIGN INVESTORS TO THE NEW U.S. TAX REGIME

Foreign investors in the United States face many of the same issues as U.S. persons, but also some additional unique issues discussed in succeeding sections. Many people in the United States do not believe that the lower rates will prevail very long. Considerable tax planning is taking place to attempt to postpone income into 1988 which may be the one year of the new low rates. Most people feel that President Reagan will veto any tax bill that attempts to raise the marginal rates. However, many believe that these low rates are not going to be a permanent feature of U.S. tax law and see 1988 as a possible window for realizing a great deal of income at the lowest U.S. tax rates that will ever prevail.

Capital intensive industries whose net returns are materially dependent on investment tax credits and generous depreciation provisions may be less attractive under the new tax law. There also will not be an ability to purchase tax benefits in ways which can artificially reduce taxable income and hence tax liability. Persons with existing businesses that have now lost a preferred tax regime will undoubtedly seek to restore the situation to some extent in future years, but it is not clear if or when they will be successful. Opportunities may exist to purchase such disadvantaged businesses at relatively low values in the aftermath of the Tax Reform Act. Tax aspects of mergers and acquisitions are substantially changed and traditional planning in this area is being rethought.

Some industries, such as service industries, which are not dependent on generous capital cost recovery provisions, and which will receive the full benefit of the lower corporate rate, will be more attractive. This may be especially so if the lower individual tax helps to restrain wage increases and increase consumption in the years to come. Service industries also, however, are highly dependent on financing and the effect of the

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tax bill on interest rates and financing sources will be of great importance.

Because the top individual rate is scheduled to be 6 points below the top corporate rate, many U.S. persons are considering whether they can effectively operate businesses in a non-corporate format. One level of tax would be saved and the current payment of tax at only 28% could be highly beneficial overall. A great number of corporations, even some which are fairly widely held, are liquidating and the former shareholders are seeking to operate in partnership form. An issue here is whether, if there is enough of this tax avoidance activity, Congress will move to tax widely-held partnerships or trusts in the same manner as corporations.

The new Act ultimately took the approach of restoring a classic corporate tax system seeking 2 full levels of income tax. While the Treasury's proposals called for an integrated approach which would have provided corporations a deduction for dividend payments and gone a good deal of the way toward eliminating 2 full levels of taxation at the corporate and individual level, revenue and equity considerations ultimately led to abandoning the integrated approach and attempting to move to a situation where a separate corporate tax would be imposed with full vigor.

Since the lower individual and corporate rates are dependent on maintaining the expanded individual and corporate tax bases, Congress can be expected to react quickly if schemes to reduce the individual or corporate tax bases are successful. Nonetheless, at least in the short run, great attention should be directed to considering whether businesses or investment activities can be operated outside of the corporate form and whether individual taxes can be reduced by careful planning of investments.

Financing business through loans will probably still be attractive because of the continuation of the corporate interest deduction and the business interest deduction for individuals. However, with the lower tax rates, the value of the interest deduction is significantly reduced. A balance must be struck here between the amount of financing needed by a business and the larger net after tax costs of such financing.

III. CHANGES SPECIFICALLY AFFECTING FOREIGN INVESTORS: THE NEW BRANCH PROFITS AND INTEREST TAXES

There are several aspects to the new tax regime which make changes of specific importance to foreign investors. Perhaps the most important of these is the so-called branch profits tax which is a new and quite complex concept. In reality it basically constitutes 2 distinct taxes, one on profits and one on interest.

The first aspect of the new branch tax is to impose a tax at a 30% rate on the U.S. profits of foreign corporations doing business in the United States, to the extent such profits are deemed distributed to the home office and are not reinvested in the United States. This branch profits tax is in addition to the regular U.S. corporate tax imposed on the branch's effectively-connected U.S. taxable income. The new tax is imposed on the "dividend equivalent amount", which is the U.S. effectively-connected earnings and profits of the corporation for the taxable year, not reduced by prior year deficits, and adjusted for changes in U.S. equity.

These are new concepts, and so there is considerable uncertainty as to the base to which the new 30% tax will apply. For example, it will include municipal bond income otherwise exempt from U.S. income tax, and depreciation deductions will have to be computed under generally more restrictive rules than the rules for determining regular taxable income.

Adjustments must be made to earnings to reflect increases and decreases in "U.S. net equity". U.S. net equity is defined as U.S. assets minus U.S. liabilities. Increases in U.S. net equity are subtracted from effectively-connected earnings and profits to arrive at the tax base. Reductions, however, cannot reduce the base below zero. Subsequent disinvestment from the United States will increase the tax base only to the extent that prior reinvestments have reduced it. These calculations are done at the end of a year and seem to invite movements of assets shortly before and after the end of the year to reduce U.S. taxes. It may well be that foreign persons will be able to effectively avoid any major application of the tax on profits aspect of the new branch tax by careful planning, but we may expect anti-avoidance rules in this area.

The second aspect of the new branch tax is a new application of the old 30% tax on interest paid by foreign corporations with substantial U.S. effectively-connected income. The new tax will reach the greater of the interest paid or the interest deducted by a foreign corporation's U.S. branch. Under prior law, foreign corporations were considered to have paid interest subject to withholding only when 50% or more of income was effectively connected with a U.S. business over a moving 3-year period. Under the new law, the 50% figure is, in effect, reduced to zero.

If the interest deduction allowed exceeds the amount actually paid (which may be the case under an existing formula approach), the excess is treated as a deemed payment of interest by the branch to the home office. It is not clear whether this excess qualifies for exemption from U.S. tax as interest on portfolio debt, interest on a bank deposit or for other reasons. The Congress delegated to the Treasury the power to develop regulations to answer these questions.

Finally, the new branch tax does not apply where the United States has tax treaty obligations which prevent imposition of either or both new taxes. For example, the United States–Canada treaty permits imposition of the tax, while the United States–United Kingdom treaty does not. Most of our treaties would prohibit imposition of the branch tax as discriminatory. Here, however, Congress, for the first time, has enacted a concept of treaty shopping which, if violated, will cause a foreign person to lose protection of the treaty.

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It remains to be seen whether the new statutory treaty shopping definition has wider ramifications than the narrow technical usage for which the Congress enacted it. In this regard, the Treasury Department has in recent years taken a number of steps to attempt to deny to foreign persons the benefits of tax treaties where so-called treaty shopping has been considered to be involved, and this new statutory concept in the context of the branch tax may give these administration efforts new impetus.

The treaty shopping rules are based on the concept of a "qualified resident". Any foreign corporation resident in a foreign treaty country, as defined in the treaty, is a qualified resident for purposes of the branch tax unless either (1) more than 50% of the stock of the corporation by value is ultimately owned by individuals who are neither residents of the foreign country nor U.S. persons or (2) 50% or more of the income of the corporation in question is used directly or indirectly to meet liabilities to persons who are not residents of either the foreign country or the United States. There is a special exception from these rules, and a finding of qualified resident status, for foreign corporations whose stock is regularly traded on an established securities market in the foreign country, and for those which are wholly owned, directly or indirectly, by another foreign corporation resident in such country whose stock is so traded.

The new statute provides that the provisions of U.S. income tax treaties shall not serve to reduce or exempt any foreign corporation from the new branch tax unless the corporation is a qualified resident of the treaty country. There will be many difficult statutory and treaty interpretation questions raised by these new provisions. U.S. treaty partners may challenge application of these new taxes. Nonetheless, the Congressional mandate is clear, and the Treasury Department may well have to defend this expanded application of U.S. tax laws, which it opposed during the Congressional development of the new statute. Even more importantly, the Treasury may in negotiating new treaties or revisions of existing ones have to give way to the clear Congressional mandate to impose a sound second level tax on U.S. business income earned by foreign persons.

These provisions could well lead over time to significant increases in the tax burdens foreign investors in the United States must face. The new taxes were aimed primarily at banks, insurance and real estate holding companies. However, they will undoubtedly have a major impact on many other types of investors, including joint ventures with U.S. companies. Careful planning is now more important than ever for foreign investors.

IV. OTHER PROVISIONS DIRECTLY AFFECTING FOREIGN INVESTORS

There are a number of other provisions of the 1986 Act which may affect particular foreign investments. Those discussed below are not meant to be exhaustive, but simply to identify those which may be the most significant.

1. Under existing law, income effectively connected with a foreign taxpayer's U.S. trade or business is taxed on a net basis at graduated rates. U.S.-source annual or periodical fixed or determinable income (e.g. dividends, interest, royalties) of a foreign taxpayer that is not effectively connected with a U.S. trade or business generally is subject to a 30% withholding tax on the gross amount, unless reduced or eliminated by statute or treaty. Under prior law, foreign persons could avoid U.S. tax on income attributable to a U.S. trade or business by receiving the income in a year after the trade or business has ceased to exist, for example, by selling assets and recognizing the gain on a deferred basis. This strategy will no longer be possible. Any prepaid or deferred item of income received by a cash basis foreign person attributable to a transaction in a year in which it would be effectively-connected income will have it so treated regardless of when received.

2. Foreign-owned corporations generally must file detailed information returns, including data on transactions with related foreign or domestic corporate entities. Under prior law, transactions between a foreign-owned corporation and related individuals, partnerships, trusts or any other non-corporate entities generally were not reportable. New provisions extend the reporting requirements to transactions with related non-corporate persons. In addition, severe penalties are provided to punish not only failure to file, but incomplete or untimely reporting.

3. As a tax collection mechanism, partnerships engaged in a U.S. business are subject to new withholding requirements on distributions to foreign partners. Distributions to foreign partners are deemed to come first out of non-effectively-connected types of income so that they will be subject to 30% withholding unless reduced by an applicable treaty rate. There is a 20% withholding requirement on any remaining partnership distributions from U.S. effectively-connected income. When 80% or more of a partnership's income is U.S. business income, the entire amount is subject to withholding. Partnerships apparently will be able to accumulate and reinvest effectively-connected partnership income without withholding any U.S. taxes until actual or deemed distributions are made. This means that the payment of taxes by the partner, generally at applicable individual rates when income is earned, may not match the withholding of taxes by the partnership, and considerable administrative problems will need to be addressed by taxpayers and the IRS.

4. The Act provides that importers into the United States cannot use a transfer price for U.S. income tax purposes that is higher than the value they claim for U.S. customs purposes. One of the important outgrowths of this provision may be that the IRS, by having greater access to customs duty information and any investigation that may be done by customs agents,

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will find more cases in which they want to assert Sec. 482 pricing adjustments. This provision could have important practical consequences for many foreign persons who export goods to the United States.

5. Congress also has codified existing Treasury Regulations governing the taxation of foreign governments and controlled commercial entities of foreign governments. Foreign governments remain exempt from tax on passive, portfolio-type income but are now subject to tax on income from commercial activities and on income received from controlled commercial entities.

6. A number of changes that were primarily intended to affect U.S. persons with respect to outbound transactions were made equally applicable to inbound transactions. One of these is the new foreign currency rules which provide specific rules for the tax treatment of foreign exchange gains or losses. These rules also require that business units (corporations and branches) that use a functional currency other than the U.S. dollar now must use the profit and loss method to translate earnings and profits (or losses) into U.S. dollars. The application of these new rules with respect to persons engaging in inbound transactions with the United States may be quite significant.

7. Another new provision provides that intangibles transferred both into and out of the United States to related parties, by either sale or license, must be priced to reflect the income earned from time to time by the intangibles. This means that the IRS can adjust transfer prices to reflect income earned by the transferee even though the price was concededly fair at the time of transfer. The effect of this new so-called "super royalty" provision is to modify the traditional rule that related party transactions should be tested by an arm's length standard at the time a transaction is undertaken, i.e. the same price that unrelated parties would pay. It will undoubtedly raise problems in other taxing jurisdictions that continue to apply a traditional arm's length standard and may be considered inconsistent with tax treaty provisions based on historic concepts. The new concept here is an outgrowth of the more aggressive administrative posture of the IRS in Sec. 482 cases generally and particularly in dealing with foreign-based multinationals. To the extent that Congress has now seen fit to adopt in the statute a strong measure to augment U.S. revenues, it may be that there will be additional aggressive measures instituted either administratively by the IRS or in subsequent legislation.

8. A corporation can be a resident of more than one country when the residency rules are different. For example, many countries base residency on the place of management and control while the United States bases residency on the place of incorporation. Dual resident corporations have often been used to allow acquisition interest expense to be deducted against income in both the home country and the host country. Under the new Act, the losses of a U.S. corporation cannot offset the income of another U.S. corporation for U.S. tax purposes if these losses also reduce the foreign taxes of a related foreign corporation. Thus, the United States has chosen to deny in effect a U.S. interest deduction to certain foreign persons. Whether other governments take retaliatory action against U.S. persons who attempt to use dual resident companies to reduce taxes in foreign countries or whether income tax treaty provisions are seen as violated, remains to be seen.

9. In general, the Congress gave many indications of being concerned about U.S. interest deductions based on payments to related foreign persons. The bill contained at one time a denial of certain related party interest deductions where foreign corporations were involved, the so-called interest stripping provision. While this provision was dropped during the House-Senate Conference, it may be that the IRS will seek to move against some of these situations under more traditional treaty shopping or thin capitalization approaches. It also may be that the legislative proposal will be renewed at some time. As with many provisions affecting foreign income in this Act, the Congressional staff kept track of proposals that failed enactment in previous Congresses and took advantage of the need for revenues in this Act to finally succeed in having them enacted. Thus, foreign persons should take steps, if possible, to maintain flexibility in the ways they finance U.S. investments.

V. CONCLUSION

In sum, the 1986 Act creates a new and more complex operating environment in the United States, and foreign persons, like U.S. persons, will need to work through the new taxing regime carefully. It could well be that with respect to some types of businesses and investments there are increased opportunities because of the lower individual and corporate rates. But the apparent advantages have to be weighed against possibilities of increased U.S. taxes in the future and the general hostility shown to foreign persons in the provisions specifically directed to inbound transactions in the new Act.

While some feel that the United States could become a sort of tax haven for certain types of activities, including being an even better Western Hemisphere base of operations, this is by no means clear. The new U.S. rules applicable to outward bound transactions, including increased restrictions on foreign tax credit allowances and more current taxation of foreign income, would affect the viability of a foreign parent using a U.S. subsidiary for operations outside the United States. There certainly will be greater complexity for U.S. subsidiaries with foreign (non-U.S.) activities and income.

There is clearly a need to review existing structures and activities because of the new rules. For example, it will be necessary to make sure that with investments such as U.S. real estate, and with banking, insurance and other financial activities located in the United States, the new branch tax and other new rules are fully taken into account.

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The underlying philosophy with respect to taxation of foreign persons seems essentially to seek increased revenues by restricting structures and activities that can be viewed as artificially lowering or avoiding U.S. taxes. This philosophy could lead to further restrictive changes in the future. On the other hand, tax collectors the world round are becoming more aggressive in imposing taxes on foreign persons. Thus while the United States may be leading the way, it is not alone.

A basic issue raised by the U.S. developments is how other countries will respond to the U.S. developments. Some analysts have projected that there will be a tendency to converge on a broad base – low rate pattern like that of the United States. Others have indicated that the U.S. developments are too peculiar to the U.S. economic situation to be emulated. Other developed countries such as Canada and Japan and the major western European trading partners such as the United Kingdom and Germany are giving careful attention to the effects of the U.S. developments. Preliminarily they have sought to reduce rates and broaden bases in the same way as the United States, but on a more limited scale. Any migration of business or undue competitive effects will undoubtedly cause a retaliatory response.

A closely related issue is whether the U.S. developments will lead to increased cooperation internationally or will be counterproductive from that standpoint. The United States took many actions which are directly inconsistent with tax treaty obligations and others which suggest a unilateral nationalistic approach rather than an internationally cooperative approach to international tax issues. Whether other countries in response to this will also seek to take unilateral action or whether they will renew their efforts to try to establish international cooperation remains to be seen. Certainly on this score the United States should make every effort to cooperate internationally to help other nations adjust to its changes. Whether this will happen remains to be seen.

A basic issue raised for developing countries is how to renew the quest for the best kind of tax system based on their own stage of development. The U.S. renewed commitment to income taxes as opposed to other kinds of taxes demands close scrutiny. But whether this pattern is feasible or desirable is not an easy issue.

Most developing countries have been unable to enter into tax treaties with the United States. There has been some movement in recent years to enter treaties that at least provide for administrative types of cooperation, such as exchange of information and mutual assistance provisions. These kinds of treaties would seem even more important given the changes in the U.S. tax system. One of the major issues that needs to be addressed is how developing countries can develop cooperative international relationships with the United States.

In conclusion, there is much new that has happened in the United States and it behooves us all to keep a close watch on how these changes will work out as a practical matter. Developing countries have a particular perspective on these changes that is important and valuable. I would urge you all to analyze the consequences from your standpoint and to make your views known. When it comes to matters of tax policy, we all have much to learn.

OECD *Just published*

The Taxation of Fringe Benefits

Fringe benefits account for an increasing proportion of the remuneration of employees. Because such benefits are often given a favourable tax treatment, tax revenues are reduced and the tax burden is redistributed in ways which may not have been intended by legislators. But what are these so-called "fringe benefits"? Why are they used? And how are they treated under different tax systems? This new OECD publication answers these questions.

The report first describes the main characteristics of fringe benefits and then some of the problems encountered by governments in taxing them.

The reasons why fringe benefits are used by employers and employees are extensively discussed in the report. From the employee's perspective fringe benefits are accepted because they reduce, amongst other things, his tax and social security payments and may provide him with a certain status within his company. From the employer's point of view, fringe benefits may be attractive because they lower his labour costs, provide a more flexible salary structure and may increase the productivity of employees.

The report provides a comprehensive description of what benefits are subject to tax (for example, company cars and employer-provided accommodation are normally taxed, though often at preferential rates) and the ways in which fringe benefits are valued for tax purpose. It also describes recent provisions in certain countries to tax there benefits more extensively.

Journalists may obtain a copy of the report from the OECD Press Division,
2 rue André Pascal, 75775 Paris Cedex 16 (Tel.: 45 24 80 89).

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Some Observations on Relationships Between Tax and International Trade Law

By Greyson Bryan

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INTRODUCTION

The laws and policies that govern a nation's system of taxation are normally considered to be separate and distinct from the laws and policies that describe that country's international trade regime. Plausible arguments can be made in favor of avoiding intersections between tax and trade. The former may be viewed primarily as an instrument of domestic economic policy, the latter is by definition tied to international economic concerns.

Remarkable consensus has developed concerning the fundamental components of the major systems of taxation as well as of bilateral tax relationships. By contrast, even the most basic rules governing international trade are still subject to both unilateral and multilateral reconsideration. Keeping the tax path completely parallel to the trade path allows the latter to proceed according to its own special environment. More importantly, the argument goes, parallelism protects the more well-developed tax path from the constant, and not always beneficial, roadwork suffered by the trade path.

Yet, for better or for worse, a number of crossroads and convergences already link tax and trade systems. Exports which benefit from subsidies conferred through the income tax system of an exporting country may be subject to special "countervailing duties" in the country of importation. The indirect tax system of a country may be challenged as discriminatory against imports or as a disguised export promotion scheme. Even income tax compliance may be assisted by reference to trade concepts. In the case in which an importer must declare for customs purposes the value of merchandise imported from a related party, that value may be used as a benchmark for evaluating the transfer price for income tax purposes. Although these are small intersections when compared to entire tax and trade networks, they do merit some examination.

The goal of this paper is to introduce the subject of international trade law to readers much more familiar with tax concepts and to describe in greater detail some of the ways in which tax and trade laws intersect. The discussion is limited to U.S. law and practice, but should illustrate, it is hoped, relationships that may be found in the systems of other nations.

OVERVIEW OF U.S. TRADE LAWS

Very generally, the universe of U.S. international trade law may be divided into 2 parts: customs law and trade remedy laws. This rough division ignores the Export Administration Act of 1979 and other statutes regulating export activities, the International Emergency Economic Powers Act and similar laws relating to the political and economic security implications of trade, and other relatively sui generis rules governing U.S. international trade. Nevertheless, the separation of the trade universe into its 2 principal galaxies is a useful organizing tool.

The customs law of the United States, in turn, may be separated into those rules that impose taxes upon imports and those rules that govern other aspects of the importation of merchandise into the United States. The latter category contains laws that regulate the importation of hazardous materials, require accurate labeling, and insure that imports do not threaten the health and safety of the people of the United States. For purposes of this article, this latter category is less important.

The imposition of a tax on imports requires a determination of the tax rate and the tax base. The rate of tax on imports into the United States is determined in accordance with the Tariff Schedules of the United States. The Tariff Schedules set forth rates of duty that vary depending both upon the category of the imported merchandise and its country of origin. There are arcane rules of classification to resolve questions concerning the categorization of merchandise that is not clearly identified in the Tariff Schedules and complex principles to determine the country of origin of merchandise that undergoes processing in 2 or more countries prior to entering the United States. Rates of tax vary according to country of origin for 2 reasons. First, imports from some countries are taxed more heavily because they do not benefit from "most-fa-

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vored nation treatment" by the United States. Second, certain imports from developing countries are taxed at preferential rates under the U.S. Generalized System of Preferences.

The base of the U.S. tax on imports is determined by reference to valuation principles. Prior to the 1979 Tokyo Round of Multilateral Trade Negotiations, the United States and many other countries had idiosyncratic valuation systems. The purpose of such systems often was not to determine objectively the value of imported merchandise, but rather to protect domestic industries by increasing the value subject to tax. Now, fundamentally, the United States imposes duties upon the "transaction value" of the imported merchandise, that is, upon the price actually paid by the importer. Although this system requires vigilance in the case in which the importer is related to the exporter, it is on the whole simpler and less susceptible to use as a protectionist device than the previous system.

U.S. trade remedy laws are composed of those statutes that, under certain circumstances, permit or require the U.S. Government to restrict imports. This galaxy of U.S. international trade law may itself be separated into 2 systems: those laws restricting "unfairly traded" imports and those laws restricting "fairly traded" imports. The system of unfair trade laws contains statutes that cover both unfair actions by foreign governments and unfair actions by foreign private parties.

In the category of unfair trade laws governing acts by foreign governments, the countervailing duty law and Sec. 301 of the Trade Act of 1974 predominate. The countervailing duty law of the United States imposes a tax on imports if the production or export of the merchandise has been subsidized, if the subsidy is "countervailable", and if the subsidized imports are causing or are threatening to cause material injury to an existing U.S. industry, or are materially retarding the establishment of a U.S. industry. The tax imposed is imposed upon the importer in an amount equal to 100% of the net subsidy on the imported merchandise. Subsidies include direct grants, the provision of goods or services at below market prices, certain types of tax incentives, and preferential loans. Subsidies are also classified as "export subsidies", that is, those contingent upon export and as "domestic subsidies", that is, those given irrespective of export activity. A countervailable subsidy is a subsidy which the U.S. Government finds to "distort" the allocation of economic resources from what that allocation would be in the absence of the subsidy. All export subsidies, by definition, are countervailable. A domestic subsidy, however, may not be countervailable. For example, a payment by a developing country government to its shoe industry would not be countervailable, if the payment were contingent on that industry's buying high cost domestic leather as opposed to low cost imported leather and if the payment did not exceed the difference.

Sec. 301 permits the President of the United States to take retaliatory action against the goods or services of another country to eliminate what he finds to be the "unreasonable, discriminatory, or unjustifiable" practices of a foreign government. The retaliation may take the form of a tax on imports; for example, the 100% surcharge placed upon certain Japanese products was imposed under the authority of Sec. 301 due to an alleged violation by Japanese companies of the Semiconductor Agreement with the United States.

In contrast to the countervailing duty law and Sec. 301, the anti-dumping law of the United States is concerned with unfair trade actions by private parties rather than governments. Other provisions, such as Sec. 337 of the Tariff Act of 1930 (primarily used to exclude from the United States imports that both infringe U.S. patents, trademarks, and other intellectual property rights and cause injury to a U.S. producer), also govern unfair private acts in international trade, but the anti-dumping law is by far the most important. The anti-dumping law imposes a tax on imports into the United States if the imports are sold at less than "fair value" and if such imports cause or threaten material injury to an existing U.S. industry, or materially retard the establishment of a U.S. industry. The tax is imposed upon the importer in an amount equal to 100% of the difference between the U.S. price and the "fair value". Essentially, the anti-dumping law requires an exporter of merchandise competing with a U.S. industry to have a net return upon sales in the U.S. market that is equal to or greater than the net return upon sales in the comparable foreign market. If the net return in the foreign market is negative, that is, sales are made below cost, then a theoretical net return is used as the benchmark.

Other provisions of U.S. international trade law may be invoked to impose restrictions upon fairly traded imports. Some of these provisions are non-sectoral in nature. For example, Sec. 201 of the Trade Act of 1974 ("escape clause") permits the President of the United States, upon recommendation by the International Trade Commission, to impose higher duties or some type of quantitative restriction upon imports that are fairly traded, but are nonetheless a principal cause of serious injury to a U.S. industry. And Sec. 232 of the Trade Expansion Act of 1962 permits the President, upon the recommendation of the Secretary of Commerce, to take any appropriate action against fairly traded imports, if the imported goods are found to threaten U.S. national security. Other statutes in the fair trade category are sector-specific or even product-specific, imposing restrictions upon imports of meat, agricultural, or textile products.

Before concluding this brief overview of U.S. international trade laws, several recent trends are worth noting. First, a great part of U.S. international trade laws, and the world trading system in general, is based upon out-moded assumptions about international business and economics. The complexity and intensity of the current debate over international trade law is partly due to the difficulty of adjusting existing rules to deal with the advent of phenomena such as non-market economy countries, industrial policy, multinational corporations, and barter trade. Second, the increasing

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dependence of the United States upon world trade has enhanced the political importance of international trade rules. Greater political importance has, in turn, led to more participation in trade policy-making by each Administration and Congress, with a consistent and predictable rise in inconsistency and unpredictability. Third, as the discussions in the Uruguay Round of Multilateral Trade Negotiations indicate, there is a growing awareness of the inadequacy of rules governing barriers to the international flow of investment and services. This awareness has resulted in attempts both to expand the scope of rules originally designed to cover exclusively barriers to trade in goods as well as to draft new rules for investment and services borrowing in part concepts developed in the trade area. While the impact of these and other trends on the development of U.S. international trade law is difficult to predict, both the scope and complexity of U.S. trade law seem certain to grow rapidly.

THE RELATIONSHIP BETWEEN IMPORT TAXES, INCOME TAXES, ANTI-DUMPING DUTIES AND FOREIGN EXCHANGE CONTROLS IN THE CONTEXT OF OVER-INVOICING OR UNDER-INVOICING OF IMPORTS

The price at which an importer purchases goods from a related exporter is a hub from which import tax, income tax, anti-dumping duty, foreign exchange control, and other consequences may flow. From the viewpoint of one party, for example, the importer, a change in the transfer price between exporter and importer may have tax, trade, and other consequences, only some of which are beneficial. This section of the paper examines some of the possible consequences of under-invoicing and over-invoicing in the importation of goods.

Generally speaking, over-invoicing leads to higher import taxes and under-invoicing results in lower import taxes. This conclusion rests upon several key assumptions, however. The base of the import tax must be ad valorem not specific, there must be no exemption from tax as may be granted under schemes designed to benefit imports from developing countries, and the normal tariff rate must be greater than zero. Conversely, over-invoicing generally leads to lower income taxes for the importer by furnishing the importer a higher basis for purposes of the calculation of depreciation, investment credits or of gain while under-invoicing has the opposite effect. This general conclusion also rests upon numerous assumptions; for example, the importing enterprise must be profitable and the imported merchandise must not be simply devoted to personal consumption.

The general relationship between the import price and liability for anti-dumping duties parallels the relationship between the import price and the importer's liability for income taxes, i.e. lower import prices lead to higher liability. Moreover, because the anti-dumping "tax rate" is 100% of the dumping margin, there can be a greater increase in anti-dumping duties as a result of lower import prices than in income taxes. Yet, as with income taxes, the relationship between import price and liability for anti-dumping duties is contingent upon many factors. Indeed, because the anti-dumping law in effect consolidates the operations of an importer and its related exporter, the import price only affects anti-dumping duty liability through its effect, if any, upon the importer's resale price. To illustrate an extreme case, an import price of $1.00 for a television set would not necessarily result in an increase in anti-dumping duty liability provided that the related importer's resale price were high enough.

Over-invoicing and under-invoicing may also have a number of other effects. For example, from the importer's point of view, over-invoicing may also be a way to circumvent foreign exchange controls while under-invoicing would result in less foreign exchange leaving the importing country. Of course, this general point assumes a difference between the official exchange rate and the black market exchange rate. Similarly, in cases in which an ad valorem quota is established, under-invoicing would be beneficial in that it would use up the quota more slowly. In fact, because many quotas established by the United States are actually administered by the exporting country, there has been an inconsistency in some cases between the amount declared to the exporting country's authorities and the amount declared by the U.S. importer for U.S. customs purposes. Further, under-invoicing would also be attractive to an importer of goods that receive preferential tariff treatment but only up to a certain limit. This would be the case, for example, for importers of merchandise benefitting from the U.S. Generalized System of Preferences and similar regimes in Japan and the European Community. Finally, over-invoicing might be beneficial in cases in which investment benefits, such as tax holidays, are tied to the amount of investment made in the project.

The discussion of considerations relevant to over-invoicing and under-invoicing would be misleading without mention of some practical constraints upon the importer's ability to manipulate the import price. Both the perspective of the exporter and the element of risk deserve mention here. Obviously, in cases in which the importer may, on balance, seek an inflated price, the exporter may have a different priority after considering its own position regarding income tax liability, foreign exchange control, and export performance requirements. If consistency in the declaration of the transfer price is to be maintained, then the exporter's position may well influence the extent to which an importer may adjust the import price. More importantly, an importer must consider the risk that the fact of under-invoicing or over-invoicing would be discovered by authorities in the importing country. Inconsistency between the price declared by the exporter to the exporting country and the price declared by the importer would seem to increase the risk of discovery as would the following:

(1) the presence of another importer of the same goods from the same exporter;

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(2) the presence of another exporter of the same goods to the same importing country;
(3) price and foreign exchange stability;
(4) the importation of homogenous, as opposed to unique, products; and
(5) importation from a "related party" as that is defined by the customs law of the importing country.

This discussion indicates that the decision to under-invoice or over-invoice is not as simple as it may first appear and that conclusions are difficult to state. If the inquiry is confined to income taxes and import taxes and if the perspective of the exporter is forgotten, then it is possible to conclude that under-invoicing becomes more beneficial to the importer as the tariff rate goes up versus the income tax rate. However, over-invoicing would still be preferable in the case in which rates were equal because import taxes are normally deductible against the income tax base. By the same token, exemptions from income tax would stimulate under-invoicing and exemptions from import tax would stimulate over-invoicing. Table I indicates the various questions and the very tentative answers that complicate the drawing of more definitive conclusions.

Table I
Some factors in over and under-invoicing decisions

Factors	Over-invoicing	Under-invoicing
Importer's view		
Import taxes	Cost	Benefit
Income taxes	Benefit	Cost
Anti-dumping duties	Benefit	Benefit
Exchange control	Benefit	Cost
Investment performance	Benefit	Cost
Import quota	Cost	Benefit
Import preferences	Cost	Benefit
Exporter's view		
Income taxes	Cost	Benefit
Exchange control	Cost	Benefit
Export performance	Benefit	Cost
Export restraint	Cost	Benefit

The various incentives to manipulate the import price make it clear that coordination between the income tax and customs agencies of the importing nation could be quite effective in increasing compliance with both customs and income tax rules. Despite the obvious arguments in favor of such cooperation, it has not always been achieved. Competition between agencies for scarce resources, different and sometimes conflicting priorities, restrictions on sharing information submitted in confidence by taxpayers, and a less than clear relationship between the value declared for customs purposes and the price declared for income tax purposes have all contributed to the lack of coordination.

One recent development in this area was the enactment in 1986 of what is now Sec. 1059A of the Internal Revenue Code. This provision, taking advantage of the 1979 change in U.S. valuation rules to a "transaction value" principle, attempts to link the reporting of the import price for customs purposes to the price declared for income tax purposes. Sec. 1059A applies only to transactions between related parties and requires that the price reported for income tax purposes be "no higher" than the value reported for customs or "any other duties". Adjustments are permitted in cases in which the customs valuation rules differ from tax rules. The benefit of Sec. 1059A seems to be the establishment of an easily verifiable "ceiling" for tax examiners concerned with the reliability of the import price. Some disadvantages include the fear that a customs audit might slow the finalization of U.S. tax returns. Moreover, despite the clear statutory language, there is a possibility that examiners or the courts might accept consistency between customs and tax declarations as proof of the reliability of the import price rather than only as proof that the import price should not be any higher. Despite these potential disadvantages, however, the provision does have merit as an attempt by a tax administration to define and then utilize to its advantage the relationship between U.S. income tax and trade laws.

THE RELATIONSHIP BETWEEN IMPORT TAXES AND EXCISE TAXES AND THE DEFINITION OF UNFAIR GOVERNMENTAL RESTRICTIONS ON TRADE

Assuming that an excise tax is ad valorem in nature and that import taxes are included in the base of the excise tax, the excise tax may be viewed as "multiplying" the burden of the import tax. For example, assuming a 20% import tax and a 55% ad valorem excise tax on cigarettes, the combined tax on imported products is, under this view, 31% [(20%) × (1 + 55%) = 31%] and not 20%. This extra burden on imported products was, among other problems, at issue in a recent Sec. 301 proceeding brought by the U.S. Government against the Government of Japan. From the brief description of Sec. 301 given above, it should be clear that the U.S. Government was, in effect, declaring to the Government of Japan that this particular aspect of its tax system was "unreasonable, unjustifiable, or discriminatory". As a result of negotiations growing out of the Sec. 301 proceeding, the Government of Japan agreed to eliminate its tariff on imported cigarettes.

This example of a trade proceeding affecting the tax system of an importing nation is particularly disturbing. First, many nations have equal or higher ad valorem rates of import taxes on cigarettes or equal or higher ad valorem cigarette excise taxes. Second, Japan's import tax on cigarettes accorded with its obligations ("most favored nation treatment") under the General Agreement on Tariffs and Trade (GATT) and its excise tax system accorded with its obligations ("national treatment") under the U.S.–Japan Treaty of Friendschip, Commerce & Navigation. Despite these strong facts in its favor, the Government of Japan changed its system of indirect taxation in response to the U.S. complaint. Although this case may cause concern to other trading partners with similar indirect tax systems, its precedential value may be

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slight because of the special trade problems between the United States and Japan, because the Government of Japan acted before a formal decision could be made, and because of the high discretionary nature of Sec. 301 proceedings in general.

THE RELATIONSHIP BETWEEN THE DIRECT TAX POLICY OF AN EXPORTING NATION AND THE COUNTERVAILING DUTY LAWS

In contrast to the decision described in the previous section in which a U.S. trade action affected the tax system of a nation importing U.S. products, this section takes as its subject the interaction between the countervailing duty law of an importing nation, like the United States, and the tax policy of an exporting nation. As briefly set forth above, a countervailing duty law imposes under certain conditions a duty upon subsidized imports equal to the amount of the net subsidy found. The Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade (Relating to Subsidies and Countervailing Measures) includes in its "Illustrative List of Export Subsidies" certain tax preferences. The tax preferences treated as subsidies fall into 2 broad categories. First, any direct tax preference, such as reductions in income taxes, real property taxes, or taxes on wages, is considered a subsidy. Second, any "excessive" remission or exemption of indirect taxes, such as sales or excise taxes, is also considered a subsidy. "Excessive" means a refund in excess of the indirect tax actually imposed or a refund of taxes imposed at a prior stage of production in excess of the amount levied on goods that are physically incorporated in the exported product.

The distinction drawn between direct and indirect taxes relates to the concept of "shifting" of the tax burden. Based upon the premise that direct taxes are borne economically by the taxpayer and that indirect taxes are "passed on", a direct tax preference is viewed as bestowing an economic benefit to the taxpayer that distorts its economic behavior. By contrast, the non-excessive remission of an indirect tax is not viewed as an economic benefit to the taxpayer which, in the absence of the refund, would pass on the indirect tax burden. The premise of full-shifting of indirect taxes and complete non-shifting of direct taxes, of course, has been contradicted by modern economic theory. This more recent learning holds that both direct and indirect taxes may be shifted either completely or partially. Indeed, the more recent learning on shifting calls into question two basic assumptions of the countervailing duty law, namely, that only the technical recipient of a subsidiy derives benefit and that the technical recipient receives its full economic benefit.

Whatever the merits of the premise upon which the distinction was originally based, the different treatment of direct and indirect tax preferences has become part of the rules of international trade. Similarly, the distinction between the standard of "excessive remission" applicable to prior-stage cumulative indirect taxes (the "physical incorporation" test) and that applicable to final-stage indirect taxes has survived. Both rules provide an incentive to an exporting country to adopt a value-added tax and exempt export sales. This incentive is particularly keen if the current indirect tax system contains multiple-stage cumulative indirect taxes ("cascade tax system") refunded upon export in a lump-sum manner which raises concerns of excessive remission.

THE RELATIONSHIP BETWEEN THE INDIRECT TAX POLICY OF AN EXPORTING NATION AND THE ANTI-DUMPING LAW

The anti-dumping law takes as its principal object the comparison of returns on sales to the United States with returns on sales or theoretical returns on sales in a comparable foreign country. This comparison of returns is accomplished by comparing prices in the 2 markets, after adjusting those prices for differences between the 2 markets in the cost of selling and producing the product under investigation. Adjustment is also required under GATT for differences in taxation affecting price comparability, but there is disagreement in the United States over what adjustment should be made and whether the adjustment should take into account the possibility that indirect taxes may not be fully borne by the technical taxpayer. The questions are of some consequence to U.S. trading partners with indirect tax systems and a substantial proportion of whose products are subject to U.S. anti-dumping duties. Table II helps to illustrate the problems involved, assuming a $ 100 pre-tax price for merchandise sold in Japan, a $ 90 pre-tax price for the same merchandise sold to the U.S. market, a 15% single-stage sales tax imposed upon merchandise sold by producers for resale in Japan, and an exemption from that tax for merchandise sold for export.

Table II
Adjustments for differences in taxation

	Japan price	U.S. price	Margin	Margin (%)
Pre-tax situation	100	90	10	11.0
Post-tax situation	115	90	25	27.7
U.S. adjustment #1	115	103.5	11.5	11.0
U.S. adjustment #2	115	105	10	9.5
Japan adjustment	100	90	10	11.0

In order to re-produce exactly the pre-tax situation regarding the absolute dumping margin (10), it is necessary either to make an upward adjustment to the U.S. price equal to the full amount of the indirect tax paid on the Japanese sale (U.S. adjustment #2) or a downward adjustment in the Japan price equal to the full amount of the indirect tax paid (Japan adjustment). However, U.S. adjustment #2 is subject to criticism in that it yields a margin percentage (margin/U.S. price) less than the pre-tax margin percentage. U.S. adjustment #1, which is derived by adding to the U.S. price the amount of tax that would have been imposed absent an exemption ($90 \times 1.15 = 103.5$),

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recreates the pre-tax margin percentage, but yields an absolute margin (11.5) greater than the absolute pre-tax margin. The Japan adjustment recreates both the pre-tax absolute margin and the pre-tax margin percentage and would appear for those reasons to be the preferred method. Unfortunately, the anti-dumping law of the United States, unlike the GATT Antidumping Code, specifies that the adjustment for indirect taxes must be made to the U.S. price, a mandate which, if followed, would yield either a result unfair to exporters (U.S. adjustment #1) or to the U.S. industry (U.S. adjustment #2).

The second issue that has arisen in making adjustments for indirect taxes is whether the adjustment should be limited to the amount of the indirect tax that affects the Japan price, that is, to the amount "passed through". In support of such an interpretation is language found in the House Report to the Trade Act of 1974: "[t]o the extent that the exporter absorbs indirect taxes in his home market sales, no adjustment to [U.S.] price will be made and the likelihood or size of dumping margins will be increased". H.R. Rep. No. 93-571, 93rd Cong., 2d Sess. 69 (1973). Against such an interpretation is an argument that begins with the proposition that Congress intended to harmonize the treatment of indirect taxes in the countervailing duty and anti-dumping duty laws. Because Congress never required that the degree of shifting of indirect taxes be measured in countervailing duty cases, it could not have intended such a result in anti-dumping duty cases. Put differently, because the full-shifting of indirect taxes is assumed in countervailing duty cases, it should also be assumed in anti-dumping duty cases.

With respect to both of the issues discussed here, the current situation in the United States is unclear. The U.S. Department of Commerce, charged with administering the anti-dumping law, prefers the Japan adjustment for indirect taxes and assumes full-shifting. The Department, however, has been challenged by representatives of U.S. industries and has received contradictory instructions from the Court of International Trade as to the propriety of its actions.[1]

CONCLUSION

This paper has brought to light and explored some of the intersections between tax and trade law and policy. Although the crossroads at present are few and much less travelled (some might add, less will lit) than the main tax and trade paths, that situation will change given the increasing importance of trade and the pervasive nature of tax issues to international economic relationships.

Moreover, even in places where the tax path and the trade path remain distinct, a comparison between the two is often fruitful. For example, developed nations have, to varying degrees, recognized the special status of developing countries in the world economic order and have consequently implemented policies with respect to developing nations, albeit in different ways, in both their tax and trade systems. Further, a concern with the avoidance of protectionist trade statutes, such as the anti-dumping law, has recently surfaced in both the United States and the European Community. In addressing the problem of avoidance of trade statutes, the much longer experience with examining tax avoidance may well provide useful insights. Finally, there is common to both tax and trade systems an aspect of public international law that is missing from many other fields. Moreover, while international tax relationships are primarily bilateral and international trade relationships primarily multilateral, the more recent advent of multilateral tax compliance agreements and bilateral free trade arrangements has blurred that distinction. The internationalization of tax and trade laws, therefore, is another area which invites comparative analysis.

In sum, while the well-beaten tax and trade paths may remain quite separate, there is nevertheless good reason to believe that travel along one may well make a journey along the other both easier and more interesting.

1. Compare *Zenith Electronics Corporation v. United States,* 633 F. Supp. 1382, 1388 (CIT 1986, Watson, J.) with *Atcor, Inc., et al. v. United States,* Slip Op. 87-26, March 12, 1987 (Carman, J.).

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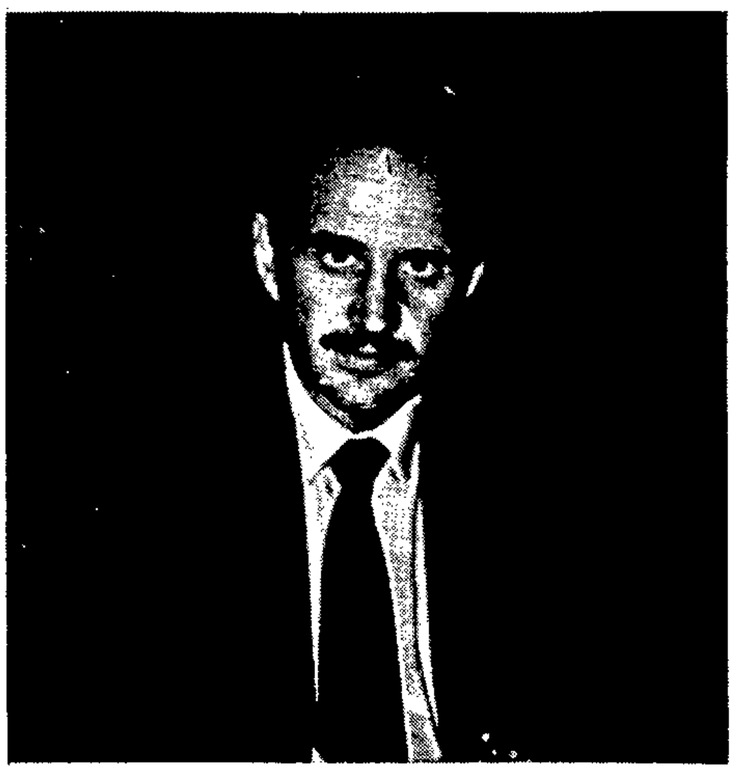
URUGUAY:

Evolution of Taxation and Promotional Regimes

By Ricardo Villarmarzo



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I. INTRODUCTION

In the past, Uruguay has been considered an attractive location for the development of foreign investment activities and the undertaking of financial transactions. Two factors in particular accounted for this attraction, i.e. the stable conditions which prevailed for many years and Uruguay's strategic geographic location between Argentina and Brazil. After 13 years of military rule, a democratic civilian Government was elected. The basic tax structure which was inherited from the military Government proved difficult to alter. Nevertheless, certain changes as well as ideas for changes are now taking place. This article briefly overviews the background of the current situation in Uruguay, the new developments, and the promotional laws and regulations for local and foreign investors.

II. EVOLUTION OF TAXATION

A. Characteristics of Uruguayan taxation at the beginning of 1985

During the period of military Government, there were few changes in taxation. Generally speaking, the major objective during this time was to simplify the taxation system and facilitate collection of taxes. In pursuance of this objective, several taxes were abolished, i.e. personal income tax, tax on average productivity of agricultural activities, the stamp tax, and specific taxes on financial activities.

At the time the democratic Government took office, Government revenue was mainly derived from indirect taxes, i.e. the value added tax, excise taxes and foreign trade taxes.[1] Direct taxes, i.e. income tax and capital tax, contributed an insignificant amount towards the total Government revenue.[2] Other than certain minor taxes, the above-mentioned taxes covered the major portion of the State's resources.

B. Taxation projects of the political parties

During the course of the political campaign, all groups presented their ideas and projects in respect of taxation. Some consensus was reached during various meetings.[3] A written report was finally prepared by economists of all the parties. The most important aspect stressed in the report concerned the transfer from a system of indirect taxation to one of direct taxation. Evaluation of potential contributions from various sectors of the economy was another integral part of the report. Specific measures included:

- establishing a broader base for calculation of income taxes;
- re-creating an income tax on agricultural activities in order to promote efficiency and productivity in that sector; and
- reducing the minimum tax rate of the value added tax and eliminating export taxes.

A clear preference was expressed for taxes to be levied on property, income, surplus and perhaps luxury consumption items. It was also deemed important to reduce taxation on exports and items of popular consumption and to promote a more efficient use of the agricultural sector's production.

1. Value added tax and excise taxes have an obvious effect on consumers and foreign trade taxes are also transferred to the public through higher prices.
2. Income tax was levied exclusively on commercial and industrial activities. Individuals were exempted from income tax. Capital tax applied to both companies and individuals based on a concept of territoriality.
3. The meetings were held as part of what is known as CONAPRO (concertación nacional programática).

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C. 1985 tax events

The Government approved certain specific laws and decrees in 1985 which, in some cases, effectively aimed to tax property and improve the administration of resources. All of the enactments tended to increase the amount of tax collected. Examples of these measures included increasing the taxable value of real estate for calculation of the capital tax and reduction of the available period to pay value added tax and excise taxes.

Towards the end of the year, new ordinances were approved employing the same criteria. In connection with income tax, new taxable transactions were added: fictitious interest on loans[4], payment of dividends abroad, etc. New taxpayers were defined.[5] Deduction of some items was restricted, such as the possibility of a loss carry-forward which was reduced from 5 years to 3 years. As compensation, the possibility of avoiding double taxation was regulated in respect of technical assistance.

A decision was taken to maintain the status of corporate capital tax. Some amendments were made, however, with more stringent criteria for the treatment of foreign assets, deductible liabilities and in respect of machinery and equipment utilized in the manufacturing process. The capital tax rate was reduced from 4.5% to 2.8%. A new tax, known as the control of corporations, was created. This tax must be paid promptly upon formation of a corporation or when an increase of authorized share capital takes place.

The most significant change affecting the value added tax was the exemption in respect of independent personal services related to human health and the inclusion of non-profit organizations as taxpayers in respect of taxable transactions. The rates of some excise taxes was increased (as well as some other minor changes). In all cases, the effect was to collect more taxes and extend the application of taxes.

D. The 5-Year Government Budget

Taking into consideration arguments advanced by the President at the time the 5-Year Budget was presented to the Parliament, it is clear that the policy of increasing indirect taxation would continue but the current status of the economy would also be considered to avoid negative consequences and extensive changes in the actual collection of taxes.

The most significant regulations contained in the bill related to income tax, value added tax and capital tax. Some new taxpayers were brought within the scope of income tax. In addition, the criterion for creation of the reserve for bad debts for tax purposes was amended to the effect that deductible expenses would no longer be permitted for both provisions or bad debts. Only specific amounts of uncollectible accounts would be admitted.

The value added tax imposed on purchases of fixed assets would no longer be accepted to offset value added tax on sales for taxpayers providing personal services. New criteria for the valuation of real estate would be applied in respect of the net wealth tax. An amount of certain types of life insurance could be included as taxable amounts for this tax.

Information available during discussions of the bill in respect of the current and future structure of Government resources is shown in Figures 1 and 2.

Figure 1
Structure of Government resources

Resources	1984	1985	1986
From taxes	90%	94%	93%
Others	10%	6%	7%

Figure 2
Significance of each type of tax in respect of resources

Kind of tax	1984	1985	1986
On goods and services	60%	63%	63%
On foreign trade	16%	16%	15%
On income and surplus	9%	9%	10%
On property	5%	6%	5%
	90%	94%	93%

These figures indicate the significant impact of indirect taxation on consumption, i.e. specifically the value added tax and excise taxes, although taxes on foreign trade are also significant. Resources arising from income taxes, taxes on property and other taxes account for a very low percentage of consumption.[6]

E. Preliminary evaluation at the end of 1985

The approach taken during 1985 endeavoured to achieve the objective of equitable distribution of wealth and social justice. Under pressure for the need for additional resources, the Government implemented decisions designed to increase resources.

As indicated by Figures 1 and 2, it is easier to suggest changes than to promote and implement them. Indirect taxation was extremely high, and changes were difficult to implement. The fiscal deficit and its reduction were significant aspects of the Government's economic strategy and did not allow for trials or risks. It may be assumed that the idea would be to increase

4. For income tax purposes, fictitious interest is calculated on loans and similar balances on a base established by the tax authorities (this interest must be computed as taxable income), except in the case of loans made by banks and loans between persons who are income taxpayers. If real interest exists and is higher than the fictitious interest, the real interest should be considered as taxable income. The idea of the tax law is to avoid unfair advantages derived from inflation.

5. Profit organizations performing taxable activities are not included, however.

6. Many of the items have been included, under the heading "Taxation", in the Memorandum of Agreement with the International Monetary Fund. Additionally, the Agreement endeavours to obtain resources by an increase of 16.5% (previously 14%) in gross national product (as a minimum) for the first year of the programme with subsequent increases. A commitment to improve the tax administration, specifically through implementation of better controls via electronic data processing, was also established.

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some taxes on property but maintain indirect taxation without significant amendments until such time as economic conditions warranted such changes.

F. 1986 tax events

During 1986 some innovation took place in respect of taxation. In respect of the value added tax, taxpayers of agricultural income were included. Consequently, the exemption for agricultural products in natural form was restricted so that the exemption applies exclusively to horticultural products. The Government was authorized to establish monthly payments of value added tax for certain taxpayers.

The main change in income tax concerned calculation of the inflation adjustment. The liabilities for assets used for non-taxable activities were to be computed as a percentage, based on the ratio between specific assets and total assets. The Government was authorized to require advance payment without restriction. The Government was also authorized to establish differential tax rates for value added tax and excise taxes taking into account the geographic location in which economic activities were carried out.

Since July 1986 financial institutions have been subject to a new tax on certain assets. All private and official financial institutions are subject to this tax. In general, tax is imposed if the institution has cash and corresponding accounts, securities, loans and some other minor items.

The taxable amount is computed on the balance of those items at the end of each month. Some assets are excluded for purposes of the computation. The basic rate of tax is 1% annually and the minimum rate is 0.25% for specific assets. Regulations were approved to facilitate payment of delayed liabilities (taxes and social security charges). The combined effect is to permit the taxpayer to fulfil tax requirements as well as increase Government revenue.

A specific income tax on agricultural activities was also created. The tax was based on revenues, expenses and net income effectively incurred. For a period of time, the taxpayer could opt to pay either this tax (called IRA)[7] or a tax based on the potential productivity of the land. A maximum amount was established in excess of which all taxpayers were included in the IRA system.

No significant conceptual changes in taxation were instituted in 1986. The objectives of the measures were to improve revenue through collection of taxes. The challenge was to achieve a reasonable balance between Government finances and distribution of wealth using a tax policy which did not inhibit economic development.

G. The National Agreement

At the beginning of 1986, all political parties held meetings and discussed significant aspects of economic development and social improvement. Fourteen areas of interest were analyzed and described in a signed document known as the National Agreement. Several of the more important areas of interest for business activities are as follows:

1. Agricultural sector

The bills refer to:
- promotion of exports of milk products;
- development of the wine industry;
- changes in the rural social security system which would be based on payments by hectare;
- taxation on agricultural assets of non-resident owners; and
- adjustments of direct taxation to promote technology, better use of the land, etc.

Some potential decrees would cover the reimbursement of taxes paid for gasoline used for agricultural products which were destined for export.

2. Fishing industry

The bills refer to
- promotion of exports and craft fishing.

3. Industrial sector

Several proposals include:
- establishment of preferences to companies engaging in export activities in respect of Government acquisitions;
- reimbursement of excise taxes on exports;
- partial or total exemption of income tax, capital tax and real estate tax for 5 years for export activities declared to be of national interest;
- public fares at international prices.

4. Commercial sector

The bills in the commercial sector aim to promote trading companies.

5. Construction sector

No specific bills were mentioned.

6. Transportation sector

Certain bills would cover Government commercial activities such as airlines, railways, etc.

7. Communication sector

Notwithstanding the fact that no specific bills were mentioned, the measures announced referred to improvement of telephones, telex, etc.

8. Tourism sector

The bills include:
- creation of duty-free shops;
- reimbursement of 50% of the value added tax paid for hotel services rendered outside the high season, together with an exemption of income taxes during the same period;
- special system for the sale of real estate for purposes of time-sharing.

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7. Impuesto a las rentas agropecuarias.

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9. Financial sector

Announcements covered the following:
- regulation of offshore banking;
- creation of an investment bank;
- authorizing cooperatives of savings and credit to operate as financial institutions;
- updating the law for corporations (Sociedades Anónimas);
- promotion and better regulation of stock exchanges and capital markets and updating of the bankruptcy law;
- regulation of leasing activities.

10. Development of the country

No projects were announced.

11. Social policy

The bills refer to:
- a new legal system for unemployment insurance;
- promotion of temporary activities and training facilities for young people;
- changes in the labour legislation and prohibition of labour law court actions;
- a new system for pensions.

12. Health sector

A national health system would be promoted.

13. Institutional reforms

Changes in respect of the political parties' law[8], labour agreements and others would be promoted.

14. Administrative reform

Announcements included improvement of the quality and quantity of public services without increasing taxes.

Some bills are currently being studied by Parliament but none have been approved as yet.

H. 1987 tax events

Some additional changes have been made in respect of specific taxes. However, no significant modifications of the previously discussed taxes have been introduced. The most significant aspects of the changes are as follows:[9]

- The benefit of "channelled savings": taxpayers will compute, as exempted income, any amount invested in companies declared to be of national interest. This option must be exercised within the period set for filing tax returns.
- Taxpayers in the agricultural sector have been included in the value added tax by means of a special system for calculation and payment of taxes.
- Social security charges for agricultural activities will be a responsibility of the taxpayer for the period in which he engages in agricultural activities regardless of the legal status for which he uses the land. Calculation would be based on a fictitious amount by hectare.
- A new coordinated text of Uruguayan taxation was published during 1987 (Texto Ordenado).

Other measures include the potential exemption of income to be used for the acquisition of certain assets, i.e. industrial machinery, agricultural machinery, fixed improvements in the agricultural sector, furniture and fixtures for hotels, computers, communication equipment, etc. (a maximum exemption of 40% of the investment); construction and improvement of hotels or buildings used for industrial purposes (a maximum of 20% of total investment). There will be a limit of 40% of the investor's pre-tax profits.[10]

Expenses incurred for research and development projects in the area of science and technology (especially biotechnology) are computed by 1½ times the actual amounts for income tax purposes. With respect to the capital tax, the possibility of deducting 50% of the tax value of industrial equipment exists for assets acquired after Parliamentary approval.

A credit may be obtained for the value added tax included in the purchase of assets and services for purposes of exploration of mineral resources for the period in which no sales are made.

The basic rate of the value added tax has been increased from 20% to 21%.

III. PROMOTION OF BUSINESS ACTIVITIES

The most important schemes in force for promotion of business activities are an industrial promotion law, a foreign investment law and a holding company law. Additionally, certain ordinances in respect of income and capital tax can be considered as tax incentives.

A. Industrial Promotion Law

The Industrial Promotion Law is regulated by Law 14,178 of 28 March 1974 and Decree 703/974 of 5 September 1974.[11]

1. Objectives

The promotional measures are designed to accomplish the following objectives:
(a) to reach maximum production and marketing efficiency based on adequate levels of dimension, technology and quality;
(b) to increase and diversify exports of industrialized goods which incorporate the highest possible added value on the constituent raw materials;
(c) to locate new industries and expand or reform existing ones, if doing so encourages the use of raw material markets and available manpower;

8. Ley Orgánica de los Partidos Políticos.
9. All of these changes were passed by Law 15,903, published in the Official Gazette of 18 November 1987 and effective, in general, on 1 January 1988.
10. This ordinance enters into force for fiscal years beginning after 1 January 1988.
11. Decree No. 703/974 regulates some specific aspects of the law.

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(d) to stimulate selected technical research programs directed towards the economic use of unexploited national raw materials and obtaining or improving national products, training technicians and workers and controlling and certifying the quality of products;
(e) to increase the economic impact of the tourism industry by improving the national tourist infrastructure.

2. National interest

An industry which is considered to be of national interest will receive credit assistance and tax exemptions.

3. Credit assistance

Credit assistance may consist, in whole or in part, of the following benefits:
(a) *Local currency loans*
- loans for a maximum period of 20 years with mortgage guarantees for the establishment of new industries or improvement of existing industries;
- loans for a maximum period of 8 years for the purchase of equipment, machinery, accessories and spare parts;
- loans for a maximum period of 1 year for the purchase of domestic raw materials to be industrialized and exported;
- reinvestment loans to draw up projects of technical and economic feasibility studies;
- loans for a maximum period of 2 years to cover up to 50% of the value or estimated value of projects, assembly, installations and initial operating expenses of new industries or for the modernization or expansion of existing industries;
- loans for a maximum period of 5 years to finance all types of accumulated tax debts arising from the inefficiency or unprofitability of an industry.

(b) *Foreign currency loans or guarantees*
- loans or guarantees for the purchase abroad of industrial equipment, spare parts and special materials;
- short-term credits for the purchase of raw materials or other materials to be used in predominantly export products.

4. Tax exemptions

Tax exemptions may consist of:
- total or partial exemption from all types of taxation as well as rebates on tariffs imposed on the cost of services rendered by the State;
- exemption of up to 60% of employers' contributions to social security funds with respect to that portion of the payroll corresponding to the labour costs included in goods manufactured for export;
- exemption from all taxes on the company's income as well as on the distribution of profits;
- exemption from port tariffs and additional charges due upon importation of goods required for the industrial equipment of the company (not produced by local industry);
- fiscal liabilities arising from importation.

The amount and periods of time for these exemptions will be established by the Executive Power with prior approval of the Advisory Group.

5. Channelling of savings

Individuals or legal entities which invest in companies included in the law (by purchasing registered shares to be issued by the companies) will be entitled to deduct from their taxable income the amounts invested before the due dates for filing the corresponding tax returns.

6. Export houses

The Executive Power will promote the establishment and operation of export houses to market locally-manufactured products abroad, to provide representation services in other countries and to promote export of products manufactured by local industrial companies (preferably those of medium and small size). They will enjoy a tax exemption to be granted in each individual case by the Executive Power for a maximum of 10 years.

B. Foreign Investment Law

The Foreign Investment Law is regulated by Law 14,179 of 28 March 1974, including modifications and additions introduced by Law 14,244 of 26 July 1974 and Decree 808/974 dated 10 October 1974.

1. Definition

Foreign investment is defined as all capital originating abroad with rights of repatriation and transfer of related profits. The investment may be in the form of foreign exchange, machinery, patents, technical processes, trade marks or any other form deemed to be of interest by the Government.

2. Subjects

Only individuals or legal entities domiciled abroad are entitled to the rights and obligations arising from this law.

3. Authorization

Foreign investment is authorized in all areas of economic and social development if compatible with the national interest. Some activities, however, require specific authorization from the Executive Power.

4. Guarantees

By authorizing foreign investment, the Government guarantees the remittance of capital and related annual profit. The Central Bank of Uruguay will provide the corresponding foreign exchange at the exchange rate prevailing on the last day of the financial year in which the profits were earned, provided that the exchange is requested within 60 days of the financial year-end. After this period, the applicable exchange rate will be that prevailing on the day the request for remittance was made.

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5. Repatriation of capital

The invested capital cannot be repatriated before the end of the third year after the effective date of the contract. The remittance abroad will always be first applied against the profits earned by the business. Remittances exceeding such profits will be applied against the invested capital.

6. Foreign capital company

For purposes of this law, a foreign capital company is a business enterprise whose capital (originating abroad) constitutes more than 50% of the capital with voting power.

7. Use of external and internal credit

Foreign companies included in this law may not avail themselves of medium and long-term internal credit. It is necessary, in each individual case, to obtain consent of the Government to use external credit.

8. Decree 808/794

Decree 808/794 regulates certain aspects of the law. Most relevant for the foreign investor are the following:

(a) *Administration*
In general, foreign investors must request authorization from the Ministry of Economy and Finance for the location of the investment. In some cases, the Executive Power must intervene. The authorization will be preceded by the opinion of an Advisory Group. The rights granted by law exist in addition to those established in Law 14,178, i.e. the Industrial Promotion Law. The Uruguayan Central Bank maintains a register of authorized foreign investments.

(b) *Remittance of profits and transfer of capital*
The State guarantees the remittance of profits and the transfer of capital under the conditions agreed to by contract. The Central Bank will assure the availability of the corresponding foreign exchange.

(c) *Capital with the right to transfer abroad*
This is understood to be the capital initially authorized and brought into Uruguay, plus capitalized net profits, less the capital already transferred and less net losses (all expressed in the currency of origin). For purposes of the law, all profits not remitted abroad within a period of 2 years will be considered as formally capitalized as from the date of the corresponding financial year.

(d) *Loans*
Business entities covered by the law will not be able to make use of internal medium and long-term financial credit in any form. Operations with terms not exceeding one year are considered to be short term. External credit must be authorized by the Government and entered in the register maintained by the Central Bank. The Bank will assure the conversion and transfer of the amortization and interest corresponding to the external credits used by foreign investors.

C. Holding Company Law

Holding company activity is regulated by Law 11,073 of 24 June 1948, as amended, and Decree 664/979 of 20 October 1948.

1. Tax treatment

Holding companies engaging in activities under the ordinances of the law will only pay one tax of 0.3% on capital and reserves plus liabilities which exceed twice the amount of capital and reserves.

2. Definition

A holding company, under this law, is a corporation (Sociedad Anónima) whose main activity is to perform, directly or indirectly, for its own account or on behalf of others, investments abroad in securities, bonds, shares, real estate, etc.

3. Prohibited activities

Holding companies may not perform the following activities:
- to own as assets (i) shares or similar interests in national companies which are not holding companies under the law, or (ii) national real estate;
- to purchase Government bonds as part of their assets for a nominal amount exceeding 20% of their capital;
- to remit annually to Uruguay revenues derived from direct investments of amounts exceeding 5% of the paid-in capital and reserves;
- to remit to Uruguay funds arising from the disposal of foreign assets;
- to enter into transactions such as loans and investments implying a control over national companies.

4. Special conditions

In order to pay only the 0.3% tax, holding companies cannot have assets in Uruguay other than shares of similar holding companies and balances of current bank accounts, which, in total, should not exceed 10% of their assets or Government bonds.

IV. OTHER COMMENTS

A free zone regime is in force and a new bill was recently passed by Parliament.[12] Special conditions for activities and tax exemptions can be obtained in respect of capital and income tax. Offshore banking has a general exemption established by Law 15,322 of 19 September 1982 in respect of all taxes.[13] Certain activities are granted tax exemptions, i.e. the fishing industry, the national merchant marine, national aviation, the forestry industry, the citrus fruit industry, etc.

12. Law 15,921 of 7 December 1987.
13. Even when no regulation controls, the tax authorities have granted exemptions in specific cases.

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V. CONCLUSION

This article attempted to trace the evolution of taxation in Uruguay since 1985. Specific changes have occurred but without a significant impact on tax policy. Indirect taxation remains the most important part of Government resources and it is difficult to foresee immediate and significant changes.

There are, however, promotional schemes which create a more convenient environment for doing business in Uruguay and new incentives in this respect are being reviewed. It is possible to conclude that Uruguay is still an attractive country for business and investment.

Conference Diary

FEBRUARY 1988

The Impact of U.S. Tax Reform on International Investment and Financing. Lausanne, 18-19 February (English):
International Bar Association, 2 Harewood Place, Hanover Square, London W1R 9HB, United Kingdom.

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.

European VAT Case Law. London, 26 February (English):
Centre for Commercial Law Studies, 339 Mile End Road, London E1 4NS, United Kingdom.

MARCH 1988

De directeur-grootaandeelhouder en de fiscus. Rotterdam, 1 March (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

How to set up and operate Holding and Finance Companies in Switzerland, Liechtenstein, Luxembourg, Anglo-Saxon jurisdictions, Netherlands and Netherlands Antilles. Vienna, 7-8 March (English):
Seminar Services SA, Blvd de Pérolles 7a, CH-1700 Fribourg, Switzerland.

Unit Trusts and the Financial Services Act. London, 8 March (English):
Oracle Business Information, 31 Gunnersbury Crescent, London W3 9AA, United Kingdom.

Tax Planning for Non-resident Trusts. London, 21 March (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Münchner 1988 Steuerfachtagung. München, 23 March (German):
Münchner Steuerfachtagung e.V., c/o Lehrstuhl Prof. Dr. Klaus Vogel, Ludwigstrasse 28 Rückgeb. 8000 München 22, Federal Republic of Germany.

Current Developments in German Taxation. London, 24 March (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

The 1988 European Bank Accounting Conference – Financial Controls for Europe's Changing Markets. London, 24-25 March (English):
Jan Holman, Lafferty Conferences Ltd., Axe & Bottle Court, 70 Newcomen St., London SE1 1YT, United Kingdom.

APRIL 1988

8th National Convention; Consolidation or Change. Sydney, 12-15 April (English):
Executive Director, The Taxation Institute of Australia, 7th Floor, 64 Castlereagh Street, Sydney, N.S.W.2000, Australia.

Recent Tax Cases. London, 19 April (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

International Taxation Management Techniques – Transfer Pricing, Currency Management, Mergers and Acquisitions. Strasbourg, 21-22 April (English):
To the Customer Service Department, Management Centre Europe, Postbus 95 – 3417 ZH Montfoort, the Netherlands.

MAY 1988

The Taxation of Government Personnel in Europe – Diplomats and Consular Officials. London, 9 May (English):
Miss Audrey Evelyn Bone, 606 Bryer Court, Barbican, EC2Y 8DE, United Kingdom.

U.S./International Corporate Taxation, Bougival, 9-14 May (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

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Tax Reform in Grenada

By Wendell A. Samuel

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I. INTRODUCTION

The Government of Grenada has embarked upon a complete reform of its tax system. The reform has been implemented in 2 phases, i.e. Phase I was introduced in the 1986 Budget and Phase II in the 1987 Budget. In Phase I, the number of taxes was reduced from 20 to 7. This entailed elimination of certain taxes and consolidation of others. Phase II focused on tightening the tax net, closing loopholes in the legislation and redressing some negative effects of the taxes.

The reform package abolished income taxes on both individuals and companies, export duties, stamp duties and the consumption tax (see Appendix for the list of abolished taxes). The 7 taxes now in existence are: (1) the value added tax (VAT), (2) the modified land value tax (MLVT), (3) the petrol tax, (4) the company/business levy, (5) import duties under the Caribbean Community (CARICOM) Common External Tariff (CET), (6) the foreign exchange tax and (7) the motor vehicle purchase tax.

The tax changes not only completely reversed the marxist-oriented policies which emerged during the People Revolutionary Government (PRG) which ruled the country between 1979 and 1983, but also dispensed with some of the legacies of the Eric Gairy regime which preceded the PRG administration.

Despite the marxist orientation of the PRG, they were never able to make the tax system responsive to the need for more revenue collection to finance the increased social expenditures undertaken by the Government. Most of the increases in Government expenditures were financed by foreign loans and grants (see Table I). This resulted from the fact that the PRG only made token changes in the archaic tax system which it inherited from the Gairy regime. Therefore, low yield nuisance taxes like export duties, package tax, entertainment tax and radio and television purchase taxes were retained by the PRG.

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The Grenadian tax system emerged from the colonial administration's effort to raise revenue to defray some administrative expenses which would otherwise have to be paid by the British Treasury. Slight attention was turned toward other functions of budgetary policy. Upon attainment of Associated Statehood and later, independence, the local authorities succeeded to the colonial administration. All the trappings of that administration, including the tax system, were retained, and as British aid grants were reduced, the local authorities were forced to rely on their own efforts to augment the national fisc. Taxes were introduced indiscriminately in order to raise revenue; for example the "nuisance taxes" were introduced with little regard to economic efficiency.

The reform package was a bold and innovative step by the Government. The stated goals of the reform were to increase the level of productivity and competitiveness of the Grenadian economy and to encourage growth in savings, investment and production at both the individual and corporate levels. The new proposals, which embody some of the proposals of supply side economic policies pursued by the current administrations in the United States and the United Kingdom, have gone to the other extreme. They do not extend sufficient consideration to the peculiar conditions existing in small developing economies. The inadequacies of the tax administration and the structure of production in Grenada limit the revenue potential and economic incentives of the taxes.

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Although the objectives of the tax reform are admirable, the effectiveness of the measures implemented to achieve the goals is questionable. This article focuses on 2 new taxes, i.e. the business levy and the value added tax (VAT), which were introduced to replace the individual and corporate income taxes and accomplish a radical change in the theory of the tax system in the Caribbean.[1]

Table I

	Government expenditure	Grants & loans	Local revenue
1975	43.90	20.62	23.28
1976	50.44	23.05	27.39
1977	58.14	21.72	36.42
1978	63.37	18.20	45.17
1979	68.68	15.31	53.37
1980	91.45	32.49	58.96
1981	160.03	99.93	60.10
1982	214.00	139.50	74.50
1983	166.60	85.30	81.30
1984	211.40	124.10	87.30
1985	249.86	154.86	95.00

The figures are in millions of Eastern Caribbean dollars. *Source:* Government of Grenada, Official Estimates.

II. THE BUSINESS LEVY

The business levy was introduced at a rate of 10% on gross receipts, meaning that the tax makes no allowances for legitimate business expenses. Imposition of the business levy in this manner can be unduly hard on enterprises which sell many low mark-up items in their product mix.

The business levy was projected to yield EC$ 6.3 million in revenue during the fiscal year 1986. No revenue was collected during that year because the business community objected to paying the tax and negotiations on a compromise agreement were in progress. The tax was subsequently modified in the 1987 Budget, as follows:

0 to 100,000: no tax
100,001 to 1,000,000: 1%
1,000,001 to 2,000,000: 1.5%
2,000,001 and over: 2%

The tax base is gross receipts from the sale of goods and services exclusive of VAT. The tax is to be paid by the owner of the business or the person who provides the service.[2] Enterprises are required to remit the proceeds of the tax to the department of Inland Revenue in 12 monthly instalments beginning 31 January 1987. The projected receipts for 1987 were EC$ 8 million. However, as of August 1987, no revenue had been collected.[3]

The main attraction of the business levy is its ease of administration as compared with the company income tax which it replaced. The company income tax was set at 50% of net income. The tax administration argued that, for the most part, business enterprises paid less than their fair share of taxes. One reason for this was that some firms were able to employ better-trained accountants than the tax administration was able to attract.[4]

The business levy represents the effort of the administration to tax the income of companies more effectively. The tax administration concluded that another reason for the difficulties in collecting the company tax was that unscrupulous businessmen wrote off questionable expenses as business expenses. To prevent such practices, the business levy taxes receipts before any deductions are taken. Taxing gross receipts without any allowances for legitimate expenses is unfair because operating expenses differ according to the type of firm.[5] The tax is payable whether the firm makes a profit or a loss.[6]

The cost of the business levy in terms of efficiency is high and the tax is inequitable. A tax levied on gross receipts is no longer a tax on income but rather a sales tax and business firms may be encouraged to shift the tax forward to the consumer.

The business levy is supposed to be a tax on income and should be borne by the enterprises. However, income is not the tax base and the tax is, in fact, not necessarily borne by the enterprise in all circumstances. Statutorily, the business levy is imposed on businesses but it is possible that a portion of the tax can be shifted forward. To the extent that enterprises differ in their ability to shift the tax forward, the tax burden will differ depending on the type of firm. On this basis alone, the business levy violates the equity principle which was embodied in the company tax which it replaced.

If a portion of the tax is shifted forward, the business levy can have cascade effects similar to the turnover tax, i.e. if a portion of the tax is shifted forward at each stage of production and distribution, the tax will pyramid as the shifted part of tax is included in the tax base at a subsequent stage.[7]

A second alleged advantage of the business levy is the high revenue yield at low rates of taxation. A 3% tax

1. These 2 taxes constitute the largest source of Government revenue.
2. Certain firms are exempt from the tax. For instance, enterprises in the tourism and manufacturing sectors are exempt under the Grenada Fiscal Incentives Act. However, non-profit organizations like the Grenada Banana Cooperative, the Grenada Cocoa Association and the Grenada Nutmeg Association must pay the tax. The Grenada Banana Cooperative is challenging this requirement in court.
3. These difficulties should have been foreseen because a similar tax was introduced in the neighbouring island of St. Vincent. The business community refused to pay the tax and it was later repealed.
4. This observation is characteristic of most tax administrations in less developed countries, i.e. they are poorly staffed and lack the necessary resources to upgrade revenue collection capabilities.
5. The cost of goods purchased is not even a deductible expense under the business levy.
6. Consequently, it is not possible to deduct losses incurred in previous periods as is the case in some countries.
7. The variations in the ability to shift the tax forward and the subsequent pyramiding makes the incidence of the tax impossible to discern so it is difficult to devise any policy to offset the differential.

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on gross receipts will yield just as much (or more) revenue than a 50% tax on net income. In certain ways, the business levy is similar to the turnover taxes which were used in Europe during the first half of this century. In 1970, Due[8] wrote the following about the turnover tax: "...[it] appears to be very simple and maximizes revenue at a given rate; accordingly it has a siren-like appeal to governments, which have frequently followed this path to disaster". This same line of reasoning holds true for the business levy, i.e. once the country becomes dependent on this tax, subsequent amendments to more economically efficient forms of taxation will be difficult because a much higher rate of tax will have to be imposed.

Unlike the company income tax, the business levy can cause adverse changes in the structure of economic activity. The tax encourages vertical integration in production. A firm can reduce its tax liability by integrating vertically, rather than incurring tax on the sale of intermediate goods. The firm will then be taxed only on final sales. If producers do their own wholesaling and retailing, middlemen are eliminated and a loss of employment results.[9] In addition, the tax discriminates against firms which are unable to integrate vertically. These firms have no option but to pay the tax while firms which are able to integrate can avoid some of the tax liability.

The Caribbean Association of Industry and Commerce (CAIC) conducted a study of the business levy's impact on different types of businesses in Grenada. A stratified random sample of 48 firms in the distributive trades was studied. The firms were stratified by size, type and product mix. They were small, medium and large firms. The firms were either wholesale or retail and their product mix was determined by the proportion of low, medium or high profit margin products sold.

Using information from the accounting records of the firms, CAIC simulated the effect of the business levy on the various types of firms under the assumption that there was no forward shifting of the tax and infinitely elastic demand curves. Although the assumption of no forward shifting is questionable, the assumption of an infinitely elastic demand curve may be justified on the grounds that most Grenadian enterprises are small or medium-sized. However, the analysis applied only to individual firms and not to the economy as a whole. Nevertheless, the results of the simulations are interesting and perhaps indicative of the true picture.

CAIC found that the product mix of the firms was the most important consideration in ascertaining the final effect of the tax on the firms. The tax liability under the business levy was much higher than the 50% company tax on net income for firms whose product mix included a large proportion of items on which a low-profit margin was charged. Low-profit items included food and other essential household goods many of which fall under the price control regulations. In these cases, the tax cannot be shifted forward. 45% of the firms in this category had tax liabilities which were greater than their net profit.[10] Such a result provides a strong incentive for firms to change their product mix and could potentially result in shortages of essential items.

The size of the firm itself was not an important variable in determining the effect of the business levy. Small firms did just as well as large firms under the new tax regime for any given product mix.

The simulations projected the total tax revenue from the business levy marginally (i.e. 2.1%) below the company tax. Although the tax burden was somewhat less, the division of the burden between firms was grossly inequitable. Under the business levy, 23 firms were better off while 25 firms were worse off. In some cases, the tax liability was as high as 174.1% of net income.

At first it was unclear whether the business levy was applicable to agricultural producers' associations which are non-profit organizations. The operating surplus of these organizations is used to support the price paid to farmers when the market price of the products falls below a predetermined level. Thus, the effect of the business levy on these organizations is to reduce the current price paid to farmers and a diminution of the fund available for price support for farmers. In the long run, the ability of these associations to support the price paid to farmers for any prolonged period is reduced.

The tax can also be viewed as discriminatory against small farmers whose receipts would have been too small to be taxed had they sold their output directly to the exporters. If the farmers find that their individual position is improved in the absence of associations, the associations may be disbanded with a concomitant reduction in marketing efficiency.[11]

The foregoing discussion suggests that, although the business levy may boost Government revenue and is easy to administer, it is accompanied by numerous negative side-effects which, in the long run, may have an adverse impact on the structure and growth of the economy.

III. THE VALUE ADDED TAX

A. Introduction

VAT was introduced in the 1986 Budget, a complete surprise to taxpayers and tax administrators alike. It has become quite fashionable in the Caribbean for budgetary proposals to be presented as a surprise

8. Due, J.F., *Indirect Taxation in Developing Countries* (Johns Hopkins Press, 1970) at 117.
9. This imposes an efficiency cost on the economy because specialization is reduced. If there was an excess of middlemen in Grenada, perhaps this would not be an issue. However, there is no evidence to suggest an excess of middlemen in the country.
10. Overall, one-third of the firms studied had tax liabilities which were greater than net profit.
11. Farmers may also switch to other agricultural products which are not sold through associations.

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package. This is the least desirable method of introducing a tax such as VAT, which is not the simplest of taxes and under which compliance primarily depends on the taxpayers.[12]

VAT is a tax levied on the value added at each stage of production and distribution. It is equivalent to a sales tax on final commodities since the value of goods in their final stage equals the values added at each stage. Therefore, with identical tax bases, a value added tax and sales tax of the same magnitude should yield equal tax revenue.

VAT can be viewed as a consumption, income or product tax depending on the treatment of capital goods. The consumption variety of VAT effectively excludes all goods purchased for business use from the tax base during the period in which the goods are purchased.[13] In this form VAT is equivalent to a sales tax on consumption expenditure because all capital goods are exempt. This form of VAT has been adopted by the EEC and Grenada.

The income variety of VAT also exempts all capital goods from the tax. However, non-durable capital goods are deductible at the time of purchase, but deduction of taxes on durable capital is allowed on a depreciation basis rather than at the time of purchase. As a result, deductions are delayed until the capital is used. The tax base in this case is personal income.

If deductions are only permitted on goods which become a physical part of the final product, then VAT is a product tax. In this form, durable capital is not deductible either on a current or depreciation basis. The base, therefore, is the sum of final consumption and capital expenditure.

The consumption variety of VAT is favoured over the income and product variety because it stimulates new investment. The income variety of VAT retards new investment because it increases the working capital which firms must develop as compared to the consumption form of VAT which permits full deduction during the period in which the capital is purchased.

VAT is a multi-stage tax, and in order to fully exploit its advantages, must be imposed at all stages of production and distribution. However, it can be imposed at limited stages; for example, in manufacturing and wholesale or wholesale and retail stages.

VAT can be computed in a number of ways. The most popular and least difficult method of calculation is the tax credit method. This method requires an enterprise to calculate its tax liability on total sales and subtract the tax paid on goods purchased in the current period (or, in some cases, the tax paid on goods purchased in the previous period), from the tax paid on total sales. A second method, called the subtraction method, requires an enterprise to calculate the value added by subtracting the amount paid for producers' goods during the current period from the firm's sales during that period. The tax rate is then applied to the values added. A third method, the addition method, requires the firm to calculate the values added by totalling the various elements which constitute value added (i.e. wages, interest, net profit, etc.). The tax rate is then applied to the values added.

The tax credit method is the best method to calculate tax liability because it avoids problems which arise in calculating value added. The tax credit method facilitates the use of differentiated rates for certain goods and makes exemption easier. Most important, it provides a mechanism for cross-checking the accuracy of the firm's returns. The tax paid by one firm appears as a deduction for the firms to which it sells its output. Therefore, under-reporting by a supplier is likely to be detected. The purchaser has no incentive to buy tax-free from the supplier since he will incur the tax liability on his total sales anyway. It is only at the point of final sales to the consumer that the cross-checking function does not function.

Theoretically, VAT has the advantage that it is neutral with respect to economic activity. It can be levied on all goods except leisure goods and at all stages of production. Consequently, VAT does not change the relative price of any goods nor does it offer any incentives to alter the organization of production. VAT therefore creates very few distortions compared with the sales tax which is levied only at the retail stage. There is no incentive for firms to shift activities forward to the retail stage in order to avoid the tax.

If the consumption form of VAT is utilized (i.e. the most popular form), and a single rate applies to all goods, the tax is proportional to consumption and has the essential attributes of a lump-sum tax which is viewed as the most neutral form of taxation. However, lump-sum taxes are unfair in terms of ability to pay because they impose an equal burden on all individuals regardless of the level of income. A single rate VAT is no different. Although it is proportional to consumption, it is regressive with respect to income, for consumption as a proportion of income declines as income increases. This means that the proportion of VAT to income is higher for individuals with lower incomes.

To avoid this tendency for inequality, differential rates can be imposed and exemptions provided for. Goods which low income groups consume proportionately more of can be taxed at a lower or zero rate, and goods which high income groups consume proportionately more of can be taxed at a higher rate. The European experience with VAT has shown that it can be made progressive by rate differentiation and exemptions but this increases the complexity of administration of the

12. In European countries, there was an adequate waiting period during which the pros and cons of VAT were debated publicly. This approach is desirable because the taxpayers and the tax administration become acquainted with the intricacies of the tax. A waiting period would have enabled the tax administrators in Grenada to prepare for the tax and enabled interest groups to submit their own opinions, thus obviating the spate of amendments which have been hastily, and in a very ad hoc manner, implemented. These amendments have been made as one group after another developed arguments which appeared reasonable to the tax administration.

13. *Editor's note.* Capital goods are included in the taxable base but input tax is credited against output tax – or refunded.

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tax. The neutrality of VAT also disappears with rate differentiation. The gains derived from the increased equity of the tax are swamped by the losses due to increased administrative and compliance costs and distortions introduced by rate differentiation.

It is quite paradoxical that an administration which found collection of the company income tax difficult (a tax which has been described as "almost an administrator's dream")[14] introduced VAT, one of the most complex taxes to administer. The high administrative and compliance costs are obvious deterrents. The start-up cost is extremely high for countries which do not already have similar multi-stage taxes. An entire new tax administration must be created and firms must be registered. The cost of further rate increases will be significantly less but other costs will be incurred to ensure compliance.

Compliance costs are borne by the taxpayers. Such costs can be onerous for small firms which do not have a history of efficient record-keeping. The cost associated with the increase in paperwork required by VAT may be greater than the tax liability itself. Thus, most countries have a sales threshold below which firms are exempt from paying tax.

Due to the sudden introduction of VAT, registration had to be accomplished in a short time (i.e. simultaneously with the tax collections). Firms with annual taxable sales of more than $ 1,000 in each of any 3 consecutive months, or whose monthly average over any 12 consecutive months exceeds $ 1,000 are required to register. A firm making only zero-rated sales may apply not to be registered.

Three categories of goods and services fall under VAT. Category I consists of goods which attract a zero-rate of tax, i.e. all exports, unprocessed foods, goods and services classed as basic needs (these include smoked and salted meats and fish, rice, raw sugars, cereal flour, kerosene, medication and pharmaceuticals). Category II consists of goods and services which are exempt from VAT, and include land, postal services, education, health services, burial etc. All other goods fall within the third category which attracts a 20% rate. Imports are taxed on the same basis as domestically-produced goods. Thus, VAT has been introduced according to the 'destination' rather than the 'origin' principle and it can help improve the balance of payments. VAT is a tax on local value added so if the tax is levied according to who receives the goods, the destination principle is used. On the other hand, if the tax is based on who produces the value added, the origin principle is used. When the destination principle is used, exports are either exempt or zero-rated with a refund for all VAT paid at prior stages.

The competitiveness of exports increases especially if VAT replaces corporation income tax which is not refunded. On the other hand, imports are taxed at the same rate as domestic goods and to the extent that tax collection is more efficient on international transactions, domestically-produced goods may have an advantage over imports. The experience in Europe has been that (except for Italy which is a special case) there has been no discernible effect on the balance of payments. Floating exchange rates will also tend to negate this effect.

There is no rate differentiation which usually increases the complexity of the tax. However, exempt goods can cause problems. Zero-rating is preferable to exemptions. No VAT is paid on exempt goods and by the same token, no credit can be claimed for VAT paid at prior stages. This leads to 2 problems. If exempt goods are sold at a subsequent stage to firms which must pay VAT, double tax is paid on the values added which were created at the stage prior to exemption. Firms with a significant amount of exempt sales may be disadvantaged since they have no way of recouping VAT paid at previous stages.

The services of financial institutions are also subject to VAT. Initially only credit unions[15] were exempt, but the exemption was extended to insurance companies. For the latter, the 20% VAT was replaced by a 5% tax on premiums. VAT is, however, still applied to commercial banks. Financial institutions like banks and insurance companies, create many complications for VAT administration. The tax base is not easily identified; only part of the revenue of these institutions is derived form services rendered. The remainder is investment income which should not be taxed. Separating the income of financial institutions in this way is difficult so they are usually exempt and alternative means of taxation are devised.

VAT is imposed on financial institutions in the consumption form, so investment goods do not attract tax on a current basis. The invoice method, which has cross-checking potential, is employed. Credits are given for taxes paid for the previous accounting period. The tax must be stated separate from the price of goods to facilitate accounting.

A much vaunted advantage of VAT, when implemented by the invoice method, is the cross-checking facility. Like income tax, VAT relies on self-assessment. The taxpayer fills in the appropriate returns and submits them to the tax administration. Firms have an incentive to understate their tax liability if they think the fraud will not be detected. Under the invoice method, the tax credit of a purchaser is the tax liability of his supplier so if an enterprise suspects the tax return may be audited there is no incentive to understate its liability. The purchaser has no incentive to buy tax-free for he must pay the full VAT on his own sales.

This self-policing feature may, however, be illusory, because it requires efficient auditing to uncover fraud.

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14. See Prest, A.R., *Public Finance in Developing Countries* (London 1975) at 49.

15. The term credit unions refers to cooperative credit unions, i.e. cooperative non-banking financial institutions which accept deposits from their members in the form of shares on which dividends are paid. These funds are used to make personal loans to cooperative members. The interest rate on these loans is generallly lower than the market interest rate and less collateral is required.

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As a general rule tax administrations in the Caribbean do not have such expertise. Even the EEC countries lack the manpower to fully exploit the benefits of the cross-checking feature. The usual procedure is to audit a small sample of firms and fines are imposed for falsified returns with the hope that the fear of being chosen for intense scrutiny will encourage compliance.

The cross-checking feature, however, still has potential if the tax administration is efficient.[16]

All registered firms must file a return either on a monthly or quarterly basis. Firms whose tax liability is less than $ 1,000 per month can opt to file quarterly. All other firms must file on a monthly basis. The firm must compute gross tax on its total sales and deduct any credits or add any over-payments in the previous accounting period. Sales are deemed to have been made when they are invoiced. The forms must be returned with a cheque for the tax due by the 20th of the following month for firms which file monthly. Firms which file quarterly must return their forms by the 20th of the month following the end of the quarter.

The returns are then checked by the department of Inland Revenue. Fines are payable for late or falsified claims. The incidence of incorrect returns abounds and much time is spent checking the accuracy of returns rather than attempting to detect genuine cases of fraud.

No special rules apply to farmers. However, to the extent that most of the sales of farm products are zero-rated they seem to be favourably treated. Small farmers, however, are at a disadvantage. Their sales may be so small that they need not register but only registered firms can claim credit for VAT paid at prior stages. Most small farmers choose not to register because of the amount of record-keeping which is necessary, and thus forego credit for VAT already paid. There is need for a special regime for farmers who constitute the backbone of the Grenadian economy.[17]

The projected revenue yield for VAT in 1986 was $ 42.6 million. Of this amount, only $ 31.9 million was collected (i.e. approximately 70%). The $ 10 million dollar shortfall in VAT receipts is just under 50% of the $ 21 million dollar Government deficit. The reasons for this massive shortage in VAT revenue can be dismissed simply as an extravagant over-estimation of the projected revenues. However, such a conclusion is far from the truth and covers up some of the deeper structural reasons for the shortage, i.e. factors related to the nature of the Grenadian economy and the way in which VAT was implemented.

The tax base may well have been under-estimated because insufficient consideration was given to the structure of production in Grenada. Unlike the EEC countries, there are very few linkages between different sectors of the economy; thus, multi-stage processing of goods is limited. In addition, the divergence between the island's production and absorption mix implies that the greatest proportion of consumption is imported in its final stage. Therefore, the largest portion of VAT will be collected at the port. In fact, 27.8 million or 87% of VAT revenue was collected by the Customs and Excise department. The revenue projections did not contain any VAT revenue projections from the Customs and Excise department. All revenue was projected as coming from the department of Inland Revenue.

The tax base was also significantly eroded by granting exemptions and zero-rating of goods. Arguably exemptions and zero-rated goods are necessary to make the tax more progressive. Under normal circumstances, the tax is proportional to consumption but regressive with respect to income. Exemptions and zero-rated goods, however, rob the tax of any neutrality attributes. Zero-rating and exemptions change the price of these goods relative to the other goods and services and may result in artificial expenditure switching. The argument for exemptions appeals to the approach to taxation which maintains that budgetary measures which lead to inequalities must be corrected at the same time. This clearly should not be the case if the budgetary process is viewed in its totality. Inequities which arise from a given measure can be corrected elsewhere in the system.

Art. 39 of the VAT legislation which sets forth the manner in which a credit is granted for purchases made has contributed to the shortfall in revenue. The wording and practice of Art. 39 makes it possible for firms to continuously replenish their inventory without paying VAT.

The handling of inventory on hand when VAT was introduced also accounted for the low yield in revenue in 1986. Businessmen claimed (correctly) that it would have been unfair for them to pay VAT on old inventory since they would receive no credit under Art. 39. They were, therefore, allowed to work off existing inventories without paying VAT. This arrangement was abused by unscrupulous businessmen who replenished their inventories several times and paid no VAT on the pretext that they were still selling old inventories.

A deadline was imposed once it became clear what the businessmen were doing. The use of a deadline, however, is not the correct method of rectifying the situation. A fixed deadline presumes that all goods turn over at the same rate, which is not true because some goods are sold quickly while others remain on the shelves for a longer time. The correct procedure would

16. The administration of VAT can also be combined with administration of income tax, where the information collected can assist in detecting under-reporting of income.

17. Agriculture production constitutes about 23% of the GNP. In Europe, special rules have been devised for agriculture. The reason for the special rules are more political than economic. The size of output of the individual farmers and the dearth of sufficiently accurate records to support the paperwork required by VAT make such rules mandatory. Farmers are usually exempted and cannot claim credit for tax paid at prior stages. Firms which purchase output from farmers for further processing are required to pay tax on their sales, resulting in double taxation on value added at stages prior to agriculture. Some ad hoc and not too efficient measures have been used to get around this. These include allowing the firms to collect VAT on their sales and keeping it. This may cause problems if the VAT so collected is different from the VAT paid at earlier stages.

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have been to grant the firms a credit based on an estimate of existing inventories (for instance, use the inventory figure in the firms' most recent accounting statement).

Because VAT is a tax on consumption expenditure, it is intended that the tax be shifted forward to the consumer. In fact, separation of the tax from the purchase price facilitates the forward shifting, so imposition of VAT will increase the rate of inflation. It was observed in Europe that a 1% increase in VAT increased prices by slightly less than 1% because of incomplete shifting and zero-rating of certain commodities.

VAT has caused increased prices for basic commodities in Grenada. Despite exhortations by the Government to take the reduction in cost occasioned by the abolition of other taxes into account, businessmen simply added VAT to existing prices. Between March 1986 and March 1987, prices of household goods increased by 25.8%, alcohol and tobacco produces were up 6.9%, furniture and appliances increased 3.6%, and food, which is largely zero-rated was up 2%.

Replacement of the personal income tax with VAT is consistent with the policy prescriptions of supply side economics. Proponents of supply side economics advocate a shift from direct taxes to indirect taxes because this is supposed to increase the supply of labour and work effort. The increased labour supply and work effort, it is argued, will be transformed into increased output and real income. Such an analysis, however, ignores certain factors inherent in the labour market in small and less-developed countries. It presupposes a sufficient capacity to absorb the increased supply of labour. However, in a country like Grenada, the labour market is in chronic disequilibrium with the level of unemployment (in excess of 20%). The supply of labour already exceeds existing capacity so that an increased willingness to work only increases the rate of unemployment.

The impact on work effort is also questionable. The CAIC team which investigated the tax reform in Grenada posed the question to self-employed professionals and businessmen. The answer was always the same. Abolition of personal income tax had no effect on their work effort.

The substitution of VAT for personal income taxes can be unduly harsh on retired individuals who previously paid income taxes. With the imposition of VAT, these individuals must pay tax a second time (i.e. when they make purchases) while individuals in the work force reap the benefit of lower taxes. Special measures may need to be instituted to rectify this adverse effect of the VAT system.

VAT should be used in conjunction with personal income tax not as a substitute for it. The rates of personal income tax could have been reduced and adjusted to account for the regressiveness of VAT. In addition, the cross-checking feature of VAT would be helpful in verifying income tax returns filed by self-employed businessmen and professionals.

The consumption form of VAT exempts investment goods from taxation and can thus stimulate new investment. Saving can also be stimulated by VAT. VAT is a tax on consumption and increases the relative price of consumption goods. People may respond by reducing consumption and increasing savings.[18] Indirect evidence of the impact on savings in Grenada can be gleaned from the increase in savings and fixed deposits. The total of savings and fixed deposits increased by 17.1% between March 1986 and March 1987. Deposits by private individuals increased 19.1% during the same period. However, this is not conclusive evidence of the positive impact of VAT on savings. Total deposits have increased by similar proportions in the rest of the OECS countries which did not impose VAT. The comparative figures for St. Vincent and St. Lucia, respectively, are: total deposits 21.5% and 24.8%; private deposits 19.2% and 12.7%.[19]

Investment decisions take time to come into effect and various gestation lags are associated with these decisions. The impact of VAT on investment may also be clouded by the uncertainty in the business environment surrounding imposition of the business levy.

From the discussion above, it is clear that VAT has some potential benefits. However, because of the slipshod way in which it was implemented in Grenada, most of its benefits have been nullified. The tax administration has ignored lessons which could have been learned from the European experience, and consequently not only have been confronted by the same problems but have created new problems as well.

IV. CONCLUSION

The idea of reforming the tax system to make it more responsive to the revenue needs of Government and simultaneously increase productivity and growth, is a good one. However, the tax measures which implemented these goals reflect the absence of a study of the effects of the taxes in the context of small developing economies.

The discussion on VAT and the business levy reads like "a tale of 2 taxes". On one hand, VAT is very difficult to administer but promotes economic efficiency. On the other hand, the business levy is easier to administer but distorts the structure of the economy. The 2 taxes essentially cover the same base, so it is difficult to identify the rationale for imposing both taxes at the same time.

The tax reform package suggests the abandonment of the redistributive function of the Government. Progressive income taxes coupled with negative income tax are the major tools for redressing inequality in the distribution of personal income. The abolition of both personal and company income taxes and replacing

18. Neither of these effects have been conclusively borne out by the evidence from Europe.
19. See Eastern Caribbean Central Bank, *Commercial Banking Statistics,* June 1986.

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them with indirect taxes means that the Government has eschewed the goal of an equitable distribution of income.

It may be argued that Government expenditure patterns can offset some of the income inequality. However, the Government of Grenada has embraced the Public Sector Investment Programme (PSIP) proposed by the World Bank. The programme de-emphasizes expenditure on social services like health and education and focuses on "productive" public investment expenditure. Therefore, both the revenue and expenditure policies tend to intensify income inequality.

Given that the objective of the tax reform is to reduce the overall tax burden and increase productivity and growth, these goals could have been more effectively achieved by (1) abolition of the low revenue-yielding taxes; (2) retention of personal income taxes but at reduced rates and wider brackets (standard deductions could be allowed to simplify administration and the structure of the personal income tax should be set to take care of any inequality introduced by VAT); (3) instead of imposing one rate of 50% on all firms for the company tax, 3 rates (possibly 25%, 35% and 45%) could be levied depending on the level of profit; and (4) VAT should be levied on all goods to simplify administration and exploit its efficiency potential. The VAT cross-checking feature could be exploited to facilitate assessment of company income tax.

The apparent lack of success of the tax reform package in Grenada should not deter other countries in the region from undertaking the much-needed overhaul of their own tax systems. In particular, the experience with VAT in Grenada should not deter other countries from experimenting with what is theoretically a good tax. However, administrators should be mindful of the difficulties which are likely to be encountered in implementation of the tax and the limitations which arise from the peculiar characteristics of these countries.

The argument that the tax administration is not equipped to deal with such taxes can evoke some sympathy. However, this should not be an argument to defer much-needed tax reform. The tax administrations in the region will need to upgrade themselves if they are to deal effectively with the challenges of the twenty-first century.

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APPENDIX

List of taxes abolished and new taxes introduced

Abolished	New taxes
Excise duty	Petrol tax
Export duty	Value added tax (VAT)
Consumption duty	Transfer tax
Package tax	Modified land value tax (MLVT)
Petroleum profit tax	(MLVT is a consolidation of land and house taxes)
International airport levy	Business levy
Income tax on companies	
Personal income tax	
Withholding tax	
Stamp duty	
Entertainment tax	
Radio and TV purchase tax	
Hotel occupancy tax	
Telecommunications tax	
Airline ticket tax	

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Tax Reform in Japan

By Torao Aoki

I. NEW TAX REFORM BILLS

A. Introduction

The major tax reform bills were not approved during the ordinary session of the Diet which ended 27 May 1987, mainly because of the strong opposition manifested to the proposed introduction of a sales tax. The budget for the fiscal year 1987 was premised on the approval of a never-realized tax reform.

An extraordinary session of the Diet convened on 6 July 1987 to deliberate a draft supplementary budget for the fiscal year 1987. The government also intended to propose bills for a limited tax reform. The special parliamentary study panel[1], which was created during the last regular Diet session to end the stalemate in the Diet, submitted an interim report on tax reform to the Speaker of the House of Representatives on 24 July 1987. According to the report, several items were agreed upon:

(1) as part of a radical tax overhaul, tax cuts would be implemented emphasizing reduction of the tax burden on middle-level salaried employees;
(2) revenue sources for this tax reduction would need to be secured on a permanent basis; and
(3) in fiscal year 1987, tax cuts should be implemented before the overall tax reform.

Following the recommendations of its Tax Commission, on 31 July 1987 the government presented to the Diet Bills to amend the income tax and other tax laws, the local tax and local allocation tax laws. The bills called for implementation of a ¥ 1.3 trillion income tax cut for fiscal year 1987, with funds to be raised by abolishing the "maruyu" tax exemption system for small deposits. The Diet, however, was stalled as opposition parties boycotted Diet business protesting the government package which scrapped the "maruyu" tax-free savings system. Opposition parties wanted to increase the income tax cut to ¥ 2 trillion and finance the planned tax reduction by surplus tax revenues rather than by withdrawing the "maruyu" system. On 8 August the ruling Liberal-Democratic Party (LDP) and 3 major opposition parties agreed to resume ordinary Diet business on the condition that the income tax cut for the current fiscal year be increased from ¥ 1.3 trillion to ¥ 1.5 trillion and that income and local inhabitants taxes be reduced another ¥ 2 trillion in fiscal year 1988. The ruling and opposition parties also agreed to delay the date for termination of the "maruyu" system (from 1 January 1988 to 1 April 1988) in order to maintain the tax exemption for interest on personal savings for pensions and personal housing funds, and further, to reassess the taxation on interest, including the issue of comprehensive income taxation, after a period of 5 years.

During the course of the Diet debate, the parties reached agreement to further expand the income tax cut to ¥ 1,540 billion mainly by widening the minimum tax rate bracket in exchange for abolition of the "maruyu" tax-exempt savings system. The compromise tax reform package was passed by the House of Representatives on 3 September 1987, and by extending the extraordinary session from 8 September 1987 to 19 September 1987, the House of Councillors approved the tax bills on the last day of the session.

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He has been a staff member of the International Monetary Fund and an Executive Director with the Inter-American Development Bank.

1. The panel consisted of 7 LDP members and 6 opposition members; 2 members each from the Japan Socialist Party, the Komeito and the Democratic Socialist Party.

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II. AMENDMENTS TO NATIONAL TAXES

A. Reduction and rationalization of income tax burdens

1. Rate structure revised

The reduction in the income tax rates is mainly for the benefit of middle-income earners in their forties or fifties who have pressing financial obligations (education, housing, etc.). The number of income tax brackets has been reduced from 15 to 12 with the maximum tax rate lowered from 70% to 60% (see Table I). The minimum amount of income which is taxable at the lowest rate (i.e. 10.5%) has been increased from ¥ 500,000 to ¥ 1.5 million. In other words, the minimum income for a married couple with 2 children is now ¥ 4,760,000 as compared with the previous ¥ 3,150,000. As a result, nearly two-thirds of salaried employees are subject to a flat rate of 10.5%.

Table I

Income tax rate schedule

Before amendment		After amendment	
Taxable income not over (million yen)	Tax rates (%)	Taxable income not over (million yen)	Tax rates (%)
0.5	10.5		
1.2	12.0	1.5	10.5
2.0	14.0	2.0	12.0
3.0	17.0	3.0	16.0
4.0	21.0	5.0	20.0
6.0	25.0	6.0	25.0
8.0	30.0	8.0	30.0
10.0	35.0	10.0	35.0
12.0	40.0	12.0	40.0
15.0	45.0	15.0	45.0
20.0	50.0	30.0	50.0
30.0	55.0	50.0	55.0
50.0	60.0	over 50.0	60.0
80.0	65.0		
over 80.0	70.0		

It has been argued that too steep progressivity and a high level of marginal tax rates discourage labour supply and entrepreneurship. Therefore, the maximum rate of 88%, consisting of 70% for national tax and 18% for local tax, has been slashed to 76%, comprising 60% and 16% for national and local tax, respectively.

2. Creation of a special deduction for spouses

An additional deduction of ¥ 165,000 has been created for the spouse of a salaried employee whose total income is ¥ 8 million or less. This deduction takes into account the fact that housewives support the earnings of their husbands. In addition, it equalizes the tax treatment of these taxpayers with proprietors who are granted a deduction for family employees as part of the privileges of filing a "blue return".

To resolve any eligibility questions with respect to housewives who work part-time, the special spouse deduction is also granted in cases where the spouse earns income from part-time employment up to an amount of ¥ 1,065,000 under the prescribed formula of the vanishing deduction. The deduction for family employees of a proprietor who files a white (ordinary) return has been increased from ¥ 450,000 to 600,000.

3. Measures against the perceived inequity in the tax burden

With a view to ameliorating the perceived inequities in the tax burden (an opinion prevalent among salaried employees), the following measures have been taken:

a. *Deduction of itemized expenses for salaried employees*

Salary earners may claim a deduction for that part of specified actual expenses which exceeds the standard employment income deduction by filing their own final tax return. The deductible expenses include those for commuting, relocation of assignment, training costs to acquire expertise or skills or to attain particular qualifications for employment and travel between the place where the employment duties are carried out and the employee's home for those employees working away from their families.

b. *Revision of the special taxation rule on deemed corporate income*

Very often a proprietor who has elected to be treated as a corporation for tax purposes fully benefits from the employment income deduction by diverting almost all the business income to remuneration to a self-employed taxpayer. To prevent abuse, under the new law if the remuneration exceeds 80% of the annual average of the total business income and real estate income (for the first 3 years of the 5 years preceding the current taxable year), that excess amount is to be included in the taxable income.

c. *Improvement of the climate for tax compliance*

In a move to consolidate the self-assessment regime and promote equity in taxation, the minimum amount of gross receipts to be reported to the Taxation Office has been lowered from ¥ 50 million to ¥ 30 million.

4. Review of taxation on pensions

Because of the increasing number of older taxpayers, the Tax Commission felt that the taxation of pensions should be reevaluated. Under the new legislation, the exemption for aged persons (i.e. 65 years or older) has been doubled from ¥ 250,000 to ¥ 500,000. An exemption for public pensions replaces the special deduction for the elderly and the employment income deduction. As a result, taxation on public pensions will be improved and rationalized and the tax burden on the aged beneficiaries of public pensions will be considerably eased.

5. Miscellaneous

The threshold for the medical expenses deduction has been increased from ¥ 50,000 to ¥ 100,000.[2] The cur-

2. The deductible amount is the actual payment of medical expenses, less 5% of the taxpayer's total income or ¥ 50,000 (now ¥ 100,000) whichever is less. A ceiling of ¥ 2,000,000 is imposed.

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rent amount, which has not been changed since 1975, was considered too small in light of rising household medical expenses.[3]

B. Review of taxation on interest

1. Problems of the tax exemption system

The "maruyu" tax exemption system for small deposits has given rise to several problems:

a. Since more than 70% of individuals' savings are enjoying tax-exempt status, income from interest to the tune of ¥ 16 trillion (as compared with taxable business income of individuals and corporate income of ¥ 9 trillion and ¥ 30 trillion, respectively) is excluded from the tax base. This erosion of the tax base has caused a glaring inequity in tax burdens with other types of income.

b. While high income earners are exempt from tax by fully taking advantage of the tax-free savings system, ordinary salaried employees cannot afford such savings which would benefit from the tax exemption.

c. Unlike the wartime and postwar period, Japan has now become the world's largest exporter of capital so that the wisdom of granting across-the-board favourable treatment to savings may be questionable.[4]

d. A considerable number of abuses seem to be prevalent.

2. Revisions

The exemption of tax on interest income from deposits in financial institutions, postal savings and government bonds will be reorganized into a system of tax exemption for persons 65 years or older, fatherless families and the disabled. The number of taxpayers entitled to such tax-free savings is estimated to be 15 to 20 million. A separate 20% tax (15% national and 5% local) will be withheld at source on all deposits by other persons.

Income from the so-called quasi-financial instruments, such as mortgage securities and certain types of life insurance, which is not treated as interest, will also be subject to tax at the uniform rate of 20% (separate from other income). Under the promotion scheme of wage earners' property accommodation, interest on savings for specific purposes of pensions and housing construction will remain untaxed.

3. Rationale of the revision

It is presumed that high income classes maintain tax-free savings to the maximum allowable extent. Above that ceiling, these taxpayers presumably hold discount bonds which are subject to the separate withholding tax and can opt for separate withholding tax at source on interest derived from the bonds. Although the tax burden will be reduced to the extent that the optional 35% withholding tax has been abolished, the tax burden will be substantially increased by the reorganization of the tax-exempt system for deposits and by the increase in withholding tax on discounts bonds, i.e. from 16% to 20%. Taxpayers who have abused the tax exemption system will bear the full brunt of the reorganized regime. Since interest income arises, in large part, by its nature and the financial assets which produce interest income are so diversified, a withholding tax imposed at a uniform rate will best satisfy the requirements of neutrality, simplicity and efficiency.

During the course of the Diet debate, some opposition party members insisted on maintaining the "maruyu" tax-exemption system, but with introduction of a savers' identity card. Utilization of a card system may resolve some, but not all of the problems associated with the "maruyu" system. The ill-fated 1980 green card system, which was repealed without ever being implemented, is evidence that no national consensus has been reached on a satisfactory card system to identify taxpayers and savers. In addition, the restructuring of the system is designed to secure sustainable financial resources for the tax cut.

C. Review of taxation of land

The soaring price of land in metropolitan areas and major cities has escalated into a social problem. Measures designed to approach the dilemma (under the recent legislation) include:

1. More appropriate taxation of capital gains from land

Capital gains derived by realtors and the like from the sale of land held 2 years or less are to be heavily taxed as extra-short-term capital gains during the period from 1 October 1987 to 31 March 1990. In order to broaden the tax base, the preferential tax treatment for replacement of an individual proprietor's business property has been reduced by 20%.

If land which has been held for more than 5 years is sold between 1 October 1987 and 31 March 1990, the income from the sale will be treated as long-term capital gains (previously the holding period was more than 10 years).

2. Increase of the registration and licence tax

The registration and licence tax is based on the value of an asset at the time it is entered into the official books or documents. For this purpose the assessed value of land for the local property tax is used as the tax base. However, the current assessed value of land deviates substantially from the actual sale price on the open market. Under the recent revisions, the tax base has been increased by 50% for purposes of the registration and licence tax with a view to making the tax burden more appropriate.

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3. In addition, there have been an increasing number of tax returns being filed claiming refunds due because of medical expenses; the amendment should reduce the administrative burden in this respect.
4. Criticism has also been increasingly voiced from abroad.

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D. Review of taxation of capital gains from securities

1. Taxation on capital gains from sale of securities

In order to achieve equity and fairness (and taking into account equality with the tax on interest), the tax base on capital gains derived from the sale of securities will be broadened. The definition of a "continuous trading in securities" will be changed from 50 or more transactions involving 200,000 or more shares to 30 or more transactions involving 120,000 or more shares per year. The minimum taxable base for income from the sale of a large block of shares of identical issue and for income from the sale of "special report issues" will be reduced from 200,000 shares to 120,000 shares. The scope of a sale of shares which is equivalent to the transfer of business ownership has been broadened.

The criterion for a taxable sale of securities tantamount to the disposition of the business of a company (i.e. sale of a substantial participation) will be changed from 15% of the total issued stock to 10%. Income derived from the sale of futures will now be taxed and, finally, income from sales of public and corporate bonds whose interest is calculated on a basis of more than one year will also be subject to tax.

2. Revision of the securities transaction tax

In light of the recent progress in internationalization of finance and in the interest of equitable taxation of various securities, the securities transaction tax has been revised (see Table II).

Table II

Type of security	Sale by	Before revision	After revision	Effective from
Stocks, stock investment trusts, etc.	Securities companies	0.18%	no change	
	Others	0.55%	0.50%	1 October 1989
Convertible bonds and warrant bonds	Securities companies	0.015%	0.9%	1 October 1987
	Others	0.045%	0.26%	
Local bonds, corporate bonds, bank debentures, etc.	Securities companies	0.015%	0.01%	1 January 1988
	Others	0.045%	0.03%	
National bonds	Securities companies	0.01%	no change	
	Others	0.03%	no change	

3. Amendment to the bourse tax

To equalize the treatment among various types of securities, the bourse tax imposed on futures has also been amended. For example, the rate on stock futures on the Osaka Stock Exchange has been reduced from 0.2% to 0.0125%, while national bond futures on the Tokyo Stock Exchange are made subject to tax at the rate of 0.001%.

E. Corporate income tax

The aborted bill of last February (during the ordinary Diet session) which proposed to lower the base rate of corporation tax from 43.3% to 37.5% over a 3-year period has not been reinstated. Subsequently, changes to other provisions related to corporations such as dividends received, reserves, and the foreign tax credit have also been postponed. The basic rate of corporation tax is now 42% since the temporary additional rate of 1.3% expired at the end of March 1987.

III. AMENDMENTS TO LOCAL TAXES

At the end of the ordinary Diet session, the Parliament passed only those provisions of the reform bills which were necessary to maintain the relevant tax laws during the fiscal year.[5] The Bill to Amend the Local Tax and Local Allocation Tax Laws was approved during the extraordinary session in September 1987.

A. Review of local taxes

The amendments are designed to achieve the following goals:

(1) the levy on income of the individual inhabitants tax will be reduced by about ¥ 660 billion on a full year basis;
(2) an interest rate will be created in the prefectural inhabitants tax, thereby securing some ¥ 650 billion in a year;
(3) while 60% of the revenue derived from the tax on interest will be granted to the municipalities, the tax reduction in the interest rate should be shared by prefectures and municipalities at the ratio of 4 to 6 according to the attribution of revenues from the interest tax.[6]

5. The passed bills concerned both local and national taxes.
6. The cut in the levy on income will be effective from fiscal year 1988 because of the technical difficulties involved in implementing such a reduction during the middle of the year when income is assessed on a previous year basis.

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Reduction in the levy on income of the inhabitants tax

The reduction in the income levy of the inhabitants tax will be implemented over a period of 2 years in view of the current situation of local government finances. The reduction will be accomplished as follows:

a. *Rate structure revision*
In order to mitigate the feeling (prevalent among salaried employees) that the tax burden is heavy and, additionally, to simplify the system, the number of tax brackets will be halved from 14 to 7 and the range of rates, i.e. from 4.5% to 18%, will be changed to rates ranging from 5% to 16%.[7]

b. *Increase in deductions*
Taking into account current standards of living and the tax burdens affected by restructure of the tax rates, the basic exemption and deductions for spouse and dependents will be increased by ¥ 20,000. By its nature, the burden of the levy on income of the inhabitants tax should be shared by a wider range of taxpayers than the national income tax. Therefore, taking into account the newly-introduced special deduction for spouses, the minimum taxable income for a couple with 2 children is ¥ 2,261,000 for the income levy as compared with ¥ 2,619,000 for the national income tax.

c. *Creation of a special deduction for spouses*
With due emphasis on the tax cut for middle-class salaried employees, a special deduction for spouses, in the amount of ¥ 140,000 for those with income totalling ¥ 8 million or less, will be introduced. This is a vanishing deduction like its national income tax counterpart.

d. *Other amendments*
Paralleling the changes made on the national level, other local tax amendments include introduction of the deduction of itemized expenses, a change in the deduction for the elderly, an additional limitation imposed on the medical expenses deduction and a revision of the taxation of capital gains accruing from the sale of land.

Introduction of a tax on interest in the prefectural inhabitants tax

The inhabitants tax levy on income is imposed only on income from interest which is subject to comprehensive income taxation but it is not imposed on interest income subject to withholding tax at source. This has given rise to considerable inequities in income taxation. The inhabitants tax on interest income is, in substance, an individual income tax and should be included in the levy on income. However, since the tax is also imposed on corporations it cannot be included in the levy on income. A tax on interest at the rate of 5%[8] has now been created in the prefectural inhabitants tax as distinguished from the levy on income or the corporation tax rate.

This new tax on interest income is imposed at the place where the financial institution is located; it is a prefectural tax rather than a municipal tax; it is imposed on the basis of the current year's income; and it is taxed separately from other income. The revenue derived from the tax on interest will be granted to municipalities in such a way as to produce the same result as taxation at 2% and 3%, the minimum tax rates of the prefectural and municipal inhabitants tax, respectively.

IV. THE LATEST DEVELOPMENTS

The new Prime Minister requested the Tax Commission of the Government to study a tax system which balances charges on income, consumption and assets. After reshuffling its members, the Tax Commission held the first general assembly on 12 November 1987 to embark on intensive deliberations.

On 8 December 1987, the government Tax Commission approved the recommendations for a revision of taxes for fiscal year 1988. On the same day, the Tax System Research Commission of the LDP also adopted their recommendations. The contents of both sets of recommendations are substantially the same. This package of tax revisions is limited to an annual review since both the government and the LDP are prepared to propose a sweeping overhaul of the tax system (including introduction of a new large-scale indirect tax) for implementation in fiscal year 1989. Under the circumstances, substantial reform proposals such as those on inheritance tax and corporate tax have been shelved until next year's debate.

The main features of the proposals include revision of taxes on real estate transactions and housing construction. The preferential tax treatment for sales combined with purchases of land and housing will be abolished and substituted with a new system. On the other hand, tax incentives for house financing will be expanded. In consideration of criticism from abroad (in particular the European Community), the liquor tax will be amended by abolishing the ad valorem duty and unifying tax rate on whisky. The petroleum tax will also be converted from an ad valorem duty to a specific duty. The proposals for the tax revision were approved at a cabinet meeting on 12 January 1988 and the bills are expected to be submitted to the Diet which reconvenes on 25 January.

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7. The function of income redistribution and, hence, progressivity in the rate structure of the income levy are not so vital as those of the national tax.
8. The rate of 5% is the same as the lowest levy on income.

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ARGENTINA:

Rescheduling and Consolidation of the External Debt

By Nestor J. Belgrano*

On 16 November 1987 the Central Bank of the Argentine Republic (B.C.R.A.) issued Communication "A" 1122, establishing the procedure to be followed to obtain the rescheduling and consolidation of the Argentine external debt instrumented in

(1) Nominative Bonds of the National Government denominated in U.S. dollars (Bonod);
(2) Promissory Notes of the National Government denominated in U.S. dollars (Promissory Notes);
(3) Promissory Notes of the B.C.R.A. denominated in U.S. dollars (B.C.R.A. Notes); and
(4) Interim Obligations denominated in U.S. dollars (Interim Obligations);

issued in accordance with Communications "A" 251, 695, 696, 697, 790, 893, 894, 895, 946, 956, 1084 and "B" 2663 of the B.C.R.A. ("the Securities"). The rescheduling and consolidation of the obligations correspond to the Argentine Republic 1987 Financing Plan agreed to with the International Banking Community.

A. RESCHEDULING

The principal amount of the Securities will be rescheduled as from the first maturity date of interest occurring after 15 October 1987. The rescheduling will take place through the issuance and delivery of National Government or B.C.R.A. Notes, as the case may be, in guarantee of or in cancellation of the corresponding private sector debt and in deletion of the corresponding Bonod, Promissory Note, B.C.R.A. Note or Interim Obligation.

Issuance of documents

Notes can be issued at the option of the external creditor:

(1) in the name of the external creditor in cancellation of Bonod, Promissory Notes or B.C.R.A. Notes, issued or to be issued in payment of or as a guarantee of private sector obligations;
(2) in the name of the external creditor as a guarantee of obligations of the private sector, including local financial entities, and in cancellation of Bonod, Promissory Notes, B.C.R.A. Notes or Interim Obligations, issued or to be issued as guarantees;
(3) in the name of the local private sector borrower or local financial entity in order to be endorsed by the borrower or financial entity in favour of the external creditor, as guarantee of its obligations and in cancellation of Bonod, Promissory Notes, B.C.R.A. Notes or Interim Obligations issued or to be issued as guarantees.

The Notes will be issued in U.S. dollars.

Payment of Notes

Payment of the Notes will be made in 25 semi-annual instalments, the first of which will mature on 26 May 1994 and the last on 26 May 2006. A portion of the principal will be paid in each instalment, as follows:

Quota	*Amortization (%)*	*Quota*	*Amortization (%)*
1	1.00	14	5.00
2	1.00	15	5.25
3	1.50	16	5.25
4	1.50	17	5.50
5	1.75	18	5.50
6	1.75	19	5.75
7	2.00	20	5.75
8	2.00	21	6.00
9	2.50	22	6.00
10	2.50	23	7.00
11	3.00	24	7.00
12	3.00	25	7.50
13	5.00		

Payments will be made in U.S. dollars by the B.C.R.A., by transfer on the New York account indicated by the external creditor.

Issue date

The issue date will be the first maturity date corresponding to interest to be paid on the Bonod, Promissory Note or B.C.R.A. Note or Interim Obligation after 15 October 1987, which is replaced by the issuance of the Note.

Face value

The face value of the Notes will be equal to all principal instalments (whether or not overdue) of Bonod, B.C.R.A. Note, Promissory Note or Interim Obligation which is replaced by the issuance of the obligation.

Interest

The external creditor will have the option to select one of the following interest rates:

(i) Libor plus 13/16% for 180-day U.S. dollar deposits; or
(ii) Adjusted CD rates in U.S. dollars plus 13/16% for 180 days.

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Any kind of overrate or additional commission in Argentine currency may be freely negotiated between local borrowers and their external creditors.

Interest will be paid in arrears semi-annually, except in the case of the first interest period which will commence on the issuance day and will be paid on 26 May or 26 November after the issuance date, whichever comes first.

Negotiation

The Notes may be transferred or assigned only to external financial institutions. An external financial institution is any financial institution established abroad or which maintains its headquarters abroad without taking into consideration the existence of any branches, agencies, subsidiaries or representatives within the Argentine territory. The assignor must formally notify the B.C.R.A. of the date of the assignment, the name and address of the assignee and indicate the New York bank and account number where payments should be credited.

Notes issued as guarantees of private sector debts can only be assigned to the assignee of such guaranteed private sector debt. The B.C.R.A. is bound by notice of the assignment only after 30 days of its receipt.

Exemption of taxes

Payment will be made without any deduction by reason of present and future taxes, withholdings, levies or duties applicable in Argentina.

Delivery of the Notes

The Buenos Aires branch of the Chase Manhattan Bank N.A., located at 25 de Mayo 140, 1002 Buenos Aires ("the Agent") will act on behalf of the B.C.R.A. in receiving the applications for refinancing and exchanging the Securities.

Foreign creditors must request exchange of the Securities by delivering to the Agent a special rescheduling advice 20 working days before or on the first interest maturity date occurring after 15 October 1987.

The deadline date for filing the application of rescheduling was 22 December 1987 for Securities whose first interest payment was due before 31 December 1987.

The Notes will be delivered within 45 days from the filing of the application with the Agent. The Agent will deliver the Notes to the external creditor at the same time the external creditor delivers the corresponding Securities to the Agent.

B. CONSOLIDATION OF TITLES

At their own option, external creditors may consolidate the Securities in their own names. This option may be exercised on 6 dates ("consolidation dates"). The consolidation dates are the ninth day of March, June, September and December of each year. The deadline for filing a consolidation advice corresponding to the first consolidation date was 20 November 1987.

The option may be exercised according to the following scheme: a consolidation advice must be delivered to the Agent within 60 days of the consolidation date. The advice must request that the B.C.R.A. issue (on the consolidation date) a National Government Consolidated Promissory Note or a B.C.R.A. Consolidated Note in payment of, or a guarantee of a private sector debt, as the case may be, for the total principal amount of the Securities indicated in the consolidation advice. The Consolidated Promissory Note of the National Government or of the B.C.R.A. will be issued under the same conditions established for the Notes, except for the issuance date which will be the consolidation date chosen by the creditor.

Bonods and Promissory Notes will be consolidated through Consolidated Promissory Notes of the National Government. The B.C.R.A. Notes will be consolidated through Consolidated Promissory Notes of the B.C.R.A.

It will be possible to consolidate issued Securities which accrue interest under different interest rates (i.e. Prime, Libor or adjusted CD rates) by indicating in the consolidation advice the chosen interest rate (the rate will not be changed in the future).

The minimum amount of a Consolidated Promissory Note of the National Government or of the B.C.R.A. will be US$ 30,000, unless the principal amount due by the National Government or the B.C.R.A. to the external creditor is less than US$ 30,000. In this case, the Consolidated Promissory Note will be for the nominal value equal to the principal amount due.

The Securities to be consolidated will accrue interest within the period between the last interest payment and the consolidation date chosen at the Libor rate or adjusted CD rate, as the case may be. Such interest will be paid on the consolidation date.

The signature of the external creditor on the application for rescheduling or consolidation must be certified abroad by a bank or the corresponding Argentine consulate. The application may also be signed by attorneys of the external creditor in Argentina. However, their signatures and power of attorney must be certified by an Argentine notary public.

Communication "A" 1122 also governs the procedures for converting securities received in guarantee into securities received in payment.

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New York, United Nations, 1987. 471 pp.
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United Kingdom National Committee of Comparative Law. Volume 7. Edited by Francis G. Jacobs and Shelley Roberts.
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Coggeshall, Hawkins Publishers Ltd., 2 Church Street, Coggeshall, Essex CO6 1TU, U.K. 1987. 360 pp.
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Les tribunaux israéliens suivaient, jusqu'à récemment, la règle d'interprétation littérale traditionnelle dans leur interprétation des lois fiscales. Cette règle s'est progressivement érodée et a été remplacée par une "nouvelle approche", qui insiste sur une interprétation extensive faisant ressortir l'intention du législateur. Le Professeur Lapidoth commente de façon approfondie la règle de l'interprétation littérale, sa raison d'être et son rapport avec des points particuliers de la législation fiscale. Il examine ensuite la "nouvelle approche" quant à l'interprétation des lois fiscales et termine son article par une évaluation personnelle.

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Prof. Arye Lapidoth:

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Bis vor kurzem befolgten die israelischen Gerichte die traditionelle Regel genauer Deutung bei der Auslegung der Steuergesetze. Diese Regel ist allmählich immer mehr ausgehöhlt worden und wurde von einem neuen Ansatz ersetzt, der eine gezielte Deutung benachdruckt. Professor Lapidoth gibt eine eingehende Besprechung dieser Regel der gezielten Deutung, die Gründe dahinter und ihre Beziehung zu speziellen Merkmalen der Steuergesetzgebung. Darauf untersucht er diesen neuen Ansatz zur Auslegung der Steuergesetze und beendet diesen Aufsatz mit seiner persönlichen Beurteilung.

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Arthur Young International:

Nouvelle Zélande: Le Rapport Economique et la réforme fiscale *180*
Le Ministre des Finances a proposé, le 17 décembre 1987, le Rapport Economique du Gouvernement et les Documents Consultatifs sur les sujets de totale imputation et de réforme fiscale internationale. Bien que plusieurs des dispositions annoncées aient pris effet le 17 décembre 1987, la législation doit encore être promulguée. Cet article commente de façon détaillée les propositions de modifications de la loi fiscale sur le revenu de Nouvelle Zélande.

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Neuseeland: Wirtschaftliche Stellungnahme und Steuerreform ... *180*
Am 17. Dezember 1987 präsentierte der Minister der Finanzen eine "Wirtschaftliche Stellungnahme" der Regierung und auch wurden "Consultative Documents" über die Themen der völligen Anrechnung und internationalen Steuerreform veröffentlicht. Trotz der Tatsache, dass verschiedene der angekündigten Massnahmen seit dem 17. Dezember 1987 in Kraft sind, wurde bis heute noch keine Gesetzgebung erlassen. Dieser Artikel gibt einen detaillierten Kommentar zu den vorgeschlagenen Änderungen des neuseeländischen Einkommensteuergesetzes.

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18 July 1988 – 19 August 1988

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Taxation of Income Derived by Non-Residents in Latin America

By Pedro Massone

Pedro Massone is Professor of Tax Law at the University of Valparaiso, a non-resident staff member of the International Bureau of Fiscal Documentation and Executive Editor of the Bureau's publication *Taxation in Latin America*.

Mr. Massone graduated from the Law School of the University of Chile (in Valparaiso) and worked at the Chilean Internal Revenue Service, where he reached the position of Chief of the Department of Legal Advice of the National Directorate. He has published various works on Chilean taxation and written several articles on Latin American taxation for the *Bulletin of International Fiscal Documentation*.

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I. INTRODUCTION

This article surveys the principal features of income taxation of non-residents in Latin American countries. Various aspects are covered, i.e. general aspects of income taxation, the taxation of the principal forms of income (business income and investment income) and the measures adopted in Latin America to avoid double taxation. The coverage of these topics is limited to general considerations and attempts to highlight areas where the same or similar rules apply in all or several Latin America countries and those areas where outstanding differences exist.[1]

II. GENERAL ASPECTS

A. Concept of non-residency

1. Relevance of the distinction between resident and non-resident

The distinction between the concepts of resident and non-resident is crucial in those Latin American countries which tax residents on their world-wide income but tax non-residents only on their local-source income. This group includes Brazil (as regards individuals), Chile, Colombia, El Salvador (as regards individuals), Honduras, Mexico and Peru. The distinction between resident and non-resident is of less concern in other Latin American countries where income is taxable only if derived from local sources. Most Latin American countries fall into this category: Argentina, Bolivia, Brazil (as regards legal entities), Costa Rica, the Dominican Republic, El Salvador (as regards legal entities), Guatemala, Nicaragua, Panama, Paraguay and Uruguay.

Nevertheless, the distinction may assume importance as regards withholding taxes, either because items of income are subject to withholding tax when paid to non-residents or because items of income may be subject to withholding tax at a different rate than that applied to residents. The distinction is also significant with respect to personal allowances or credits which are normally granted only to resident individuals.

2. Definition of non-resident

As a general rule, Latin American tax laws do not directly refer to the concept of non-resident. A person or entity will be considered non-resident if he (it) does not fall within the scope of the rules defining resident. The prevailing approach in defining the residence of a company is to apply resident treatment to entities organized or incorporated under the laws of the country. This approach is followed in Chile, Colombia, Ecuador, Guatemala, Paraguay, Peru, Uruguay and Venezuela (if the corporation is organized or registered in Venezuela).

Certain countries, however, define resident companies as those having their seat or management in the country. This is the case of Brazil (legal entities whose headquarters or main offices are located in Brazil), Colombia (legal entities whose management headquarters are located in Colombia), Honduras (corporations which have their administration and management in Honduras) and Mexico (legal entities which maintain the principal administration of their business in Mexico).

1. The sources used for this research include the Bureau's publication *Taxation in Latin America*, the material prepared for this publication and information received up to 31 December 1987.

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The residency of individuals is usually established on the basis of physical presence in the relevant country. Thus, an individual is considered resident if he remains permanently in the country. This rule applies in Brazil (an individual acquires residency by intending to stay in Brazil, e.g. by possessing a permanent resident visa), Chile (residence in a given place with the real or presumed intention of remaining there), Honduras (persons living in the country and not merely transients or tourists) and Mexico (individuals having a permanent home in Mexico, unless they are present in another country for more than 183 days in a calendar year, whether or not continuous, and offer proof that they are considered residents in that country for tax purposes) and Uruguay (permanent residence in Uruguay).

Similarly, in certain countries an individual is considered resident if he remains in the country for more than a certain period of time. For example, in Argentina the time period is more than 6 months (however, this definition is provided for specified purposes only); Brazil requires more than 12 months; Chile more than 6 months in a calendar year or within 2 consecutive assessment years; Colombia at least 6 months in the taxable year or a period of 6 months which ends in the taxable year; Ecuador more than 6 months; Guatemala more than 6 months during the taxable period; Paraguay more than 180 days during the tax year or within the last 12 months; and Venezuela more than 180 days in the taxable year or in the preceding year (in computing the 180 days, the days of a particular year are not added to the days of another year).

Resident individuals usually include persons who, although staying abroad, maintain certain ties with the country. In Argentina, residents include individuals employed by the government and Argentineans employed by international bodies of which Argentina is a member; public officials in Chile who discharge their duties outside Chile and individuals leaving the country but retaining a business in Chile; Colombian citizens who maintain their family or business headquarters in Colombia; in Guatemala, individuals discharging representative duties abroad or executing official public sector duties; in Honduras residents include persons who are part of the crew of a Honduran ship registered in Honduras; and in Mexico, unless proof to the contrary is provided, individuals and legal entities of Mexican nationality are presumed residents of Mexico.

B. Territorial scope of the income tax

1. Allocation rules

Most Latin American countries utilize the source principle as the only (or overriding) principle of income allocation. In accordance with this principle, income derived by residents of the respective countries from sources located abroad is normally not subject to domestic income tax.

Several countries, however, apply the residence principle of taxation, i.e. residents are subject to tax on their world-wide income and the limited taxation of domestic-source income is restricted to non-residents, i.e. Chile, Colombia, Honduras, Mexico (until 1980 the world-wide principle was also applicable to Mexican citizens) and Peru.

The world-wide principle applies only to individuals (i.e. not to legal entities) in Brazil and El Salvador. Other countries adopt the source principle as a general rule but apply the world-wide principle to specific situations. In Mexico, non-residents having a permanent establishment in Mexico are taxed on income attributable to the establishment and on income otherwise arising from Mexican sources. Income which is attributable to a permanent establishment includes income from business activities (actividades empresariales) carried on by the permanent establishment and income derived from sales of merchandise of immovable property carried out in Mexico by the head office or by any of its branches. Since the Income Tax Law does not limit the income which is attributable to the permanent establishment to Mexican-source income, foreign-source income can be subject to Mexican income tax derived through a permanent establishment in Mexico. In Ecuador, dividends and interest derived from investments abroad are taxable unless specifically exempt, and income from services rendered abroad is taxable in the hands of resident individuals or corporations. Venezuelans and Venezuelan residents are also taxed on specific foreign-source income items. International transportation enterprises established and domiciled in Venezuela are taxed on world-wide receipts derived from their normal activities.

It should be noted that a country may tax income on the basis of the source principle but, simultaneously, treat income which under ordinary rules is foreign-source income as if it were domestic-source income when derived by certain persons or when certain income items are involved.

In Argentina and the Dominican Republic, income derived by resident individuals from occasional activities performed outside the country is subject to income tax. A similar situation exists in Chile (consideration paid to non-residents for services rendered abroad is subject to tax when paid from Chilean sources), Ecuador (dividends and interest derived from investments abroad are taxable unless specifically exempt and income from services rendered abroad is taxable in the hands of resident individuals or corporations) and Honduras (income from services rendered abroad is deemed to be sourced in Honduras when it is paid from Honduras).

In certain countries remuneration derived by persons living abroad for services rendered for the government is deemed to be from domestic sources. This is the case in Argentina (the same principle applies to income derived by Argentine officials working for international organizations of which Argentina is a member), Bolivia (diplomatic personnel only), El Salvador, Colombia (compensation for services paid by the govern-

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ment), Nicaragua (salaries paid by the government and its agencies, provided such salaries are not subject to a similar tax in the country of residence), Panama (persons discharging public duties abroad), Peru (remuneration paid to persons discharging representative or official duties abroad) and Venezuela (income derived by public officials or representatives of government agencies or enterprises from official activities performed abroad, provided the income is exempt in the country of origin).

Similarly, remuneration paid to boards of local companies may be treated as domestic-source income even if the services are rendered abroad. This applies to companies or entities incorporated in Argentina; in Bolivia, for activities developed abroad on behalf of resident enterprises; Costa Rica; Mexico includes managers and controllers; and in Peru, remuneration paid to members of administrative boards.

2. Source of income

Certain Latin American countries provide a general definition of domestic-source income and additionally, list several items of income which are specifically considered domestic-source income. Other countries do not provide a general definition but specifically list items of income which are treated as domestic-source income. As a general rule (either on the basis of the general definition or on the basis of the specific lists), domestic-source income is income derived from property located in the country or from the development of acts or activities in the country. Additional specifications may also be set forth; for instance, in Honduras when income is obtained by the joint use of capital and personal services, the source is determined by the location of the assets constituting the capital. Mexican local-source income does not include income from personal services paid by non-residents even if derived from services rendered in Mexico. Such income is deemed to be Mexican-source when paid by or related to a non-resident's establishment in Mexico. Local-source income in Nicaragua includes income from business transactions conducted or "producing effects" in the country. In Panama, some specified foreign-related income items are not considered to be Panamanian-source income.[2] Income is considered to have a domestic source in Venezuela when any of the acts which give rise to the income occur within the national territory.

Legislation frequently specifies that domestic-source income includes not only the income from property located in the country but also income from property exploited therein. This group includes: Argentina (property economically used in the country), Bolivia (goods economically used in Bolivia), Costa Rica (income from the use of capital and goods in Costa Rica), the Dominican Republic, Chile (royalties, fees for trade marks and similar payments derived from the exploitation in Chile of industrial or intellectual property), Colombia (profits derived from the exploitation in Colombia of movable goods; a similar rule applies to intangibles), Ecuador (income from loans, assets and claims placed on or used in Ecuador), Guatemala (income from capital, property or rights invested, located or used in Guatemala and income from any goods located or used in that country), Mexico (rent from movable property used in trade, industry, agriculture, cattle raising and fishery if the property is utilized in Mexico and royalties for property or rights utilized there[3], Panama (income from property, capital, securities and rights located, invested or economically used in Panama), Paraguay (income from capital, goods or rights situated, located or economically used in Paraguay), Peru (income from capital, assets or rights, including royalties, located or used for economic activities in Peru and interest, commissions, premiums and any sum paid for loans, financing or, in general, for any capital placed or economically used in Peru), Uruguay (income from rights economically used in Uruguay) and Venezuela (income from technical assistance or technical services used there).

Examples of particular items of income contained in the lists of domestic-source income include:

(i) Income from the export of goods produced in the country. This rule applies in Argentina (export of goods produced, manufactured, processed or purchased in Argentina), the Dominican Republic (export of merchandise produced, manufactured or brought into the country), Ecuador (income from export activities carried out in Ecuador), Guatemala (export of goods produced, manufactured, processed or purchased in Guatemala), Mexico (income from exports), Nicaragua (income derived by residents or foreign purchasing agencies in Nicaragua from the export of goods produced, manufactured, processed or

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2. The following are not considered to be Panamanian-source income:
(a) income from invoicing sales or merchandise or products from an office in Panama for amounts greater than billed costs, provided the merchandise or product does not enter Panama;
(b) income from directing transactions which are concluded or which produce effects outside Panama from an office in Panama;
(c) income from distributing dividends and profits shares paid out of income not produced in Panama (including income from the activities described in (a) and (b) above); and
(d) interest, financial commissions and other similar items derived by individuals or legal entities (irrespective of their domicile or establishment) from loans, cash deposits or any other financial transactions carried out with borrowers domiciled outside Panama, even if the principal and interest are paid from Panama, but provided the money is used outside Panama (Decree 60 of 1985).

In accordance with the foregoing rules, even if a Panamanian corporation (i.e. a company organized under the laws of Panama) has an office in Panama, employees in Panama, and a licence to engage in business in Panama, it need not pay Panamanian income tax if the transactions out of which the income arose took effect or were performed outside Panama. No tax liabilities arise even though payment for the merchandise is made from Panama or received in Panama, or if the sale or purchase operations are directed from an office situated in Panama, provided the merchandise involved in the transaction does not physically enter Panama.
If a Panamanian corporation engages in business both within the Republic of Panama and abroad (offshore), it is subject to income tax only on that portion of its net income arising from business carried on within the territory of the Republic of Panama.

3. The property is deemed to be utilized in Mexico if the tenant is a resident thereof or if he has a permanent establishment in Mexico. This presumption is rebuttable.

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purchased therein) and Paraguay (all income derived from exports originating in Paraguay).

(ii) Income from transportation. This rule specifically applies in Guatemala, i.e. income derived from transportation and communication between Guatemala and a foreign country, from tickets issued in Guatemala and freight hired and paid in Guatemala for shipments abroad); and Chile (income from coastal trade).

(iii) Dividends and profit shares paid or distributed by resident entities. This rule applies in Argentina (dividends and participations in profits when paid or distributed by legal entities domiciled in Argentina), Chile (dividends and participations in profits distributed by corporations organized therein), Colombia, Costa Rica, Mexico and Venezuela (dividends paid by enterprises resident in Venezuela receiving dividends or participations in profits from abroad are taxable only to the extent that they represent Venezuelan-source income).

(iv) Interest on debts if the debtor is a resident of the country. This rule applies in Argentina (for bonds if the issuing institution is established or located there), Chile (if the debtor is domiciled in the country), the Dominican Republic (for bonds if the borrower or issuer is located in the country), El Salvador, Guatemala (for securities issued by persons domiciled in the country) and Peru (if the issuing company is organized in Peru).

(v) Interest on loans secured by property located in the country. This rule applies in Argentina, the Dominican Republic and Guatemala.

(vi) Interest on loans placed or used in the relevant country. Included in this rule are debt-claims held in Colombia or economically connected to the country; loans placed or used in Ecuador; income from capital invested or used in Guatemala; capital placed or invested in Mexico[4]; and capital placed in or used for economic activities in Peru.

(vii) Royalties or benefits derived in the country from the exploitation of industrial property and similar payments for the exploitation of copyrights. This rule applies in Chile (trade marks are specifically mentioned), Colombia (know-how is specifically mentioned), Guatemala (royalties from property located or used in the country), Mexico (royalties for property or rights utilized in Mexico)[5], and Peru (under general rules royalties are taxed if located or used for economic activities in Peru; moreover, royalties paid by residents of Peru are specifically taxable).

(viii) Fees and other remuneration derived from technical and financial assistance provided from abroad which is used in the country. This applies in Argentina if the assistance is "economically" used therein (other assistance is also included); in Bolivia if the assistance relates to goods located therein or to Bolivian-source income (commercial assistance is also included); in Chile for services rendered by non-residents if the payment is made in Chile or from Chilean sources; in Colombia (only technical assistance is mentioned); in Costa Rica administrative and other types of assistance are included; and in Guatemala (technical, financial, administrative and other assistance rendered to residents of Guatemala).

(ix) Gains derived from the transfer of property located in the country. This rule specifically applies to transfers of immovable property in Colombia and Mexico. More general standards apply in other countries.

(x) Gains derived from the transfer of securities issued by local companies. This rule applies in Honduras (transfers of shares or securities issued by companies established under Honduran law), Mexico (transfers of securities issued by Mexican companies) and Peru (shares and participations in the capital of enterprises organized there).

(xi) Remuneration paid to board members of local companies if the services are rendered abroad. This applies in Argentina (for companies or entities incorporated in Argentina), Bolivia, Costa Rica, Guatemala, Mexico (managers and controllers are also included), and Peru (remuneration paid to members of administrative boards).

(xii) Receipts from insurance and reinsurance operations covering risks located in the country or concerning resident persons. This applies in Argentina and Chile (the law does not specifically state that this income is Chilean-source but submits the relevant premiums to income tax), Guatemala (income from insurance contracted in Guatemala and covering persons domiciled and property located in the country).

(xiii) Income derived from the importation of goods. This rule applies in Argentina (income from imported goods in excess of their normal wholesale price in the country of origin, increased by transportation and importation expenses and income from the transfer of goods situated, located or economically used in Argentina which belong to enterprises or companies organized, established or located abroad) and the Dominican Republic (export of goods to the Dominican Republic gives rise to taxable income when the goods are shipped on consignment or when the sale price exceeds the normal price between unrelated parties).

C. General rules for the taxation of non-residents

1. General aspects

In principle (unless otherwise provided for by domestic law or treaty provisions), non-residents in Latin

4. See footnote 3 for deeming provision (also applicable to capital).
5. See footnote 3 for deeming provision (also applicable to royalties).

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America are subject to the same legislation applicable to residents. Nevertheless, income tax legislation frequently includes separate rates applicable to non-residents and provides for the withholding of the income tax at source even in cases where such withholding would not apply if the income were derived by a resident person. The income tax is sometimes imposed on gross receipts. This is the case in Bolivia (the tax is levied upon distribution), Chile (the income tax is levied upon withdrawal or remittance) and Honduras.

In certain countries, the withholding tax may be calculated on a percentage of gross payments and the percentage may vary in accordance with the income item involved. This is the case in Argentina (80% of the amount of unspecified income), Colombia (60% of payments for the exploitation of cinematographic films and 80% for computer programmes), Guatemala (80% of gross receipts of non-resident producers, distributors or agents of films, tapes and records; 10% of receipts from insurance; 70% of gross income from the provision of international news; 15% of Guatemalan-source gross receipts from freight and tickets), Nicaragua (the net taxable income of non-resident natural persons or non-resident enterprises rendering services or conducting business in various countries, so that the costs or expenses incurred by their activities in Nicaragua are difficult to establish, is officially determined as a certain percentage of gross income obtained), Panama (50% of the sums derived from rents, royalties, and income from life insurance; 10% of sums derived from transportation and communication when the company remitting the payments has chosen to be taxed on 10% of its gross income; and 15% of the gross receipts of foreign film producers remitted by Panamanian film distributors), Paraguay (90% for royalties and 85% for fees and commissions), Peru (90% for income from professional services paid to non-residents) and Venezuela (90% of gross receipts for income paid to non-resident employed professionals).

2. Tax rates

In the absence of a specific rate, several countries apply a general rate to income derived by non-residents. The rates are as follows:

Argentina:	45% (normally applied on a percentage of gross payments)
Bolivia:	10%
Brazil:	25% (in special cases the tax may be increased by 20% or reduced to 15%)
Chile:	35%
Colombia:	30% (a surtax also applies at a rate of 30%, 12% or 1%)
El Salvador:	22% or 20% (22% for legal entities and dividends and 20% for individuals)
Ecuador:	40%
Guatemala:	34%
Honduras:	10%
Nicaragua:	45%
Paraguay:	30%
Peru:	45%

Certain countries tax non-residents at the same rates as residents. The Dominican Republic provides progressive rates (from 10% to 46% for legal entities having an establishment in the country and from 3% to 70% for individuals; a final withholding tax of 35% applies to Dominican Republic-source business income derived by non-resident companies without an establishment in the country).[6] Panama also has progressive rates (from 20% to 50% for legal entities and from 2.5% to 56% for individuals). Uruguay imposes a 30% rate for legal entities and Venezuela's progressive rates range from 15% to 50% for legal entities and 4.5% to 45% for individuals.

In addition to the "general" rate (or absence thereof), the taxation of Latin American-source income derived by non-residents may vary according to the income item involved. Consequently, it may be necessary to consider whether the income is derived from business activities, passive investments or personal services. If the income is derived from business activities, the type of business organization through which the business operates (i.e. subsidiary, branch, agency, representative office) must be considered and it is also possible to encounter special rules for particular kinds of businesses. In the case of passive investments, taxation may vary depending on whether dividends, interest, royalties, service fees, rent or capital gains are involved.

D. Excess profit taxes

Except for Argentina and Brazil, no special taxation applies to excess profits. Chile recently introduced an excess profit tax but it only applies if a foreign investor elects to be taxed at a special 40% rate.[7]

In Argentina, a special tax normally withheld at source (impuesto especial a las remesas de utilidades de las empresas de capital extranjero) is levied on after-tax income (and repatriable capital gains derived from disposal of the investment) exceeding an annual 12% of the registered foreign investments, as follows:[8]

- on profits between 12% and 15% the tax is 15%;
- on profits between 15% and 20% the tax is 20%; and
- on profits above 20% the tax is 25%.

An excess of profits (or capital gains) in one year may

6. Law 78/87 of 15 November 1987, published in the Official Gazette of 26 November 1987 and effective, in general, as of 27 November 1987.
7. A foreign investor subject to the Foreign Investment Statute has the right to have a provision for special income tax treatment included in his investment contract with the Chilean government. Under this special treatment, a final income tax of 49.5% is paid which covers all income taxes. This method of taxation cannot be changed for a period of 10 years from the date on which the enterprise's operations commenced. Nevertheless, the investor has the right to renounce this special tax treatment in favour of being subject to the general rules but this decision is irrevocable. The period during which the special tax treatment cannot be changed by the government may be extended to 20 years for any projects involving at least 50 million dollars. Under Law 18,682, published in the Official Gazette of 31 December 1987, the foreign investor can choose to be taxed at a 40% rate (instead of 49.5%) but in such a case he is subject to a supplementary tax of 30% on remittances, withdrawals or distributions which (within the last 60 months) exceed 40% of average capital.
8. The tax is assessed progressively.

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be set off against profits of less than 12% of registered foreign investment capital in the 5 previous years.

Certain categories of profits are not taxed, i.e. profits arising from unregistered investments, profits from unregistered temporary investments and profits not exceeding 12% of registered capital. An exemption from the tax is granted for profits reinvested in Argentina, either in the same or another enterprise, profits paid to foreign-controlled local enterprises and profits paid in stock dividends.

A "supplementary" tax is levied in Brazil when distributions of profits and dividends (net of the 25% withholding tax) exceed, in a 3-year period, an average of 12% per year of the registered capital (original investment plus reinvestment). The supplementary tax does not apply to non-distributed profits of branches, agencies and representative offices in Brazil of companies domiciled abroad. These profits are computed to determine the taxable excess only when actually distributed.

The supplementary tax is due on profit distributions in excess of the established limits even though related to profits of prior years. The tax is calculated annually with reference to the appropriate 3-year period. For this purpose, the last 2 years of a 3-year period are computed as the first 2 years of the subsequent 3-year period.

The 12% limit need not be observed for each year since it may be admissible to compensate the shortfall of one year with the excess of another. This compensation is allowed only between the years of one and the same 3-year period but is not permitted between different 3-year periods.

Any excess over the 12% limit on which the tax is levied is excluded from the basis in calculating the tax in subsequent years. The supplementary tax is assessed on the excess over the 12% average at the following graduated rates[9]:

– between 12% and 15%	40%
– between 15% and 25%	50%
– over 25%	60%

III. TAXATION OF BUSINESS INCOME

A. Subsidiaries

1. Basic taxation rules

Local subsidiaries of non-resident companies are normally subject to income tax under ordinary rules, i.e. the income of the subsidiary is subject to the corporate income tax and income distributions are subject to dividend taxation. Computation of the subsidiary's income is also made under ordinary rules. However, certain countries have specific provisions relating to business conducted by a local subsidiary and its parent company abroad.

2. Computation of income

In principle, there is no difference between computation rules applicable to local companies and those applicable to subsidiaries. However, some countries require that contracts between a local subsidiary and its parent company conform to normal market practices between independent entities (i.e. the arm's length principle). In other countries, a similar principle applies under general rules and the deductibility of expenses such as interest, royalties and technical assistance fees paid by the subsidiary to its parent may be limited or even disallowed.

(a) In order to allow the deduction of costs or expenses, some countries specifically require that the contract or transaction under which the payment is made be in accordance with normal market practices.

Argentina
Interest on loans paid by a foreign-controlled local enterprise to a non-resident controlling entity or person is deductible as far as the contract under which it is paid is in accordance with normal market practices between independent entities and with the provisions of the Foreign Investment Law.[10]

Brazil
When the import or the export of goods involves related parties, the arm's length principle generally applies. For this purpose, local customs have established standard prices for most kinds of goods and significant departures from these prices are not permitted.

Chile
Corporate law provides that transactions between related companies (i.e. between the parent company and a subsidiary or between subsidiaries of the same company) must observe conditions similar to those commonly prevailing in the market-place.

Venezuela
The cost of the goods is the amount appearing on the invoices received directly from the vendor provided prices are not higher than those normally found in the market-place.

(b) Certain countries do not specifically require for deduction purposes that payments be made in accordance with normal market practices but rather rely on more general provisions vesting power in the tax administration to correct the local income of the subsidiary.

Colombia
The transfer of assets must conform to general rules on pricing and costs.

Dominican Republic
When the profits obtained in the country cannot be determined easily and accurately from the accounting records of the entity, the net Dominican-source in-

9. The tax is assessed progressively.
10. Loan contracts are deemed to comply with such conditions if the Argentine Central Bank raises no objection on the grounds of the specific contractual conditions or of the inadequate level of indebtedness of the subsidiary.

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come will be determined on the basis of results of independent entities engaged in the same or similar activities. The tax administration is empowered to adopt other indexes for tax purposes in appropriate circumstances and consider that the subsidiary constitutes, with the parent company, an economic unit. Based on this assumption, the tax administration may determine the net taxable income of the subsidiary.

Guatemala
The tax administration can make the necessary corrections so that the subsidiary pays taxes on its actual profits from Guatemalan sources. The price of imports cannot exceed the international price in the place of origin and transportation and insurance expenses to Guatemala. The price of exports cannot be less than international prices less transportation and insurance expenses to the place of destination.

Mexico
The price of goods acquired or sold can be corrected by the government in several instances, including imports and exports and, in general, payments abroad and transactions between connected enterprises.

Paraguay
The tax administration is empowered to introduce necessary corrections to determine the actual Paraguayan-source results.

(c) In certain cases, the deduction of expenses is permitted but payments may not exceed a certain percentage or amount provided by the law, regulation or the authorities.

Argentina
Technical assistance fees are limited to 3% of sales or receipts and 5% of the investment made on the basis of the assistance.

Peru
Interest paid to foreign entities which are economically connected with the debtor is not deductible insofar as it exceeds the limit established in regulations. The limit for interest is normally the prime rate of the lender's market. For credit destined for the construction, acquisition or installation of new fixed assets or for working capital, the limit is increased by 3 points. Likewise, interest on that part of financing which is more than 3 times the net worth of the debtor is not deductible. The taxpayer may choose to limit the deduction to 4 times the registered capital (capital social) at the end of the taxable period.[11]

(d) Some payments to parent companies are entirely disallowed.

Brazil
Interest on loans passed on to other companies of the same group are not considered business expenses and royalties and technical assistance fees paid by subsidiaries to their parent companies are not allowed as a deduction.

Colombia
Expenses, commission fees, management fees, royalties and compensation for exploitation of any kind of intangibles paid by a subsidiary to its parent company are not allowed as costs or deductions from their receipts.

Guatemala
In general, amounts credited or remitted to the parent company are not deductible.

Honduras
Interest from capital invested in or loaned to an enterprise by the parent company is not deductible.

Mexico
Interest can be treated as a dividend by the tax administration if paid by a resident company to a non-resident company if one of the companies has an interest in the business or goods of the other, or both companies have common interests, or if a third enterprise has an interest in the businesses or goods of both companies.

Peru
Royalties for the supply of intangible technology paid by a "foreign enterprise" (foreign-controlled local enterprise) to the parent company or to a subsidiary thereof are not allowed as a deduction in the computation of taxable income.

Uruguay
Interest paid by a subsidiary to its parent company is not deductible.

Venezuela
If contribution of technology is provided by a parent company or a subsidiary thereof to a resident "foreign enterprise" (foreign controlled local enterprise) in Venezuela, the payment of royalties or other consideration will not be allowed as a deduction for tax purposes. This rule does not apply to occasional specific technical services (i.e. those rendered to resolve unexpected situations arising in the course of the enterprise's activity); nor does it apply to non- occasional specific services (i.e. those rendered to resolve expected non-recurring situations lasting up to 6 months and which are paid by means of fees or tariffs arising in the course of the enterprise's activity).

(e) A few countries specifically allow the deduction of expenses incurred by the parent company on behalf of the subsidiary.

Panama
Subsidiaries of foreign corporations may deduct administrative expenses incurred by the parent company. In the majority of cases, the proportion of expenses applicable to the Panamanian subsidiary is accepted as a deductible expense when the allocation is made on the basis of total international sales. Expenses which are not deductible pursuant to Panamanian tax legislation are to be excluded from the total expense to be apportioned.

11. The rules do not apply where the limit has been amended by the government.

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Uruguay
Expenses incurred by a parent company aimed at obtaining and preserving the Uruguayan-source income of a subsidiary or agency in Uruguay are allowed as a deduction provided sufficient evidence is supplied as to their origin and nature.

3. Taxation of corporate income

Except in Bolivia, income derived by subsidiaries is subject to corporate income tax under ordinary rates:

Argentina:	33%
Brazil:	35% (an additional 10% tax is levied on that part of profits exceeding 40,000 adjustable units, i.e. approximately US$ 30,000)
Chile:	10% (creditable against liability of the recipient)
Colombia:	30% (effective as from taxable year 1988)
Ecuador:	20% (creditable against liability of recipients, plus surcharges)
Nicaragua:	the general rate is 45% (reduced to 40% for the agropastoral sector) and trading companies are assessed at 50%; a 10% surcharge is imposed in all 3 cases)[12]
Peru:	35%
Uruguay:	30%

Progressive rates apply in Costa Rica (from 10% to 50%), Dominican Republic (from 10% to 46%), El Salvador (from 15% to 35%), Guatemala (from 12% to 34%), Honduras (from 3% to 40%), Mexico (from 5% to 42% on traditional base and 35% on new expanded base, both results being combined under adjustment percentages)[13], Panama (from 20% to 50%), Paraguay (from 25% to 30%) and Venezuela (from 15% to 50%).

4. Taxation of dividends

Dividends paid to the parent company are normally subject to a final withholding tax at flat rates. The rates are:

10%	in Bolivia, Paraguay and Panama (20% for bearer shares)
12.5%	in Guatemala
15%	in Costa Rica and Honduras
15.4%	in Peru
17.5%	in Argentina;
20%	in Dominican Republic, Nicaragua and Venezuela
22%	in El Salvador
25%	in Brazil (15% if specific conditions are fulfilled)
30%	in Colombia and Uruguay (taxable only if certain conditions are fulfilled)
35%	in Chile
40%	in Ecuador
50%	in Mexico.

B. Establishments and branches of foreign companies

1. Concept of permanent establishment

The concept of permanent establishment is generally irrelevant for income tax purposes in Latin America because the income of non-residents which is derived from local sources is taxable whether or not it is obtained through a permanent establishment. As a result, the taxation of the income of non-residents is not substantially altered by the existence of a permanent establishment.

Perhaps the only important consequence of having a permanent establishment is that in Mexico non-residents with a permanent establishment are taxed not only on income arising from Mexican sources but also on income attributable to the permanent establishment. It is therefore not surprising that the domestic legislation of most Latin American countries lacks a definition of permanent establishment. Permanent establishment is provided for, however, in Argentina[14], Ecuador, Guatemala, Mexico, Peru and Venezuela.

Ecuador
A permanent establishment of a foreign enterprise is deemed to exist if there is a fixed place for carrying on the business activities of the enterprise in Ecuador (either totally or partly), including research and consulting, and other establishments of a productive nature. In this sense, the law covers branches, agencies, offices, warehouses, mines, oil wells, plantations, forests, factories, workshops, research establishments, consulting agencies and other permanent places of business of the foreign enterprise.

In addition, Ecuadorian regulations provide that a permanent establishment is deemed to exist when the foreign enterprise maintains a fixed place of business in the country or has maintained, for more than 12 months, a place to carry out technical services and if its agent has power to conclude contracts on behalf of the foreign enterprise or if he is under a labour contract and habitually carries out commercial transactions on behalf of the enterprise, has usually in deposit assets for sale and delivery, and principally if the administrative expenses (in particular the office rental) are paid for by the foreign company.

Guatemala

The concept of permanent establishment includes any office, factory, building or other immovable property, plantation, business or forestry, agricultural, stock raising or other exploitation, warehouse or other fixed place of business, rendering of services, use of technol-

12. See Decree 240 of 5 December 1986.
13. The income tax was amended by the Law of 28 December 1986 and during the period 1987-1990, business companies must compute taxable income and calculate the corporate tax separately under both the old rules and the new rules. The result of each of the 2 calculations must be adjusted respectively by a phase-out percentage or by a phase-in percentage and both adjusted results must be added together in order to arrive at the tax due to the Treasury.
14. Argentina also provides a definition of permanent establishment for purposes of the net wealth tax law.

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ogy, including the temporary use of storage facilities, as well as establishments utilized for the purchase or sale of merchandise or products in the country and any other type of enterprises which derives income in Guatemala.

Mexico

The Mexican concept of permanent establishment is similar to that found in the OECD Model Treaty. For income tax purposes, the term "permanent establishment" refers to any place of business in which business activities are wholly or partly carried on. The term includes branches, agencies, offices, factories, workshops, installations, mines, quarries and any other place of exploration for or extraction of natural resources. Construction work or installations, maintenance or assembly services connected with immovable property are deemed to constitute a permanent establishment only if they exist for more than 365 days.

An individual or legal entity acting in Mexico on behalf of a non-resident (even if he lacks a place of business in Mexico) is deemed to have a permanent establishment as regards all activities he performs on behalf of the non-resident, if he has (and exercises) authority to conclude contracts in the name of the non-resident, or if he maintains an inventory of goods or merchandise out of which he makes deliveries on behalf of the non-resident.

Mexican law further provides that the following activities do not constitute a permanent establishment:

- the use or maintenance of facilities solely for the purpose of storage or display of goods or merchandise belonging to the non-resident;
- the maintenance of a stock of goods or merchandise belonging to the non-resident solely for the purpose of storage or display of the aforesaid goods or merchandise or for the processing by another person;
- the maintenance of a place of business solely for the purpose of acquiring goods or merchandise or for collecting information for a non-resident;
- the use of a place of business solely for the purpose of carrying on, for the non-resident, any activity of a preparatory or auxiliary character, such as advertising, the supply of information, scientific research, preparation of loans and similar activities; and
- the fiscal deposit of goods or merchandise belonging to a non-resident in a bonded warehouse (almacén general de depósito) or the delivery of such goods or merchandise for their import into Mexico. Such delivery, however, is subject to income tax at a 5% rate as applied to the gross value of the goods.

Peru

The concept of "permanent establishment" in Peru is also based on the OECD Model Treaty. The term means any fixed place of business where the business of a sole proprietor, company or entity organized abroad is wholly or partly carried on. The term "permanent establishment" includes a place of management, an office, a factory, a workshop, a place of extraction of natural resources, and any installation or structure, fixed or movable, used for the exploration for or exploitation of natural resources.

The following are not regarded as a "permanent establishment" in Peru:

- the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
- the maintenance of a fixed place solely for the purpose of purchasing goods or merchandise for the sole proprietorship, company or entity organized abroad, or for collecting information therefor; and
- the maintenance of a fixed place solely for the purpose of activities which have a preparatory or auxiliary character for the sole proprietorship, company or entity organized abroad.

The fact that a sole proprietorship, company or entity organized abroad controls a resident company or carries on business in Peru does not, standing alone, constitute a permanent establishment.

Venezuela

Income tax regulations provide that a company is deemed to have an agency, branch or similar establishment in Venezuela if, during the taxable year, it maintains or establishes (either on a permanent or temporary basis) any income-producing property, office, warehouse, installation or other fixed place where its activities are carried out, either with or without employees. However, if the taxpayer only has movable goods in Venezuela, the taxpayer must also maintain (in Venezuela) an office or fixed place of business where its activities are performed.

2. Basic taxation rules

Branches and other establishments of foreign companies are normally treated as separate entities. In general, foreign legal entities operating in a Latin American country through establishments or branches are taxable on their local-source profits in the same manner as a domestic legal entity and independently from the profits of the head office.

In Mexico, however, profits of establishments are more broadly taxed on income attributable to the establishment. Business companies not resident in Mexico which have permanent establishments in that country are taxed not only on income arising from Mexican sources but also on income attributable to the permanent establishment. Income attributable to a permanent establishment includes income from business activities carried out by the permanent establishment as well as income derived from sales of merchandise or immovable property carried out in Mexico by the head office or by any of its branches. On the other hand,

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such companies are allowed to take deductions under general rules even for expenses incurred abroad. However, deduction of expenses incurred abroad are disallowed if they are allocated on a proportional basis between the Mexican branch and head offices or other establishments located abroad.

3. Computation of taxable income

In general, the amount of local-source income of branches and other establishments of foreign enterprises operating in Latin America is established on the basis of actual results obtained in the corresponding country, i.e. on the basis of separate accounting records. The income of branches and establishments is computed under ordinary rules. However, certain countries have specific provisions covering (or relating to) business done by a local branch and its parent company abroad. Moreover, the deductibility of expenses such as interest, royalties and technical assistance fees paid by the branch or establishment to its head office may be limited or disallowed.

(a) Certain countries provide (directly or indirectly) that the conditions of transactions entered into between foreign-controlled local enterprises, establishments or branches and non-resident entities controlling directly or indirectly such establishments or branches be in accordance with normal market practices between independent entities (i.e. the arm's length principle). This rule applies in:

Argentina
Besides the general arm's length principle, some additional requirements or limitations must be met, i.e. it is necessary that loan transactions are not rejected by the Central Bank within 30 days of reporting the transaction; and with respect to the transfer of technology, the relevant agreement must be approved by the authorities responsible for implementation of the Law on Transfer of Technology.

Brazil
If the import or the export of goods involves related parties, the arm's length principle is generally applicable. Standard prices have been established for most kinds of goods and significant departures from such prices are not permitted.

Colombia
The transfer of assets must conform to general rules on pricing and costs.

Dominican Republic
The taxable income of branches of foreign entities is determined on the basis of separate accounting records and the tax administration has authority to make necessary corrections to reflect the effective Dominican-source profits.

Guatemala
The tax administration can make necessary corrections so that branches of foreign entities pay taxes on actual profits from Guatemalan sources. The price of imports cannot exceed the international price in the place of origin and transportation and insurance expenses to Guatemala. The price of exports cannot be less than international prices less transportation and insurance expenses up to place of destination.

Mexico
If permanent establishments located in Mexico and belonging to non-residents send or receive goods from their head office or from other establishments located abroad, the government may correct the cost, acquisition or sale price of such goods considering:

- the current price in the internal or external market or the estimation made by the tax administration;
- the cost of the goods as increased by the percentage of gross profits obtained by the taxpayer; or
- the price at which a person transfers the goods acquired from the taxpayer, as decreased by a percentage provided by Law (the percentage varies for different branches of businesses).

Paraguay
The tax administration has authority to make necessary corrections to determine the actual Paraguayan-source results of branches, agencies and representative offices of foreign enterprises or entities.

Peru
Expenses incurred by a branch which represent taxable income for other branches or agencies are deductible provided the disbursement can be controlled and does not constitute an indirect distribution of profits.

Uruguay
The tax administration is authorized to make necessary corrections to appraise the actual profits of branches or agencies of foreign entities.

(b) The deduction of certain expenses incurred abroad or payments made to the head office may be disallowed in certain circumstances.

Brazil
Costs and expenses are deductible only if incurred in the territory of Brazil. Depreciation, amortization and depletion allowances can be taken only on property located in Brazil. Reserves can be made only as regards transactions carried out in Brazil. Payments made to head offices for technology are disallowed as a deduction, and salaries and profits shares paid to members of a board of directors of stock corporations, not resident in Brazil, are not deductible.

Colombia
Expenses, commission fees, management fees, royalties and compensation for the exploitation of any kind of intangibles (including technical assistance fees) paid directly or indirectly by branches to their head offices are not allowed as costs or deductions from their receipts and are subject to the surtax on transfer of income abroad at a rate of 12%. In this case, the 12% surtax is creditable against the final liability to the branch surtax which is calculated at 30%.

Guatemala
In general, sums credited or remitted to the head office are not deductible.

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Honduras
Interest from capital invested in or loaned to an enterprise by the head office is not deductible.

Mexico
The deduction of expenses incurred abroad is disallowed if they are allocated on a proportional basis between the Mexican branch and head offices or other establishments located abroad. Moreover, remittances by a permanent establishment located in Mexico to the head office or other establishments located abroad are disallowed as a deduction even if they represent royalties, fees or similar payments for patents or rights, commissions, or interest.

Paraguay
In the case of interest remitted abroad, the tax administration has disallowed the deduction of interest paid to the head office. This view, however, has been reversed by the Exchequer's Court and by the Supreme Court of Justice.[15]

Uruguay
Interest, royalties and technical assistance fees are not deductible if paid by local branches to their non-resident head offices.

Venezuela
The deduction of interest paid by a branch in Venezuela to the head office abroad or to other branches abroad has been disallowed as a deduction on the ground that the entities constitute a single legal and economic unit.

(c) The deduction of an expense may be permitted but there is a limit to the deduction.

Peru
Interest paid to entities abroad which are economically connected with the debtor is not deductible so far as it does not exceed the limit established by law, i.e. the limit is normally the prime rate of the lender's market. The limit for credit which is to be used for the construction, acquisition or installation of new fixed assets or for working capital is increased by 3 points. This increase covers expenses, commissions, premiums and any sum added to the interest. Similarly, interest on that part of financing which is more than 3 times the net worth of the debtor is not deductible. The taxpayer can choose to limit the deduction to 4 times the registered capital (capital social) at the end of the taxable period.[16]

(d) Certain countries specifically allow the deduction of expenses incurred by the head office on behalf of the branch or permanent establishment.

Argentina
A reasonable allocation of head office expenses related to world-wide operations may be deducted in computing the taxable profits of a branch.

Panama
Branches of foreign corporations may deduct administrative expenses incurred by the head office. In most cases, the proportion of expenses applicable to the Panamanian branch is accepted as a deductible expense when the allocation is made on the basis of total international sales. Expenses which are not deductible pursuant to Panamanian tax legislation are to be excluded from the total expense to be apportioned.

Uruguay
Expenses incurred by the head office to produce and maintain Uruguayan-source income are accepted as deductible expenses, provided that their origin and nature are substantiated. The expenses must be properly authenticated, the amount must be considered reasonable by the tax authorities and the expenses must relate to obtaining or maintaining Uruguayan-source income. Moreover, the taxpayer must establish that expenses attributed to the branch in Uruguay have not been deducted in any other foreign tax assessment.

4. Estimation of income

If the establishment or branch does not maintain separate records or if the economic result of the branch's activities cannot be determined according to accounts, the tax authorities in some countries may deem the establishment or branch and the head office as one economic unit and/or estimate the amount of net taxable income of the establishment or branch on the basis of indexes or ratios of profits. This is specifically the case in the following countries.

Argentina
If separate records are not maintained, the tax authorities may consider that the branch office and the head office form one economic unit and then estimate the amount of net taxable profits on the basis of average ratios of profits which are obtained by independent enterprises engaged in the same or similar activities.

Chile
An estimation system may be applied by the tax administration if the economic result of the branch's activities cannot be determined according to accounts. Taxable income may then be determined:
(i) by applying to the branch's gross receipts the same ratio which exists between the gross receipts and the net income of the parent company; or
(ii) by applying to the branch's overall assets the ratio between gross assets and net income of the parent company.

The income determined by application of such ratios is deemed to be withdrawn from the enterprise and is subject to the income tax on non-residents irrespective of actual withdrawal or remittance abroad.

Dominican Republic
If the profit obtained in the country cannot be determined easily and accurately from the accounting records of the branch, the net Dominican-source income

15. Exchequer's Court, First Panel (la Sala), ruling (Acuerdo-Sentencia) 14 of 31 August 1982 at 25-27; Supreme Court of Justice, ruling (Sentencia) 90 of 12 July 1983.
16. The rules do not apply where the limit has been amended by the Government.

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will be determined on the basis of results of independent entities engaged in the same or similar activities. The tax administration is empowered to adopt other indexes for tax purposes when circumstances so require, and may consider that the branch and its head office constitute an economic unit. Based on this assumption, the tax administration may determine the net taxable income of the branch.

Paraguay
In the absence of books of account or where Paraguayan-source net profits are not clearly demonstrated, the net income may be estimated by the tax administration.

Uruguay
When the accounting records do not accurately reflect the net Uruguayan-source profits of branches or agencies of foreign entities, the tax administration may establish the taxable income on the basis of the volume of business and adequate indices for these purposes.

5. Taxation of branch profits

(a) In some countries, branch profits are subject to corporate income tax under general rules and the after company tax profits are subject to a branch tax *whether or not remitted* to the head office abroad or to other persons. This additional taxation is based on the assumption that the after company tax profits are automatically distributed and represent a taxable dividend. This is the case in:

Brazil
The corporate tax is 35% (an additional 10% tax is levied on that part of profits exceeding 40,000 adjustable units). Under case law which states that foreign headquarters and the domestic branch are one and the same entity and the profits of the latter belong to the former irrespective of distribution, branches pay an additional tax of 25%. However, that portion of profits which is reinvested in the expansion of industrial plants in Brazil is subject to tax at 15% instead of 25%.

Mexico
The profits of branches of foreign companies which are engaged in business activities in Mexico are subject to the corporate income tax and to a 50% final tax.[17] The 50% tax is levied on the profits after deduction of profit distributions to employees.

Panama
The corporate tax is progressive from 20% to 50% and branches of foreign companies are subject to a 10% "withholding" tax on after-tax profits.

Peru
The corporate tax is 35% and after-tax profits which are available to the head office abroad are subject to a 15.40% withholding tax. For these purposes, the after-tax profits include dividends and exempt interest received by the branch during the taxable period.

Venezuela
The corporate tax for companies not engaged in the exploitation of hydrocarbons, mines and related activities is progressive from 15% to 50% and the after-tax profits of an agency, branch or establishment are subject to a 20% tax, irrespective of actual distribution.

(b) In other countries, branch profits are subject to corporate income tax under general rules but non-distributed branch profits are not subject to any additional tax. Only profits *remitted or credited* abroad are subject to a branch tax which is normally withheld at source and (somehow) represents a dividend tax. This applies in:

Chile
The corporate tax is 10% (creditable against the branch tax), and the branch tax is 35%.

Colombia
The corporate tax is 30% (as from taxable year 1988) as is the branch tax. It should be noted that Colombian legislation determines a presumptive remittance of profits for foreign company branches that fail to demonstrate that they reinvested the non-remitted profits for the corresponding fiscal year.

Costa Rica
The corporate tax is progressive from 10% to 50% and the branch tax is 15%. The Administrative Tax Tribunal has ruled that the 15% tax is applicable to any profits not capitalized in the country.[18]

Dominican Republic
The corporate tax is progressive from 10% to 46% and the branch tax is 20%.

Guatemala
The corporate tax is progressive from 12% to 34% and the branch tax is 12.5%.

Honduras
The corporate tax is progressive from 3% to 40% and the branch tax is 15%.

Nicaragua
The general rate of tax is 45% (reduced to 40% for the agropastoral sector) and trading companies are assessed at 50%; a 10% surcharge is imposed in all 3 cases. The branch tax is 20%.

Paraguay
The corporate tax is progressive from 25% to 30% and the profits remitted abroad are subject to a 10% withholding tax (dividend tax).

(c) Some countries tax branch profits at flat rates which consolidate both the corporate income tax and the branch tax, i.e. Argentina (45%), Bolivia (10%), Ecuador (40%), El Salvador (38%) and Uruguay (the corporate tax is 30% and no branch tax is levied provided certain conditions are fulfilled).

6. Economic double taxation of dividends

In certain countries, the Latin American branch of a foreign company may, in calculating taxable profits to

17. See footnote 13.
18. Administrative Tax Tribunal, First Panel (Sala Primera), ruling (Resolución) 14 of 15 April 1980.

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be credited or paid to its head office, exclude the dividends received from other companies; or, in other countries, credit the tax previously paid upon collection of the dividends against the tax liability on such profits. This is specifically the case in:

Brazil
Under a court ruling, the branch may exclude the dividends received from other companies.

Chile
Dividends received by the branch are not subject to corporate taxation in the branch's hands but subject only to the additional tax on non-residents (upon withdrawal or remittance abroad).

Honduras
If the remittance is taken out of dividends already subject to the tax imposed on dividends paid to residents (i.e. 10% or 15%), only the difference necessary to complete the 15% payable by non-residents (if any) is due.

Panama
Dividends received by the branch are exempt from the 10% branch tax provided they were previously subject to withholding or specifically exempt.

Venezuela
Dividends and similar participations derived in Venezuela by a branch or establishment from other companies or entities are not subject to the withholding tax (branch tax) otherwise due if the dividend withholding tax was already paid. Moreover, dividends and participations in profits derived from corporations and companies engaged in the exploitation of mines, hydrocarbons and connected activities are excluded from gross receipts and are exempt from the withholding tax.

IV. TAXATION OF INVESTMENT INCOME

A. Dividends

1. Dividends in general

In addition to the corporate tax previously paid in the hands of the distributing entity, dividends paid to non-residents are usually subject to a withholding tax. This is true in almost all Latin American countries, except for Bolivia (where no corporate tax is due) and Uruguay (dividends are taxable only if they are taxed in the country where the recipient is domiciled and a credit is granted there for the tax paid in Uruguay).

The withholding tax referred to is normally a final tax. This is the case in Argentina, Bolivia, Brazil, Chile, Colombia (for non-resident companies and foreign individuals), Costa Rica, Dominican Republic, Ecuador (all taxpayers subject to payment of income tax are also subject to a surcharge as a form of financial assistance to universities[19], El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru and Venezuela. The withholding tax, however, can be an advance payment creditable against the final liability on local-source income, as is done in Colombia (for Colombian non-residents).

The rates of the withholding tax are:

10% in Bolivia, Panama (dividends paid on bearer shares are taxed at 20%[20]) and Paraguay (no tax is withheld if the shareholder invests the dividends in enterprises resident in Paraguay);

12.5% in Guatemala (however, dividend and profit distributions remitted or credited to shareholders or partners domiciled abroad out of profits derived by the distributing company up to 31 July 1983 are subject to a final 12.1% withholding tax);

15% in Costa Rica and Honduras (if the dividends are paid out of dividends already taxed upon payment to the distributing entity only the difference necessary to complete the 15% is due);

15.4% in Peru;

17.5% in Argentina (if dividends remitted abroad exceed a certain percentage they are subject to the supplementary tax discussed above);

20% in the Dominican Republic and Venezuela;

22% in El Salvador;

25% in Brazil (in certain cases, however, this withholding tax is 15%[21]; moreover, if dividends remitted abroad exceed a certain percentage, they are subject to the supplementary tax discussed above);

30% in Colombia (for foreign companies and individuals; note that the 12% surtax levied on transfers of income abroad does not apply to dividends) and Uruguay (dividends are subject to the business income tax when such dividends or profits are taxed in the country where the recipient has his domicile and a credit is granted therein for the tax paid in Uruguay[22];

35% in Chile (a credit of 10% of dividends paid out of sums subject to First Category tax is granted[23]; and

19. For individuals and personal businesses, the surcharge is 11% (19% in the provinces of Guayas and Manabi) and 15% (23% in the provinces of Guayas and Manabi) for corporations.

20. No tax is withheld on dividends or profit shares paid by companies located in the Free Zone of Colon out of income from external operations which are exempt from income tax. External operations are those concerning Panamanian or foreign merchandise leaving the Free Zone and sent abroad.

21. A 15% rate applies to dividends and other similar profits distributed in cash by an exempted investment company. If the benefits are paid for investments made in Brazil prior to 29 December 1982 and maintained in Brazil continually and without any withdrawal for more than 6 years, the withholding tax is levied at the rates given below:

Investments maintained in Brazil	Rate of withholding tax
6 to 7 years	12%
7 to 8 years	10%
over 8 years	8%

22. The tax is withheld at source at a rate which, when combined with the rate applicable to the taxable income of the resident taxpayer (distributing entity), is equal to the credit granted abroad. Note, however, that the withholding rate cannot be higher than 30%.

23. Shareholders can also credit against their liability a percentage of dividends paid out of sums previously subject to the tax on stock corporations (additional rate). This credit is 40% for dividends paid out of income derived up to taxable year 1983; 30% for dividends paid out of income derived in taxable year 1984; and 15% for dividends paid out of income derived in taxable year 1985. The credit is not granted for dividends paid out of income derived as from taxable year 1986.

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40% in Ecuador (all taxpayers are subject to a surcharge as a form of financial assistance to universities[24];

50% in Mexico (dividends and profits distributed by business companies to non-resident individuals, non-resident legal entities or branches of foreign corporations are subject to a final withholding tax).

Progressive rates apply in Colombia, i.e. from 0.07% to 22.35% for dividends paid or credited to non-resident Colombian individuals or their undivided inheritances during taxable year 1987[25]. In Nicaragua, dividends and profits paid by resident entities to non-residents are subject to a final withholding tax at progressive rates ranging from 6% to 50%; the tax, however, cannot be less than 20%. Where the dividends or profits are paid by a subsidiary or a branch to its parent company or head office, a flat 20% final withholding tax applies.

2. Profits of unincorporated entities

The share of profits of partnerships and limited liability companies belonging to non-residents may be subject to "dividend" taxation upon actual distribution.

Chile
The tax is levied upon withdrawal or remittance abroad.

Colombia
Profits of partnerships, limited liability companies and similar companies distributed or credited to partners who are "foreign investors" are subject to a 30% withholding tax. Such distributions are also subject to a 1% surtax on the transfer of income abroad.

In certain cases, profits of partnerships and limited liability companies belonging to non-residents are subject to withholding dividends tax irrespective of actual distribution. In Argentina, profits derived by sole proprietorships, general partnerships, limited partnerships and limited liability companies are deemed to be entirely allocated to the owner or distributed among partners or members. In the case of partnerships limited by shares, the profits are deemed to be so distributed in that part belonging to general partners. If the profits are distributed or deemed to be distributed to non-residents, they are subject to income tax at a 45% rate withheld at source (this rate consolidates both the corporate and the dividend tax).

In many countries, no specific rules provide for taxation of profits derived by non-residents through unincorporated entities. In such cases, dividend taxation may be applicable under general rules.

3. Stock dividends

Most countries do not specifically provide whether stock dividends are taxed; therefore, stock dividends are treated the same as ordinary dividends.

(a) Stock dividends are specifically taxed in Venezuela.

(b) Stock dividends are specifically exempt from income tax in:

Argentina
Distributed stock dividends are exempt from income tax.

Bolivia
The distribution of shares or ownership interests (cuotas de capital) originating from reinvestment of profits made by stock corporations, partnerships limited by shares, companies of persons and sole proprietorships to their shareholders or partners are exempt from the tax on receipts.

Chile
Stock dividends representing the capitalization of profits or reserve funds are exempt from tax. The same exemption applies to refunds of capital when a corporation is liquidated and to repatriation of capital which entered Chile under the Foreign Investment Statute.

Ecuador
Stock dividends derived from exempt funds or funds which have already been taxed are not subject to income tax.

B. Interest

Interest payments to non-residents are normally subject to the withholding of the income tax at source. Although most Latin American countries abide by this principle, there are exceptions, i.e. Ecuador (registration fees on foreign loans replace the income tax) and Uruguay (interest paid to individuals or legal entities domiciled abroad is exempt from income taxation).

It should be noted that certain countries follow the general principle of withholding the income tax on interest paid to non-residents but simultaneously provide for specific exemptions that may cover important cases of interest payments to non-residents.

In most cases the withholding tax is a final one, i.e. in Argentina; Bolivia; Brazil; Chile (however, if the recipient has a permanent establishment in Chile or is a Chilean citizen, the withholding tax is treated as a prepayment creditable against the final tax); Colombia; Costa Rica; Dominican Republic; El Salvador; Guatemala; Honduras; Mexico; Paraguay; Peru; and Venezuela (for loans granted by financial institutions). On the contrary, in Chile (if the recipient has a permanent establishment in Chile or is a Chilean citizen), Panama and Venezuela (for taxpayers other than financial institutions) the taxpayer must file a return for a final assessment at the end of the year.

The withholding tax is normally calculated on the gross amounts. Some countries, however, permit a deemed allowance for expenses when computing the taxable

24. See footnote 19.
25. The amount of the withholding tax varies with the amount of dividends derived in the month. A long list sets forth the brackets and the amount of tax corresponding to each bracket is specified in pesos. The average percentage for an amount of income equal to the average amount included in the bracket is also shown in the list.

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amount paid to non-residents, i.e. in Argentina, a 65% deduction is allowed and only 35% of the amount of interest paid to non-residents is taxable. In Nicaragua, the net taxable income of non-residents granting loans or credits in various countries is determined as a certain percentage of gross income (10% for non-resident financial institutions and 75% for other entities and individuals). In Venezuela, the tax is calculated on 85% of gross payments for taxpayers other than financial institutions.

(a) The normal or ordinary rates of the withholding tax are:

5% in Honduras;

10% in Bolivia and Costa Rica (the law, however, provides for an increased rate of 30% which is applicable in certain instances);

20% in the Dominican Republic and El Salvador (for interest paid to non-resident individuals);

22% in El Salvador (for interest paid to non-resident companies);

25% in Brazil (the tax, however, can be reduced in the case of foreign financing and loans) and Guatemala;

30% Colombia (interest is additionally subject to the 12% surtax on transfers of income outside Colombia; the ordinary withholding tax is calculated on the gross amount and the surtax on income after the ordinary withholding tax resulting in an effective 38.4% rate); and Paraguay;

40% in Chile;

42% in Mexico (interest paid by a resident enterprise to a non-resident related enterprise is, in certain instances, considered a dividend; moreover, the law provides for reduced rates of 15% or 21%);

45% in Argentina (if a deemed allowance is taken into account, the effective rate is 15.75%), Nicaragua (if the deemed allowance is taken into account, the effective rate is 33.75 or 4.5%) and Peru (in specified instances interest is taxed at 1%).

Progressive rates apply in Panama (20% to 50% for entities and 2.5% to 56% for individuals); and Venezuela (15% to 50% as applied on 85% of gross payments for entities other than financial institutions and from 4.5% to 45% as applied on 85% of gross payments for individuals; interest paid on loans and other credit granted by non-resident financial institutions is subject to a 20% final withholding tax).

(b) The normal interest rate may be reduced in specific instances:

Brazil
In the case of foreign financing for imports and foreign currency loans, the National Monetary Council can reduce the tax applicable to interest and commissions.

Chile
The law provides for a 4% reduced rate which covers the most important cases of interest payments made to non-residents such as:
- interest paid to foreign or international banks;
- interest on foreign currency bonds issued by Chilean companies;
- interest paid for financing imports; and
- interest paid on deposit accounts in foreign currency.

Costa Rica
Interest paid to non-residents on deposits, cash loans, securities or bonds and broker's commissions on loans is subject to a 10% final withholding tax.

Mexico
A 15% rate applies to interest paid to financial institutions which belong to foreign States or to foreign banks, provided the institution and the transaction are registered with the Mexican Government, or to foreign establishments of financial institutions of Mexico. Moreover, a 21% rate applies to:
- interest not subject to the 15% rate mentioned above paid by credit institutions or on any kind of security;
- interest paid to suppliers abroad for the transfer of machinery and equipment included in the acquirer's fixed assets; and
- interest paid to non-residents other than those subject to the 15% rate referred to above for the financing of machinery and equipment included in the acquirer's fixed assets, provided companies registered with the Government are involved.

Peru
In the following instances, interest paid to legal entities is subject to a 1% tax rate:
(a) interest on foreign financing provided certain conditions are fulfilled; and
(b) interest paid abroad by banks and financial enterprises established in Peru for the use of their credit lines abroad.

(c) In many countries, interest paid to non-residents may be exempt from income tax in order to facilitate the foreign financing of imports, exports or investments.

Argentina
Interest paid on foreign loans made after 5 January 1977 for the purpose of financing imported fixed assets subject to depreciation is tax-exempt.

Brazil
Interest and commissions paid on foreign financing of exports of Brazilian products is exempt from the 25% withholding tax, provided the financing is duly registered with the Central Bank and the payment is made out of the price of exports.

Colombia
Certain items of interest are not treated as Colombian-source income and are exempt from both the ordinary withholding tax and the surtax on remittances. The exempt items are:
- interest on short-term import loans (not exceeding 24 months) and on export loans;
- interest on bank overdrafts;
- interest on foreign credit granted to banks and financial entities;

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- interest on credit for foreign trade transactions made through financial entities and banks; and
- interest on credit obtained abroad by national, foreign or mixed enterprises established in Colombia, the activities of which are considered of interest for the economic and social development of the country.

Costa Rica
The following are exempt from income tax:
- payments made to foreign State banks;
- payments made to approved foreign banks and financial institutions, when the loan is granted to agricultural or industrial enterprises and is to be used in the normal course of business;
- interest on loans made to Costa Rican banks; and
- interest paid on securities issued in foreign currency by the Treasury and by State-owned banks.

Dominican Republic
The following types of income are exempt:
- interest from certain securities, bonds and certificates as well as income from documents issued by the State or its agencies provided such documents do not constitute mortgages or liens;
- interest received on savings accounts and time deposits in commercial banks, savings banks, and other credit institutions established in the Dominican Republic provided interest does not exceed 6% per year (if the interest exceeds 6% per annum only the excess is taxable);
- interest earned by banks or other credit institutions on loans or credits made in foreign currency from abroad and authorized by the Secretary of State for Finance.

Ecuador
The following foreign loans are exempt from the single tax payable upon registration:
- loans granted to entities in the public or semi-public sectors;
- loans granted by foreign governments and multinational financing organizations to the private sector;
- financing granted by providers without the entry of foreign currency into Ecuador;
- loans granted to finance investments in agriculture and fisheries provided the terms are longer than 2 years; and
- loans granted to finance equipment, machinery and other capital assets provided the terms are longer than 2 years.

El Salvador
The following items of interest are exempt from income taxation:
- interest, premiums and other profits arising directly from bank deposits; and
- interest on loans and financing granted by credit institutions domiciled abroad.

Guatemala
The following are exempt from income tax:
- interest and commission fees paid on foreign loans by the State, municipalities and agencies thereof;
- interest on FHA mortgage bills issued for the financing of dwellings the value of which does not exceed 100,000 quetzales;
- interest on deposits made in Guatemala with banking or financial institutions operating in Guatemala;
- interest on bonds and credit documents issued or endorsed by the State, State agencies, financial institutions, banks operating in Guatemala and enterprises whose issues are deemed to be of first grade by the Commission of Securities;
- interest on Treasury bonds, notes and bills issued by the State, its autonomous, semi-autonomous, and decentralized institutions, and the municipalities; and
- interest on foreign loans granted by financial institutions, provided the foreign currency was sold to a local bank.

Mexico
The following interest is exempt from income tax:
- interest on loans granted to the Federal Government;
- for traditional base purposes, fixed interest on loans (whose term is at least 5 years) granted by financial institutions registered with the Finance Ministry;
- for expanded base purposes, fixed interest on loans (whose term is at least 5 years) granted by financial institutions that promote exports by means of preferential loans or guarantees or pension funds, provided the creditor and the loan are registered with the Finance Ministry;
- interest on bonds, debts and other credit documents, except acceptances issued in foreign currency and placed abroad publicly; and
- interest on bank acceptances in foreign currency provided they can be discounted by the Central Bank of the issuing country.

Nicaragua
Exempt income includes:
- interest on free negotiable mortgage certificates, bonds or other securities issued by the State, its institutions and the municipalities and by institutions that are legally exempt from tax;
- interest earned on loans made by international credit institutions and by agents of development institutions of foreign governments;
- interest earned on loans made by foreign banks or private institutions to the State, its entities and municipalities;
- interest earned on short-term loans made by foreign banks or private institutions to National Institutions of Finance;
- interest earned on loans for a period of more than 3 years made by foreign banks or private institutions to financial institutions and to private enterprises, provided the loans are intended to increase the taxpayer's production capacity in the agricultural, livestock and industrial sectors, tourism industry or the construction of dwellings; and
- interest earned by foreign financial institutions on loans for a period not exceeding 3 years granted to private persons or enterprises, provided the loans

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are intended to finance industrial, agricultural or commercial activities of a productive nature.

Peru
The following interest is exempt from income tax:
- interest on development loans granted by international organizations or by institutions belonging to foreign governments;
- interest on loans granted by foreign institutions for the construction, acquisition, installation or commencing of operation of new fixed assets, or for working capital necessary for the establishment or development of the enterprise, provided some additional requirements are met; and
- interest on certain deposits.

C. Royalties

Royalty payments to non-residents are normally subject to the withholding of the income tax at source. This is the case in all Latin American countries. The withholding tax is a final tax in Argentina, Bolivia, Brazil, Chile (however, if the recipient has a permanent establishment in Chile or is a Chilean citizen, the withholding tax is treated as a prepayment creditable against the final tax), Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Paraguay, Peru and Uruguay.

In other countries, the recipient of royalties must file a return for a final assessment at the end of the year, i.e. in Chile (if the recipient has a permanent establishment in Chile or is a Chilean citizen, the withholding tax is treated as a prepayment creditable against the final tax), Panama and Venezuela.

The tax is sometimes specifically calculated on the gross amount: in Bolivia, Brazil, Chile, Colombia (the ordinary 30% withholding tax is calculated on the gross amount and a 12% surtax is applied on income after deducting the amount of the ordinary withholding tax) and Mexico.

Peru allows, within certain limits, the deduction of effective expenses (non-resident recipients of royalties continually carrying out research activities to locate the kind of assets for which the royalties are paid, may deduct the corresponding expenses up to 5% of gross royalties; the government can alter the limit for specific cases).

Some countries permit a deemed allowance for expenses when computing the taxable amount paid to non-residents. This group includes:

Argentina
Local-source net income from the licensing of patents and trade marks is presumed to be (without right of rebuttal) 80% of the payments to non-residents.

Dominican Republic
Beneficiaries of royalties are allowed to deduct 20% as expenses, but the tax administration can apply a different percentage and not permit any expenses.

Nicaragua
Net taxable income of non-residents rendering services or performing business in various countries, so that the costs or expenses incurred in Nicaragua are difficult to establish, is determined as a certain percentage of gross income. In the case of royalties and other payments for the use, or the privilege of using, copyrights, patents, designs, secret processes or formulas, trade marks and other similar rights, the percentage is 95%.

Panama
Only 50% of the amount of royalties paid to non-residents is subject to withholding of income tax.

Paraguay
The withholding tax is calculated on 90% of royalties.

Venezuela
Net income derived by non-residents from royalties and similar payments is represented by 90% of gross receipts. However, licence fees paid for the use of trade marks are taxed on gross amounts.

(a) The rates of the withholding tax are:
10% in Bolivia and Honduras (this rate applies to royalties and other payments for the use or privilege of using copyrights, designs, secret processes or formulas, trade marks and similar rights, including rental of motion pictures, paid to non-residents);
20% in Costa Rica and the Dominican Republic;
22% or 20% in El Salvador (non-resident legal entities are taxed at a 22% rate and individuals without domicile or residence in El Salvador are taxed at a 20% rate);
25% in Brazil (royalties are not subject to the excess profit tax discussed above);
30% in Colombia (in addition to the 30% ordinary withholding tax, a 12% surtax on transfer of income abroad applies; the ordinary withholding tax is calculated on the gross amount and the surtax on income after deducting the amount of the ordinary withholding tax resulting in an effective 38.4% rate); Paraguay (the withholding is calculated on 90% of royalties making an effective rate of 27%) and Uruguay[26];
34% in Guatemala (the rate applies to royalties and similar consideration paid to non-residents for the use of patents and trade marks);
40% in Chile (royalties and any other consideration paid for the use of trade marks, patents and for know-how are liable to the 40% tax on non-residents withheld at source on the gross amount) and Ecuador (all taxpayers subject to payment of income tax must also pay a surcharge as a form of financial assistance to universities[27];
45% in Argentina (as only 80% of the royalty is taken,

26. Income from technical assistance that persons subject to the business income tax pay to persons domiciled abroad is exempt from income taxation, provided such income is taxed in the country where the recipient has his domicile and provided that no credit is granted in such a country for the tax paid in the source country. Regulations to the law establish the conditions under which the exemption applies.
27. See also footnote 19. The surcharge is also applicable to withholding taxes.

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the effective rate is 36% for royalties from the licencing of patents and trade marks), Nicaragua (as only 95% of the royalty is taken, the effective rate is 42.75%) and Peru;

42% in Mexico (the rate is 21% for copyrights)[28].

Progressive rates apply in Panama (20% to 50% for entities and 2.5% to 56% for individuals); and Venezuela (15% to 50% for entities and 4.5% to 45% for individuals).

(b) Certain countries provide for increased rates which are applicable in certain circumstances.

Argentina
If requirements of the Law on Transfer of Technology are not complied with, payments are subject to a 45% withholding tax on gross payments.

Chile
Royalties which are unproductive or non-essential for the economic development of the country may be taxed at increased rates of up to 80%.[29]

Mexico
If royalties paid abroad are not deductible for income tax purposes (e.g. royalties paid by a permanent establishment located in Mexico to the head office or other establishments located abroad), they are treated as dividends and subject to final withholding tax at 50% instead of 42% or 21%.

(c) Royalty payments may be exempt from income tax.

Chile
Payments made by Chilean navigation enterprises to non-residents can be exempt from taxation.

Panama
Royalties paid by Colon Free Zone companies to non-residents are not subject to income withholding tax. However, the paying companies may not deduct tax-exempt royalty payments.

Peru
Royalties paid for technical, economic, financial or any other assistance rendered from abroad by governmental agencies or international organizations are exempt from income tax up to 31 December 1990.

V. AVOIDANCE OF DOUBLE TAXATION

A. Unilateral measures

As explained above, most Latin American countries utilize the territoriality or domestic-source principle of income taxation. In accordance with this principle, income derived from foreign sources is not subject to tax in such countries. In addition, certain Latin American countries tax foreign-source income, either as a general rule (i.e. Chile, Colombia, Honduras, Mexico and Peru) or on an exceptional basis (i.e. Ecuador and Venezuela) but (except for very special cases) only in respect of residents.

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With respect to non-residents, the income tax applies only to local-source income; income not originating within the national territory of a Latin American country is, in principle, protected against double taxation. Moreover, due to the territoriality principle of taxation, in the absence of tax treaties, no measures are normally taken to avoid double taxation of domestic-source income.

In general, Latin American countries assume they have a priority right to tax local-source income. If the same income is included in the world-wide income of non-residents for the purpose of being taxed in the home country, it is the responsibility of the home country to initiate measures to avoid any double taxation issues which may arise. Consequently, when income is taxed in a Latin American country on the basis of the source principle and simultaneously in another country on the basis of the residence or world-wide principle, the domestic legislation of the Latin American countries does not include, as a rule, measures of a general nature aimed at avoidance of such double taxation. Nevertheless, the legislation of some countries contains particular rules designed to avoid double taxation of domestic-source income of non-residents, or which, although not specifically designed for that purpose, in fact avoids or alleviates double taxation of domestic-source income.

(a) The countries providing particular measures which avoid or alleviate double taxation of domestic-source income are:

Chile
A tax exemption is granted on a reciprocal basis to non-residents as regards income from sea transportation.

Costa Rica
The tax administration can exempt dividends paid to non-residents from income tax when evidence is provided that the recipient of such dividends is not entitled, in his country of residence, to a credit for the Costa Rican income tax. When the credit granted is

28. Royalties paid to non-residents are subject to withholding tax on gross receipts at different rates, as follows:
- royalties for the use or temporary enjoyment of copyrights on literary, artistic or scientific work including movie films and tapes for radio and television, designs or models, plans, formulae or processes and for the use of industrial, commercial or scientific equipment and sums paid for information related to industrial, commercial or scientific experiments and, in general, for technical assistance or transfer of technology: 21%;
- royalties for the use or temporary enjoyment of patents or rights for discoveries or improvements, trade marks and for advertising: 42%;
- royalties paid abroad which are not deductible (e.g. royalties paid by a permanent establishment located in Mexico to the head office or other establishment located abroad) are treated as dividends and subject to a 50% final withholding tax.

29. Pursuant to this provision, royalties related to the production of the following items have been declared unproductive or non-essential for the economic development of the country, and are taxed at a 60% rate:
(i) manufacturing of perfumes, cosmetics, dyes and toiletries;
(ii) reproduction of prints and designs;
(iii) clothing;
(iv) wines, liquors and spirits; and
(v) furniture.

lower than the income tax applicable in Costa Rica, the government can exempt the difference.

Ecuador
Where there is a national interest in the development of an economic activity, the Executive Branch may grant a temporary reduction of up to 50% of the income tax to foreign enterprises domiciled in countries not granting tax credits for income taxes paid in the source country.

Uruguay
Maritime or air transport companies are exempt from income tax (in the case of foreign companies, the exemption is only applicable on a reciprocal basis). The Executive Branch is vested with power to exempt foreign companies engaged in overland transport (also on condition of reciprocity).[30] Income from technical assistance which persons subject to the business income tax pay to persons domiciled abroad, is exempt from income taxation, provided such income is taxed in the country where the recipient has his domicile and provided that no credit is granted in such a country for the tax paid in the source country. Regulations establish the conditions under which the exemption applies.

Venezuela
Foreign international transportation enterprises established and domiciled in countries with which Venezuela has subscribed a double taxation agreement contemplating an income tax exemption but which is not yet in force are exempt from income tax for 5 years provided the same exemption is granted in the other treaty country to Venezuelan enterprises.

(b) As regards measures not specifically aimed at avoiding double taxation, it is necessary to mention exemptions granted to promote activities, investments or financing. These measures may have the effect of avoiding double taxation although they may also involve a transfer of revenue. In fact, if a Latin American country exempts a domestic-source item of income, that income is subject to taxation only in the recipient's home country and double taxation is avoided, even if the exemption is granted for purposes other than avoidance of double taxation.

B. Regional agreements

1. General information

Latin American countries have entered into several international or regional agreements which include provisions covering taxation (either directly or indirectly). Most of the provisions relate to customs duties but some affect or may affect income taxation.

The agreements referred to are:
- General Agreement on Tariff and Trade;
- the Latin American Integration Association;
- the Andean Pact; and
- the Central American Economic Integration Treaty.

A brief reference will be made to the Latin American Integration Association and to the Andean Pact because they are the most important for purposes of this article.

2. The Latin American Integration Association – LAIA (Asociación Latinoamericana de Integración)

The LAIA, established by the Montevideo Treaty of 1980, was signed by Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. The purpose of the treaty is to continue the integration process commenced by the Latin American Free Trade Association (LAFTA), to promote the economic and social development of the region with a view to gradually and progressively establishing a Latin American Common Market. The basic functions of LAIA include promotion and regulation of mutual trade among member countries and the development of cooperative activities which contribute to the enlargement of the markets available to each country.

Neither of the 2 associations (LAFTA and LAIA) enacted concrete provisions referring to income tax matters. However, Art. 48 of the Montevideo Treaty of 1980 provides that capital originating in a member country may not be less favourably treated in another member country than capital originating in any non-member country.

3. Andean Pact

The Andean Pact was established by the Cartagena Agreement and signed by Bolivia, Colombia, Chile (which has since left the Andean Group), Ecuador, Peru and Venezuela. It is inspired by the Declaration of Bogotá and based on the Montevideo Treaty.

The Andean Pact has adopted provisions referring to taxation including:
- a liberalization programme which aims to eliminate conditions and restrictions of all kinds concerning the importation of products originating in the territory of member countries;
- a Convention for the Avoidance of Double Taxation among members of the Andean Pact known as Decision 40 (see below)[31];
- a model convention for the avoidance of double taxation between member countries and non-member countries; and
- measures for the avoidance of double taxation of income derived by Andean multinational enterprises (EMAs).

The Andean multinational enterprise (EMA) is a special form of business organization. EMAs can be organized under one of 2 different statutes, but they cannot take advantage of both. The 2 statutes were respectively approved by Decision 46 and Decision 169 of the Andean Pact. Double taxation of income

30. The exemption has actually been granted to Brazilian enterprises engaged in land transportation of passengers.
31. Under Decision 40, income originating in member countries is, in general, taxable only in the member country in which the source of such income is situated.

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derived by EMAs is avoided under rules included in Decision 169 of the Andean Pact approved in 1982 by the Commission of the Cartagena Agreement:

- dividends paid by the EMA out of profits previously taxed in the member country where the EMA has a branch shall be exempt in the country where the EMA has its principal domicile; and
- redistribution by investor enterprises (i.e. EMA shareholders) out of the same dividends shall also be exempt, either in the country where the EMA has its principal domicile or in other member countries.

C. Tax treaties

1. General information

Most Latin American countries seem to have been reluctant to enter into comprehensive tax treaties for the avoidance of double taxation, especially with non-Latin American countries.[32] Apart from a few exceptions, most treaties with non-Latin American countries have been concluded by 2 Latin American countries, i.e. Argentina and Brazil.[33]

Even treaties between the Latin American countries themselves are scarce. The most outstanding example is the multinational Convention for the Avoidance of Double Taxation of the Andean Group. This Convention was established by Decision 40 of the Cartagena Agreement and was ratified by each member country.[34] Other examples of intra-Latin American treaties include the treaty between Argentina and Bolivia, Argentina and Brazil, Argentina and Chile and Brazil and Ecuador (not yet in force).

2. Allocation principles

A thorough examination of such treaties manifests that, although Latin American legislation (and Latin American authors) give a preeminence to the source principle, certain treaties concluded with non-Latin American countries grant preeminence to the residence principle, especially as regards business income.

Under most treaties concluded with non-Latin American countries, the profits of an enterprise of a State are taxable only in that State unless the enterprise carries on business in the other Contracting State (source country) 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 as is attributable to that permanent establishment.

These features can be found in the following treaties: Argentina–Austria (if the enterprise carries on business in the source country through a permanent establishment, that part of the profits of the enterprise attributable to the permanent establishment is taxable only in the source State); Argentina– France; Argentina–Germany; Argentina–Italy; Argentina–Sweden (profits derived through a permanent establishment are exempt in the country of the head office); Argentina–United States (business profits derived by an enterprise of a Contracting State from the activity of granting insurance covering property situated in the other Contracting State, or covering persons who are residents of that other State at the time the insurance contract is concluded, may be taxed in that other State, whether or not the enterprise carries on its activity in that other State through a permanent establishment situated therein); Brazil–Austria; Brazil–Belgium; Brazil–Canada; Brazil–Denmark; Brazil–Finland; Brazil–France; Brazil–Germany; Brazil–Italy; Brazil–Japan; Brazil–Luxembourg; Brazil–Norway; Brazil–Portugal; Brazil-Spain; Brazil-Sweden; Dominican Republic–Canada; Ecuador–Germany; Peru–Sweden (profits derived through a permanent establishment are exempt in the country of the head office); and Uruguay–Germany. These features can also be found in 2 treaties concluded between Latin American countries, i.e. Argentina–Brazil and Brazil–Ecuador.

Under other treaties between Latin American countries, business income is taxed in the source country only. This is the case of the following treaties:

Andean Pact treaty: profits resulting from business activities shall be taxable only by the Member Country in which such business activities have been carried out[35];
Argentina–Bolivia: profits resulting from business activities shall be taxable only by the Contracting State in which such business activities have been carried out; if an enterprise carries out activities in both Contracting States, each State may tax the income, gains or profits derived from within its territory;
Argentina–Chile: as in the case of the Argentina-Bolivia treaty, profits derived from business activities are

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32. It is striking that Mexico, one of the most important Latin American countries, has not concluded any comprehensive double taxation treaty.
33. The Dominican Republic entered into a treaty with Canada. Ecuador concluded a treaty with the German Federal Republic and has also signed comprehensive tax treaties with Brazil and Italy (not yet in force). Peru has concluded a treaty with Sweden and Uruguay has recently concluded a treaty with the Federal Republic of Germany (the comprehensive treaty which was signed on 5 May 1987 is not yet in force; see *Tax News Service*-213 (1987)).
34. The deposit of the instruments of implementation of the Convention was completed on 18 June 1980. According to Art. 21 of the Convention, it entered into force:
(a) for individuals, with respect to income received or accrued on or after 1 January 1981;
(b) for business enterprises, with respect to income received or accrued during the first accounting period starting after 18 June 1980; and
(c) with respect to taxes on net wealth, on 1 January 1981.
35. Note, however, that it is understood that a business enterprise undertakes activities in the territory of a Member Country when it has in the Member Country any of, but not limited to, the following:
(a) an office or place of business management;
(b) a factory, plant, industrial workshop or assembly shop;
(c) an on-going construction project;
(d) a place or facility wherein natural resources are extracted or exploited, such as a mine, well, quarry, plantation, or fishing boat;
(e) an agency or premises for the sale of goods;
(f) an agency or premises for the purchase of goods;
(g) a depository, storage facility, warehouse, or any similar establishment used for receiving, storing or delivering goods;
(h) any other premises, office or facilities the purpose of which is preparatory or auxiliary to the business activities of the enterprise; and
(i) an agent or representative.

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taxable only by the Contracting State in which the business activities were carried out; if an enterprise carries out activities in both Contracting States, each State may only tax the income, gains or profits derived from within its territory.[36]

The source principle appears to play a stronger role as regards investment income (dividends, interest and royalties). Some treaties provide that income from dividends, interest and royalties is, as a rule, taxable only in the source country. This is particularly true in treaties signed between 2 or more Latin American countries. More specifically, this group includes the following treaties: Andean Group treaty; Argentina–Austria (taxation is limited to a percentage of gross amount, i.e. 15% for dividends, 12.5% for interest and 15% for royalties); Argentina–Bolivia; Argentina–Chile; Argentina–Sweden (the rule applies to dividends and interest which are taxable in the source country only); Ecuador–Germany (taxation is limited to a percentage of gross amounts, i.e. 15% for dividends, 10% or 15% for interest and 15% for royalties; in Ecuador the limit does not apply to dividends as long as under Ecuadorian law the tax on distributed and undistributed profits is credited against the tax on the dividends) and Peru–Sweden (the rule applies to dividends and interest which are taxable in the source country only.

Under most treaties, investment income is taxable in both countries i.e. in the source country and in the recipient's country of residence. All treaties signed by Brazil and most of the treaties signed between Argentina and a non-Latin American country (except for the treaties with Austria and Sweden) apply this rule. Except for the Argentina–Brazil treaty, other treaties included in this group limit taxation in the source country to a percentage of investment income. This group includes the following treaties:

Argentina–Brazil: taxation in the source country is not limited;
Argentina–France: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 20% for interest and 18% for royalties;
Argentina–Germany: taxation in the source country is limited to a percentage of gross amount, 15% for dividends, 10% or 15% for interest and 15% for royalties;
Argentina–Italy: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 20% for interest and 10 or 18% for royalties;
Argentina–Sweden: royalties are taxable in both countries but taxation in the source country is limited to 20% and is creditable against the tax of the recipient's country;
Argentina–United States: Argentine tax on dividends is limited to 20%, but the tax on dividends plus the tax on profits out of which the dividends are paid may not exceed 45%; the United States tax on dividends is limited to 20% of gross amount of dividends;
Brazil–Austria: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 15% for interest and 10%, 15% or 25% for royalties;
Brazil–Belgium: taxation in the source country is limited to a percentage of gross amount, 15% for dividends, 15% for interest and 10%, 15% or 25% for royalties;
Brazil–Canada: taxation in the source country is limited to a percentage of gross amount, i.e. 10% or 15% for dividends, 10% or 15% for interest and 15% or 25% for royalties;
Brazil–Denmark: taxation in the source country is limited to a percentage of gross amount, i.e. 25% for dividends, 15% for interest and 15% or 25% for royalties;
Brazil–Ecuador: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 15% for interest and 25% or 15% for royalties;
Brazil–Finland: taxation in the source country is limited to a percentage of gross amount, i.e. 25% for dividends, 15% for interest and 10%, 15% or 25% for royalties;
Brazil–France: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 15% for interest and 10%, 15% or 25% for royalties;
Brazil–Germany: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 10% or 15% for interest and 15% or 25% for royalties;
Brazil–Italy: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 15% for interest and 15% or 25% for royalties;
Brazil–Japan: taxation in the source country is limited to a percentage of gross amount, i.e. 12.5% for dividends, 12.5% for interest and 12.5%, 15% or 25% for royalties;
Brazil–Luxembourg: taxation in the source country is limited to a percentage of gross amount, i.e. 15% or 25% for dividends, 10% or 15% for interest and 15% or 25% for royalties;
Brazil–Norway: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 15% for interest and 15% or 25% for royalties;
Brazil–Portugal: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 15% for interest and 10% or 15% for royalties;
Brazil–Spain: taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, 10% or 15% for interest and 10% or 15% for royalties;
Brazil–Sweden: taxation in the source country is li-

36. This treaty, however, adds that the fact that an enterprise of one of the Contracting States carries out activities in the other Contracting State through a broker or independent agent acting in the normal course of his activities and not exclusively for that enterprise, shall not be deemed to be carrying out business activities by that enterprise in that other Contracting State, unless the enterprise's business activities are deemed to be the habitual activities of such enterprise, as determined by the judgement of the competent authorities of the Contracting State in which the activities are conducted.

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mited to a percentage of gross amount, i.e. 15% or 25% for dividends, 15% or 25% for interest and 15% or 25% for royalties;
Dominican Republic–Canada: taxation in the source country is limited to a percentage of gross amount, i.e. 18% for dividends, 18% for interest and 18% for royalties;
Peru–Sweden: royalties are taxable in both countries but taxation in the source country is limited to 20% and is creditable against the tax of the recipient's country;
Uruguay–Germany:[37] taxation in the source country is limited to a percentage of gross amount, i.e. 15% for dividends, interest and royalties and 10% for technical assistance fees.

3. Avoidance of double taxation

As regards methods for the elimination of double taxation, some treaties use the exemption method, some use the credit method, some treaties use both methods and some treaties do not include any method.

The exemption method (i.e. exemption with progression) is used in the Argentina–Austria, Argentina–Sweden and Peru–Sweden treaties.

The credit method is employed in the following treaties: Brazil–Canada (Canada grants exemption for dividends derived from related companies), Brazil–Denmark, Brazil–Ecuador (the exemption method is used for dividends derived from related companies); Brazil–Finland, Brazil–France (France grants exemption with progression for dividends derived from related companies), Brazil–Italy (Italy grants exemption for dividends derived from related companies), Brazil–Japan, Brazil–Portugal, Brazil–Spain (in the case of dividends, Brazil grants an exemption and Spain grants exemption with progression), Brazil–Sweden (inter-company dividends paid by a resident of Brazil to a Swedish company may be exempt in Sweden); Dominican Republic–Canada (in certain cases, Canada grants a tax sparing credit).

The following treaties utilize both the exemption and the credit method depending on the residence of the recipient: Argentina–Brazil (Argentina grants exemption and Brazil credit or, in certain cases, exemption), Argentina–France (Argentina grants exemption and France credit, or in certain cases, exemption), Argentina–Germany (Argentina grants exemption and Germany exemption with progression or credit), Argentina–Italy (Argentina grants exemption and Italy credit, or in certain cases, exemption), Argentina–United States (Argentina grants exemption and the United States credit), Brazil–Austria (Brazil grants credit or, for dividends derived from related companies, exemption and Austria grants exemption with progression or, in certain cases, covering (principally) investment income, credit), Brazil–Belgium (Brazil grants credit and Belgium exemption with progression), Brazil–Germany (Brazil grants credit and Germany exemption with progression or credit), Brazil–Luxembourg (Brazil grants credit and Luxembourg grants exemption with progression and in certain cases, covering (principally) investment income, credit), Brazil–Norway (Brazil grants credit and Norway grants exemption with progression and, in certain cases covering (principally) investment income, credit), Ecuador–Germany (both grant exemption with progression or credit, depending on the item of income involved); Uruguay–Germany (both grant exemption with progression or credit, depending on the item of income involved).[38]

Treaties which do not include any method for the elimination of double taxation are: the Andean Group treaty, Argentina–Bolivia, Argentina–Chile (however, foreign-source income of a resident can be computed for progression purposes).

VI. FINAL REMARKS

Although Latin American authors are among the most fervent advocates of the source principle of income taxation and the domestic law of most Latin American countries adopts the source principle as the only (or the overriding principle) of income taxation, several countries do apply the residence principle.

A country may tax income on the basis of the source principle but simultaneously treat income that, under ordinary rules or principles is foreign-source, as if it were domestic-source. Such an approach, in fact, indirectly taxes certain items of income which, properly speaking, are foreign-source, without openly recognizing their actual nature.

The income of non-residents may be taxed under the same rules and rates as residents but Latin American legislation frequently includes separate rates applicable to non-residents and provides for withholding of the income tax at source even in circumstances where the income of residents is not subject to tax.

The rates applicable to non-residents in the absence of specific provisions may vary from the low 10% applicable in Bolivia to the high progressive rates reaching 50% for legal entities in Panama and Venezuela and 70% for individuals in the Dominican Republic.

Only 2 countries provide for an excess profits tax, i.e. Argentina and Brazil. Chile has introduced this type of taxation but only for foreign investors who choose to be subject to a special income tax regime.

The income of subsidiaries of non-resident companies is, in general, subject to the corporate income tax under ordinary rules and distributions are subject to dividend taxation. The income of permanent establishments is, in general, also subject to the corporate income tax and to a branch tax (somehow) representing a dividend tax. In some countries, however, the branch tax is due irrespective of actual distribution.

When computing the income of subsidiaries and branches, it may be necessary to consider rules affect-

37. See footnote 33.
38. Id.

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ing transfer pricing or otherwise limiting or disallowing the deduction of certain expenses.

In principle, it appears to be more convenient to do business through a subsidiary as compared with a permanent establishment, especially in those countries where the branch profits are taxed irrespective of actual distribution and in those countries where rules concerning business conducted with the foreign-connected company are more stringent for branches than for subsidiaries.

The corporate income tax ranges from none in Bolivia to progressive rates up to 50% in Costa Rica, Panama and Venezuela; the dividend tax and the branch tax range from 10% in Bolivia to 50% in Mexico.

Under specific rules, interest paid to non-residents is frequently exempt from income tax to facilitate the financing of imports, exports or investments. This feature may promote debt financing as compared with equity financing and may involve the transfer of revenue to foreign Treasuries. Chile has taken steps to correct this problem by taxing (at a 4% rate) the items of interest which were previously exempt. Likewise, Guatemala has introduced a new provision stating that exemptions and deductions (desgravaciones) which reduce the taxable base or the income tax are applicable only when the interest of the Guatemalan Treasury is not affected by the transfer of resources for the payment of taxes abroad. If exemptions and deductions represent an actual tax benefit to the taxpayer, they apply only up to the limit of the benefit.

Interest taxation ranges from 5% in Honduras to progressive rates up to 50% for entities and up to 56% for individuals in Panama. Royalty taxation ranges from 10% in Bolivia and Honduras to progressive rates of up to 50% for entities in Panama and of up to 56% for individuals in Panama.

The tax on interest and royalties is sometimes calculated on gross amounts but some countries permit the deduction of actual or deemed expenses.

As a rule, the legislation of Latin American countries does not include measures aimed at the avoidance of double taxation on income derived by non-residents. There are, however, some examples of internal measures taken in order to avoid double taxation of local-source income of non-residents and measures (e.g. exemptions) which, although aimed at other purposes, produce the same effect.

Treaties for the avoidance of double taxation are scarce and most have been concluded by Argentina and Brazil. Treaties among Latin American countries include a multilateral agreement concluded among Andean Group countries and most are based on the source principle.

Treaties concluded between a Latin American country and a non-Latin American country give preeminence to the residence principle, especially as regards business income. This kind of income is taxable in the source country provided the enterprise conducts its business through a permanent establishment located therein. The source principle seems to have a stronger role as regards investment income either because such income is taxable in the source country only or at least because such income is taxable in both countries.

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The "New Approach" towards Construction of Tax Statutes Adopted by the Israeli Courts

By Prof. Arye Lapidoth

I. INTRODUCTION

This article examines the "new approach" taken by the Israeli Courts in interpreting tax statutes. As will be shown, the "new approach" rejects the use of special rules in interpreting tax laws, it departs from the "strict" or "literal" construction of tax statutes and instead emphasizes modern "purposive construction".[1] Similarly, transactions and documents have recently been interpreted in reference to their "substance" rather than their "form".

The traditional British "strict construction" rule, as followed by the Israeli Courts, and the process of its gradual erosion, will first be surveyed. The survey is followed by an examination of the reasons for the strict construction rule and its relation to special features of tax legislation. The new approach to interpretation of statutes and transactions will then be considered more closely. The article concludes with an evaluation of the new approach.

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II. THE "STRICT CONSTRUCTION" APPROACH

A. Defined

The doctrine of strict interpretation has been phrased in various forms.[2] There is no doubt that a Court should attempt to ascertain the meaning of a tax provision by first resorting to general rules of interpretation, and fairly apply that meaning to the facts of the case before it. A dilemma arises, however, if the Court applies all the general rules of interpretation and a doubt remains as to the meaning of a certain provision and how that provision should be applied to the circumstances of the case.

Should the very nature of the law concerned, i.e. the imposition of a tax, require special rules of construction (as there are – or at least used to be – for interpretation of the penal laws) or should tax laws be interpreted in the same manner as any other law? Under the doctrine of strict construction, tax laws differ from "regular" laws and hence special rules of interpretation should apply. Assuming special rules should apply, what are those rules?

During the time that strict construction was fashionable, a common approach of the Courts was that found in Income Tax Appeal 2/44:[3]

> in any event, in case of doubt or difficulty in interpreting tax statutes, one must lean towards that interpretation which is more favourable to the taxpayer.

Similar observations can be found in Israeli decisions as well. For example, in Civil Appeal 340/62[4], the Court held:

> Since the issue is that of imposing tax, I have reached the conclusion that the taxpayer should benefit from any doubt which may arise.

Those dicta represent an over-simplified (and inaccurate) enunciation of the strict construction rule. The rule was never meant to allow taxpayers to benefit from any doubt as to the meaning of a tax statute. The basic idea is that a taxpayer should be obliged to pay tax only by clear and unambiguous language of the statute which imposes the tax, i.e. he should not be subject to tax by implication or by presuming the "intent" of the legislature in cases where that intent has not been clearly expressed.

1. The problem of interpreting tax statutes has arisen in numerous cases. Typically, the cases involved complex technical definitions and deeming clauses. Only a handful of these cases will be dealt with in this article. The decisions of the Israeli Courts are written in Hebrew. The citations (as well as the statutes cited) have been freely translated by the author.
2. The main features of the "literal" or "strict" interpretation approach have been expressed in passages written by British Courts in tax decisions.
3. *Jacob Gesundheit v. Assessing Officer, Palestine Income Tax Cases* (1945) at 122, 128.
4. *Poskalinsky v. Assessing Officer*, 17 *Piskei Din* 794.

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Consequently, if the statutory provisions do not clearly apply to the facts before the Court, the Court cannot, so to speak, "rewrite" the law. The Court cannot extend the meaning of the statute beyond the words used so as to give effect to the intent of the legislature even though the Court may have no doubt that had the legislature envisioned the particular set of circumstances it would surely have drafted the law accordingly.

The need to impose tax by "clear words" does not necessarily mean words which are easy to understand. The wording may be difficult to understand but once it is comprehended, the provision becomes "clear". What is meant by "clear words" is that the interpreter may not bend over backwards in his efforts to find support in the language of a provision, which will give effect to what the legislature apparently "intended" to stipulate but failed to set forth in words. It boils down to the degree of latitude which is allowed to stretch words beyond their natural meaning to endow them with a more desirable meaning. It is not sufficient that the legislative language "can bear" the interpretation that a tax is meant to be imposed; the words should expressly state that fact. On the other hand, once it is established that the taxpayer must pay the tax but he wishes to benefit from an exemption or relief provision, the burden is on the taxpayer to demonstrate that the provision is applicable to his case. If the provision is ambiguous, the taxpayer will not derive the benefit from the doubt. Even if the provision is clear and unambiguous, the Court cannot mitigate any hardship imposed by the provision by ascribing to it a more reasonable or equitable meaning.

B. The Israeli Courts

The first tax cases, which were decided after income tax was introduced in Palestine under the British Mandate in 1941, illustrate that the traditional British doctrine of strict interpretation was readily adopted by the Palestine Courts under the British Mandate. For instance, the following observations were made in 1943 and 1944:

> I agree entirely with the various quotations made from Maxwell on *Interpretation of Statutes* as to the necessity for a strict interpretation of tax statutes, and if there is a doubt, then the subject should have the benefit of such a doubt.[5]

In Income Tax Appeal 9/42[6], the Court cites Lord Buckmaster in *Ormond Investment Co. v. Betts*[7]:

> The only safe rule is to look at the words of the enactments and see what is the intention expressed by those words.

As will be illustrated, the notion that the taxpayer should benefit from any doubt is perhaps an oversimplification of the strict construction rule.

The "strict construction" rule continued to be applied by the Courts of law after Israel was established in 1948. In *Komerovski v. Director of Land Appreciation Tax*[8], the following passage of Lord Atkin in *Ordmond Investment Co. Ltd. v. Betts*[9] is cited with approval:

> . . . one is bound in construing Revenue Acts to give a fair and reasonable construction of their language without leaning to one side or the other; no tax can be imposed on a subject by an Act of Parliament without words clearly showing an intention to lay the burden upon him – the words of the statutes must be adhered to – so-called equitable constructions are not permissible.

The Court also cited the following dictum of Rowlatt, J. in *The Cape Barandy Syndicate v. I.R.C.*:[10]

> In a taxing act one must look merely at what is clearly said. There is no room for intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[11]

The observations made in *Komerovski* were followed in *Director of Land Appreciation Tax v. Chayim Cohen and others*.[12] The issue in this case involved the meaning of a certain exemption provision stipulated in Sec. 67 of the Land Appreciation Tax Law. Sec. 67 exempted from tax a sale of land where "the sale constitutes a partition of land among co-owners". The exemption clearly applied as far as one parcel of land (or building) was concerned. For example, a building, composed of 4 flats, is co-owned by 4 individuals. The co-owners agree to convert the building into a condominium of 4 units and each co-owner becomes the full owner of one flat. The co-owners do not have to pay the tax.

However, is the exemption limited to a partition of one parcel of property or should it also apply to the following arrangement (which was reached by the taxpayers in *Cohen*): 4 separate parcels of land were co-owned equally by 4 individuals (the land had been inherited by the 4 individuals). After a lengthy dispute, the co-owners agreed to dissolve the co-ownership by allocating one parcel of land to the full ownership of each one of them. The individuals were denied the exemption (under Sec. 67) and they appealed the decision to a Special Committee. Their appeal was successful but the Revenue appealed the Committee decision to the Supreme Court, which reversed the decision of the Special Committee, holding that the exemption was not applicable. At the end of its decision, the Court made the following observation:[13]

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5. Income Tax Appeal 20/42, *Berko Dov Osherovitz v. Assessing Officer, Palestine Income Tax Cases* (1945) at 37, 41.
6. *Solomon Horowitz v. Assessing Officer, Palestine Income Tax Cases* (1945) at 43.
7. *Appeal Cases* (1928) 147.
8. Civil Appeal 120/52, 7 *Piskei Din* at 141, 153.
9. 13 *Tax Cases* at 400, 434.
10. 1 *King's Bench* (1921) at 64, 71.
11. Both of these passages were cited in the dissenting opinion in *Komerovski*. However, there has been no controversy that the passages represent the approach which should be followed in the interpretation of tax statutes.
12. Civil Appeal 245, 165/79, 34 *Piskei Din* (Part III) at 284. A petition for a further hearing was dismissed. Further Hearing 22/80, 34 *Piskei Din* (Part IV) at 589.
13. Ibid. at 292.

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> Lastly I would like to refer, in a few words, to the statement made by the Committee, namely that "tax policy" demands an extensive interpretation of Sec. 67 of the Land Appreciation Tax Law. The Committee pointed out that "not one of the parties realized any profit; it follows that if no profit is realized no obligation to pay Land Appreciation Tax arises". With all my sympathy to the good intentions of the Committee, I cannot agree with that statement. The rule is that in interpreting tax laws one should examine only what is clearly stated in the law itself without attributing to the legislature any intentions one way or the other. That is the rule followed by this Court in the past and I have not found sufficient reason to deviate from this rule, either in the decision of the Committee or in the pleadings of the parties before us. The scope of Sec. 67 of the Land Appreciation Tax Law should not be extended beyond what has been clearly stated in it; all the more so since it is an exemption provision, which, in accordance with the rules, should not be extensively interpreted.

The Court continued by citing the above passage of Rowlatt J. in *Cape Barandy Syndicate*[14] and concluded with this statement:

> The legislature imposed a Land Appreciation Tax on every sale, whether or not the seller realized any profit. This Court cannot alter the law even though it may think that the policy behind imposition of the tax is doubtful and undesirable.

As illustrated, the strict construction rule continued to be applied by Israeli Courts after Israel was established in 1948. As a general rule this approach was acknowledged not only by the judiciary but also by authors of textbooks and treatises and the tax community itself.[15] While the rule was applied in most cases, a tendency could be observed which emphasized its limited application, e.g. by indicating that "the argument that fiscal law should always be construed in favour of the taxpayer is greatly exaggerated; it should be followed most cautiously".[16] In *Director of Land Appreciation Tax v. Iskar Ltd.*[17], the Court went so far as to deviate from the strict interpretation rule, maintaining that "in this case the literal interpretation – or the plain natural meaning – would lead to an absurd result".

The issue in *Iskar* involved the computation of an "additional tax" (a new name for a "transfer tax" or "registration fee") payable upon disposition of land. Apparently, the legislature wanted to impose a lower rate of tax on the transfer of non-residential *buildings* (3%) as distinguished from unbuilt *land* (4.5%). The problem facing the draftsmen was how to deal with a situation where the land was partially built, i.e. where the area of the existing building on the land sold constituted only a small part of the total area upon which a building could be constructed.

The legislature granted a discretionary power to the tax administration but limited the discretion by application of the following technical numerical tests: where the total area of the existing building was less than 30% of the total area permitted to be built upon at the time of the sale, the Revenue could regard the building as 2 assets, one of which was the "building" plus an area of land 300% its total area and the other asset a "residual land". The value of the "residual land" was the value of the asset sold less the value of the "building".

Application of the tests proved arduous because the legislature (in this provision as well as in similar legislation) failed to define the tests by reference to certain other factors which could be relevant, i.e. (1) the area of the parcel of land; (2) the area of the actual land covered by the building; (3) the floor area of the building including all stories; (4) the building rights, namely the total legally permitted floor area (generally expressed in terms of a certain percentage of the area of the parcel and the number of stories); and (5) the value of the different factors. The failure of the legislature to clearly refer to these factors caused confusion in the *Iskar* case (as well as in *Director of Land Appreciation Tax v. Ha-Chevra Ha-Chabashit Lemischar Ltd. and others*[18], which is discussed below) as to the precise meaning of the prescribed tests.

In *Iskar,* the area of the land was 630m^2; the area of the existing building was 214m^2. The legally permissible building floor area was 1517m^2 (in 5 stories). Since the existing building (214m^2) covered less than 30% of the permitted area (1,517m^2), the Revenue considered the building as being composed of 2 assets, i.e. a "building" and a "residual land".

The taxpayer argued that the law should be literally interpreted: 300% (642m^2) should be added to the building area (214m^2). 214m^2 plus 642m^2 equals 856m^2 and since this is more than the total area of the land (630m^2), there is no residual land. Hence, the entire asset sold should be regarded as a "building" subject to 3% tax. The Revenue's view, however, was that the "residual land" refers to the total area of the building which may be constructed, i.e. 1,517m^2 minus 856m^2 equals 661m^2.

The taxpayer appealed to a Special Committee and his appeal was successful. The Committee found that although the Revenue's argument was logical, the clear literal meaning of the phrase "residual land" could not be departed from. The Revenue appealed the Committee decision to the Supreme Court.

The Supreme Court deviated from the literal construction of the statute by interpreting the phrase "residual *land*" as meaning "residual *floor area*". A literal interpretation, the Court concluded, would lead to an

14. See footnote 10.
15. With respect to the situation before 1948, see for example, S. Moses, *The Income Tax Ordinance of Palestine,* Tarshish Books, Jerusalem (1942) at 8. This treatise was published shortly after income tax was first introduced in 1941. A similar view was taken by A. Witkon, *Introduction to Taxation, Income Tax, Estate Duty and Land Appreciation Tax,* (first edition) (1956) Shocker Publishing House, Ltd., Tel Aviv at 30, et seq. See also, later editions by A. Witkon and Y. Neeman; A. Witkon, "Legislation and Adjudication in Tax Matters", *Quarterly Tax Journal,* Vol. 1 (1966) at 263; cf. H.S. Lowenberg, "Comments on Fiscal Legislation, with Special Reference to Form and Content", *Quarterly Tax Journal,* Vol. 1 (1966) at 268.
16. Civil Appeal 39/61, *Hamashbir Hamerkazi Ltd.,* 15 *Piskei Din* at 1765, 1769.
17. Civil Appeal 133/77, 32 *Piskei Din* (Part II) at 529.
18. Civil Appeal 486/85, Collection of Civil Judgments, Vol. 14 at 163.

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absurd result. The Court supported its conclusion by quoting Blackstone:

> If a literal understanding of words leads either to no significance or an absurd significance, we must deviate a little from them.[19]

The decision in the *Iskar* case demonstrates a trend to limit the effect of the strict construction rule. However, any consistency in the approach of the Israeli Courts remains difficult to discern. For example, in the *Bank Leumi Trust Company*[20] case, the Court preferred an over-simplified literal construction of the statute. This case involved an assessment to estate duty imposed on the estate of a foreign resident. The estate, which included real property situated in Israel, was administered by the Bank. Upon receipt of the assessment, the Bank (represented by attorneys) lodged an objection and the assessment was amended. The Bank did not appeal the amended assessment and paid the amount of estate duty. Somewhat more than 2 years later, the Bank raised a new argument, namely that since the land which comprised the estate had been purchased for foreign currency, the land was totally exempt from estate duty under Sec. 55 of the Law for the Encouragement of Capital Investment.

The time limit for lodging an appeal (i.e. 30 days) had long since elapsed so the Bank applied to the Revenue for an extension of the period of time for lodging an appeal. The application was rejected. Consequently, the Bank claimed repayment of the tax paid on the basis of Sec. 28 of the Estate Duty Law, which governs "repayment of tax collected in excess". Sec. 28 provides that

> if the Director is satisfied that excess taxes have been paid, and an application has been submitted for its repayment within 10 years from the time notice of assessment was received, the Director shall repay any amount paid in excess.[21]

The Supreme Court interpreted Sec. 28 as meaning that the estate was entitled to apply for repayment under the statute. One of the Justices found support for his opinion in Jewish law, i.e. if the language of the legislation is unambiguous, the law should be interpreted literally and not according to an intent that the legislature may have had but failed to express in the words of the statute. The Court appears to have overlooked the history of the legislation, i.e. that Sec. 28 was an amended version, replacing a provision which referred to the repayment of an amount of tax unduly paid "for any reason whatsoever".

The inconsistency of the Court's approach as reflected in various cases reached a state where judicial decisions were unpredictable. However, even in cases where the rule of literal construction was, in effect, not followed, the Court stressed its limitations rather than denying its application in principle. Indeed, it is only in recent cases that one can locate dicta explicitly stating that special rules of interpretation should not be invoked in respect of tax laws, i.e. that tax laws should be interpreted according to the general rules of construction. In general areas of the law, Courts have tended to direct their attention to the "legislative object" or "purpose" in preference to the literal or strict construction. Likewise, in the sphere of tax legislation, the strict or literal construction rule should not be adhered to.

C. Reasons for the strict construction rule: special features of tax legislation

Various reasons may be advanced for the special approach towards interpreting tax laws. One should bear in mind that taxation, as well as the Budget, have always been sensitive constitutional areas. It is common in democratic regimes to ensure that taxes be imposed only by law. As a general rule, tax laws are statutory; Israeli law is no exception. That basic principle is followed to protect taxpayers from arbitrary taxation and to ensure proper parliamentary control of Government revenue and expenditure.

In Israel, the principle that taxation be imposed only by law was first laid down in Secs. 4 and 5 of the Law and Administration Ordinance 5708-1948.[22] That same principle, in an improved form, was again emphasized in Basic Law: The Economy of the State.[23] In 1975, a special statutory provision was introduced into the Israeli Income Tax Ordinance, which limits the power of the Revenue to grant extra-legal concessions (presumably because granting a concession may have the effect of indirectly increasing the tax burden on those taxpayers who do not enjoy any concession).[24]

Arguably, the insistence that tax be imposed only by law lends support to the view that the legislature never intended that taxes be imposed by judge-made law. Obviously, a tax statute may be deliberately phrased so as to confer discretion upon the judiciary (either directly or indirectly). For example, the legislature may use general terms (such as "income", "expenses", etc.) without defining them, thus leaving it to the judiciary to develop the so-called "common law" concepts of taxable income. The legislature may also allow the judiciary to assume a more prominent role in counteracting tax avoidance by the use of such phrases as "bona fide transaction" or "fictitious transaction" or "artificial transaction". In the absence of such legislative latitude, however, there is less room for judge-made law in the tax area.

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19. It is submitted that if the legislature limits a discretionary power by using technical tests, it is not safe to look for the "logic" of the tests. The safest path is to adhere to the literal meaning of the words used by the legislature.
20. High Court 333/78, 32 *Piskei Din* (Part II) at 163.
21. This wording of Sec. 28 was introduced by Estate Duty (Amendment No. 3) Law, 5724-1964, *Sefer Ha-Chukkim* No. 434 of 7 August 1964 at 179. It replaces the original version of Sec. 28, which read:
> Repayment. If a request for repayment for money paid as estate duty has been submitted to the Director within 10 years after delivery of the notice of the assessment, and it has been proven to the Director that, for any reason whatsoever, an amount of tax has been paid which is not due, the Director shall repay any such amount which has been paid.
22. *Iton Rishmi* (Official Gazette), No. 2 of the 12th Iyar, 5708 (21 May 1948) Supplement No. 1 at 1.
23. *Sefer Ha-Chukkim,* No. 777 of 31 July 1975 at 206.
24. Income Tax Ordinance Sec. 245.

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It has been suggested that the special approach to construction of tax statutes owes its origin to the somewhat punitive nature of taxes, i.e. in the sense that taxes impose a burden or restrict the taxpayer's enjoyment of his wealth. For example, in the Canadian case of *Canadian Northern Railway Co. v. The King*[25], the Court stated:

> A law imposing taxation should always be construed strictly against the taxing authorities, since it restricts the public in the enjoyment of its property.[26]

A quite different theme can be discerned in a decision rendered some 40 years later in *Guay v. Lafleur*:[27]

> Modern commerce and the levying of taxes upon it is very different from what it was in the 19th century. Since then we have seen a vast growth in the scope of Government activities. If we are to live in the welfare state it must be supported by all. Public policy in this respect is determined through the democratic process. The surest way to create dissatisfaction with it is to ignore the "tax dodgers".[28]

Whilst the notion that taxes are somewhat punitive may appear outdated, one should bear in mind that taxes have retained their compulsive nature. Taxes by definition are not voluntary and they still restrict enjoyment of one's wealth.[29]

It has further been suggested that certainty of the law is of utmost importance in the tax area since taxes have increasingly become an essential element in commercial transactions. Certainty assumes a special importance in tax systems (like the Israeli system) which lack an "advance ruling" procedure.

The need for certainty has not diminished in modern times. Modern tax law has evolved into such complexity that it is frequently difficult to venture a definitive professional opinion as to the tax consequences of a bona fide uncomplicated commercial transaction. If the literal construction rule is not strictly adhered to (even in cases where the wording of the statute is plain) one should always keep in mind the possibility that the Court may hold that literal interpretation leads to an absurd result and hence the legislature could not possibly have intended what the plain language means.

A weighty argument against the strict construction approach is that adherence to it may breed tax avoidance. The general trend of the judiciary in recent years has been to deviate from the strict construction approach in order to counteract tax avoidance. One can welcome such an attitude in cases where a tax avoidance issue is distinctly identified (for example, if a taxpayer deliberately creates facts to escape taxation).

A case in point is the device known as a "step transaction". Rather than entering into one transaction which attracts tax, a taxpayer carries out a series of transactions, each of which, standing alone, does not attract tax. However, it is apparent by the end of the day that the ultimate consequence of all the transactions (which have been carried out step by step) is a taxable transaction. So long as the tax avoidance character of the transactions can be clearly identified, the Court may properly deviate from the strict construction rule to counteract the intended tax avoidance. In actuality, the issue in cases involving "step transactions" is not only interpretation of the *law* but also the meaning of the *transaction* itself. Rather than analyze the various transactions, the Court may prefer to synthesize them.[30]

The question remains, however, whether the Courts should also depart from the strict interpretation rule where no tax avoidance is involved. As will be demonstrated below, the new trend is to reject the strict construction rule even in cases where no issue of tax avoidance arises and instead treat tax statutes the same as other laws, i.e. use "purposive interpretation".

Before considering the new approach it may be useful to briefly point out some of the salient features of modern tax legislation. Modern tax legislation is characterized by a growing use of various legislative techniques which have been adopted to counteract tax avoidance and ensure proper administration of the law. In the income tax area, the "statutory income" or "presumptive income" technique is widely employed. Instead of determining the "real" taxable income or the "real" deductible expenses in accordance with income tax principles (which may be difficult to apply), the legislature may prescribe simplified, technical rules (which may be rigid, artificial or even arbitrary) but which are easy to administer.[31]

Another legislative technique in the tax area is the wide application of "deeming clauses" as well as comprehensive artificial definitions, subject to elaborate provisions granting exemptions (usually subject to

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25. 64 *Canada Supreme Court Reports* (1922) at 264.
26. Id at 275.
27. *Canadian Tax Cases* (1963) at 208; *Dominion Tax Cases* (Canada) at 1098.
28. Id. at 1104.
29. The relationship between counteracting "tax dodging" and the strict interpretation rule will be dealt with below.
30. This may also be true in respect of the "business purpose" which guides United States Courts. See *Gregory v. Helvering,* 293 United States 465 (1935); *Helvering v. Elkhom,* 9 Fed. 2d 732 (4th Circuit 1938); see also *Ramsay v. I.R.C.,* 2 W.L.R. 449; the Israeli decision in Civil Appeal 356/61, *Rosenfeld v. Assessing Officer,* 16 *Piskei Din* 715 (but see also the recent case Civil Appeal 83/81, *T.M.B. Ltd. v. Assessing Officer,* 40 *Piskei Din* (Part III) at 414).
31. For example, in practice, it has proven to be a most tedious task to determine in each individual case whether expenses incurred by the taxpayer in maintaining an automobile could be properly regarded as a business expense incurred "wholly and exclusively in the production of the income", and hence deductible. The deductibility of the expense has been statutorily determined by reference to simple indications such as the type of automobile, mileage, amount and type of expenses.
Similarly, the nature of a transaction, whether "capital" or "revenue" may be statutorily determined by the duration of possession of the asset sold, e.g. long-term and short-term capital gains may be determined by duration of possession.
A typical example is introduction of technical tests (e.g. number of days or months) to determine a taxpayer's residency in lieu of, or in addition to, the traditional indications of residency (e.g. place of residence, family, or are the taxpayer's "temporary absences" such "as to appear reasonable to the Assessing Officer and not inconsistent with the taxpayer's claim of residency". See Income Tax Ordinance Sec. 1.
The technical tests for determining what is regarded as a "building" as distinguished from "land" as in the *Iskar* case discussed above is also quite typical.

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provisos themselves). Cross-references of definitions are also quite common.

Where such techniques are employed, it is not merely an arduous task to search for the intent of the legislature if the drafters of the statute failed to express such intent in clear and unambiguous language. Once the legislature deliberately substitutes "technical rules" for "real" tests, it would be safer for the interpreter to ascribe the plain meaning to the rules rather than look beyond the language or figures used to try to understand the "real intent" of the legislature. If certain rules miss the legislature's "real intent", it is up to the legislature to change the law, perhaps on the recommendation of the judiciary.

III. THE NEW APPROACH

Recent decisions of the Israeli Supreme Court demonstrate a "new approach" to the construction of tax statutes. The leading case in this trend is *Kibbutz Chatzor v. Assessing Officer*[32]. The issue in *Kibbutz Chatzor* was how to construe a statutory definition (passed in 1975) imposing a certain compulsory loan on taxpayers who enjoy the benefits of the Law for the Encouragement of Capital Investment[33]. The compulsory loan was imposed on taxpayers who received "beneficial income", which was defined as "income to which Sec. 47 of the Law for the Encouragement of Capital Investment applies". Sec. 47 deals with companies which own an "approved enterprise". However, that section also provides (Sec. 47(c)) that

> notwithstanding anything stated in this provision, in respect of income of a Kibbutz which owns "approved enterprise", Sec. 19A of the Income Tax Ordinance and Sec. 46(a) of this Law shall apply.

The Treasury argued that Sec. 47 "applies" to a Kibbutz. The Kibbutz therefore received "beneficial income" and should pay the compulsory loan. The Kibbutz argued, however, that ultimately Sec. 46 of the law applies to its income so Sec. 47 is not applicable and the Kibbutz should not be regarded as having derived "beneficial income".

Noting that the word "apply" (*Khal* in Hebrew) has several meanings, the Court decided in favour of the Treasury, i.e. Sec. 47 "applies" to the income of a Kibbutz in the sense that it deals with the Kibbutz and refers it to Sec. 46, which ultimately "applies". The Court reached its conclusion by using general rules of interpretation, emphasizing that the Court should interpret the law so as to give effect to the "legislative object". The object of the legislature can be ascertained by common rules of interpretation such as the history of the legislation and any reliable sources (in this case the official comments on the purpose of the statute as stated in the "blueprint" of the law). Once the Court reached the conclusion that the object of the legislation was to impose the compulsory loan on the Kibbutz, the Court gave effect to that object. The Court felt it was entitled to do so because support for the interpretation could be found in the language of the statute. This decision may be of special interest because the Court not only limited application of the traditional approach to construction of a tax statute but explicitly departed from it.

Some observations of the Court are worth noting.[34] Tax statutes lack their own rules of interpretation. As with any other law, one should commence with the language of the statute. If the law can be interpreted in various ways, the interpretation which gives effect to the object of the legislation should be the preferred interpretation so long as it finds support (even minimal support) in the language of the provision. A provision *imposing* tax and a provision *exempting* from tax should both be construed in the same manner, i.e. so as to give effect to the legislative object.

Neither strict construction nor liberal construction should be adopted. Even in the United Kingdom, the traditional literal construction rule is no longer followed. Instead, the Courts are increasingly applying the "purposive construction" to all statutes, including tax statutes.

A tax is neither an evil nor a penalty. It is an essential need. The words used in a tax provision may be given an "ordinary" meaning or they may be given a "special" meaning. It is meaningless to say that a tax should be imposed only if the language of the statute is clear. Unclear language, too, may impose tax if it is made clear by interpretation.

The Court should first exhaust all methods to reveal the object of the legislation, i.e. from the language of the law, the history of the legislation and any reliable sources. If the wording still remains obscure, the interpreter should resort to the general principles of the system. One of those principles, relevant to tax legislation, is protection of individual freedom and property from intervention by the authorities.

Admittedly, the Court adds, tax legislation contains special features which make it difficult to ascertain the object of the legislation and these features should be taken into consideration. It should be assumed that the legislature intended to impose tax and not create gaps; to make an efficient tool and not a useless one.

In a more recent decision[35], the Israeli Supreme Court appears to have gone even farther in its "purposive interpretation". The Court was apparently prepared, if necessary, to adopt an interpretation based on the logic and object of the law even without any support from the statutory language.

The issue in *Hershkovitz* concerned computation, for land appreciation tax purposes, of a capital gain derived by the taxpayers upon the sale of property they had received as a gift from their father shortly before

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32. Civil Appeal 165/82, 39 *Piskei Din* (Part II) at 70.
33. Legislation passed in 1976 removed any doubt that the compulsory loan is imposed on a Kibbutz which derives income from an "approved enterprise" owned by it.
34. These observations are paraphrased by the author.
35. Civil Appeal 65/82, *Director of Land Appreciation Tax v. Hershkovitz*, 39 *Piskei Din* (Part IV) at 287.

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his death.[36] The tax provisions involved were somewhat technical and consequently it is useful to briefly examine them because the provisions illustrate certain drafting techniques characteristic of tax legislation which can result in interpretation questions.

Since 1 April 1981, there has been no estate duty in Israel. Prior to that time, however, estate duty was imposed under the Estate Duty Law 5709-1949. To counteract tax avoidance schemes, under which the deceased would confer a gift shortly before his death, Sec. 3(a)(3) of the Estate Duty Law contained a presumption that (subject to certain exceptions) gifts conferred by the deceased within 5 years of his death were deemed to be part of his estate and subject to estate duty (such a gift may be referred to as a "constructive bequeath").

The taxpayers in *Hershkovitz* had received land as a gift from their father about 8 months before his death; the gift was therefore regarded as a "constructive bequeath". Approximately 3 years after the father's death, the taxpayers sold the land. The question was how to compute the amount of gain derived by the taxpayers for purposes of the Land Appreciation Tax Law.

The amount of gain subject to the land appreciation tax is the difference between the "value of the property at the time of the sale" and the "value of the property at the time of acquisition". In the case of inherited property, the value of property at the time of acquisition is deemed to be the value assessed for estate duty purposes, or, if not so assessed, the market value of the asset on the date of death.

The taxpayer may deduct certain amounts from the taxable gains, including any amount he invested in the asset for improvements during the period of time from the date of acquisition to the date of sale. As far as the deductions are concerned, the legislature failed to make any reference to the "constructive bequeath". Therefore, under a literal interpretation of the statute, the taxpayers were allowed to deduct the improvement expenses they incurred during the time since they acquired the land (i.e. 8 months before their father's death). However, for purposes of computing the taxable gain, the basis was the value of the asset on the date of their father's death. In so far as the taxpayers' investment was reflected in the appreciated value of the land on the date of their father's death, the taxpayers could, in effect, benefit from an increased deduction.

Obviously, it would have been more logical for the legislature to state that in the case of a "constructive bequeath" both the value at the time of acquisition and the date of acquisition shall be presumed to relate to the same date (e.g. the date of the donor's death). However, can such an "intention" be inferred by way of interpretation?

The Supreme Court decided that the "date of acquisition" in the case of a "constructive bequeath" is not the actual date the asset was acquired (as a gift) but rather the date of the donor's death. The Court noted that perhaps the legislature should have expressly stated that in a "constructive bequeath" the "date of acquisition" should be deemed to be the date of death. Nevertheless, the Court held that its interpretation was sufficiently supported by the language of the statute. The Court added, however, that even if the language of the law did not offer sufficient support, "it is permissible to adopt an interpretation based on the object of the legislation rather than apply a literal interpretation which will miss that target".

The Court went on to cite with approval a passage from the *Kibbutz Chatzor* case (as well as other dicta of the Supreme Court) which emphasized the need to give effect to the "purpose of the legislation". For example, the Court cited the following from a case not involving tax law:[37]

> The law is an instrument for implementation of a legislative object and hence needs to be interpreted in accordance with the object inherent in it.

The Court later mitigated the effect of this statement when it observed that

> admittedly, the Court is not allowed to change the language of the law, and the interpreter is not allowed to give effect to an object that has no literal support in the law, but one could, sometimes, add words to the law, or detract from it in order to prevent an absurd result . . ..

The Court then added that

> absurdity is established in light of the purpose of the legislation.[38]

The Court concluded by stating that if asked to base its decision

> solely on the logic and object of the law without support in the wording of the statute [I] would be troubled, but [I] think that my conclusion is also based on the language of the law.

Hershkovitz is not exceptional in following the "new approach", as reflected in the *Chatzor* case. The guidelines for interpretation of tax statutes as set forth in *Chatzor* appear to have been readily accepted in recent tax cases.

The guidelines cited in *Chatzor* were cited with approval in *Director of Land Appreciation Tax v. Ha-Chevra Ha-Chabashit Lemischar Ltd. and others*[39]. The issue in that case involved interpretation of the Property Tax Law as amended in 1981. The 1981 amendment abolished property tax payable on *buildings* but retained the property tax payable on *land*. Again, the legislature was confronted with the problem of how to deal with partially built land, and again,

36. The Land Appreciation Tax Law imposes, in effect, capital gains tax on gains derived from the sale of land.
37. Civil Appeal 481/73, *Rosenberg v. Shtessel,* 29 *Piskei Din* (Part I) at 505.
38. Here the Court refers to A. Barak, "Interpretation and Judging: Elements of an Israeli Theory of Statutory Interpretation", *Tel Aviv University Law Review,* Vol. 10 at 467, 485. See also A. Barak, "The Intention of the Legislature: Reality or Fiction", *Hapraklit,* Vol. 36 at 165; *Judicial Discretion,* PAPYRUS, Publishing House at Tel-Aviv University (1987).
39. Civil Appeal 486/85, *Collection of Civil Judgments,* Vol. 14 at 163.

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the legislature employed technical tests, apparently to ensure that property tax on land would not be avoided by erecting cheap temporary buildings, claiming that the property did not constitute "land" but rather "buildings" which are free from property tax. The legislature apparently neglected to clearly distinguish between various relevant factors, e.g. the total area of the parcel of land, the area actually covered by the building and the total floor area (in all stories).

The District Court of Haifa (sitting as a court of appeal for decisions of the Committee of Objections under the Property Tax Law) adopted a literal interpretation of the law and decided in favour of the taxpayers. On appeal, lodged by the Revenue, the Supreme Court reversed the decision of the District Court. The Supreme Court interpreted the statute so as to give effect to its purpose. The purpose, ascertained by reference to the legislative history (including the official comments of the blueprint)[40], was to retain the property tax on land, to promote construction and to counteract tax avoidance.[41] Since the language of the legislation could also be interpreted in a way which would give effect to the purpose of the statute thus ascertained, that interpretation should be preferred even though it may result in inconsistencies (for instance, that the same phrases, used in various provisions of the statute, would be interpreted as having a different meaning).[42]

The recently reported cases illustrate that the new approach is quite widely followed. It should, however, be noted that acceptance of the new approach is not universal, i.e. some decisions (both Supreme Court and District Court decisions) still rely on the strict construction approach.[43]

IV. GENERAL LEGAL TERMS AND CONCEPTS USED IN TAX LEGISLATION: "FORM" AND "SUBSTANCE"

Another aspect of the new approach relates to the interpretation of legal terms and concepts derived from other areas of the law (primarily civil law), as used in tax legislation, with or without a specific definition. The interpretation of such terms may also involve interpretation of the legal effect of the *transactions* entered into by the taxpayer, i.e. it may raise problems of "form" and "substance".

Certain tax provisions expressly refer to considerations which are not purely legal. For example, the term "a right in property", for purposes of the Land Appreciation Law 5723-1963, as amended in 1984[44], has been defined as follows: "Ownership or lease for a period exceeding 10 years, whether legal or equitable, *including a licence to use the land, which in substance can be considered as ownership or lease of the said period*". Clearly, this provision should be interpreted by reference to "substance" rather than "form". The question remains, however, how to deal with provisions which lack a specific directive.

When the strict construction approach was in vogue, the Courts were reluctant to interpret legal terms as having a special meaning (for tax purposes) which differed from the general legal meaning. For example, the term "sale" in the original version of the Land Appreciation Tax Law was literally construed. Its meaning was not extended to cover granting a long-term lease, although from an economic perspective granting a long-term lease for a symbolic amount of rent has practically the same effect as sale.[45] The Court in *Vaadia* observed that "certainly it is not the economic substance (or contents) of the transaction which should be followed, but its formal, abstract form".[46]

Occasionally, however, one could come across decisions where the Court preferred "substance" over "form". In 1955, the Supreme Court held that:

> in interpreting and explaining a given transaction, one should not forget the economic reality which serves as a background to the transaction.[47]

The emerging trend is to seek the special meaning of general legal terms in the context of fiscal legislation. In *Director of Land Appreciation Tax v. Ben Ami*[48], the Court stated (in frequently cited dictum):

> Land Appreciation Tax Law is a fiscal law, in which the legislature deviated from the categories of formal property law, aiming at the economic substance of transactions.

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40. As far as the legislative history is concerned, the Court was somewhat cautious, citing the following:
> The reliance on the legislative history can be justified only where there are doubts as to the meaning of the wording. For example, where there is an ambiguity or where the simplified interpretation would lead to an unreasonable result.

41. One of the taxpayers was a company which manufactured matches and it maintained that the nature of its plant required large open spaces of land on which it could not build; hence, the promotion of construction, in its case, was irrelevant. The Court observed that perhaps, in such a case, imposition of the tax was unjust, but the purpose of the statute was to promote construction so the reason no building was constructed was irrelevant.

42. It is also of interest to note that, among the other numerous grounds for its decision, the Court notes that "the interpretation suggested by the taxpayer may create a wide gap for tax avoidance". The Court also resorts to the "economic approach", which has been adopted in other cases and which is considered in the text below.

43. See in this respect Civil Appeal 392/82, *Director of Land Appreciation Tax v. Ben Dror and Others,* 39 *Piskei Din* (Part II) at 540, 545. Similarly, the District Court of Jerusalem in Motion 152/87, *Civil Cases,* Vol. 15 at 61 followed the traditional approach (see also footnote 12).

44. Land Appreciation Tax Law (Amendment No. 15) 5744-1984, *Sefer Ha-Chukkum* of 11 July 1984 at 179.

45. See Civil Appeal 34/61, *Vaadia v. Director of Land Appreciation Tax,* 15 *Piskei Din* 2255.

46. Id at 2260.

47. Civil Appeal 341/54, *Attorney General v. Ben Avi,* 9 *Piskei Din* 24, 26. It may be interesting to compare the "economic approach" adopted by the Israeli Supreme Court in this case (and other cases) to the "*wirtschaftliche Betrachtungsweise*" in German fiscal law. See the German National Report by R. Thiel to the I.F.A. Congress, London, 1965; *Studies on International Fiscal Law,* Vol. La at 123. For an up-to-date study of the subject in German tax law, see K. Tipke, *Steuerrecht, Ein Systematischer Grundriss,* 11th Edition (1987) at 122 et seq.

48. Civil Appeal 265/79, 34 *Piskei Din* (Part IV) at 70.

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This approach is reflected in many other decisions.[49]

An interesting illustration involving both the interpretation of a statutory provision and the legal effects of a transaction is the case of *Assessing Officer v. Lidor*[50], in which the Supreme Court (in the "further hearing") reversed its own decision. The issue in *Lidor* concerned the tax consequences of a transaction in Government bonds issued under the Savings Loan Law 5730-1970. The law imposed a compulsory loan on employers. Taxpayers who paid the loan received bonds (or rather "certificates of savings loans"). Sec. 12(b) of the law provided that "the certificates of loan *shall not be negotiable*". The loan itself was linked to the cost of living index and the owner of the bond was exempt from any tax payable on the "linkage differentials" he received upon redemption of the bond.

A company, controlled by the taxpayer in *Lidor,* owned a substantial amount of loan bonds. When the company needed cash, it "sold" the bonds to the taxpayer for 40% of their nominal value (i.e. the fair market value of the bonds at the time). The "sale" was executed by an agreement between the taxpayer and the company (controlled by the taxpayer), under which "the company sells to the taxpayer and the taxpayer purchases from the company the 'savings loan bonds'".

Presumably, the company attempted to deduct or set off the loss (amounting to 60% of the nominal value of the bond). The Revenue took the position that the controlling *taxpayer* should pay income tax on the profit which *he* made when the bonds were redeemed. The main issue before the Court was whether the term "non-negotiable", as used in the Savings Loan Law, only meant lacking the features characteristic of negotiable instruments (i.e. transferability by delivery and transferability free from equities) or did "non-negotiable" also mean not transferable in any legal form (i.e. by contract under which the debt embodied in the bond is "transferred" or "assigned"). In order to determine whether any taxable event occurred, the Court had to examine the legal effects of the parties' agreement and their subsequent conduct.

The District Court decided in favour of the taxpayer and the Revenue's appeal to the Supreme Court was dismissed by a majority of 2 to one. The Revenue petitioned for a "further hearing" which was granted, and by a majority of 3 to 2, the Supreme Court held in favour of the Revenue.

The majority of the Court were of the opinion that the phrase "non-negotiable" should be interpreted as also meaning "non-transferable"; hence, the agreement between the taxpayer and his controlled company was null and void and no property rights in the bonds passed to the taxpayer. Consequently, the company remained the legal owner of the bonds. Upon their redemption, the *company* received, tax-free, the linked loan repaid by the Government and the company gave that money to the taxpayer.

The majority was also unanimous concerning the tax consequences of the transaction, i.e. that a "taxable event" occurred. The taxpayer should be regarded as having made a profit. Part of the profit should be regarded as "capital income", which may be tax-free so far as it relates to the period prior to the 1975 tax reform (which, among other things, aimed at treating "linkage differentials" as interest). The profit relating to the post-1975 period should be treated as subject to income tax.

Two different methods were advanced as the basis for the taxable event but the Justices saw no need to decide which method was the correct one. One opinion emphasized the "economic-legal" aspect of the transaction, which leads to the conclusion that the taxpayer derived a profit from a loan (or rather a financing transaction):

> both from the economic and legal point of view, the difference between the amount given by the taxpayer to his controlled company and the amount received by him, constitute a yield of the transaction whose nature and scope stem from the facts and circumstances of the case.

According to the second opinion, the taxable event could be based upon the legal consequences of the transaction and the conduct of the parties as defined by the civil law. Given that the transaction was void, there was no financing transaction but rather a mutual waiver (by both the taxpayer and his controlled company) of the right to reimbursement of money paid pursuant to a void contract. It was the "enrichment" resulting from the failure to realize the right which gave rise to the taxable event.

The issue of whether the formal legal effects of the transaction could be ignored (preferring "substance" over "form") was not decided because a taxable event could be established in any case. Arguably, if the "form" of the transaction is adhered to, it may be difficult to discern the legal basis for imposing *income tax* on the taxpayer. His profits more resemble capital gains, which should (if at all) be subject to capital gains tax.

Although the problems of "substance" and "form" were not definitively resolved in the *Lidor* case, one can discern an inclination to establish a "taxable event" in order to counteract a tax-planning transaction, where the transaction can not be legally defined as "artificial or fictitious" under Sec. 86 (i.e. the general anti-avoidance provision of the Income Tax Ordinance).[51]

In December 1987, the District Court of Tel-Aviv decided that a hire-purchase agreement may be regarded as a sale if it can be inferred from the circumstances that (from the economic point of view) the

49. For example, Civil Appeal 702/84, *Yuval Gad Ltd. v. Director of Land Appreciation Tax, Civil Cases,* Vol. 14 at 355; see also Y. Hadari and A. Alter, "Civil Litigation in Tax Law", *Tel-Aviv University Law Review,* Vol. 10 at 429.

50. Civil Appeal 557/79, 36 *Piskei Din* (Part III) at 505; further hearing 16/82, *Civil Cases* Vol. 13 (1986) at 113.

51. See for example, Civil Appeal 571/87, *Assessing Officer v. Raz, Civil Cases,* Vol. 15 at 67.

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parties intended a sale transaction, even though the parties drew up a contract in the form of a lease. Following the American approach, as well as the new approach of the British Courts[52], the Court stressed that in Israel, too, the approach has changed. "Form" should no longer be preferred over "substance".[53]

V. CONCLUSION

As has been shown, the traditional British doctrine of strict construction of tax statutes was readily adopted in Palestine under the British Mandate. It was subsequently retained by the Israeli Courts but has been gradually eroded and replaced by the new approach. The new approach rejects the use of special rules for interpreting tax statutes and instead emphasizes "purposive interpretation". This new approach is widely followed although not generally accepted.

Judicial interpretation of transactions also departs from the traditional approach which preferred "form" over "substance"[54], but it remains to be seen just how far the judiciary will go.[55] One may welcome the new approach to the extent that the judiciary assumes a greater role in counteracting tax avoidance in cases where an avoidance scheme is clearly identified but where the transaction involved does not amount to an "artificial or fictitious" transaction which can be ignored under the general anti-avoidance provisions.[56]

The main criticism of the strict construction rule was that it led to tax avoidance. In many cases, that effect can be eliminated by adopting a different approach towards the interpretation of the *transaction* involved.[57]

The strict construction rule was not necessarily in favour of the taxpayer. It appears to have struck a balance between the taxpayer and the Revenue. Weighty considerations compel against introduction of the "purposive interpretation" in the tax area, i.e. the insistence of the legislature that tax should be imposed by statute leaves less manœuvrability for judge-made law in this area.[58] In the absence of an "advance ruling", certainty in the legislation is crucial. The relatively short process of the legislation in Israel enables the Revenue to initiate new legislation to fill gaps fairly soon after the Court's decision. The legislation may even have a retrospective effect (preferably in cases where a fair warning was given to the taxpayers).

On the other hand, in difficult cases, the Courts may recommend mitigation of the burden. Although not legally binding, as a general rule such recommendations are generally followed. The broad use of legislative techniques such as "deeming clauses" and "technical tests" (as opposed to real tests), not only makes it more difficult to ascertain the intent of the legislature but such tests also make it unclear *which* intent is sought. Finally, taxation has remained a burden; ultimately, the "purposive interpretation" takes this factor into consideration.

As illustrated in the *Hershkovitz* case,[59] the Court may be tempted to extend the "purposive interpretation" too far by adopting a construction based on the logic and object of the law even without any support in the legislative language. It has even been recently suggested that, in view of the new approach, entirely new concepts of "income" could be introduced by judge-made law.[60] However, introduction of new concepts of "income" as well as the manner of taxing income are tasks better left to the legislature. The judiciary should interpret the law and leave the problems of tax policy to the legislature. In any case, the new approach has been widely accepted and it should now be taken into consideration in any assessment of the tax consequences of commercial activities.

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52. See *Ramsay v. I.R.C.*, (1981) *Weekly Law Reports* 449 and *Furniss v. Dawson*, (1984) 1 *All England Reports 530*.
53. Income Tax Appeal 181/84, *Bernstein v. Assessing Officer, Civil Cases*, Vol. 15 at 179.
54. The seminal case in this area is the British case of *I.R.C. v. Westminister*, (1936) A.C. 1.
55. The *Bernstein* decision, supra, is quite far-reaching but it was not rendered by the Supreme Court, the final arbiter of the judge-made law.
56. The Court may carefully use, for example, the "step transaction" or the "business purpose" doctrines in order to counteract obvious tax avoidance devices.
57. See, in this respect, Civil Appeal 390/80, *Mor v. Director of Land Appreciation Tax*, 37 *Piskei Din* (Part I) at 449, in which one of the justices took such an approach.
58. Unless, of course, the legislature specifically uses general terms.
59. See footnote 35 and accompanying text.
60. Y. Edrey, "The Source Doctrine – Is it the End? On the Definition of the Term "Income" in the Israeli "Common Law", *Mishpatim*, Vol. 17 (September 1987) at 25.

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NEW ZEALAND:

The Economic Statement and Taxation Reform*

I. TAXATION REFORM OVERVIEW

The taxation reform measures announced in the Economic Statement of 17 December 1987 are amongst the most fundamental and far-reaching changes to our tax system since the introduction of income tax in New Zealand in the late nineteenth century.

While some of the announced measures represent significant progress in the drive for a neutral and equitable tax system, others are discriminatory as between taxpayers and may result in disinvestment in New Zealand rather than the increased investment and job creation that the Government seeks. Positive aspects of the reform proposals include significant reductions in the rates of personal and company tax and the introduction of an imputation system which will largely remove the double taxation of dividends inherent under the current classical tax system.

However, the reform proposals in relation to international taxation represent a sharp move away from income tax neutrality and equity.

In relation to attracting overseas investment into New Zealand, whilst the reduction in tax rates is a positive step, the retention of dividend withholding tax will mean that, in tax terms, New Zealand will continue to be an expensive place in which to invest.

The alterations to the provisional tax payment rules and the introduction of a withholding payment regime for resident contractors, interest and foreign dividends are clearly steps to advance the timing of tax collection and improve the Government's cash flow. These proposals are not without their practical difficulties.

As has become a feature of this Government's tax reform process, a broad range of proposals and intentions were announced. Some of these took effect from 17 December 1987, and no legislation has been released to date. The uncertainty that this creates for New Zealand business ignores a basic tenent of fair taxation systems and is unhelpful to business planning.

Overall, the announcements did contain positive elements. However, the positive aspects, in particular imputation and the tax rate reductions, may have initially obscured the far-reaching and negative effects of the international tax reforms. These are now being more fully recognized and real concerns exist in relation to their long-term effects on the New Zealand economy.

II. INTERNATIONAL TAXATION

The Minister of Finance's announcement of 22 December 1986 foreshadowed the introduction of anti-tax haven measures which were promulgated in some detail in the 1987 Budget. The 1987 Budget proposals were principally targeted at passive income earned by entities controlled by New Zealand residents and located in low or no tax jurisdictions.

The announcements of 17 December 1987 and the accompanying Consultative Document on International Tax Reform have abandoned the former proposals directed at tax haven activities. The regime now proposed will essentially result in New Zealand taxpayers being subject to New Zealand tax on all income derived by all overseas entities in which they have an economic interest, whether or not that income is repatriated to New Zealand.

Further, where New Zealand taxpayers are unable to measure their share of each overseas entity's income (according to New Zealand tax principles) they will be deemed to derive income for New Zealand purposes equivalent to the increment in value of their overseas investments during the year. This will be the case for all or most portfolio investors. This will mean that taxpayers in this situation will be required to pay New Zealand income tax on all unrealized capital gains accruing on their overseas investments.

Given the fundamental changes to the way in which it is proposed to tax foreign income, we will first outline the new rules in some detail and then comment on certain important issues.

To whom will the new rules apply?

The new rules will apply to all New Zealand residents who have an interest in an overseas company or trust. This interest can be direct or indirect.

Normal New Zealand tax residence rules will apply to determine those persons subject to the new rules, with 2 modifications:

Short-term or temporary residents
An individual who has been resident in New Zealand for a total period of less than 24 months in the immediately preceding 15 years will not be a New Zealand resident for this purpose only.

Trusts
For the first time in New Zealand tax law, the tax residence of a trust will be defined. A trust will be resident in New Zealand for tax purposes if any trustee is resident in New Zealand at the end of the trust's accounting year.

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* This article was written by Arthur Young International, New Zealand.

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What income will the new rules apply to?

All income earned by New Zealand residents through their interests in non-resident companies and trusts will be covered by the new rules.

What is a non-resident company?

A non-resident company is an overseas entity that is comparable to or deemed to be a company under New Zealand law; e.g. an overseas unit trust will be a non-resident company for this purpose. Also included are companies which are resident in both New Zealand and another country with foreign income not taxed in New Zealand.

What is a non-resident trust?

A non-resident trust is one of which no trustee is resident in New Zealand at the end of its accounting year.

What is an interest in a non-resident company?

Broadly, an interest in a non-resident company is the economic interest in an overseas company measured by the ability to extract income from the company. This will generally be measured by reference to the following types of instruments issued by a non-resident company:

- Shares;
- Units in a non-resident unit trust;
- Floating rate debentures and debentures issued in substitution for shares;
- Options or rights to acquire such interests;
- Convertible debt.

There will be an unlimited look through of chains of non-resident companies and trusts to determine the New Zealand resident's percentage interest in an overseas company, e.g. –

A ——— 50% —— B ——— 20% —— C ——— 50% —— D
(NZ resident) (Foreign co.) (Foreign co.) (Foreign co.)

A's percentage interest in D is 5%.

In addition, the rules relating to nominees will be strengthened if necessary to ensure that an interest in an overseas company held by a nominee of a New Zealand resident will be deemed to be held by the New Zealand resident.

De minimis exemption

The new regime will not apply to New Zealand individuals who hold directly interests in non-resident companies that do not, in total, exceed NZ$ 10,000 in value at all times during the individual's income year.

What is an interest in a non-resident trust?

It is often not possible to determine the economic interest of a beneficiary in a trust, particularly where the trustees have discretion as to the distribution of income and capital. For this reason, the new regime will principally apply to New Zealand resident settlors of non-resident trusts. Any New Zealand resident person (the settlor) who has contributed property by way of gift or transfer for inadequate consideration to a non-resident trust, will be considered to have an interest in that trust.

The value of a contribution to a non-resident trust will be the difference between the market value of the property transferred and the consideration given by the trustees. New rules will be enacted in relation to financial assistance given to trustees where property is transferred to a non-resident trust. This is likely to affect transactions which involve the sale of an asset to an overseas trust for a consideration that comprises an interest-free or low interest loan. Such loans may be deemed to be inadequate consideration.

A New Zealand resident settlor's percentage interest in a non-resident trust will be calculated by reference to the market value (at the time of contribution) of property contributed by the settlor as a percentage of the market value of the trust's net assets. Once established, the settlor's percentage interest will remain fixed until such time as a further contribution is made.

De minimis exemption

The new regime will not apply to New Zealand resident individual settlors who have made contributions to non-resident trusts the total market value of which is less than NZ$ 500 at any time.

When will the new rules take effect?

The new regime applies from 1 April 1988 and only income earned or capital gains accruing from that date will be subject to tax. Therefore, interests in overseas companies computed under the comparative-value basis will be required to be valued at 1 April 1988 to establish a base valuation.

How will the income earned through non-resident companies and trusts be calculated by New Zealand residents?

Non-distributed income

1. *Non-resident companies*

A New Zealand resident holding an interest in a non-resident company must report for New Zealand tax purposes his or her share of the income derived by that company.

The share of the overseas company's income can be calculated, under election, on the *branch-equivalent basis*, or the *comparative-value basis*.

A. *Branch-equivalent basis*

The branch-equivalent basis may only be used by taxpayers who are able to obtain sufficient information to essentially enable the compilation of a New Zealand tax return for the overseas company.

Therefore, portfolio investors will probably be unable to use the branch-equivalent basis which will in effect

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be restricted to those New Zealand residents who control or are able to exert adequate influence over the non-resident companies. This basis requires the calculation of the overseas company's income under New Zealand tax rules and principles. The New Zealand resident's percentage interest in that income is then included in that person's New Zealand tax return and taxed in the normal way.

Features:

(i) Income will be reported in New Zealand dollars calculated by using the spot exchange rate on the last day of the overseas company's accounting year.

(ii) The percentage interest of a New Zealand resident is calculated at the end of the overseas company's accounting year.

(iii) A New Zealand resident's share of the income of an overseas company to be reported for a given income year will be that which falls in the accounting year ending during that income year. For example, a non-resident company's accounting year ends on 30 June 1989; the New Zealand resident's share of that income will be included in his or her assessable income for the income year ended 31 March 1990.

(iv) Any losses incurred by the non-resident company, as calculated under New Zealand tax rules, can be set off only against the taxpayer's share of income of other non-resident companies. As proposed, New Zealand losses cannot be offset against overseas income and overseas losses cannot be offset against New Zealand income.

Where the taxpayer is a company and is included in a group of companies (i.e. there is at least a two-thirds commonality of ownership), foreign losses may be transferred to other group companies and set off against the foreign income earned by those companies. It is not yet clear whether foreign losses unable to be utilized in a given year can be carried forward for set-off against foreign income earned in future years.

(v) The branch-equivalent basis is applied to determine the share of the undistributed income earned by the foreign company which will be subject to New Zealand tax. Distributed income is taxed on a different basis.

Therefore, dividends received from a non-resident company (gross of foreign withholding taxes) will be deductible from the New Zealand taxpayer's share of the foreign company's income that is calculated on the branch-equivalent basis. Where the dividend deduction results in a branch-equivalent loss, that loss may be set off against the taxpayer's share of income of other non-resident companies, or carried forward to set off against such income in future years.

(vi) New Zealand residents who acquire or sell an interest in a non-resident company will be required to include in their assessable income their pro-rated share of the non-resident company's income after the date of purchase and prior to the date of sale respectively.

(vii) *Credit for foreign taxes*
A taxpayer's New Zealand tax liability arising on income reported under the branch-equivalent basis will be reduced by his percentage interest in the foreign taxes paid by the non-resident company.

(a) Foreign tax credits will be limited to the amount of New Zealand tax payable on the income of each non-resident entity; the foreign tax credits will only be available on a source-by-source basis.

For example, if a New Zealand corporate taxpayer has an interest in an Australian company and a Cayman Islands company and the New Zealand company tax rate is 25%, the excess foreign tax credits in respect of the Australian income, 24% (being 49%-25%), will not be able to be utilized against the New Zealand tax payable on the income attributed from the Cayman Islands company.

(b) Foreign taxes eligible for credit will be those income and company taxes which are substantially the same in nature as New Zealand income tax and will include New Zealand taxes paid by a non-resident company on New Zealand-sourced income (e.g. withholding taxes on interest) and foreign withholding taxes levied on distributed income.

B. *Comparative-value basis*

Given the qualification requirements to elect for the branch-equivalent basis, those taxpayers not electing to adopt the branch-equivalent basis will automatically be deemed to have adopted the comparative-value basis. Most New Zealand portfolio investors in overseas companies will therefore be required to report their foreign income on the comparative-value basis. Under this basis, taxpayers will be required to include in their assessable incomes the increment in value of their overseas share investments over a 12-month period. This basis is no more than a tax on the unrealized capital gains accruing to New Zealand residents on their overseas equity investments.

Features:

(i) Taxpayers affected will be required to include in their assessable income any change in value of an interest in the non-resident company by comparing the market values at the beginning of the taxpayer's income year, generally 1 April, and the end of the income year, generally 31 March.

(ii) Market values will be determined under one of 3 bases; traded price basis, other acceptable valuation methods or an imputed return basis.

(a) *Traded price basis*

Where an interest in a non-resident company is traded on a public exchange, the reported traded prices will be used as the basis of valuation.

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Non-traded overseas unit trusts that are redeemable at call will be valued by reference to the most recent quoted redemption price.

The market value must be computed in New Zealand dollars using the spot exchange rate at the taxpayer's balance date; for an individual this will generally be 31 March.

(b) *Other valuation methods basis*

Where traded prices are not available or are unreliable, the market value must be calculated using other acceptable valuation techniques.

Such techniques will reflect:

- the shareholder's funds of the non-resident company, and/or
- the net after-tax earnings of the non-resident company, perhaps based on present values of future cash flows or on an appropriate price/earnings multiple applied to projected future earnings.

The market value determined under this basis will be computed at the end of the non-resident company's accounting year.

Income computed under this basis must be converted to New Zealand dollars using the spot rate on the last day of the company's accounting year.

(c) *Imputed return basis*

Where the trade price is unavailable or unreliable and the compliance costs of establishing market values by other acceptable valuation methods are excessive, market value will be calculated on an imputed return basis.

This will be based on an imputed return equivalent to a yield of 5% over the 5-year New Zealand Government stock yield. Currently, this will result in an imputed return in excess of 20% per annum. This rate will be announced annually by the Inland Revenue Department.

Under this basis, dividends received are deductible from the computed market value.

Once the imputed return method is adopted for a given income year, taxpayers will be unable to alter this valuation basis for a further 4-year period.

(iii) Where an interest in a non-resident company is sold or disposed of, the difference between the sale proceeds and market value at the beginning of the year of sale will be included in assessable income.

(iv) Similarly, where such an interest is purchased during the year, the difference between the cost of that interest and its market value at the end of the year will be taxable.

(v) *Post facto adjustment*
Where the market value of an interest has been calculated on a basis other than traded price and the interest is sold for a price which exceeds the last reported value by more than 30%, an adjustment may need to be made to the reported income of previous years to recover and tax the deferred income.

It is not proposed to give relief on a similar basis for any losses subsequently realized.

2. *Non-resident trusts*

A New Zealand resident settlor will be assessable on income attributable to his or her interest in a non-resident trust. As for non-resident companies, the income to be reported by the New Zealand settlor can be calculated under the branch-equivalent or comparative-value bases. The same principles applying to the measurement of income under these bases for non-resident companies will apply equally to the measurement of income derived by non-resident trusts. New Zealand resident settlors will be required to compute and report their share of the income of the non-resident trust based on their percentage interests held in the trust.

Distributed income

In addition to introducing a new regime for the taxation of undistributed foreign income, a number of amendments are proposed in relation to the taxation of foreign income that is distributed to New Zealand residents.

1. *Company recipients*

Under current law, all dividends received by New Zealand companies are exempt from tax. Under the new rules:

Dividends received by New Zealand companies from other New Zealand companies will continue to be exempt from tax.

Dividends received after 17 December 1987 from overseas companies of which the recipient owns less than 10% ("portfolio dividends") will be taxable.

Dividends received from overseas companies of which the New Zealand recipient owns more than 10% of the paid-up capital ("non-portfolio dividends") will continue to be exempt from tax.

Features:

A. *Portfolio dividends*

(i) Foreign portfolio dividends received by New Zealand companies after 17 December 1987 will be subject to New Zealand tax.

For this purpose, a dividend will be deemed to be received when it is declared by the foreign company.

(ii) A credit against the resulting New Zealand tax liability will be allowed for foreign withholding taxes paid on the dividends received.

(iii) Where the rate of foreign withholding tax paid on a foreign dividend exceeds the New Zealand company

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tax rate, which may be the case when the company tax rate is reduced and dividends are received from companies located in countries with which New Zealand does not have a double tax treaty, excess foreign tax credits may arise. It is not clear whether relief will be allowed for excess foreign tax credits arising in this way and in addition whether or not portfolio dividends wil be taxed on a source-by-source or on a pool basis.

B. *Non-portfolio dividends*

Foreign non-portfolio dividends received by New Zealand companies will continue to be exempt from New Zealand tax. However, with effect from 17 December 1987, a New Zealand company receiving a non-portfolio foreign dividend must withhold and pay to the Inland Revenue a withholding payment equivalent to the reduced rate of personal tax which will apply from 1 October 1988. The benefit of this withholding payment will be passed on to New Zealand individual shareholders under the imputation system when these dividends are paid out to shareholders. For this purpose a dividend will be deemed to be received at the time it is declared by the foreign company.

The withholding payment due will be calculated for each quarter and paid to the Inland Revenue within 20 days of the end of the quarter. Payments due for the December 1987 quarter will be included in the payment for the March 1988 quarter by which time the rate of withholding will have been announced.

2. *Individual recipients*

There is no change to the taxation of foreign dividends received by New Zealand resident individuals. These will continue to be taxed in the hands of individual recipients and a credit allowed for foreign withholding taxes paid.

3. *Distributions by non-resident trusts*

All distributions of trustee's income to New Zealand beneficiaries will continue to be subject to New Zealand tax. This will include any amount which vests indefeasibly in the beneficiary.

Foreign withholding taxes levied on distributions by the trust will be creditable against the resulting New Zealand tax liability. However, distributions of trust capital will continue to be non-taxable.

Anti-avoidance

Legislation will be enacted to include disguised distributions by non-resident companies and trusts in the assessable income of the New Zealand recipients where appropriate. Disguised distributions may include upstream loans by the overseas entity at a preferred interest rate or the sale of property at an undervalue.

Disclosure and administration requirements

The disclosure and compliance requirements of the new proposals will undoubtedly be onerous. Given the lack of resources in the Inland Revenue Department (IRD) to enforce the new rules, the primary thrust is to ensure affected taxpayers fully disclose their interests in overseas companies and trusts under the threat of substantial penalties for non or inadequate disclosure.

1. Each income year, taxpayers will be required to disclose whether they:

- held an interest in a non-resident company or trust;
- received a dividend from a non-resident company;
- received a distribution from, or became indefeasibly vested in the income of, a non-resident trust.

2. A separate schedule for each non-resident company and trust in which the taxpayer has an interest must be submitted with the annual tax return. Information to be disclosed in the schedules will include:

- the name, address and other details of the overseas entity;
- the taxpayer's percentage interest in the entity;
- a calculation of the income to be reported on either the branch-equivalent or comparative-value basis;
- a computation of the New Zealand tax liability on any dividends or distributions received from non-resident companies and trusts;
- a re-calculated New Zealand tax liability where the post facto adjustment is applicable for those taxpayers reporting income on the comparative-value basis;
- any change in the balance date of the overseas entity during the income year.

3. Taxpayers reporting income on the branch-equivalent basis will be required to:

- provide the annual balance sheet and profit and loss statement for each overseas entity;
- provide in New Zealand, if requested by the IRD, each overseas entity's financial accounts and copies of tax returns filed with foreign tax authorities;
- advise the IRD of the accounting year adopted by the overseas entity and any changes thereto;
- provide the IRD with information similar to that which New Zealand companies with overseas branches are currently required to supply if requested.

4. Taxpayers reporting income on the comparative-value basis must provide sufficient information to support the basis of valuation used for each interest.

Where the traded price basis is adopted, this will include the name of the exchange on which the interest is traded, the dates of traded prices that are used and the volume traded.

Elections

The new rules in relation to undistributed foreign income earned or accrued apply from 1 April 1988.

1. Taxpayers qualified to and wishing to adopt the branch-equivalent basis will be required to file with their annual tax returns a separate election for each

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overseas entity for which income will be reported on this basis.

2. Elections to use the branch-equivalent basis that are filed before 1 April 1988 will be effective from that date. Elections filed after that date will be effective from the first accounting year of the overseas entity commencing after the date on which the election is filed.

It is to be hoped that legislation enacting these reforms is passed in sufficient time for taxpayers wishing to adopt the branch-equivalent basis from 1 April 1988 to make the appropriate elections on an informed basis.

3. Taxpayers not electing the branch-equivalent basis will be required to report their foreign income on the comparative-value basis.

4. Taxpayers may elect to change from the branch-equivalent to the comparative-value basis if they notify the Inland Revenue at least one month before the commencement of the next accounting year of the overseas entity.

The change in basis will be effective from the beginning of the overseas entity's next accounting year.

5. Taxpayers may elect to change from the comparative-value to the branch-equivalent basis by giving notice to the Inland Revenue before the beginning of the overseas entity's accounting year for which the change is to be effective.

Specific comment

1. The taxation of undistributed foreign income on the branch-equivalent or comparative-value bases may result in tax being payable on income and gains that have not been repatriated or realized. This will have adverse cash flow implications for taxpayers affected by the proposals.

2. Given the investment in overseas equities and the high compliance costs that will arise in fulfilling the reporting requirements under the branch-equivalent and comparative-value bases, the NZ$ 10,000 de minimis exemption level is unrealistically low.

In terms of income tax neutrality, there is no economic difference between investing in equities and financial arrangements as defined in the accrual tax rules. The de minimis exemption for the accrual rules regime should be adopted for these proposals; namely total overseas investments in any income year of NZ$ 400,000.

3. Tax sparing relief should be given to those New Zealand investors who take advantage of tax incentives and concessions given by other countries, e.g. Chile and Singapore. Developing countries often offer a concessional rate of tax for investment in certain types of industries and the United Kingdom, for example, allows a notional credit for tax that would have been paid had the concessions not been given.

4. The exchange rate to be used when converting overseas income or gains to New Zealand dollars is the spot rate at year end. Given that exchange rates fluctuate, often markedly, it is unfair not to recognize the exchange rate over the year that the income is earned or at the date a transaction is executed. Therefore, the exchange rate to be used should properly reflect the economic reality of the earning of the income and be based on a yearly average, or that on the transaction date.

5. Overseas losses are only able to be set off against overseas income. If a world-wide basis of taxation is to be applied, in equity there should be full relief for domestic and foreign profits and losses on an entity and group basis.

In addition the ability to carry losses back as well as forward should be available to taxpayers. The carry-back of losses is a feature of developed taxation systems that could easily be implemented in New Zealand and would give taxpayers earlier relief for losses incurred.

6. *Foreign tax credits*

A. Timing differences in the tax treatment of certain items will occur between New Zealand law and overseas countries. This will have a direct and significant impact on New Zealand taxpayers reporting income on the branch-equivalent basis.

Assume Country A has a 100% depreciation write-off in the year of first use for specialized plant, and imposes tax on companies at the rate of 35%.

A New Zealand company has a wholly owned subsidiary in Country A. In year one, that company's taxable profit is:

	NZ$
Net profit before depreciation	100
Depreciation (cost NZ$ 100, 100% depreciation)	(100)
Taxable income	NIL
Tax paid in Country A	NIL

The year one branch-equivalent computation for New Zealand tax purposes will be:

	NZ$
Net profit before tax	100
Depreciation (10% D.V. on cost of NZ$ 100)	(10)
Taxable income	90
NZ tax (at, say, 25%)	23
Less foreign tax credits	NIL
New Zealand tax to pay	23

In year two: Country A	
Net profit before depreciation	100
Depreciation	NIL
Taxable income	100
Tax paid in Country A	35
New Zealand	
Net profit before depreciation	100
Depreciation (10% of NZ$ 90)	(9)
Taxable income	91
New Zealand tax (25%)	23
Less tax paid in Country A	(35)
New Zealand tax to pay	NIL
Excess foreign tax credits	12

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The Consultative Document states that where excess foreign tax credits arise as a result of timing differences between New Zealand and foreign tax law, that excess can be carried back or forward to the extent permitted under current New Zealand law. However, current New Zealand law does not permit the carry-back or forward of foreign tax credits. New Zealand tax law should therefore be amended to allow for the full and unlimited carry-back and carry-forward of excess foreign tax credits so that income is not subject to tax twice.

B. In addition to the carry-back and forward of foreign tax credits, foreign income from different sources that is reported on the branch-equivalent basis should be taxed on a pooled rather than on a source-by-source basis. The pooled basis is that adopted in Australia and removes the distortions in giving relief for foreign taxes that arise because of differing rates of company tax and timing differences in different countries.

7. The new measures take effect from 1 April 1988. Taxpayers wishing to adopt the branch-equivalent basis from that date must file an election before 1 April 1988. Given the lack of specific detail released to date, and the likelihood that legislation will not be available until 31 March 1988 at the earliest, taxpayers in this position may be forced to make a decision in the absence of full information. The date for the filing of the branch-equivalent election should be deferred until legislation is enacted and taxpayers and their advisers have had sufficient time and opportunity to fully examine the implications.

8. The comparative-value basis of reporting foreign income is no more than a tax on unrealized capital gains and a further tax on unrealized exchange variations. Such a selective capital gains tax is neither equitable nor tax neutral as between taxpayers. If a capital gains tax is to be introduced, it should be comprehensive, treat all New Zealand taxpayers on the same basis and tax only realized gains from which inflationary gains have been excluded.

9. The imputed return valuation option under the comparative-value basis does not reflect economic reality. Taxpayers required to report their income on this basis will be deemed to earn income at a rate in excess of current New Zealand interest rates on their non-New Zealand investments.

Of the major industrial countries in which New Zealanders invest, New Zealand interest rates are by far the highest. The imputed return method should be amended so that imputed yields reflect a more realistic economic return in relation to the country in which the investment is made, e.g. income deemed to be derived on a Swiss investment should be reflective of Swiss returns, not New Zealand returns. The yield should better reflect returns on equity rather than debt instruments.

10. Failure to make the branch-equivalent election by 1 April 1988 means many taxpayers may be restricted to the imputed return basis for five years. In our view, the length of this restriction is unreasonable and should be reduced.

11. The post facto adjustment proposed under the comparative-value basis applies where an interest in an overseas entity is disposed of for a price that exceeds the last reported value by 30%. Where applicable, the excess "income" is recouped and taxed. However, no similar relief is given for losses that may be subsequently realized. In the interests of equity, if subsequent profits are to be taxed in this manner, losses realized subsequently should be deductible in a like manner.

12. Foreign portfolio dividends received by New Zealand companies after 17 December are subject to tax. It is difficult to see the logic in selectively taxing one source of dividends whilst continuing the tax exemption for dividends received from New Zealand companies and foreign non-portfolio dividends. If our tax system is to be neutral, dividends received by New Zealand companies should either be all taxable or all exempt.

13. The exemption from these rules for expatriates on secondment to New Zealand is too restrictive. This may serve to discourage overseas experts from accepting secondments to New Zealand.

14. The compliance costs of these proposals, particularly for New Zealand-based multinational groups, are likely to be very high. They may also be a significant shortage of skilled personnel to undertake this additional compliance work.

A worked example of the international tax reform proposals is included at Appendix I.

III. IMPUTATION

The Government first announced that a full imputation system was to be introduced in August 1985. That announcement was confirmed in the Budget Statement of 18 June 1987 and is the subject of a Consultative Document released on 17 December 1987.

Prior to the December announcement 2 alternative imputation systems appeared most likely:

- a Compensatory Tax System based on the advance deduction of tax from dividend payments; and
- a Qualifying Dividend Account System involving the accumulation of imputation credits which are then passed to shareholders on the declaration of dividends.

The Government has followed the Australian approach and chosen the latter alternative utilizing an Imputation Credit Account. The proposed implementation date is 1 April 1988 provided legislation is enacted. However, a number of the proposals will take effect retrospectively.

Submissions on the imputation proposals are required to be lodged with the Consultative Committee by 12 February 1988. That committee is due to report to the

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Minister of Finance by 31 March. Given this timetable it is not easy to see how the implementation date of 1 April 1988 will be achieved.

Parallel to the introduction of an imputation system to eliminate the double taxation of dividends, the tax rules governing distributions have been significantly widened in line with the Government's objective to broaden the tax base.

1. Which distributions are affected?

Bonus share issues declared after 17 December 1987 that have been capitalized from other than qualifying share premium reserves will be treated as a dividend. The taxable value of the bonus shares will be calculated as the aggregate amount of reserves or earnings capitalized to paid-up capital as a result of the issue divided by the number of bonus shares so created.

All distributions (with one exception) made by a company will be treated as a taxable dividend. The exception is the return of paid-up capital made on the redemption of shares in the company. Paid-up capital for tax purposes will include share premiums paid in cash or other consideration. The current tax exemption for certain distributions on winding up of a company is to be revoked effective from 17 December 1987. Therefore all distributions on liquidation, other than distributions of paid-up capital, will be treated as dividends. This includes all capital profits which are distributed in the process of winding up.

All cash dividends remain taxable in the hands of individual shareholders regardless of their source.

The dividend exemption remains for dividends received by New Zealand resident companies from:

- other New Zealand resident companies, and
- non-portfolio dividends from non-resident companies (i.e. where the New Zealand resident company holds more than 10% of the paid-up capital of the non-resident company).

Where dividends or bonus issues are received by a trust they will be assessed as trustee's income irrespective of whether a beneficiary is entitled in possession to the income. However, trusts may subsequently distribute the resulting after-tax income to beneficiaries free of tax.

In addition, the following amendments are proposed to remove the double taxation formerly present in the Tax Act:

(i) From 1 April 1988 expenditure incurred by a proprietary company for the benefit of a shareholder (or an associate) remains non-deductible to the company but will no longer be treated as a dividend to the shareholder.
(ii) Distributions of trading stock by a company to a shareholder will be taxed as a dividend in the hands of a shareholder as from 1 April 1988 based on the market value of the trading stock.
(iii) With effect from 1 April 1988, fringe benefits granted to major shareholders will be subject to fringe benefit tax as opposed to being treated as a dividend to the shareholder.

2. What is the imputation credit account?

The proposals require that New Zealand resident companies maintain an Imputation Credit Account (ICA) from 17 December 1987. The ICA is necessary to record tax paid by the company that is available for allocation as imputation credits to shareholders.

Credits in the ICA will arise in the following circumstances:

(i) The payment of provisional or terminal tax for the 1989 income year, i.e. the income year commencing on 1 April 1988 or the company's equivalent accounting year, and future income years. For companies with a 31 March balance date the first tax payment creditable to the ICA is the first instalment of provisional tax paid in July 1988. For an October balance date the first payment creditable would be the provisional tax payment in February 1988.

No credit is available for:
- foreign company tax paid
- penalty and additional taxes
- fringe benefit or land tax
- goods and services tax

(ii) The receipt of a dividend from a New Zealand resident company that has an imputation credit attached. The ICA credit will arise on the day the dividend is paid or bonus share issued. This will apply to dividends received after 1 April 1988 assuming the legislation has been enacted. Otherwise ICA credits will not be available from this source until the legislation has been enacted.

(iii) The receipt of a dividend (paid after 17 December 1987) from a company which is resident in a country with which New Zealand has a double tax treaty where that dividend has borne non-resident withholding tax in that country. The amount of the ICA credit will be the New Zealand dollar value of the non-resident withholding tax. We assume that the New Zealand dollar value will be calculated using the spot rate on the date of payment.

Debits in the ICA will arise where:

(i) Imputation credits are allocated to shareholders through payments of cash dividends or the declaration of bonus issues. The debit in the account will arise on the day on which dividends are paid or bonus shares issued.

(ii) A refund of New Zealand company tax. The debit arises on the day a notice of assessment is issued indicating a refund is due.

3. How is the ICA balanced?

A company will be required to provide comprehensive details of the ICA account movements during the financial year with the company's tax return. The balance of the ICA is not permitted to fall below zero at

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any time during the financial year as a result of the allocation of imputation credits to dividends and bonus issues.

To discourage a company overpaying provisional tax to gain a timing advantage from increasing the imputation credit available for distribution prior to receipt of a tax refund, the legislation will limit tax refunds to the credit balance of the ICA at the end of the financial year in respect of which the refund is due. The balance retained will be used to offset future provisional tax liabilities.

The intention to allocate notional credits to shareholders as an anti-avoidance measure in some situations is discussed below under Allocation of Credits. The allocation of a notional credit may result in the ICA balance falling below zero. In this situation the company will be required to make an advance payment of provisional tax to cover the deficit. This payment is due within one month of the company's balance date and will be creditable against future provisional tax payable by the company.

Unlike the Australian system, the New Zealand proposals do not provide for penal tax where an additional provisional tax payment is required.

4. How are credits allocated?

The Consultative Document proposes that 3 criteria must be met when allocating credits:

(i) The ratio of the imputation credit to the taxable value of a dividend or bonus share cannot exceed:

$$\frac{\text{Corporate rate}}{1 - \text{Corporate rate}}$$

i.e. with a company tax rate of 25% this ratio would be 25:75.

In effect the ratio prevents the allocation of an imputation credit greater than the corporate tax payable on the company's underlying earnings from which the dividend was sourced.

Credits can be allocated so that the ratio of credit to taxable value is less than the maximum, i.e. say 10% in the above example.

(ii) The ratio of credit to the aggregate taxable value of dividends paid or bonus shares issued during a financial year must be the same for all classes of shares in that financial year.

(iii) Where imputation credits are allocated to holders of a particular class of share the credit allocated per share must be the same for all shares of that class on issue on the day the allocation is made.

Two shares will be defined to be the same class of share if they have the same, or substantially the same, entitlement to dividends, bonus shares and distributions on wind up. All classes of share including redeemable preference shares will be subject to the conditions outlined. Where at the end of the financial year it is determined that above conditions (ii) and (iii) have not been met a notional credit will be deemed to be allocated in order that the requirements are satisfied. This may lead to the requirement for an early provisional tax payment noted at 4 above.

The company must provide to the Inland Revenue Department when the tax return is filed:
- details of the number of classes of shares on issue, the number of shares in each class and if any new shares were issued during the financial year;
- details of the method of allocating credits during the financial year between each class of shares.

There are a number of specific provisions in the Act which deem certain instruments to be either debt or equity for tax purposes. Under the proposed imputation system those instruments will retain that tax status. Therefore floating rate debentures and debentures issued in substitution for shares as well as convertible notes issued prior to 23 October 1986 will be treated as equity for the purposes of imputation.

Under the credit allocation rules, imputation credits may have to be allocated to any returns to holders of those types of instrument. Similarly, imputation credits may also attach to dividends paid on redeemable preference shares.

Specified preference shares are now generally treated as debt for tax purposes. Dividends payable on this class of share are deductible for tax purposes and will not carry imputation credits.

5. What are the implications for shareholders?

Companies must notify shareholders, when dividends are paid or bonus shares are issued, of the amount of the imputation credit, if any, allocated to the dividend or bonus share.

Individual shareholders will return the net dividend received plus the imputation credit as taxable income. The shareholder will be able to offset the imputation credit against any tax liability on the dividend or other income in the income year to which the credit relates. Where a company issues assessable bonus shares, shareholders should be notified of the taxable amount attributable to each share.

Cash refunds are not available to shareholders for unused imputation credits in any income year. In addition, unused imputation credits are not available for carry-back or forward.

The imputation credit will only be available to those shareholders who are New Zealand residents at the time of payment of a dividend or issue of the taxable bonus share to which that credit is allocated.

The tax exemption for inter-company dividends will remain for dividends and bonus shares received from resident companies. The tax implications in respect of portfolio and non-portfolio dividends are dealt with under International Taxation.

Imputation credits will pass though a company with accumulated tax losses and be available for allocation to the shareholders of that loss company. Under the international tax reform proposals a New Zealand

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company will receive a credit for certain foreign taxes. Where the New Zealand corporate tax rate is set at a level comparable with, or lower than, our trading partners no further New Zealand tax may be payable. As only New Zealand tax paid is credited to the ICA those New Zealand companies that derive a high proportion of their income from overseas sources may have a significantly reduced ability to allocate imputation credits to New Zealand shareholders.

Imputation credits will not be available to non-resident shareholders of New Zealand companies. The credits are only available to New Zealand residents. Further, unlike the Australian approach, non-resident withholding tax on dividends will continue to apply even where the dividend paid or bonus share issued to a non-resident carries an imputation credit.

Where a New Zealand partnership receives taxable dividends and bonus shares with attached imputation credits those credits should be allocated to the partners based on their partnership interest.

The ability of companies to transfer imputation credits and the effect on resident and non-resident shareholders is illustrated through a series of examples at Appendix II. The examples assume a flate rate of corporate and individual tax of 25%.

The requirement for a company to deduct a withholding payment on the receipt of a foreign non-portfolio dividend will result in a further cash deficit. This may encourage the use of bonus issues rather than cash dividends to transfer imputation credits to shareholders.

6. Other matters and associated amendments

Provisional taxpayers may take into account in the calculation of their provisional income tax liability in any income year the imputation credits they expect to receive in that year. There are likely to be great practical difficulties in completing this calculation.

Where a company acts in the capacity of a trustee, taxation paid as trustee will not be subject to the imputation system.

Unit trusts are presently deemed to be companies for tax purposes. Therefore, distributions to unit holders are dividends which under imputation may have imputation credits attached. Similarly we assume that bonus units issued to unit holders will also be treated as a taxable dividend.

Excess retention tax which is currently imposed on "insufficient distributions" of profit by privately controlled investment companies will be repealed with effect from the income year commencing 1 April 1988.

Specific comment

1. There is some logic in the argument that bonus shares issued under a dividend reinvestment scheme should be taxable as a cash dividend. In this situation shareholders electing the cash dividends option receive a transfer of wealth from the company. Therefore, on the grounds of consistency, bonus shares in lieu should receive the same tax treatment. However, at the time at which a full bonus issue is declared there is no transfer of resources to a shareholder. In fact, the theoretical value of a share will fall in the same manner as if a share split had occurred.

Any concerns the Government has regarding the return of paid-up capital on liquidations can be alleviated by either:

(i) retention of the existing rules regarding the return of capital within a certain period; or

(ii) altering the tax definition of paid-up capital to exclude reserves capitalized by way of bonus issue.

Under these alternatives a tax liability is not imposed until there is an actual transfer of wealth from the company to the shareholder.

Although taxing bonus issues as dividends provides a company with the ability to pass imputation credits to shareholders without a cash cost there will be a cash flow disadvantage on the issue of bonus shares to non-residents. Non-resident withholding tax will still be required to be deducted by the payer company, resulting in a cash cost.

2. Restrictions placed on the allocation of imputation credits are designed to prevent the allocation of credits to only a particular class of shareholder. Clearly there is an advantage in retaining imputation credits for those shareholders who can use them, i.e. New Zealand residents that are paying tax. Dividends and bonus shares without credits would be directed to non-residents and tax-exempt shareholders. This is an area where substantial planning has been undertaken in Australia and it is clear the Government will attempt to prevent similar opportunities being available in New Zealand.

3. As currently proposed, the rules governing the allocation of credits do not recognize a distinction between different forms of equity thereby requiring the equal allocation of imputation credits over all classes of shares. This will impact on the pricing of certain financing transactions entered into by tax loss companies. Although such companies may not be paying any tax, they may accumulate credits to the ICA through the receipt of dividends. Loss companies may be forced to pass imputation credits to the holders of, for example, redeemable preference shares.

4. The examples detailed at Appendix II clearly illustrate that a New Zealand resident shareholder will be prejudiced where a New Zealand company derives substantial offshore earnings. In the examples, imputation and withholding payment credits of 23% as opposed to 25% were available to a New Zealand shareholder in receipt of a dividend from Company A.

The position is significantly worsened where the foreign subsidiary is not resident in a tax jurisdiction with which New Zealand has a double tax treaty. In this instance the percentage credit available would be reduced to 18% in example 1.

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The imputation system as proposed indicates a clear bias against offshore investment. Where offshore investment is undertaken there is a preference for investment in tax treaty rather than non-tax treaty countries.

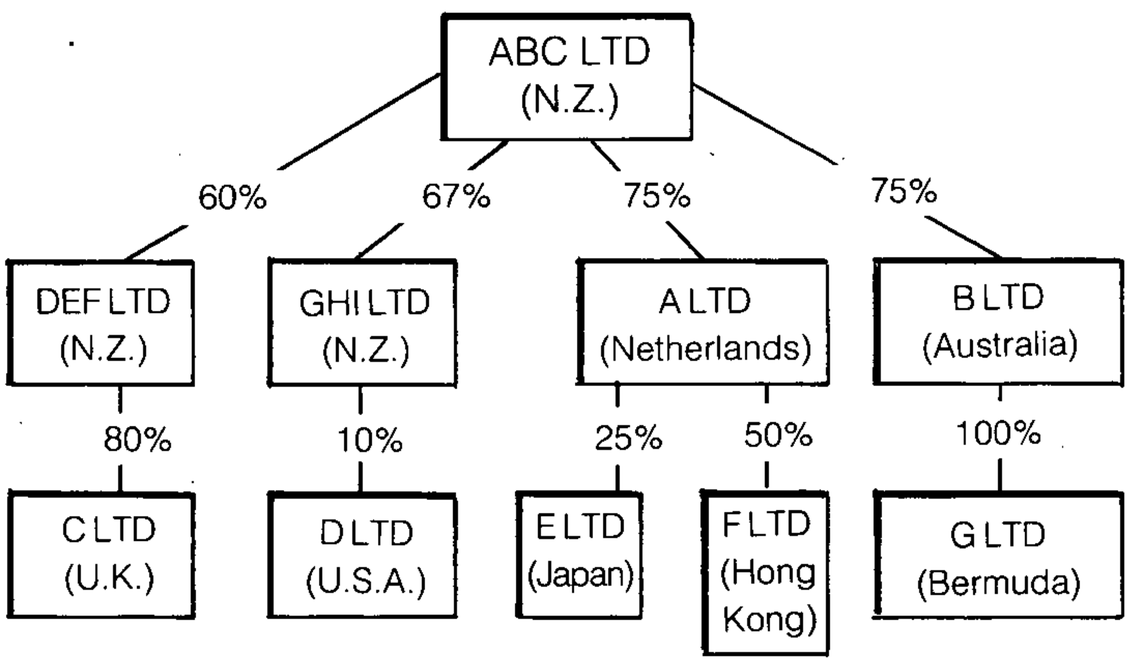
At present New Zealand has double tax treaties with only 22 countries. Government should therefore urgently expand our tax treaty network if the imputation proposals are to be implemented in their current form.

5. The non-resident shareholder receives the same amount of dividend net of withholding tax in both examples. However, if Government wishes to encourage foreign investment in New Zealand, non-resident investors should not be required to pay more than the underlying New Zealand rate of tax. Therefore where dividends are paid, or bonus shares issued, to non-residents which carry a full imputation credit, non-resident withholding tax should be eliminated.

Appendix I

International taxation

Illustrative calculation for a N.Z.-based group



Notes to Table of calculations below

1. Income computed under New Zealand tax rules and converted to New Zealand dollars at the applicable year and spot rate.

2. Publicly listed companies unable to obtain sufficient information to report their share of income on the branch-equivalent basis.

3. All foreign taxes are eligible for credit in New Zealand.

4. Calculated by multiplying through the chain of ownership.
Example – ABC Ltd's percentage interest in F Ltd:
75% × 50% = 37.5%

5. Calculated on the comparative-value basis:

	NZ$
Market value of interest at year end	600
Less market value of interest at beginning of year	(750)
Net loss	(150)

6. Calculated on comparative-value basis.

7. ABC Ltd's attributed foreign income and losses are able to be set off.

8. ABC Ltd and DEF Ltd are not group companies for New Zealand tax purposes, i.e. the commonality of ownership is less than two thirds. Therefore, foreign losses attributed to ABC Ltd cannot be offset against DEF Ltd's foreign income.

9. ABC Ltd and GHI Ltd are group companies for New Zealand tax purposes and therefore their foreign profits and losses can be offset.

10. Assume New Zealand company tax rate is reduced to 25%.

11. Low United States taxes due to tax preferences.

12. No credit for foreign taxes is available under the comparative-value basis.

13. Excess foreign tax credits in a given year appear to be lost forever under the proposals.

14. It is not clear whether foreign losses may be carried forward to future years.

Table of calculations

N.Z. company	Non-resident company	Income	Foreign taxes	Percentage interest	Share of income	Net of loss set-offs	N.Z. tax	Share of foreign taxes	Net N.Z. tax payable	Excess foreign tax credits	Foreign losses carried forward
	1	3		4			10			13	14
ABC LTD	A	500	210	75	375	225[7]	56	157	–	101	–
ABC LTD	B	(200)	–	75	(150)	–	–	–	–	–	–
DEF LTD	C	400	20[11]	80	320	320[8]	80	16	64	–	–
GHI LTD	D	N/A[2]	N/A[2]	10	(150)[5]	–	–	–	–	–	–
ABC LTD	E	N/A[2]	N/A[2]	19	200[6]	50[9]	12	–[12]	12	–	–
ABC LTD	F	1,000	185	38	380	380	95	70	25	–	–
ABC LTD	G	400	–	75	300	300	75	–	75	–	–

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Appendix II

Imputation

Illustration of Ultimate Tax Liability to Shareholders

Example 1

New Zealand company A

Assumptions
- New Zealand-sourced income 50%, foreign-sourced 50%
- United States subsidiary in a fully taxpaying position (corporate tax rate of 34%)
- Net earnings of United States company repatriated by dividend. Withholding tax of 15% imposed
- All amounts are stated in NZ$ equivalent

United States Subsidiary	*NZ$*
United States income	100
United States tax	34
	66
Withholding tax @ 15%	10
Net dividend paid	NZ$ 56

Company A	*NZ$*
United States income on a branch-equivalent basis	100
less distribution	66
	34
New Zealand-sourced income	100
	134
New Zealand tax @ 25%	34
Credit for United States tax (25% on NZ$ 34)	(9)
Loss of foreign tax credit of NZ$ 25	
New Zealand tax payable	NZ$ 25

Dividend distribution	*NZ$*
After-tax New Zealand profit	75
United States dividend	66
	NZ$ 141

Cash available		
New Zealand after-tax profit		75
Net United States dividend	56	
New Zealand withholding payment of 25% on NZ$ 66	(17)	
Credit for withholding tax deducted	10	
Net cash available		49
		124
Proposed dividend distribution		141
Cash deficit		NZ$ 17

ICA balance	
New Zealand tax paid	25
United States withholding tax	10
	35
Withholding payment account	7
	NZ$ 42
Percentage credit available 42/183	23%

New Zealand resident shareholder	*NZ$*
Net dividend received	141
Imputation credit	42
	183
Tax @ 25%	46
Imputation credit	42
New Zealand tax payable	NZ$ 4

Non-resident shareholder	
Dividend declared	141
Non-resident withholding tax at 15% (assume tax treaty country)	(22)
Credit for withholding payment deducted	7
Net dividend received	NZ$ 126

Note that where the foreign subsidiary is resident in a non-tax-treaty country the 15% overseas withholding tax would not be creditable to the ICA. Thus reducing the credits allowable to NZ$ 32 or 18%.

Example 2

New Zealand company B

Assumptions
- New Zealand-sourced income 100%

	NZ$
Company B New Zealand-sourced income	200
New Zealand tax payable @ 25%	NZ$ 50
Dividend distribution and cash available	NZ$ 150
ICA balance New Zealand tax paid	NZ$ 50
Percentage credit available 50/200	25%

New Zealand resident shareholder	*NZ$*
Net dividend received	150
Imputation credit	50
	200
Tax at 25%	50
Imputation credit	50
New Zealand tax payable	NZ$ NIL

Non-resident shareholder	
Dividend declared	150
Non-resident withholding tax	(23)
Net dividend received	NZ$ 127

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The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.

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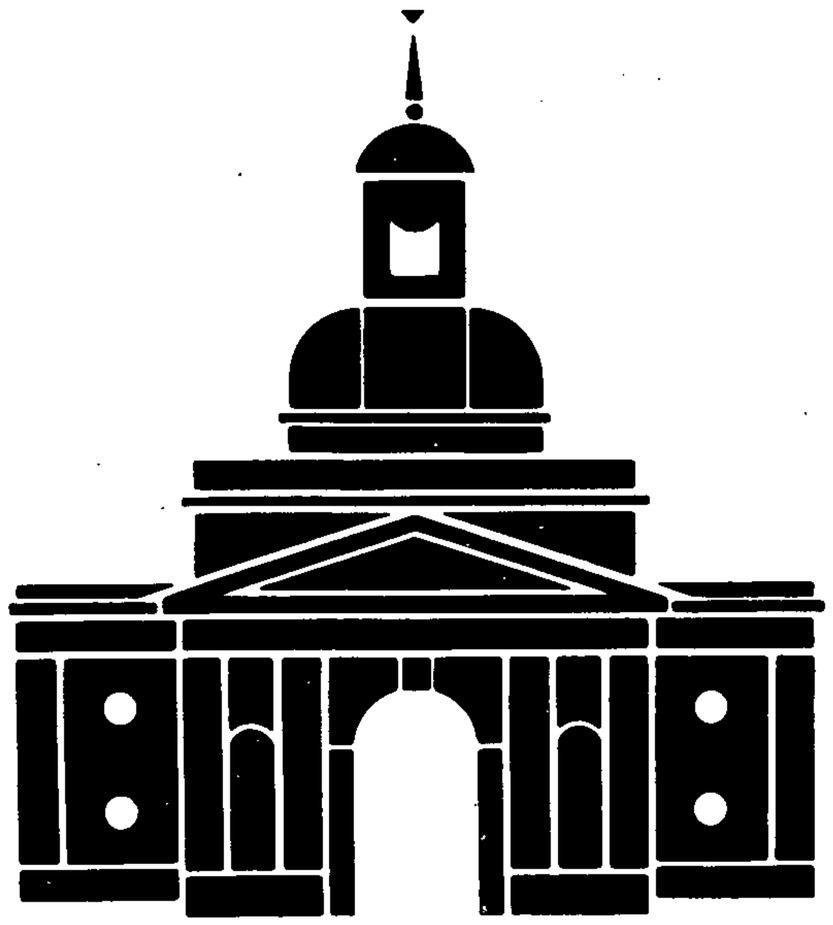

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Kanada: Ein Urteil über Transaktionen, bei denen eine ausländische „offshore" Körperschaft als intermediär fungierte: Indalex v. The Queen 202
Im Jahre 1987 erging ein Urteil des Föderalen Appelationsgerichtes, das sich mit der vom Nationalen Steueramt auf eine kanadische Körperschaft erhobene zusätzliche Steuer befasste. Das Steueramt war der Meinung, dass die kanadische Körperschaft für bestimmte Waren zu hohe Preise an eine affilierte ausländische Körperschaft bezahlt hatte. Das kanadische Steueramt jedoch beschränkte sich

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simples de prix de transfert multinational excessif, incorrect ou inadéquat versé par un contribuable canadien à un non résident ne se trouvant pas dans une position indépendante. Encore mieux, l'imposition du gouvernement reposait en premier lieu sur les dispositions de la loi ou sur les principes de la loi canadienne traitant des procédures ou des transactions en matière d'évasion fiscale. Cet article donne une analyse détaillée du cas Indalex contre The Queen.

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Singapour: Modifications de la loi sur l'impôt sur le revenu *217*
L'amendement à la loi sur l'impôt sur le revenu de 1988 a été approuvé par le Parlement le 13 janvier 1988 et est entré en vigueur le 29 janvier 1988. La loi introduit plusieurs modifications importantes à la législation existante: les plus importantes portant sur la législation contre l'évasion fiscale, le système d'affranchissement, un élargissement de l'application de certaines dispositions sur les retenues à la source, des allocations pour les bâtiments industriels, de l'application à un agent de change du taux de faveur de 10%. Cet article résume les points les plus importants de la loi de 1988.

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L'auteur décrit brièvement le récent Budget prononcé par le Ministre de Finances, M. Piers Jacobs.

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Cet article analyse 2 solutions significatives portant sur l'imposition des revenus en Indonésie, à savoir l'imposition des intérêts reçus et la déductibilité des intérêts payés, et le traitement fiscal distinct appliqué aux intérêts et aux dividendes. Les théories sur lesquelles reposent ces deux solutions sont exposées brièvement ainsi que la mise en application dans la législation indonésienne. L'auteur exprime, en conclusion, son opinion quant à la mise en application indonésienne de ces solutions.

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Vénézuéla: Consolidation du revenu net et pertes *232*
Certains groupes de sociétés recevant au Vénézuéla des revenus doivent remplir des déclarations de revenu consolidé. Le gouvernement vénézuélien a introduit à la fin de 1987 une réglementation et un décret d'application se rapportant à la consolidation du revenu net et aux pertes pour le paiement des impôts sur le revenu. Cet article analyse différents aspects de la réglementation et de la loi.

Ministère des Finances:

Hongrie: Réforme fiscale en Hongrie: Extraits des matériaux d'informations du Ministère des Finances *235*
Il s'agit d'une réimpression d'un document récent publié par le Secrétariat du Ministère des Finances hongrois portant sur deux lois nouvelles (l'une sur l'impôt général sur le chiffre d'affaires et l'autre sur l'impôt sur le revenu des personnes physiques) contenues dans la réforme fiscale.

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nicht nur einfach auf die Erhebung der Steuer über einen erhöhten Einkommensbetrag gemäss Paragraph 69(2) des kanadischen Income Tax Act, welcher sich mit einfachen und unkomplizierten Fällen von exzessiven, falschen oder unangemessenen Preisen zwischen multinationalen Körperschaften befasst, die von kanadischen Steuerzahlern an „non-arm's length" Ausländer bezahlt werden. Im Gegenteil, die Steuerveranlagung, die die Regierung aufzuerlegen versuchte, basierte sich hauptsächlich auf gesetzliche Bestimmungen oder Prinzipien des kanadischen Rechts, die sich mit Steuerhinterziehung und desgleichen befassen. Dieser Artikel bespricht im Detail *Indalex v. The Queen*.

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Lee Fook Hong:

Singapur: Zusammenfassender Überblick der durch den Haushalt 1988 vorgesehenen Steuerrechtsänderungen *213*
Der Verfasser beschreibt die neuen, im Haushalt für 1988 vorgesehenen Steuermassnahmen, welche besonders den Dienstleistungssektor Singapurs betreffen und somit die Förderung von Singapur als Geschäftszentrum zum Ziel haben. Obwohl die Körperschaftsteuersätze ungeändert bleiben, wird der effektive Höchstsatz der Steuer durch den Teil B der Zweiten Schedule des Income Tax Act auf 33% beschränkt. Weiterhin werden besondere Massnahmen für ausländische Investierungen in einem „Overseas Investment Incentive Scheme" vorgeschlagen. Auf Grund dieses Gesetzes wird es möglich sein, bestimmte Verluste bezüglich vom Staat genehmigten Investierungsprojekten vollständig vom Gewinn abzuziehen. Ein anderer Vorschlag dehnt eine Anzahl von Förderungsmassnahmen auf dem Dienstleistungssektor aus.

Alain Ahkong:

Singapur: Änderungen des Einkommensteuergesetzes *217*
Das Einkommensteueränderungsgesetz wurde am 13. Januar 1988 vom Parlament genehmigt und trat am 29. Januar 1988 in Kraft. Das Gesetz führte mehrere wichtige Änderungen zur früheren Gesetzgebung ein; die bedeutendsten Änderungen betreffen die Anti-Steuervermeidungsgesetzgebung, das „franking" System, die Ausdehnung bestimmter Quellensteuer-Bestimmungen, die Erweiterung von industriellen Bauvergünstigungen und die Erweiterung des 10%-Satzes der Konzessionssteuer für einen Wertpapierhändler. Dieser Artikel fasst die Hauptmerkmale des 1988er Gesetzes zusammen.

I.W. Harris:

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R. Mansury:

Einkommensteuer in Indonesien: zwei Fragen *226*
Dieser Artikel untersucht 2 bedeutende, die Einkommensteuer in Indonesien betreffende Fragen, d.h. die Steuerpflicht von erhaltenen Zinsen und die Abziehbarkeit von bezahlten Zinsen, sowie die unterschiedliche steuerliche Behandlung von Zinsen und Dividenden. Die theoretischen Begriffe beider Fragen, sowie die Durchführung in der Praxis nach der indonesischen Gesetzgebung werden skizziert. Zusammenfassend gibt der Verfasser seine persönliche Meinung über die Wirksamkeit der indonesischen Behandlung dieser Fragen.

Armando Montilla:

Venezuela: Gewinn- und Verlustkonsolidierung *232*
Bestimmte Gruppen von Körperschaften, welche Einkünfte aus venezolanischen Quellen beziehen, sind verpflichtet, eine konsolidierte Steuererklärung abzugeben. Die venezolanische Regierung verabschiedete Ende 1987 einen Erlass und eine Durchführungsverordnung bezüglich Gewinn- und Verlustkonsolidierung für die Steuerzahlung. Dieser Artikel untersucht verschiedene Aspekte der neuen Gesetzesbestimmungen.

Ministerium der Finanzen:

Steuerreform in Ungarn: Auszüge aus dem Informationsmaterial des Finanzministeriums *235*
Dies ist ein Nachdruck eines rezenten, vom Sekretariat des ungarischen Finanzministeriums veröffentlichten Dokumentes, betreffend 2 neue Gesetze der Steuerreform (eins über die allgemeine Umsatzsteuer und eins über die persönliche Einkommensteuer).

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A Note on the Fragility of International Tax Comparisons

By Richard Bird*

It is always interesting, if not necessarily always meaningful, to compare one country with others. Such comparisons are seldom, however, of much use in analyzing or understanding the public finances of any country. This note demonstrates this point with respect to some comparisons that have been made recently with respect to Papua New Guinea's public finances. The first panel of Table I compares Papua New Guinea's tax structure in the 1978-80 period with that of 61 other developing countries which had around the same GDP per capita. The overall tax ratio in Papua New Guinea is a bit lower than the average for the group (or for that matter the 17.5% for all 61 developing countries included in Tanzi's recent (1987) study). Moreover, in terms of the composition of tax structure, the much greater relative importance of income taxes in Papua New Guinea is clear from Table I. Excises are considerably more important in Papua New Guinea than the average, although import duties are less important. Two additional aspects of tax structure confirm these latter relationships: import duties are less than half as important relative to imports in Papua New Guinea as in other developing countries, while excises on alcohol and tobacco products are relatively much more important than in other countries (Bird 1987). Again, much the same picture would appear if comparisons were made with the entire developing country sample.

An obvious peculiarity of Papua New Guinea in terms of such international fiscal comparisons is that it receives no revenue from either general sales taxes or taxes on property. This illustrates the first point to be made about international fiscal comparisons: it is always difficult to ensure that what is compared is really comparable. In Papua New Guinea, for example, both sales and property taxes are in fact levied at the provincial level, although not in a very satisfactory form. As of 1987, 10 of the 19 provinces levied a general "retail" sales tax at rates of 2 to 4% and in addition many levied specific sales taxes on alcohol, tobacco and a few other items (Bird 1987). Four provinces also levied land taxes, although in 2 provinces the tax is limited to the urban areas (Bird 1983). The only significant source of internal revenue in most provinces is thus the sales tax. In 1982, the last year for which fairly complete collection data are available, provincial sales taxes constituted 45.6% of total provincial internal revenue – although only 4.1% of total provincial revenue (Axline 1986) and only 16.3% of central excises. The next most important tax was the land tax, which provided 19.8% of total provincial internal revenue and 1.8% of total provincial revenue. In total, provincially-generated revenue in 1982 amounted to only 4.3% of total central internal revenue (calculated from Bird 1987).

If provinces are not very important fiscally, local governments are of no fiscal importance at all in Papua New Guinea. Prior to independence in 1975, a number of local government councils were established (157 as of 1972), which derived a substantial fraction of their rather limited internal financial resources (38% of their total revenues in 1972) from head taxes which ranged up to $ 14 per adult male, although averaging less than $ 1 per capita for the country as a whole (Australia 1974). There were still 244 local government bodies of various sorts in existence, at least in principle, in 1985 (Regan 1986). However, with the exception of the National Capital District, none of these units collected any significant revenue (Bird 1983). Their only real source of revenue was the personal (head) tax, and head tax collections everywhere have fallen so drastically that this traditional fiscal institution has by now probably fallen into irredeemable disrepute in Papua New Guinea (Bird 1983).

Assuming (probably correctly) that no revenue to speak of is now received from local government taxes, the internal revenue of all levels of government in 1982 may thus be estimated at 400 million K, with the Central Government accounting for 95.9% of the total. Even with respect to domestic consumption taxes, taking the provinces into account raises the share of such taxes only from 16.5 to 18.3% of total tax revenues – a figure still well below any relevant average for developing countries. In this instance, then, correcting for this omission makes little difference.

A similar qualification that should be made to the international fiscal comparisons set out in Table I concerns social security. Contrary to what the table indicates,. there has, in fact, been a social security tax levied in Papua New Guinea since 1981 when the National Provident Fund was established. This Fund, which is financed by a 7% payroll tax on employers

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and a 5% tax on employees, covers non-agricultural companies with more than 25 employees. These payroll taxes produced 11.3 million K in revenues in 1983 and 11.9 million K in 1984 (National Provident Fund 1985).

This additional levy of 12% on salaries and wages should clearly be taken into account in evaluating Papua New Guinea's tax structure. It may be compared, for example, to the 14.7% average income tax rate on salary and wage income in 1986 (Lohnberger n.d.). If the same rate applied in 1984, the potential payroll tax base in that year would appear to have been in the order of 847 million K (Papua New Guinea, Chief Collector of Taxes 1985). The base for Fund contributions in fact was only 99 million K, or 12% of the total, however, which suggests that the 75% or so of employees who are not covered under the Fund must, in addition to excluded public sector employees, include most higher income expatriates in the private sector.

In any case, if the entire Fund levy is treated as an additional direct tax on income, personal income taxes would have constituted 38% rather than 36% of tax revenues in 1984 (Bird 1987), thus accentuating even further Papua New Guinea's apparent direct tax "dependence". Of course, given the ability of contributors to withdraw their contributions (with interest) under a wide variety of circumstances, these contributions are really taxes only to the extent that the rate of return is below that which could be earned in the market (plus the welfare costs of forcing workers to save in this way). Again, this correction does not, in this particular instance, alter the general thrust of the structural comparison in Table I: but, since no doubt similar, perhaps more substantial adjustments could be made in many of the other countries as well, it does serve to point out the need for great care in using such numbers.

More important than such minor statistical corrections is the misuse to which such international comparisons are often put, in particular to measure the relative degree of "tax effort" made by a country. The first 2 sets of figures in Panel B of Table I, for example, come from a recent study by Lim (1987), which follows the now traditional "IMF method" of comparing Papua New Guinea's actual tax ratio in the period indicated with the ratio "predicted" on the basis of a regression equation calculated for a large group of developing countries taking into account the relative importance of such characteristics of economic structure assumed to determine "taxable capacity" as the sectoral composition of output (e.g. the importance of mining) and the importance of foreign trade.

Although, as the table shows, there is considerable variation in the results produced by this method, depending upon the particular equations and years employed, on the whole Lim's results clearly suggest that Papua New Guinea's tax performance has been relatively poor during the 1965-81 period, especially given its wealth of natural resources. Similar results emerge from the most recent IMF calculations for the 1974-79 period, using a somewhat different equation specification. Lim (1987) interprets these figures not only as evidence of poor performance but as indicating that performance actually became worse in the non-mining sector between the 2 periods he studied (because the effort ratio fell from 88 to 77% when mining activities are omitted).

However, no credence at all should be placed on these results for a number of reasons (some but not all of which are recognized by Lim). In the first place, quite apart from possible biases in the sample and the meaninglessness of using an average of a group of disparate countries essentially as a normative standard, there is no real rationale for the explanatory variables used in the estimating equation: some of them may, for instance, measure the demand for pub-

TABLE I
Papua New Guinea and International fiscal comparisons

Panel A. Descriptive statistics

	Average for group[a] (% of GDP)	Papua New Guinea (% of GDP)	Average for group (% total taxes)	Papua New Guinea (% total taxes)
Personal income tax	2.2	4.6	11.8	28.3
Company income tax	4.0	5.2	20.8	32.0
Excises	1.8	2.6	10.4	15.9
Import duties	4.3	3.0	24.1	18.7
Export taxes	1.0	0.5	8.4	3.1
Social security taxes	1.7	—	9.2	—
General sales tax	1.6	—	8.9	—
Property sales	0.5	—	2.9	—
Total[b]	17.5	16.2	100.00	100.00

Panel B. Evaluative statistics

Tax revenue effort index

1965-73[c]	67.0 or 88.0 (excluding mining)
1981[c]	84.5 or 77.2 (excluding mining)
1974-79[d]	83.4 or 87.7 (ranking 39 or 43)

Total revenue effort index

1974-79[d]	94.4 or 116.6 (ranking 6 or 58)

Tax buoyancy	*1965-77[e]*	*1974-84[f]*
Customs duties	0.49	1.64
Excise duties	2.22	1.27
Personal income taxes	2.23	1.46
Company income tax[g]	1.57	1.36

a) 1978-80 averages for 11 developing countries with per capita GDP between US$ 650-1050 (Tanzi 1987).
b) Total includes "other" not shown separately.
c) Out of 52 (1965-73) and 50 (1981) countries (Lim 1987).
d) Out of 61 countries (Tabellini 1985).
e) Thac and Lim (1984).
f) Lim (1987).
g) Excluding revenues from Copper (BCL) Company.

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lic expenditure and hence be quite useless for the purpose for which they are employed, that is, as measures of "tax capacity" (Bird 1976).

Secondly, an alternative formulation of "effort" (initially suggested by Bird (1976)), which compares the amount of discretionary effort to raise various taxes with the inherent elasticity of the existing tax structure, found, in complete contrast to the results in Table I, that a substantial effort had in fact been made to improve tax performance in the 1965-77 period as, indeed, had been shown in an earlier paper by Lim (Thac and Lim 1984; see also Bird 1987 for updated numbers). In particular, great efforts were made to raise customs duties throughout the 1974-84 period, with at least nine discretionary increases being made. There were also substantial discretionary changes in excises and income taxes. The result was a continuing high tax buoyancy coefficient in both the pre and post-independence periods (see Table I, Thac and Lim 1984, and Lim 1987). Contrary to the impression left by the "IMF" figures (based entirely on cross-sectional comparisons) then, Papua New Guinea has, it may be argued, more or less continually attempted to extract more revenues from its tax base. Rather than inadequate "tax effort", its real problems, as discussed more extensively in Bird (1987) lie in 2 other directions: first, the fact that it has been set (or has set itself) a virtually impossible target in terms of increasing taxation and, second, the fact that its major tax bases are in some major respects shrinking rather than expanding, and that it has not as yet been able to develop new bases to replace those that are disappearing. Neither of these problems is even hinted at by the usual international tax comparisons, which instead focus attention on largely irrelevant "average" tax ratios.

Finally, as a last comment on the "tax effort" literature, it may be salutary to consider briefly the most recent IMF figures, shown in Panel B of Table I under the heading of "total revenue effort index". Tabellini (1985) has demonstrated clearly that the conventional regression estimates of tax capacity are almost certainly badly misspecified. He has also made a good case, as one way to reduce this misspecification error, for using total revenues rather than tax revenues in the estimating equation. Unfortunately, the resulting total revenue effort index turns out to be extremely sensitive to the correction for simultaneous equations bias. In the case of Papua New Guinea, for example, as Table I shows, its "effort" rank changes from 6th to 58th (out of 61 countries) depending on the size of this correction. Moreover, there is little correlation between either the different total revenue indexes or these indexes and the tax revenue indexes.

In short, it is hard to disagree with Tabellini's conclusion that basically no reliable international comparisons can be made using any of these equations. Nor, as Bird (1976) has stressed, would such cross-sectional comparisons necessarily tell us anything useful about any particular country in any case, even if all the data and econometric problems briefly touched on above could be overcome. On the whole, then, I see no reason to alter my conclusion of a decade ago (Bird 1976) that those interested in taxation in developing countries would be well advised to pay more attention to the details of the particular countries in which they are concerned and less to largely irrelevant international tax comparisons.

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CANADA:

An Offshore Transshipment Company Case: *Indalex v. the Queen*

By Nathan Boidman

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I. INTRODUCTION & SYNOPSIS OF CASE

A decision handed down by the Federal Court of Appeal late last year affirms some recent developments in Canada's intercompany pricing rules.[1]

The case of *Indalex*[2] involved an assessment levied by the Department of National Revenue (Revenue Canada) against a Canadian company, Indalex Limited, for allegedly paying excess intercompany (transfer) prices to a related non-Canadian company, Pillar International Services Limited, for a product, aluminum billets, used by Indalex in its business of extruding (moulding) aluminum billets for fabrication in various products including aluminum doors, windows, ladders, etc.

The key reason for the dispute between the parties undoubtedly was the fact that Pillar International was not simply a related party supplier but one which served as a transshipment point or middleman in what presumably otherwise would have been a direct purchase of the aluminum billets by Indalex from an unrelated, third party Canadian company, Alcan Ingot (a subsidiary of the Canadian-based multinational, Alcan Aluminum of Canada Limited). The assessment questioned the purpose for a non-resident person (Pillar International), not otherwise carrying on a trading business in Canada, being interposed between 2 Canadian companies, Indalex (the related purchaser) and Alcan Ingot (the unrelated vendor).

The government did not simply assess an addition to the income of Indalex pursuant to and in accordance with the provisions of Sec. 69(2) of the Income Tax Act (hereinafter "the Act"), which governs a simple and straightforward case of an excessive, incorrect or inappropriate multinational transfer price,[3] paid by a Canadian taxpayer to a non-arm's length non-resident.[4] Instead, Revenue Canada's assessments against Indalex were grounded primarily on the basis of legal rules or principles of Canadian tax law which deal with (improper) tax avoidance procedures or transactions (whereas the intercompany pricing rules of Sec. 69(2) of the Act contain, at least, on their face, no such pejorative connotation). Revenue Canada argued the following:

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1. The interposition of Pillar International in the transaction constituted a sham so that it should be ignored with the result that any profits it derived from the transaction would be added back to the profits of Indalex. This basis for the Department's position, resting on a prior decision of the Federal Court in *Dominion Bridge,*[5] discussed further below, was stated by Madame Justice Reed (of the Trial Division, at page 6041) as follows:

> They (the profits earned by Pillar International) were in reality earned by the plaintiff: the involvement of Pillar International was a sham. . . (parenthetical words added).

2. Alternatively, ". . . the purchases were made pursuant to an incomplete and ineffective contract" – that is the doctrine of ineffective transactions, so that any (net) payments made to Pillar International by Indalex should be ignored and added back to the income of the latter.

3. Alternatively, the net payments made by Indalex to Pillar International should be disallowed as a deduction to Indalex pursuant to and by reason of the provisions of Sec. 245(1) of the Act, which deals with "artificial" expenses. Sec. 245(1) reads as follows:

> In computing income for the purposes of this Act, no deduction was made in respect of a disbursement or expenses made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce income.

Only as a fourth basis did the Crown then argue the intercompany pricing rule of Sec. 69(2), which was coupled with another provision (Sec. 67 of the Act)[6] dealing with unreasonable expenses.

Based on the facts, the Federal Court Trial Division:
1. distinguished *Dominion Bridge* and rejected the sham theory, as well as the allegation that the transactions with Pillar International were legally ineffective;
2. decided, on the basis of an earlier transshipment case, *Spur Oil,*[7] that Sec. 245(1) has no application in respect of an intercompany pricing case of this type, except insofar as the price paid exceeds an arm's length or non-controlled price, which therefore meant that the issue was to be essentially determined pursuant to the intercompany pricing rules of Sec. 69(2); and
3. concluded that the price paid was excessive (by an amount equivalent to 80% of the profit earned by the Bermuda company, Pillar).

A related issue (discussed in C below) was the applicability of a tax on disguised distributions to non-residents, in relation to an excessive transfer price.

In a decision handed down on 21 December 1987, the Federal Court of Appeal, in respect of the appeal by the taxpayer and the cross-appeal by the Crown, upheld the reassessments in their entirety thereby reallocating all of the Bermuda company's income to the Canadian subsidiary.

II. THE DECISION BY THE TRIAL DIVISION

A. The facts

1. The basic structure and relationships

During the years in question (1971 and following), Indalex was an indirect (partially owned) subsidiary of the U.K. Rio Tinto-Zinc Corporation Limited group (RTZ), having been acquired in 1970 when RTZ took over Pillar Holdings Limited, which in the early sixties had been a "small London-based publicly quoted holding company with interests in 7 or 8 different businesses" (at page 6041). Pillar Holdings had been built up by its founders, Messrs. Paterson and Fredjohn, "into a successful aluminum extruding company having subsidiaries in, at least, Canada and Germany, as well as the United Kingdom".

As explained below, neither Court considered significant that the RTZ-Pillar group owned only 58% of Indalex, through the shares of Indal, an intermediary 100% Canadian parent of Indalex, the shares of which were publicly listed on the Toronto and Montreal stock exchanges.

Prior to the RTZ takeover in March 1970, Pillar International had been established in Bermuda, as a 100%

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1. For a full discussion, see Nathan Boidman, "Transfer Pricing in Canada", Chapter in *The Tax Treatment of Transfer Pricing* (1987), published by the International Bureau of Fiscal Documentation.
2. *Indalex Limited v. The Queen,* 86 DTC 6040 (F.C.T.D.), 88 DTC 6053 (F.C.A.).
3. Sec. 69(2) of the Income Tax Act, S.C. 1970-71-72, c.63 as amended (herein "the Act"), reads as follows:
   Unreasonable consideration. Where a taxpayer has paid or agreed to pay to a non-resident person with whom he was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as 'the reasonable amount') that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefor.
4. Sec. 251(1) of the Act defines as non-arm's length those persons who are either "related" within the meaning of Sec. 251(2) or unrelated parties who in fact do not deal at arm's length, a condition which the courts consider to arise where the parties do not have separate economic interests or where one imposes its will upon and dominates the actions of the other. Under Sec. 251(2), "related" persons include a corporation which controls another or 2 corporations controlled by the same third party. In the *Indalex* case, Indalex and Pillar International are both indirect subsidiaries of the same U.K. company, Pillar Holdings (as discussed further in the text), and thus related under the latter rule and did not deal at arm's length under the first branch of the rule in Sec. 251(1).
5. *Dominion Bridge Co. Ltd. v. The Queen,* 75 DTC 5150 (F.C.T.D.) and 77 DTC 5367 (F.C.A.).
6. Sec. 67 of the Act reads as follows:
   In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.
7. *Spur Oil v. The Queen,* 80 DTC 6105 (F.C.T.D.) and 81 DTC 5168 (F.C.A.).

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subsidiary of Pillar Holdings. The Trial Division noted that:

> . . . one motivation, at least, for the establishment of the Bermuda company was to allow Pillar Holdings (RTZ-Pillar) to establish a pool of capital offshore free from United Kingdom income tax and exchange controls. Whether it was created or used to avoid Canadian taxes as well is not something one would expect to hear from the mouths of the plaintiff's witnesses. Nothing stands or falls on the failure to find in the evidence any express intention in this regard. (at page 6042)

Pillar International's activities were administered by the Arthur Young and Company affiliate in Bermuda (at the inception) with the first full-time employee engaged in January 1971. The company, through its full-time "managing director" – first a Mr. Sechiari and then a Mr. Johnson – "administered the billet purchasing contracts, not only for the plaintiff (Indalex) but also for at least some of the other Pillar extruders some of the time" (at page 6042). More particularly:

> They (the managing directors of Pillar International) managed the paper flow; they seemed to have some authority to resolve minor administrative matters; they accompanied, at least on some occasions, Messrs. Paterson and Fredjohn (later Mr. Greenwood) when prices were being negotiated. They also ensured that the banking arrangements worked smoothly and they arranged for loans from the Bermuda bank account to RTZ-Pillar Pacific Limited in Australia, and Rallip (Canada), as well as to other Pillar subsidiaries, when directed to do so by RTZ-Pillar. (at page 6042)

2. The third-party arrangements

The transshipment arrangements originated in a 1965 umbrella agreement between Alcan Aluminum Limited and Pillar Holdings pursuant to which some but not all of the Pillar group of companies purchased specified percentages of the aluminum requirements from Alcan group companies.

> Each extruding company in, for example, Germany (and subsequently Portugal) was required to purchase 50% of its aluminum requirements from an Alcan group company. Each of the extruding companies in Canada and the United Kingdom was to purchase 80% of their requirements from an Alcan company. (at page 6042)

Then in February 1970 the Bermuda subsidiary, Pillar International, assumed responsibility for the 1965 umbrella agreement and undertook to "purchase these quantities, rather than the extruding companies doing so directly". (at page 6042)

The revised 1970 (umbrella) agreement had a long (15-year) term but its "effective terms were negotiated in a much shorter time span" (at page 6042). Pillar (group) was not required to purchase from an Alcan supplier "if there was available from another source at least 4 months' supply of aluminum, equal in quality, on terms no less favorable and at prices 2% below those offered by Alcan" (at page 6042). On the other hand, Alcan was required to pay Pillar International "a discount of 1½% of the total value of the purchases made by the Pillar group during the year". (at page 6042)

A supplementary letter agreement set forth the pricing mechanism:

> . . . Alcan would charge extruders in Germany, the United Kingdom and Canada, the list price respectively in each of those countries and that it would give Pillar International a minimum discount of the 'gross' value of the purchases of: 8% in Germany, 9% in the United Kingdom and 10% in Canada. These discounts were to be paid contemporaneously with payment for the billet (on a monthly basis in sterling, Canadian dollars or Deutsche marks as Pillar International should direct). (at page 6042)

(*Alcan Ingot* sold the aluminum billet at standard list prices; Alcan Aluminum (the parent) was nominated to pay the discounts.)

In contrast to the master agreement, the latter agreement terminated purchasing commitments "if a 1% better price could be obtained elsewhere". The latter agreement also provided for certain maximum and minimum purchases by the Pillar group from the Alcan group as well as a procedure for drawing down under the contract one year in advance by October of any given year within such limits.

Prices paid to Alcan by the Pillar group were "negotiated by Mr. Fredjohn (later succeeded by Mr. Greenwood) and sometimes Mr. Paterson". Mr. Fredjohn (one of the founders of Pillar) became Chairman and Managing Director of RTZ-Pillar after the takeover by the RTZ group. Mr. Paterson, the other co-founder, was Finance Director of RTZ. As well, both were directors of Pillar International, in which capacity they were said (by the taxpayer) to negotiate the prices with Alcan. Madame Justice Reed took exception to the latter point:

> This is a conclusion I am not willing to accept. Pillar International was clearly a vehicle for carrying out the purposes of RTZ-Pillar. Messrs. Paterson and Fredjohn (later Mr. Greenwood) when negotiating price were operating in the interests of RTZ-Pillar (as the apex of the pyramid of the Pillar group companies). (at page 6043)

In the context of the issue before the Court it is difficult to fully comprehend the reason for the apparent significance to Madame Justice Reed of that distinction. This is particularly so because Her Lordship relied upon the facts respecting price negotiations by these gentlemen to distinguish the *Dominion Bridge* case and rejected the Department's contention that Pillar International should be viewed as a sham.

Contrary to the umbrella agreements, actual prices negotiated from Alcan by Pillar International were established at discount of between 12% and 17% from list price during the years 1970-1972. After September 1972 there was no clear list price in respect of which such comparisons could be made. The Court noted these actual prices departed from the terms under the umbrella agreement and the supplementary letter and that:

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The defendant (Revenue Canada) argues that even during this period of time the list price was ineffective in determining the transaction price. It is argued that from mid-November 1973 to December 1974 Alcan's published list price was merely adjusted upward . . . in lock step with the effective transaction price. That would certainly seem to have been the case. Mr. Adams, an expert witness called by the plaintiff, testified that in 1973-74 effective transaction prices were at a premium over list. It was a period of tight supply. Mr. Adams' statement was general in nature, not supported by any concrete evidence with respect to the Canadian Alcan list price as it related to the effective transaction price. Nor does Mr. Culver's evidence establish the plaintiff's contention. There is no reliable evidence from which I can conclude that during the November 1973-December 1974 period (or for the first 6 months of 1970) the 10% played any effective role with respect to the price paid by Pillar. Whether the minimum discount played any role with respect to the price paid in the United Kingdom or German markets is not clear. The list prices prevailing in those countries and the prices paid by the Pillar extruders there were not subjects of evidence in this case. (at page 6043)

3. The intercompany arrangements

In light of the Alcan-Pillar International arrangements, the contractual terms between Indalex and Pillar International may be summarized as follows:

1. On 4 November 1970 Indalex signed an agreement with Pillar International to acquire aluminum billets. The agreement noted that Alcan Ingot had been designated by Alcan Aluminum as the Canadian supplier for the purposes of that agreement.

2. The precise terms under which Indalex would purchase billets from Pillar International were "to be agreed upon by the parties from time to time or as evidenced by their course of dealing" and the price was to be "the official list price minus an amount for scrap returns calculated at such rates as the parties should from time to time agree". Furthermore, "Pillar was to pay the plaintiff (Indalex) a discount from the list price such as to render the price to Pillar competitive. This rate of discount was to be 6% for the first 12 months (in fact this was changed within 6 months) and then after as the parties would agree." (at page 6043)

3. The mechanics of the transactions between the parties entailed the following:

(a) Indalex would send a purchase order for billets to Pillar International in Bermuda with a copy being sent, at the same time, to Alcan Ingot.

(b) "On receipt of the purchase order, Pillar International masked out the plaintiff's letterhead, replacing it with its own (keeping the original invoice number) and forwarded that order to Alcan Ingot." (at page 6040)

(c) The Court noted that "Alcan Ingot acted on receipt of the copy which had been received from the plaintiff . . .". (at page 6040)

(d) The billet was shipped directly by Alcan Ingot to Indalex with invoices however going from Alcan Ingot to Pillar International and the latter reinvoicing Indalex. The invoices were in both cases at list price with, as described earlier, supplementary credit invoices for the appropriate discounts, from Alcan Aluminum to Pillar International, and then, at lower rates, from Pillar International to Indalex being processed. More particularly:

> When payment was subsequently made, on what was called settlement day, the plaintiff (Indalex) credited Pillar International's Bermuda bank with the identical sum and Alcan Aluminum Limited of Canada paid to Pillar International's Bermuda bank (Butterfield) which has an account in a Canadian bank in Montreal, a discount attributable to the purchase price. This discount was paid partly in U.S. dollars and partly in Canadian dollars. The U.S. dollars were forwarded to Bermuda to the credit of Pillar International's bank account there; the Canadian dollars were forwarded to the credit of the plaintiff's Canadian bank in Toronto.
>
> (at page 6040)[8]

In other words, the settlement arrangements were designed to effect immediately the allocation of overall price between the parties.

4. Bona fide negotiations within the group?

Madame Justice Reed found that as a matter of fact prices paid by Indalex to Pillar International were effectively determined by the parent company, RTZ-Pillar through Messrs. Fredjohn and Paterson, and *did not* result from a negotiation process between Indalex and Pillar International:

> Mr. Stracey (the Chairman and Chief Executive Officer of Indal, the Canadian parent of Indalex, and President of Indalex) may have been vigorous in discussions as to price. From his demeanour on the witness stand, I would expect this to have been the case. But after all was said and done I have no doubt that it was RTZ-Pillar in the person of Messrs. Fredjohn (later Greenwood) and Paterson who finally determined the price.
>
> (at page 6044)[9]

The legal significance of this finding must not be overstated. As discussed earlier, by statutory definition, Indalex and Pillar International do not deal at arm's length. Accordingly, Sec. 69(2) of the Act, then, requires an (objectively determinable) arm's length price between the parties. While it is true that evidence of conscientious arm's length *negotiations* between members of a group, each apparently acting in their own interests, would be of assistance to the Court in making a determination, which at least in part is based on subjective and intangible elements, the absence of such arm's length negotiations (as Madame Justice Reed found in this case) will not in and of itself under-

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8. The Court also noted that:
The payment by the plaintiff to Pillar International, by Pillar International to Alcan, and the payment of the related discounts all took place simultaneously on the same day, through electronic banking facilities, in accordance with standing instructions filed with the respective banks.
(at page 6040)

9. This is an especially interesting aspect of the decision and the Court's findings and Her Lordship's comments underlying said conclusions at pages 6043-6044 should be read in their entirety.

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mine the taxpayer's position nor should evidence thereof automatically support it.

B. Analysis of the decision

1. Sham-business purpose doctrine

The Crown argued that the arrangements lacked business purpose and therefore should be struck down as a sham. Madame Justice Reed, citing the 1984 Supreme Court decision in *Stubart Investments Ltd. v. the Queen,* 84 DTC 6305,[10] rejected this argument:

> Thus the sham test when applied as a general principle of statutory interpretation requires that for a transaction to be disregarded by the Court it must exhibit an element of deception, not merely be found to have no business purpose other than tax avoidance.
> (at pages 6044 and 6045)

Her Lordship in a finding of fact that no such deception existed notwithstanding that there was "some evidence of direct dealing between Indalex and Alcan Ingot . . . and I am sure that on a daily basis many aspects of the transactions were dealt with directly by the plaintiff". The Court also noted, in this context, that:

> . . . Indalex of Indal, in the person of Mr. Stracey, would have been the major source of market information on which price negotiations with Alcan respecting the Canadian market proceeded. Equally, the quantity of billet to be purchased was determined by Indalex – by providing three year projections and then the yearly October request to Pillar International. The evidence of Mr. Sechiari was that Pillar International 'distilled' the projections received from the Pillar group extruders and passed them on to Alcan. I think a fair inference is that Pillar International did not perform much more than a collating or post office function in this regard. But, the evidence indicates that Indalex did not directly negotiate price with either Alcan or Alcan Ingot. The price which Pillar paid to Alcan was negotiated by Messrs. Fredjohn (later Mr. Greenwood (and sometimes Paterson). The price which Indalex paid to Pillar International was equally dictated by these gentlemen.
> (at page 6045)

The Court distinguished its prior decision in *Dominion Bridge,* supra, without elaboration (in dismissing the sham argument):

> Having so found it is not necessary for me to discuss the other cases cited on this point: . . . *Dominion Bridge Co. Ltd. v. The Queen* . . . . (footnote 1 at page 6045)[11]

It can also be noted that the other major Canadian case involving an offshore transshipment company, *Spur Oil Ltd.,* supra[12] involving the purchase by a Canadian company of oil through a related Bermuda company, was not attacked by Revenue Canada on the basis of sham but rather under the Sec. 245(1) artificial expense rule discussed elsewhere herein. The Federal Court of Appeal, in reversing the finding of the Trial Division, did note that the Crown argued that the finding of the lower court amounted to "a finding of sham". In response the Federal Court of Appeal stated:

> First of all, it is clear from his reasons that the learned Trial Judge did not make a finding of sham. Furthermore, it is my opinion that the facts of this case do not fit the generally accepted definition of sham provided by Lord Diplock in the *Snook* case . . . .
>
> On the uncontradicted evidence in this case, particularly the evidence detailed supra with respect to the purchase by the Appellant and the sale by Tepwin (the offshore subsidiary) and with respect to the evidence of the complex accounting procedures carried out with respect to the actual payment for subject crude oil, it is not possible, in my view, to make a finding of sham.[13]

It is difficult to reconcile this conclusion with the finding in *Dominion Bridge,* having regard to the observation by the Court of Appeal in *Spur Oil,* that the evidence adduced at trial led to a finding that:

> It was never intended that the officers and directors of Tepwin in Bermuda would exercise management and control of Tepwin's business in any aspect . . . Instead they were to carry out the instructions given by the officers and directors of the U.S. parent, and, to a lesser degree in certain matters, the instructions given by the officers and directors of the Canadian parent and the Appellant. (at page 5169)

2. Ineffective/incomplete transaction doctrine

The Crown argued strenuously that the purchases by Indalex from Pillar International were legally ineffective, that the underlying contract was "incomplete and ineffective". It adduced expert testimony to that effect but the taxpayer countered with its own expert witness, who testified that this agreement was an enforceable contract in Bermuda. Part of the issue was whether the price under the contract was certain or ascertainable, bearing in mind the rather loose and informal nature of the arrangements described above.

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10. See Nathan Boidman, "Canadian Supreme Court Rejects the Business Purpose Test – Stubart Investments Limited v. The Queen", 13 *Tax Management International Journal,* 8 (August 1984) at 251. In its 18 June 1987 and 16 December 1987 tax reform proposals, the Department of Finance proposed a form of statutory business purpose test. See Allan R. Lanthier, "Canada: Proposals for Tax Reform", 41 *Bulletin for International Fiscal Documentation* 11 (1987) at 495.

11. *Dominion Bridge* similarly involved the purchase by a Canadian operating company of raw material supplied through an offshore transshipment company (Span). However, the facts were more egregious: Mr. Justice Decary at page 5154:

> The means resorted to by the Appellant for the operations of the business of Span and the manner in which Span was controlled and managed by the Appellant preclude my being able to find that the business of Span was its own and was not that of the Appellant. I believe that the Appellant has camouflaged, disguised the operations of Span to make them appear as independent of the Appellant's whereas, in fact, the evidence, documentary and oral, is pervaded with the control, management and presence of the Appellant, its sole client. (at page 5154)

It is deception of this type (found not to exist in the *Indalex* case) which seemingly was distinguished in *Indalex.*

12. There has also been a criminal tax charge in respect of an offshore transshipment company on the basis of "criminal sham". The taxpayer was acquitted. *Redpath Industries Ltd. et al. v. The Queen,* 84 DTC 6349 [Quebec Superior Court, upholding the decision of the Quebec Court of Sessions of the Peace (83 DTC 5117)]. See Nathan Boidman, "Criminal Sham?: R. v. Redpath Industries", *Tax Management International Journal,* 83-10 (October 1983), (Trends – Canada) at 28, and Nathan Boidman, "Appeal Court Rejects Government Prosecution for Criminal Sham in Respect of an Offshore Trading Company", 57 *Taxes International* 7 (1984) at 21.

13. 81 DTC 5168, at 5174.

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Madame Justice Reed found in favor of the taxpayer on this point in the following somewhat ironic fashion:

> I think a fair inference to be drawn from the evidence as a whole is that the price which Indalex would pay to Pillar International was not uncertain because *when all was said and done, Messrs. Paterson and Fredjohn (later Mr. Greenwood) would determine that amount.* Mr. Mello was naturally reluctant to expressly base his opinion on that fact. Nevertheless, I consider it to be the unspoken premise of his opinion and to follow as an inference from the reference to discussions with Mr. Stracey, the previous dealings between the parties, from the rest of the evidence that has been given in this case.
>
> (at pages 6045 and 6046 – italics added)

3. Artificial or undue reduction of income (Sec. 245(1) ITA)

In *Spur Oil,* supra, the Crown relied on the rules of Sec. 245(1) of the Act dealing with artificial or undue reduction of income in assessing the transshipment arrangement. In that case the Federal Court of Appeal decided that:

> . . . the finding of artificiality in the transaction being examined, does not, per se, attract the prohibition set out in subsection 137(1) of the Income Tax Act (predecessor to Sec. 245(1)) . . . To be caught by that subsection, the expense or disbursement being impeached must be in an artificial or undue reduction of income. 'Undue' when used in this context should be given its dictionary meaning of 'excessive'. In light of the Crown's concession referred to supra, that under the Tepwin contract the appellant would be paying slightly less than fair market value, it cannot be said that the Tepwin contract and the Tepwin charge result in an excessive reduction of income.[14]

In other words, the "undue" aspect of the Sec. 245(1) rule in the context of a transshipment company arrangement becomes nothing more than an issue of arm's length price under Sec. 69(2) of the Act. Madame Justice Reed in *Indalex* follows this interpretation. She notes that notwithstanding the "artificiality" of the arrangement when viewed in light of "normality" in relation to transactions which as "usual and natural ones",[15] a levy under Sec. 245(1) "requires not only a finding of artificialness but also a reduction of income" (at page 6046), referring to *Spur Oil.* She concludes:

> Thus, subsection 245(1) will only be applicable if the price paid by the plaintiff to Pillar International resulted in a reduction of income otherwise payable. The sole issue becomes a determination as to the reasonableness of the price paid or fair market value under sections 67 and 69. (at page 6046)

4. Fair pricing (Sec. 69(2) ITA)

(a) *Overview*

Madame Justice Reed reduced the issue to one of fair pricing under Sec. 69(2) of the Act.[16] In order to fully understand the Court's finding, several background factors should be noted:

1. Apart from the brief statutory rule in Sec. 69(2) there are no detailed rules addressing the matter either under the statute, regulations or case law.[17]

2. It has been generally believed that Canadian courts would effectively adopt the principles underlying the U.S. Code Sec. 482 rules and the 1979 OECD report.[18] This would entail determinations in accordance with 4 methods, applied in the following order of priority:

(a) an intercompany price is to be determined by reference to transactions with third parties in comparable circumstances, that is the "comparable uncontrolled price";
(b) in the absence of a valid "comparable", either of 2 "secondary" methods would be used: the "cost-plus" or the "resale price" method. The resale price method is considered appropriate only when the purchaser adds little, if any, value to the product;
(c) where such methods are inapplicable, resort may be required to "fourth methods", entailing so-called "profit splits", "functional analysis" and so on.

3. Revenue Canada's Information Circular, #87-2, issued 27 February 1987, "International Transfer Pricing and Other International Transactions", adopts the foregoing principles.[19]

Madame Justice Reed's conclusion that the price paid by Indalex to Pillar Internatonal was excessive results from her determination that the matter could not be evaluated by reference to valid comparables and, instead, fair market was to be arrived at by assessing the relative economic contribution and purpose served by the respective companies, Indalex and Pillar International, in relation to the overall business cycle. In other words, she used a "fourth" or "other" method entailing functional analysis. Her Lordship makes no reference whatever to the cost-plus method or the resale method, as such.

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14. 81 DTC 5158 at 5173.
15. The interpretation of artificiality for Sec. 245(1) in such term was expressly advanced in 1985 in the decision of the Federal Court Trial Division in *Consolidated Bathurst Limited v. The Queen,* 85 DTC 5150 (and the Federal Court of Appeal, 87 DTC 5001), a case involving a captive offshore insurance company. See Samuel Minzberg, "Carnation North – The Federal Court of Canada Disallows Deduction of Premiums Paid to Captive Insurance Company", 14 *Tax Management International Journal,* 6 (June 1985) at 202 and Samuel Minzberg, "Canada Rejects the Economic Family Test", 16 *Tax Management International Journal,* No. 6 (June 1987) at 245.
16. See footnote 3.
17. See discussion in IBFD Service (footnote 1) of *J. Hofert Ltd. v. M.N.R.*, 62 DTC 50, and *Central Canada Forest Products Ltd. v. M.N.R.*, 52 DTC 359. In *Spur Oil,* supra, fair value for purposes of pricing intercompany shipments of oil was considered to turn strictly on prices in the organized international market.
18. "Transfer Pricing and Multinational Enterprises", Report of the OECD Committee on Fiscal Affairs (1979) *Organisation for Economic Co-Operation and Development,* Paris.
19. See IBFD Service (supra footnote 1). See also Nathan Boidman, "Canada – Transfer Pricing Issues – A Critical Discussion of the Revenue Draft Information Circular", 38 *Bulletin for International Fiscal Documentation* 8/9 (1984) at 399, and Allan R. Lanthier, "Canada: Draft Guidelines on International Transfer Pricing", 40 *Bulletin for International Fiscal Documentation* 11 (1986) at 487.

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(b) *Comparables*[20]

The following points of interest arise in the Court's assessment of "comparables":

1. Both parties adduced expert evidence as to which market should be used to determine a comparable price. The Court seems to conclude that "prices for a North American purchaser would be determined by supply and demand conditions in the North American (or smaller) market and not by conditions elsewhere" (at page 6047). In fact, the prices paid by Pillar International for aluminum billet in the various countries from the various Alcan group companies were "negotiated on a market by market basis: Canada, the United Kingdom, Germany and Portugal being separate markets . . ." (at page 6047).

2. Madame Justice Reed questioned the availability of comparables in an industry such as aluminum which is "highly integrated".

3. The Court also showed reluctance to use, as comparables, prices paid between third parties in substantially different circumstances. In other words, the Court did not subscribe to the theory that all differences can be quantified and factored out. In order to use such third party pricing, "adjustments were made for: differences in the credit terms; differences in geographical location; different contract terms respecting scrap returns; and different discount terms in the various contracts". However, one of the situations (involving a company called Zimmcor) was considered not to constitute a valid comparable, apparently because it (Zimmcor) was in considerable financial difficulty during the time in question and the third party supplier (Alcan) apparently took an active participation in the management of the company. A second comparable, involving a company called Daymond, was also found not to offer a valid comparable because it purchased only one-third the volume, from Alcan, which was purchased by Indalex (through Pillar International):

> While it may be true that there are no volume discounts (in the sense of a price per unit discount) in the aluminum billet market (apart from premiums paid for very small orders) that does not make Indalex as a customer comparable to Daymond. Mr. Culver's evidence is significant . . . He indicated that size was a significant factor in determining comparability as between customers . . . (at page 6048)

4. Madame Justice Reed found that:

> . . . the closest arm's length comparable to a sale by Pillar International to Indalex is that by Alcan to Pillar International. Each shipment of billet to Indalex was in fact purchased at arm's length by Pillar International under circumstances that are virtually identical to the purchases of the same billet by Indalex: same product; same quantity; same shipping destination; same transportation logistics; same credit terms; same scrap return arrangements. (at page 6048)

This therefore led Madame Justice Reed to conclude, in principle, that "at a first approximation an arm's length price for Indalex is that which Pillar paid" (at page 6048). Obviously on this basis the entire excess of price paid by Indalex to Pillar over that paid by Pillar to Alcan would be disallowed as an expense to Indalex. But then Her Lordship felt a determination had to be made of:

> . . . what adjustment should be made for the purpose of equating an Indalex purchase from Pillar International to a Pillar International purchase from Alcan. There is little dispute that some adjustment should be made; the dispute is with respect to quantum. (at page 6048)

In other words, the issue was reduced to determining a profit split between related parties based presumably on some sort of functional analysis. This is precisely what Madame Reed proceeded to do.

(c) *Functional analysis*

(i) *Burden of proof and the taxpayer's position*

Under Canadian tax law the Crown may presume facts which the taxpayer then has the burden of disproving. Madame Justice Reed put the matter this way ". . . the burden of proof demonstrating that the price paid to Pillar International was reasonable rests with the plaintiff" (at page 6049). In the absence of real comparables, the taxpayer's task was to demonstrate by a functional or conceptual analysis the propriety of the pricing arrangement and in particular the price differential in favor of Pillar International.

Indalex's prime argument was that the discounts earned by Pillar International were attributable to the worldwide purchasing power of the RTZ-Pillar group and therefore were properly earned by Pillar International and not by Indalex. This stemmed, in part, from the umbrella contract which Pillar International had with Alcan for the worldwide subsidiaries and markets. However, Madame Justice Reed rejected the importance of the umbrella contract:

> I have looked at the documents and the evidence . . . and am not convinced that they are attributable to the factors which the plaintiff claims. (at page 6049)

Her Lordship also stated:

> Mr. Fredjohn's statement was obviously designed to leave an impression with the Court that was some considerable distance from the truth. In light of all these factors I cannot accept that the pre-1970 5% discount was given to Pillar on account of its world purchasing power and that the new pricing arrangements between Pillar International and Indalex merely rolled the previous discounts in to a different form. (at page 6050)

(In light of these findings, the Federal Court of Appeal's criticism of the judgment (at III.D below) is difficult to understand.)

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20. It is interesting that an unresolved "threshold" issue did not arise in this case. Sec. 69(2) requires a "reasonable" price between units of a multinational. Sec. 69(1)(a) provides a more general rule for non-arm's length transactions requiring a price equal to "the fair market value". Madame Justice Reed notes that:

> Whether an expense 'reasonable in the circumstances' for the purposes of section 68 and subsection 69(2) requires the same test as 'fair market value' in subsection 69(1)(a) has not been raised. They have been treated by counsel as raising identical considerations. (at page 6047)

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The taxpayer then argued that the profit margin for Pillar International could "be justified on the ground of additional economic benefits which flowed to Indalex as a result of that contract" (at page 6050). In particular, the following advantages were cited:

> . . . the possibility of metal switches with other members of the Pillar extruder group (if Indalex should under-estimate or over-estimate its billet requirements); the extension of the billet purchase contracts by Alcan in December 4, 1973 in tight market conditions; refusal in 1974 to allow Alcan to call force majeure because of a strike at Arvida, Quebec on the ground that the contract for billet was with Alcan Aluminum Ltd. and not with Alcan Aluminum of Canada Ltd.; discount payments on billet upcharges as well as on the base metal price; 90 day credit terms, instead of the 30 days prevailing in the North American market; excellent scrap return terms; simultaneous settlement of invoice payments and discounts; regular efforts by Pillar to prevent or defer price increases in scrap tolling charge or reduction in the credit term. (at page 6050)

Madame Justice Reed systematically analyzed each of these "alleged benefits" (her words). She saw little in the "first three alleged benefits". With respect to the others, she stated the proposition as follows:

> In my view in order to conclude as counsel suggests, I have to find: (1) that these advantages are ones of an economically equivalent nature and ones which Indalex could not have obtained for itself without the interposition of Pillar International (RTZ-Pillar); and (2) that as a matter of quantum they are worth the additional amount paid by Indalex to Pillar International over what Pillar International paid Alcan. That is, the question becomes whether the plaintiff negotiating on his own could have obtained the price in the same range as that which Alcan charged Pillar International or whether the plaintiff could only have obtained the price similar to that which it paid Pillar International. (at page 6050)

Madame Justice Reed then proceeded to answer the latter question as follows:

> Despite excellent argument and presentation by counsel for the plaintiff I cannot find that the plaintiff negotiating on its own would have had to pay Alcan a price of the same order that it paid Pillar International. On reviewing the evidence carefully, I cannot find that the plaintiff has discharged the burden of proof on it and demonstrated that the price it paid was reasonable in the circumstances. (at page 6051)

This conclusion was based on 3 factors:

1. ". . . there was no particular rationale for the amount of money retained in Bermuda by Pillar International" (at page 6051) and "there was no attempt made to quantify the so-called extra benefits . . ." (at page 6051).

2. As part of its position, Indalex had argued that "Alcan gave Pillar International a much better price than it would have given Indalex alone in order to obtain a share of Pillar's European market (the European market being much more highly competitive than the Canadian one)" (at page 6051). Madame Justice Reed rejected this argument on the basis of evidence given by an expert witness, a Dr. Berry, who testified as to the international aluminum billet market.

3. The third factor was the Court's assessment of evidence given by Mr. Culver (now Chairman of Alcan) who had testified with respect to the discount structure:

> In my view, had the extra been anything more than very small (i.e.: 1% or less) Mr. Culver would have spoken in more expansive terms. I think he would not have talked about Pillar's importance as a 'shadow' effect. (at page 6051)

It is obvious, and clearly not at all surprising, that the decision of the Court came down to nothing more or less than an appreciation of the specific factors and a judgment as to what persons would have done acting reasonably in their own interest.[21]

(ii) *Crown witness and functional analysis*

It is both interesting and significant that, notwithstanding that the burden of proof was on the taxpayer (Indalex), the Crown brought forward a witness to support its own contentions on the basis of functional analysis, in a fashion not dissimilar to the approach of the Internal Revenue Service (IRS) in the well known *Du Pont* case, also involving a transshipment company arrangement.[22] The IRS used an economist to do a rate-of-return analysis, the results of which were factored into the transfer pricing computation made by the IRS and accepted by the Court. In the *Indalex* case, Revenue Canada "adduced expert evidence from Professor Quirin, to the effect that the reasonableness of the price charged to Indalex by Pillar International could be assessed by reference to the profit margin on its sales to the plaintiff and by making a direct comparison between such and the markups received by firms performing similar functions but dealing at arm's

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21. This point and the vulnerability of a taxpayer in an issue involving an aggressive intercompany tax plan is quite evident where reference is made to the subtleties underlying the last (third) point noted in the test. In particular Madame Justice Reed goes on in her judgment to note that:

> There is other testimony by Mr. Culver which at first glance seems to contradict that (her) conclusion. He responded affirmatively to a question asking whether Pillar International had obtained a significantly higher percentage discount than that which Indalex could have negotiated on its own . . . . But that does not assist this plaintiff since there is no price evidence as to what Culver meant by 'significant'. There is no evidence for which I can conclude that he had in mind a 5% differential as opposed to a 1% differential. Mr. Culver, when discussing the weight based and time based comparative price analyses he had done, referred to differences of ½ cent a lb. as significant. In dealing with purchases of a commodity such as aluminum billet I see no reason to think that a price differential of 2% or even less, would not be significant. Accordingly, Mr. Culver's statement that Pillar International obtained a discount 'significantly' better than Indalex alone could have obtained is quite consistent with a finding that 1% or less differential was the additional discount obtained by Pillar International over what the plaintiff could have negotiated on its own.
>
> (parenthetical words added – at page 6051)

22. *E.I. Du Pont Nemours Company v. The United States,* 79-2 U.S.T.C., para. 9633, 608 F. 2d 445 (Ct. Cl. 1979) Crt. Den. 100 S.Ct. 1648 (1980). Reference can also be had to the case of *Hospital Corporation of America,* 81 TC 510 (1983), in which the interposition of an offshore corporation to carry out contracts abroad resulted in functional analysis to attribute 75% of income earned by the offshore captive back to the U.S. parent company.

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length in a competitive setting" (at page 6048). The Court reviewed in much detail Professor Quirin's far ranging analysis which:

> . . . involved: (1) determining an appropriate rate of return of investment for an enterprise with risk characteristics of Pillar International; (2) determining the amount of capital needed to support Pillar International's sales; (3) using the aforementioned factors to determine an appropriate profit margin as a percentage of sales. (at page 6048)

The analysis entailed reference to certain banks and utility companies to determine a risk factor comparable to that assignable to Pillar International. Based on this analysis, Professor Quirin testified that "the profit margin necessary to support a firm like Pillar International was between 0.4% and 0.8% of sales". In fact, Pillar International realized between 3.14% and 5.27% of sales, which, Professor Quirin concluded, was not reasonable and was excessive. The Court notes that the taxpayer challenged the analysis on 2 grounds that:

> . . . the companies chosen as comparables from Moody's carried on activities considerably different from those of Pillar International; and in any event the analysis did nothing to assess the value of the Pillar International contract with Alcan (i.e.: if that contract were indeed a very advantageous one, there is nothing in Professor Quirin's analysis to reflect that fact). (at page 6048)

Madame Justice Reed stated that she found "the analysis done by Professor Quirin useful as a bottom line approach, i.e. the analysis shows what profit margin would have been required to sustain a company such as Pillar International in business (with a reasonable return on investment)" (at pages 6048 and 6049). However, having regard to the foregoing, not only was it unnecessary for Her Lordship to decide the case in favor of the Crown on this basis but, indeed, she stated that she was "not convinced that the analysis, without more, demonstrates a lack of reasonableness in the price charged".

It is well known, of course, that tax authorities are increasingly coordinating their efforts and approaches in dealing with tax planning and avoidance, both within the purely domestic context and that involving multinationals. Revenue Canada's use of an expert witness in this fashion, which is obviously patterned on the IRS's approach in *Du Pont,* is but one manifestation of such coordination.

(d) *The allocation and fair pricing determination*

Although it is not entirely clear, Madame Justice Reed seems to conclude that the prices paid by Indalex to Pillar International should be reduced by an amount equal to 80% of the net spread earned by Pillar International in order to conform with a reasonable arm's length pricing standard. Pillar International was entitled to discounts, or a profit spread of 1%, not the 5% it earned in the transaction.

C. Ancillary tax on excess price as disguised distribution

In general terms, the finding of an excess price paid by a Canadian company to a foreign parent or another related corporation gives rise (in addition to the disallowance to the payer company) to a tax on the recipient of the excess payment. Revenue Canada assessed such a tax in the *Indalex* case, on the basis of either (1) the rules governing "deemed dividends" which are subject to a 25% tax under Part XIII of the Act when paid by Canadian companies to a non-resident and involve interrelated "shareholder appropriation" rules of Sec. 15(1) of the Act[23] or (2) the broader anti-avoidance rules of Sec. 245(2) of the Act, which deal with the conferring of a benefit on a non-arm's length party which can also lead to a 25% Part XIII tax. The distinction between the 2 regimes is not terribly important unless it serves to actually differentiate between possible "taxpayers" on which the tax can be levied, perhaps resulting in differing net tax results because of applicable tax treaty provisions. (Such differentiation did not arise in *Indalex.*)[24]

Madame Justice Reed decided that the shareholder appropriation rule of Sec. 15(1) did not apply because there was no direct shareholding between Pillar International or even RTZ-Pillar and Indalex (whose shares were directly owned by Indal). The Court concluded that tax would arise under Sec. 245(2) which reads as follows:

> Indirect payments or transfers. Where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatever is that a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred notwithstanding the form or legal effect of the transactions or that one or more other persons were also parties thereto; and, whether or not there was an intention to avoid or evade taxes under this Act, the payment shall, depending upon the circumstances, be
>
> (a) included in computing the taxpayer's income for the purpose of Part I,
> (b) deemed to be a payment to a non-resident person to which Part XIII applies, or
> (c) deemed to be a disposition by way of gift.

Such tax would apply to the excess (80%) profit earned by Pillar International.

23. See also Secs. 212(2) and 214(3)(a) of the Act.
24. In the years in question the withholding tax rate under the Act was only 15%. This rate did not exceed that exigible under Canada's treaties at that time in respect of dividends paid by a Canadian company. In other words, for those years the Court's conclusion did not affect the overall Canadian tax liability on disguised distribution. However, in 1976 the Part XIII withholding tax rate increased from 15% to 25%, and accordingly the choice of regimes and identification of the recipient becomes more important. Had the issues in *Indalex* occurred after 1975, the Court's conclusion, which entailed a tax on Pillar International, a Bermuda company which does not benefit from any treaty protection, would have resulted in a 25% tax rate. Had the Court decided that the rules of Sec. 15(1) et al. apply (giving rise to a deemed dividend pursuant to Secs. 212(2) and 214(3)(a)), this would presumably mean that the taxpayer is the ultimate shareholder, Pillar Holdings, a U.K. corporation which normally would be entitled to a reduction in tax rate to 10% under the Canada–U.K. Income Tax Convention, as modified by a 1985 Protocol.

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III. THE DECISION OF THE FEDERAL COURT OF APPEAL

A. Overview

In the decision handed down 21 December 1987, the Federal Court of Appeal not only rejected the taxpayer's appeal but upheld the cross-appeal by the Crown from the allowance of 20% of the markup, thus resulting in a total reallocation to the Canadian subsidiary (Indalex).

B. Sham

As noted above, the Trial Division had concluded that there was no sham. In this respect the Federal Court of Appeal stated:

> Neither determination was questioned in this proceeding but I should not wish silence to be taken as necessarily acquiescence in the latter. (at page 6055)

C. Pricing

The Appeal Court approved the Trial Division's finding (based itself, as noted earlier, on *Spur Oil*) that the matter, resting on Sec. 245(1), required a showing of excessive pricing, that is pricing beyond the arm's length standard effectively arising under Sec. 69(2). In dealing with the question of so-called "hard bargaining" between the parties and the taxpayer's claim of error by the trial judge for not accepting the uncontradicted testimony of 3 witnesses the Appeal Court stated:

> Counsel's indignation that the word of these witnesses was not accepted at face value seemed to me not entirely unrelated to the indignation that impelled him to make so much of the outside directors of the appellant's immediate parent. It is, therefore, perhaps necessary to point out that a trial judge does not err in viewing the uncontradicted evidence of respectable participants in a non-arm's length arrangement having income tax consequences with some skepticism. In the usual absence of direct contradictory evidence, it is entirely proper to measure the outcome of a non-arm's length transaction against evidence, expert or otherwise, as to the value, in the present marketplace, of that outcome. (at page 6057)

The Appeal Court found that the trial judge did not err in rejecting the taxpayer's contention that the price paid by the Bermuda company (to Alcan) was the price that would have been established by arm's length negotiations. The Federal Court of Appeal also agreed with the trial judge who had stated:

> It is clear that the arrangements existing in the present case had a great deal of artificiality about them and I would hold that the purchasing by Indalex from Pillar International and by Pillar International from Alcan Ingot were artificial transactions. (at page 6057)

Nonetheless, the Appeal Court agreed (at pages 6057-6058) with the trial judge that the issue "turned on the reasonableness of the price paid Pillar International for billet" and that in the context of the case "the market price of billets in North America depended on North American conditions and . . . that the best arm's length comparable prices were those established from time to time between Alcan and Pillar International for billet delivered to the appellant".

The Appeal Court reviewed the process adopted by the Trial Division (detailed above) to determine whether in fact there should be any adjustment made (to the price paid by Pillar to Alcan) so as to allow profit margin to the Bermuda company. As noted, the taxpayer had contended at trial that the price differential in favor of Pillar was justified by a variety of factors so as to render the price charged to Indalex consistent with an arm's length price. The Appeal Court approved the trial judge's refusal "to find that any part of the retention had been established to be a fair return on capital employed by Pillar International in benefitting the Appellant" (at page 6058).

The Appeal Court also confirmed the trial judge's rejection of the taxpayer's arguments that the price differential was justified by the alleged benefits of continuation of supply and lack of force majeure.

D. The difference in the judgment

The 1% differential which the trial judge had allowed (comprising roughly 20% of Pillar's profit) was based on a conclusion that Pillar's global purchasing power permitted it to obtain from Alcan a price much better than the appellant could have obtained in direct negotiation with Alcan. This was rejected and reversed by the Federal Court of Appeal (at pages 6058 and 6059):

> In my opinion the learned trial judge erred in law in resolving the issue on the apparent assumption that Pillar International was entitled to the benefit of the better price obtained from Alcan because of greater bargaining power. That greater bargaining power was exclusively due to the pooling of the purchasing power of a number of members of the Pillar group to which the appellant was an important contributor. There was no evidence whatsoever that Pillar International itself contributed an iota of that pooled purchasing power. On the contrary it bought no billet for its own account. When non-arm's parties combine to obtain an advantage from an outsider not available to them individually, any allocation of the advantage among them except on a pro rata basis has to be justified. Nothing in the evidence or in the findings of fact by the learned trial judge support the allocation of any part of that advantage to Pillar International.

It is interesting that the Appeal Court reversed the Trial Division on the basis of manifest error in appreciating the facts. Most intercompany disputes are primarily a question of fact, given the imprecision of the legal requirement that intercompany prices conform to an arm's length standard. And to that extent it is unusual that a trial judge's decision in this type of issue will be reversed on appeal.

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E. The role of minority shareholding

Finally, it is quite interesting to note that the Court of Appeal had no difficulty in dismissing a seemingly valid argument that the existence of an outside 42% minority shareholding in Indalex (noted earlier) militated against impropriety in the intercompany price. In a footnote at page 6055 of the case report Mr. Justice Heald stated:

> I mention the public shareholdings only because the Appellant made much of it, apparently being of the view that the trial judgment was tantamount to a finding that income had been improperly diverted to the controlling shareholder in a manner oppressive to the minority. We were invited to infer that the Appellant's many prominent outside directors would not have permitted such a thing and that the trial judge must, therefore, have erred in her conclusion. Insofar as this Court is concerned, this is purely a tax case. We are not concerned with, nor have we jurisdiction to adjudicate either at trial or on appeal on, any obligations but those of the Appellant as a taxpayer.

IV. CONCLUSION

The decision in *Indalex* shows the role in Canada of the 1979 OECD recommendations for multinational intercompany pricing as well as the predeliction for disputes, particularly those involving transshipment company arrangements, are to be resolved by reference to "fourth methods" (functional analysis) rather than comparables.[25]

V. POSTSCRIPT

In a decision handed down after the article was submitted for publication, involving another transshipment case, *Irving Oil Limited and Her Majesty the Queen,* the Federal Court Trial Division (T-3100-79, 4 March 1988) quashed a reassessment by Revenue Canada (involving over $ 100 million) of a Canadian company, Irving Oil Limited, which imported crude oil through a Bermuda-based wholly-owned subsidiary. The Court's decision was based on findings that (1) the Bermuda subsidiary was established for valid purposes (to allow the Canadian importer to share in the non-Canadian production and transportation profits of the supplier, Standard Oil of California, which owned 50% of Irving), and (2) the transshipment price ($ 2.90 per barrel) represented a "competitive market price" (Standard Oil selling the crude to the Bermuda subsidiary at $ 2.10 and $ 2.24 per barrel). It is probable that the Crown will appeal the decision.

25. In this respect see: "Internal Revenue Service Study of International Cases Involving Section 482 of the Internal Revenue Code", Report to the Associate Commissioner (Operations) by the Assistant Commissioner (Examination), Department of the Treasury, Internal Revenue Service, Publication 1243 (4–84). See also, Guenter Schindler and David Henderson, "Intercorporate Transfer Pricing – The Role of the Functionally Determined Profit Split Explored", 39 *Bulletin for International Fiscal Documentation* 3 (1985) at 108.

Conference Diary

APRIL 1988

Recent Tax Cases. London, 19 April (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

BTW. Amsterdam, 21 April (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

International Taxation Management Techniques – Transfer Pricing, Currency Management, Mergers and Acquisitions. Strasbourg, 21-22 April (English):
To the Customer Service Department, Management Centre Europe, Postbus 95 – 3417 ZH Montfoort, the Netherlands.

MAY 1988

The Taxation of Government Personnel in Europe – Diplomats and Consular Officials. London, 9 May (English):
Miss Audrey Evelyn Bone, 606 Bryer Court, Barbican, EC2Y 8DE, United Kingdom.

U.S./International Corporate Taxation. Bougival, 9-14 May (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

Spring Meeting of the IFA Branch (Eastern Great Lakes Region). Cleveland, Ohio, 10 May (English):
International Fiscal Association, U.S.A. Branch, Att.: Mr. Larry Gearhart, Eaton Corporation, Eaton Center, Cleveland, Ohio 44114, U.S.A.

The U.K.'s approach to the negotiation of double taxation agreements. London, 11 May (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London WC4A 3TR, United Kingdom.

Hamburger Seminar zur internationalen Besteuerung. Hamburg, 30 May - 16 June (German):
Institut für ausländisches und internationales Finanz- und Steuerwesen, – Int. Steuerseminar – Grindelhof 38, 2000 Hamburg 13, Federal Republic of Germany.

JUNE 1988

The Use of Tax Havens and Low Tax Finance Centres in International Planning. Geneva, 6-7 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

U.S. Taxation: Partnerships, Trusts & Estates. Arundel, Sussex, 6-11 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Fundamental Elements of U.S. Federal Taxation. Arundel, Sussex, 6-11 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

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SINGAPORE:

A Summary of the 1988 Budget's Tax Proposals

By Lee Fook Hong, MBA, FCIS, FAIA

I. INTRODUCTION

On 4 March 1988, the Minister for Finance, Dr. Richard Hu, presented Singapore's 1988 Budget to Parliament. The 1988 Budget has been viewed by most people as the budget for business since all proposals seem to aim at further developing the service sector and promoting Singapore as a business centre.

One of the major proposals is the introduction of the Overseas Investment Incentive Scheme which allows a 100% tax write-off for losses from the sale of shares in or liquidation of approved overseas investments. Larger local companies will therefore be encouraged to venture abroad to gain access to new technology and markets.

Another notable proposal is the extension of a number of incentive schemes to the service sector. This will help Singapore achieve its goal of developing into a world-wide business centre. A larger inflow of offshore business and foreign-source income is anticipated. Among the measures to promote services is extension of the unilateral tax credit scheme to foreign-source income earned on activities of approved Operational Headquarters (OH).

The Minister also announced that the double tax deduction of research and development (R & D) expenses for manufacturing companies would be extended to service companies.

With respect to tax rates, the Minister announced that while there would be no change in corporate tax rates, the highest effective rate of tax imposed under Part B of the Second Schedule of the Income Tax Act would be limited to 33%. Such a limitation would help ensure that those entities (e.g. management corporations, clubs and associations) taxable under the existing rates in Part B of the Second Schedule would not have to pay tax higher than the effective rate of 33%.

Two measures which might not be well-received by employers and smokers are the increase in the Foreign Workers Levy and the higher import duty on cigarettes. There is also some concern over the Minister's statement that the Government would decide on the rates of contribution to the Central Provident Fund (CPF), the levy for the Skills Development Fund (SDF) and property tax rates after obtaining a clearer picture of how the economy performs in the first quarter of 1988.

The Minister clarified that for the time being a consumption tax would not be introduced; however studies and preparatory work are continuing so that the administrative machinery will be available when such a tax change becomes necessary.

The following are some of the highlights of the Finance Minister's 1988 Budget.

II. CHANGES IN INCOME TAX

A. Revision of tax rates in Part B of the Second Schedule

With effect from year of assessment 1988, the highest effective rate of tax imposed under Part B of the Second Schedule of the Income Tax Act shall be restricted to 33%. The maximum rate is currently 55%. Entities other than companies and resident individuals (e.g. management companies, clubs and associations) will benefit from this change. These entities will not be required to pay tax above the existing corporate tax rate.

B. Tax treatment of unit trusts and investment holding companies

With effect from year of assessment 1988, unit trusts and investment holding companies may elect to have their profits from stocks, shares or other marketable securities taxed according to a schedule based on the length of time the stocks, shares or marketable securities have been held (see Table I). This alternative method of taxation will only apply to investment holding companies and unit trusts approved for this purpose.

C. Deduction of trade losses by companies

With effect from year of assessment 1988, the Comptroller of Income Tax will be granted discretion to allow companies with substantial shareholding changes arising from legitimate purposes unconnected with tax considerations to deduct trade losses incurred in one year against the profits of a subsequent year. The losses will, however, only be deductible against income from the same business. This change will benefit companies whose change in shareholding is beyond their control but due to nationalization or privatization of industries. Under current legislation, companies are allowed to deduct tax losses incurred in one year against profits in a subsequent year provided there is no substantial change in shareholders.

D. Unilateral tax credits

Under current legislation, unilateral tax credit is granted to selected service income remitted to Singapore from certain non-DTA countries. The services

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Table I

Tax treatment of unit trusts and investment holding companies

Length of holding period	*Proportion of gains subject to tax (%)*	*Effective corporate tax rate*
Up to 6 months	100	33.00
Up to 7 months	95	31.35
Up to 8 months	90	29.70
Up to 9 months	85	28.05
Up to 10 months	80	26.40
Up to 11 months	75	24.75
Up to 12 months	70	23.10
Up to 13 months	60	19.80
Up to 14 months	50	16.50
Up to 15 months	40	13.20
Up to 16 months	30	9.90
Up to 17 months	20	6.60
Up to 18 months	10	3.30
More than 18 months	0	0.00

Table II

Duties on cigarettes and tobacco

CCCN No.	*Description*	*Existing import duty*	*Existing excise duty*	*New import duty*	*New excise duty*
24.02 100	Cigars, cheroots and cigarillos	$ 70 per kg	$ 70 per kg	$ 75 per kg	$ 75 per kg
24.02 200	Cigarettes	$ 70 per kg	$ 34 per kg	$ 75 per kg	$ 36 per kg
24.02 400	Snuff	$ 70 per kg	$ 70 per kg	$ 75 per kg	$ 75 per kg
24.02 810	Other manufactured tobacco:				
	Packed for retail sale	$ 70 per kg	$ 70 per kg	$ 75 per kg	$ 75 per kg
24.02 820	Not packed for retail sale:				
	Pipe tobacco (bulk)	$ 70 per kg	$ 70 per kg	$ 75 per kg	$ 75 per kg
24.02 899	Tobacco not elsewhere specified or included	$ 70 per kg	$ 70 per kg	$ 75 per kg	$ 75 per kg

SUMMARY OF BUDGET HIGHLIGHTS

A. Changes in income

1. Presently maximum tax rate for those taxed under Part B of Second Schedule of Income Tax Act is 55%. The maximum effective tax rate for this category will be 33% with effect from Year of Assessment 1988.

2. With effect from Year of Assessment 1988, Unit Trust and Investment Holding Companies can elect to have their profits from stocks or shares taxed according to length of period they held them.

3. With effect from Year of Assessment 1988, companies can deduct trade losses against profits in subsequent years even if there is major change in shareholders provided such change is for legitimate reasons and deduction is against income from same business.

4. With effect from Year of Assessment 1988, unilateral tax credit scheme is extended to foreign income earned on approved Operational Headquarters (OHQ) activities not on original list.

B. Tax incentives

1. With effect from Year of Assessment 1988, double tax deduction of research & development expenses is extended to service companies, e.g. computer software, information services, agrotechnology services, laboratory and testing services, medical research services and other services as may be prescribed by the Minister.

2. With effect from Year of Assessment 1988, Industrial Building Allowances Scheme is extended to service companies. Agrotechnology, horticulture and agriculture and other approved services can now claim depreciation of certain specialized buildings & other structures.

3. With effect from Year of Assessment 1988, new incentive for overseas investments – 100% tax write-off for losses from sale of shares in or liquidation of approved overseas investments.

4. With effect from Year of Assessment 1988, 90% tax exemption on royalties or other income from inventions. Only individuals can qualify for approved inventions and product innovations.

5. A further 5-year tax holiday for Singapore International Monetary Exchange (SIMEX).

C. Changes in duties

1. Transactions in non-Singapore Dollar stocks or shares are exempted from stamp duties with immediate effect.

2. $ 500 ceiling on stamp duties payable on lease transfer documents with effect from 1.4.88.

3. No more import duties or quotas on refrigerators and air-conditioners with effect from 1.4.88.

4. Increase in import duties on cigarettes from $ 70 per kg to $ 75 per kg and excise duties from $ 34 per kg to $ 36 per kg with immediate effect.

D. Other tax changes

1. No change to 50% rebate on property tax which expires on 31 December 1988. Rates for 1989 will be reviewed after June 1988.

2. No lifting of suspension on tax of 10% and 20% respectively on electricity and gas and on telephone calls. Taxes are further suspended until 31.3.89.

3. Increase in Foreign Workers Levy from $ 140 to $ 170 per month with effect from 1.4.88. Maids and construction workers are not affected by this change.

No change

1. No change in personal tax rates and corporate tax structure.
2. No consumption tax for the time being.

To be reviewed

1. CPF rates, after 1st quarter economic results.
2. SDF rates, after 1st quarter economic results.
3. Property tax rates for 1989, after review in 2nd half of year.

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covered include professional services, construction services, computer-related, technical and other consultancy services.

The unilateral tax credit scheme will be extended to foreign-source income earned on approved OH activities which are presently not included in the specified list of services. The purpose of the scheme is to avoid double taxation of the foreign-source income earned by these headquarter companies from countries which are currently covered by the scheme. The extension will be effective from year of assessment 1988.

III. TAX INCENTIVES

A. Extension of double deduction of R & D expenses to services

The incentive scheme under which manufacturing companies may deduct twice approved R & D expenses incurred in any R & D project will be extended to the following selected services with effect from the 1988 year of assessment:
(1) computer software;
(2) information services;
(3) agrotechnology services;
(4) laboratory and testing services;
(5) medical research services; and
(6) any other services or activities as may be prescribed by the Minister.

As usual, the Economic Development Board (EDB) will continue to administer the scheme on a case-by-case basis.

B. Extension of industrial building allowances to services

To help certain service industries develop in size and sophistication, industrial building allowances are extended to approved companies in the following industries with effect from the 1988 year of assessment:
(1) agrotechnology;
(2) horticulture;
(3) agriculture; and
(4) other approved services with specialized structures.

Previously, only companies engaged in manufacturing, warehousing and other selected activities were allowed building allowances.

C. Incentive for overseas investment

Under a new incentive scheme designed to encourage local companies to invest overseas, losses from the sale of shares in or liquidation of an approved overseas investment will be allowed as a deduction to an eligible investor. The incentive is targeted at overseas investments which provide significant economic spin-offs to the Singapore company.

These spin-offs should include one or more of the following:
(1) allow access to overseas technology, including access to design and engineering facilities, equipment, engineering and scientific personnel, designs, patents or other specialized know-how;
(2) create high value-added engineering and technical employment;
(3) provide access to overseas markets which would substantially increase the company's activities or extend its scope of operations in Singapore.

Companies incorporated in Singapore which have invested or intend to invest overseas are eligible to apply for the incentive. The incentive is effective from year of assessment 1988 and applications must be made through the EDB.

D. Tax concession on royalty income for product design and development

The existing incentive which provides for a 90% exemption on royalty income earned by authors and composers will be extended (effective year of assessment 1988) to royalty income or incentive payments from approved inventions and product innovation.

Only individuals will be eligible under the incentive. The applicant must be a Singapore citizen or permanent resident, and the originator (or one of the originators) of the invention. The activities covered under the incentive scheme include development of new products or processes, significant improvements on existing products or processes or significant design improvements. The design must be capable of industrial application and eligible for a patent or protection under copyright law.

The incentive scheme will be administered by the EDB on a case-by-case basis.

E. Extension of tax holiday for SIMEX

The Singapore International Monetary Exchange (SIMEX) was established in 1984. Since that time, the exchange has been granted a 5-year tax holiday. In line with the Government's continuing support for the development of the exchange, the tax holiday will be extended for an additional 5 years.

IV. CHANGES IN DUTIES

A. Stamp duty exemption for transactions in non-Singapore dollar stocks or shares

With immediate effect, exemption from contract note duty will apply to transactions in non-Singapore dollar stocks or shares by an Asian Currency Unit (ACU) or approved securities company in the following situations:
(1) when the transactions are with persons outside Singapore, or with other ACUs or approved securities companies; and

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(2) when the transactions are on behalf of persons outside Singapore.

Stamp duty is currently levied at the rate of $ 1 for every $ 1,000 or part thereof on contract notes issued or received in Singapore for transactions in stocks or shares. The exemption is extended to facilitate the trading of non- Singapore dollar stocks or shares in Singapore.

B. Stamp duty for assignment of leases

A $ 500 ceiling will be introduced from 1 April 1988 on the stamp duty payable when the interest in a lease agreement, other than an agreement for the lease of immovable property, is assigned. Currently, the stamp duty on such a lease agreement is subject to a maximum of $ 500. However, there is no ceiling if the interest in the lease agreement is assigned to another party, i.e. stamp duty is levied on the transfer document on the basis of the value of the interest assigned.

C. Import duty on refrigerators and quota restriction on air conditioners

The Singapore Government advocates and practices a policy of free and fair trade. In order to promote greater trade liberalization, import duty on refrigerators and quotas on imported air conditioners will be removed, ranging from $ 184 per unit to $ 368 per unit. The import duty is lifted as from 1 April 1988.

D. Duty on cigarettes

As part of the continuing national effort to discourage smoking, import duty on cigarettes will be increased (with immediate effect) from $ 70 per kilogram to $ 75 per kilogram. At the same time, excise duty on cigarettes will be increased from $ 34 per kilogram to $ 36 per kilogram (details of these increases are shown in Table II).

V. OTHER TAX CHANGES

A. Property tax

The present 50% rebate on property tax is due to expire on 31 December 1988. Property tax rates for 1989 will be reviewed during the second half of 1988.

B. Suspension of taxes on public utilities and telephone services

The 10% tax on electricity and gas was suspended for the period 1 November 1985 to 31 March 1988. The 20% tax on domestic telephone services and trunk calls to West Malaysia have been suspended since 1 April 1985. Taxes on public utilities and telephone services are further suspended until 31 March 1989.

C. Foreign workers levy

With effect from 1 April 1988, the levy for foreign workers, except construction workers and domestic servants, will be increased from $ 140 to $ 170 per month. The increase will not affect Singaporean workers and permanent residents. Those foreign workers who were recruited before 1 April 1987 and those who fall within the CPF scheme are also not affected unless they change jobs.

VI. CONCLUSION

The Minister cautioned Members of Parliament the expected slowdown of the economy might materialize in the latter half of 1988 and the distinct possibility of an increase in trade protectionism. Although these developments are possibly beyond control, the Government has taken definite steps to face the uncertainties. At the same time, the long-term goal of Singapore becoming a developed nation by the 1990s has not been overlooked.

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SINGAPORE:

Changes to the Income Tax Act

By Alain Ahkong

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The Income Tax (Amendment) Act 1988 was passed in Parliament on 13 January 1988 and came into operation on 29 January 1988. The Act introduced changes to the existing legislation, some of which were recommended in the 1987 Budget. Notable changes are:

- Modification of the anti-avoidance legislation (i.e. Sec. 33) to empower the Comptroller to disregard or vary any arrangement which was carried out for bona fide commercial reasons but which has as one of its main purposes the avoidance or reduction of tax.
- Amendment to the dividend franking system (i.e. Sec. 44) to allow the offset of any Sec. 44 charge against any tax subsequently assessed on the company.
- Extension of the withholding tax provisions under Sec. 45 to all payments made to non-residents under Sec. 12(6), i.e. interest, commission, fee or any other payment in connection with any loan or indebtedness or with any arrangement, management, guarantee or service relating to any loan or indebtedness.
- Extension of industrial building allowances to capital expenditure incurred on an approved project for the promotion of the tourist industry (other than a hotel).
- Extension of the 10% concessionary rate of tax to a securities dealer.

The Act is summarized in the following pages.

ANTI-AVOIDANCE TAX LEGISLATION

On 29 January 1988 Sec. 33 of the Income Tax Act was repealed and re-enacted. The old Sec. 33 empowered the Comptroller of Income Tax to disregard a transaction only if it was artificial or fictitious or a disposition which was not in fact given effect to, and to assess the persons concerned accordingly. It did not empower the Comptroller to substitute or vary the transaction.

The new Sec. 33 shall have effect on any arrangement made or entered into on or after 29 January 1988. The Comptroller may now disregard or vary an arrangement and make such adjustments as he considers appropriate where he is satisfied that the purpose or effect of the arrangement is directly or indirectly:

(a) to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person;
(b) to relieve any person from any liability to pay tax or make a return under the Act; or
(c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by the Act;

even though the arrangement is valid in any other respect.

Any arrangement carried out for bona fide reasons but which has as one of its main purposes the avoidance or reduction of tax would be caught by the new amendment.[1]

While it is recognized that the old anti-avoidance legislation needs to be more specific, the new legislation has far-reaching implications and creates a great deal of uncertainty. Read in its ordinary meaning, the amended provisions would appear to apply to bona fide commercial transactions which also result in significant tax savings through effective tax planning. For example, the injection of profitable activities into a loss-making company would seem to come within the ambit of the amendment even though the consolidation of such activities may be carried on for bona fide commercial reasons.

Representations have been made by several international accounting firms to the relevant authorities since the Income Tax (Amendment) Bill was first read in Parliament in November 1987, seeking further clarification on this important issue. When the Bill was read a second and third time in Parliament on 13 January 1988, the Minister for Finance assured Parliament that the amended provisions of Sec. 33 were aimed at reducing blatant or contrived tax avoidance arrangements and were not intended to affect normal commercial transactions. The relevant sections of his speech are as follows:

> The need to strengthen Sec. 33 stems from the fact that tax avoidance schemes are getting increasingly complex and are becoming more "tailor made" to suit specific clients thereby adding to the difficulty in identifying them. The existing Sec. 33 is grossly inadequate to deal with these schemes. Most countries have taken steps to strengthen their legislation to combat tax avoidance. Even Hong Kong has far wider provisions than our proposed amendment.
>
> In assessing whether a particular scheme would fall under the ambit of Sec. 33, the Inland Revenue Department would, among other things, look for the presence of artificiality, the interposing of various intermediaries or transactions to reduce or avoid tax and transfer pricing. It should be stressed that the aim is to reduce blatant or contrived tax avoidance arrangements and is not intended

1. Both the old and new Sec. 33 are reproduced in Appendix I.

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to affect normal commercial transactions. I would also like to clarify that companies and individuals granted tax exemptions and concessions under specific incentive schemes would not be affected by the new Sec. 33. They will continue to enjoy the tax concessions.

Additionally, I would like to suggest that financial institutions and other companies approach the Monetary Authority of Singapore and the Economic Development Board respectively, for assistance, in the event of any uncertainty. The Monetary Authority of Singapore and Economic Development Board would assist companies in their consultation with Inland Revenue Department to determine whether their proposed schemes or transactions fall within the ambit of the new Sec. 33. If necessary, the matter would be referred to the Ministry of Finance where a decision will be taken, after considering the substance of the transactions and the benefits they would bring to Singapore.

I believe the measures I have just enumerated would give businesses sufficient degree of certainty in respect of the new Sec. 33. I would like to reiterate that the sole objective of the amendment is to curb the proliferation of blatant tax avoidance schemes in Singapore and is not intended to affect normal commercial transactions.

We draw particular comfort from the Minister's reassurance that the sole objective of the anti-avoidance legislation is to curb blatant tax avoidance schemes and is not intended to affect normal commercial transactions. The business community and professional advisors such as lawyers and accountants are currently lobbying support for some type of ruling policy to provide guidance on the interpretation of Sec. 33 and some other areas of tax legislation which are unclear at present. It is hoped that such a ruling policy will eventually form the basis from which a set of "Statement of Practices" will be issued by the authorities on various tax issues.

DEDUCTION OF TAX FROM DIVIDENDS (FRANKING OF DIVIDENDS)

1. Under the old legislation (i.e. Sec. 44), every company resident in Singapore is entitled to deduct income tax at the rate of 33% upon payment of a dividend. Where no deduction of tax is made, the dividend is deemed to be a dividend of a gross amount which, after deduction of tax of 33%, would be equal to the net amount paid.

At the end of each year of assessment, every resident company must file a statement comparing:
(i) taxes paid/payable to the Singapore tax authorities; with
(ii) taxes deducted (or deemed deducted) from dividends paid,
both figures being cumulative from year to year.

If (ii) exceeds (i), a "Sec. 44 charge" equal to the difference is imposed on the company. The charge is not treated as "tax paid in advance" to the Singapore tax authorities. If (i) exceeds (ii), the balance is carried forward as a "Sec. 44 credit balance".

From the shareholder's viewpoint, the gross dividend is assessable to Singapore tax at his personal tax rate. However, he is entitled to a credit for the tax of 33% deducted or deemed deducted from the dividend. Any unutilized credit will be refunded to the shareholder.

2. Sec. 44 is amended retrospectively with effect from 1 January 1987 to treat the Sec. 44 charge as "tax paid in advance" to the Singapore tax authorities, which would be available for offset against any tax subsequently assessed on the company. Thus, it is now possible for a resident company to declare and pay dividends to its shareholders even though it does not have sufficient franking credits, by paying its corporate taxes in advance.

3. Illustrations of the effects of the amendment to Sec. 44 are included in Appendix II. Key points to note are:

(i) A Sec. 44 charge or credit balance will now be determined upon every dividend payment by comparing:
  (a) the tax deducted (or deemed deducted) from dividends paid, with
  (b) the aggregate of the Sec. 44 credit balance after the preceding dividend payment and any tax assessed during the period from the date of the preceding dividend payment to the day before the payment of the current dividend.

  If (a) exceeds (b), a Sec. 44 charge arises. If (b) exceeds (a), the balance will be carried forward to the next dividend payment.

  While specific provisions have been introduced to deal with the transition from the existing Sec. 44 system to the new system, there are questions which need further clarifications.

(ii) The Sec. 44 charge must be paid over to the tax authorities within 14 days from the date of payment of the dividend, failing which late payment penalties of up to 17% of the tax will be imposed. Any tax assessed on the company and which is taken into account in (i) above and which is unpaid as of the date of payment of dividend must be paid immediately to the Comptroller, notwithstanding that it is not due or it is under dispute.

(iii) Where any tax assessed which has been taken into account under (i)(b) above is subsequently reduced and as a result a Sec. 44 charge or additional charge arises, such charge or additional charge must be paid to the Comptroller within 14 days of the notice of the charge or additional charge; failing which late payment penalties of up to 17% of the charge or additional charge would be imposed.

(iv) Every company must now submit a statement of its Sec. 44 account immediately after payment of the dividend, in addition to filing a statement of Sec. 44 account at the end of each year of assessment.

(v) Any Sec. 44 charge or additional charge paid by a company will be used to offset any tax subsequently assessed on the company. There is no provision for any refund of any unutilized charge in the event of winding up.

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(vi) Where the Sec. 44 charge or additional charge is not paid within 14 days, or by 31 December of the year in which the dividend is paid, whichever is later, the shareholder will be taxed on the net dividend received and no underlying tax credit will be given to him.

EXTENSION OF THE WITHHOLDING TAX PROVISIONS

(1) Currently, under Sec. 12(6), any interest, commission, fee or any other payment in connection with any loan or indebtedness or with any arrangement, management, guarantee or service relating to any loan or indebtedness is deemed to be derived from Singapore where it is borne directly or indirectly by a person resident in Singapore or a permanent establishment in Singapore except in respect of any business carried on outside Singapore through a permanent establishment outside Singapore or any immovable property situated outside Singapore. Where, however, the arrangement, management, guarantee or service is performed outside Singapore, the Minister of Finance issued a Press Statement in 1977 to confirm that the payments for such arrangement, guarantee, management or service do not fall within the ambit of Sec. 12(6).

(2) While a payment may be deemed to be derived from Singapore under Sec. 12(6), the old withholding tax provisions (i.e. Secs. 45, 45A and 45B) cover only interest (other than inter-bank interest), royalties, technical fees, rental, management fees and directors' fees. Commission, fees or any other payment (e.g. discounts) falling within the ambit of Sec. 12(6) were not subject to withholding tax. The withholding provisions have now been extended to cover such payments. The effective date for the change will be 29 January 1988.

We understand that the Press Statement issued by the Ministry of Finance in 1977 will continue to prevail and that the current concession given to exempt inter-bank interest from withholding tax will be extended to cover inter-bank payments for commission, fees, discounts and other payments on debt instruments.

OTHER CHANGES

(1) *Special tax concession for royalties or other payments received from a publisher carrying on the business of publishing in Singapore*

Sec. 10(9) was introduced in 1983 to encourage authors and composers, living in Singapore or abroad, to publish their works in Singapore. The concession limits the taxable income of the authors or composers to the lower of the net royalties (i.e. after allowing for tax-deductible expenses) and 10% of the gross royalties.

The concession granted under Sec. 10(9) is now restricted to exclude royalties or payments received in respect of any work published in any newspaper or periodicals.

(2) *Industrial building allowances (IBA)*

IBA would be granted in respect of capital expenditure incurred on or after 1 January 1986 on an approved project for the promotion of the tourist industry (other than a hotel). The rate of allowances would be 20% for initial allowance and 2% for annual allowance.

(3) *Tax incentive for securities trading*

The 10% concessionary rate of tax applicable to ACUs and approved fund managers has been extended to a company whose business includes dealing in securities and which is licensed as a dealer or is exempt from holding a dealer's licence under the Securities Industry Act.

(4) *CPF Minimum Sum Topping-up Scheme*

Tax relief would be granted to an individual resident in Singapore in respect of contributions made on or after 1 April 1987 to top up the Minimum Sum Accounts of his parents. The maximum relief, however, is restricted to S$ 6,000.

(5) *Exemption on withdrawals from any approved pension or provident funds*

Sec. 13(1)(j) has been amended to restrict the tax exemption granted in respect of withdrawals from any approved pension or provident funds to withdrawals which satisfy the conditions relating to withdrawals under the Central Provident Fund Act and Regulations.

(6) *Tax rate for non-exempt dividends received by any institution, authority, person or fund specified in the First Schedule to the Income Tax Act*

The tax rate would be specified as the normal corporate tax rate which is 33%.

APPENDIX I

ANTI-AVOIDANCE TAX LEGISLATION (SEC. 33 OF THE INCOME TAX ACT)

Old legislation

33(1) Where the Comptroller is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the persons concerned shall be assessable accordingly.

(2) In this section "disposition" includes any trust, grant, covenant, agreement or arrangement.

New legislation

33(1) Where the Comptroller is satisfied that the purpose or effect of any arrangement is directly or indirectly:

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(a) to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person;
(b) to relieve any person from any liability to pay tax or to make a return under this Act; or
(c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by this Act,

he may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or vary the arrangement and make such adjustments as he considers appropriate, including the computation or recomputation of gains or profits, or the imposition of liability to tax, so as to counteract any tax advantage obtained or obtainable by that person from or under that arrangement.

(2) In this section, "arrangement" means any scheme, trust, grant, covenant, agreement, disposition, transaction and includes all steps by which it is carried into effect.

(3) This section shall not apply to:
(a) any arrangement made or entered into before the commencement of the Income Tax (Amendment) Act 1988; or
(b) any arrangement carried out for bona fide commercial reasons and had not as one of its main purposes the avoidance or reduction of tax.

APPENDIX II

ILLUSTRATIONS ON THE AMENDMENTS TO SEC. 44

Illustration 1

(a) Where an assessment has not been raised but a company commenced to pay the tax by instalment, the instalments paid will not be taken into account in computing the Sec. 44 account balance on the date of dividend payment. An arrangement, however, would be made to revise the instalment plan to reflect the tax charge paid to the Comptroller of Income Tax (CIT).
(b) Where an instalment arrangement has been made with the tax authorities in respect of an assessment raised, the following special arrangements would apply:

Facts

(i) Company X's Sec. 44 account balance as at 31 December 1987 was S$ 5,000,000.
(ii) Company X arranged an instalment payment plan for year of assessment (YA) 1988 estimated tax of S$ 10,000,000 to be paid by 10 instalments commencing 31 January 1988.
(iii) Company X received an estimated assessment for YA88 for S$ 10,000,000 on 1 February 1988.
(iv) Company X paid a gross dividend of S$ 30,000,000 on which the tax deducted is S$ 9,900,000 on 1 April 1988.

Solution 1

Sec. 44 account as of 1 April 1988:

	S$ '000
Balance as of 1 January 1988 (credit)	5,000
Add: YA88 tax assessed on 1 February 1988	10,000
	15,000
Less: Tax deducted from dividends paid on 1 April 1988	(9,900)
Balance as of 1 April 1988 (credit)	5,100

Tax to be paid to the CIT immediately upon payment of dividend:

	S$ '000
Tax deducted from dividend	9,900
Taxes paid brought forward	(5,000)
Taxes paid by instalment from January to March 1988	(3,000)
Tax to be paid on 1 April 1988	1,900

The instalment plan from April to October 1988 would be revised to take into account the S$ 1,900,000 paid on 1 April 1988.

Illustration 2

Facts

(i) As of 31 December 1986, the Sec. 44 account of Company X shows a NIL balance.
(ii) On 1 February 1987, Company X declared a gross dividend of S$ 1m.
(iii) The tax computation of Company X shows that Company X will have a chargeable income of S$ 1.5m for YA87.
(iv) On 31 December 1987, an estimated assessment was raised on Company X for S$ 495,000 based on an estimated chargeable income of S$ 1.5m.

Solution 2

Before

Sec. 44 account is prepared by Company X at the end of each YA.

At the end of YA87, the Sec. 44 account of Company X will appear as follows:

	S$ '000
Balance at 31 December 1986	NIL
Tax payable for YA87	495*
	495
Less: Tax deducted from dividends paid on 1 February 1987	(330)
Balance as of 31 December 1987	165

* To be paid to the CIT before 30 January 1988.

Now

Sec. 44 account is prepared by Company X on payment of a dividend and at the end of each YA.

	S$ '000
Balance as of 31 December 1986	NIL
Add: Tax assessed during the period 1 January to 31 January 1987	NIL
Less: Tax deducted from dividends paid on 1 February 1987	(330)
Sec. 44 charge	(330)*
Add: Tax assessed during the period 1 February to 31 December 1987	495**
Balance as of 1 January 1988	165

* Strictly speaking, the charge has to be paid to the CIT within 14 days by 15 February 1987. The CIT has indicated that for charges arising before the enactment of the Act, the company may comply with the new provision within 14 days from the date of enactment.
** Only S$ 165,000 needs to be paid to the CIT before 30 January 1988.

Illustration 3

Facts

(i) Company A closes its financial year annually on 31 December.

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(ii) It has accumulated tax losses of S$ 10m up to 31 December 1986, which have yet to be agreed with the CIT, and no Sec. 44 credits as of 31 December 1987.
(iii) During financial year ending 31 December 1987, its trading activities resulted in a taxable profit of S$ 9m. Company A also received a net dividend of S$ 1.34m (gross dividend of S$ 2m on which tax of S$ 660k has been deducted at source). The tax computation shows the position of Company A for YA88 to be as follows:

	S$ '000
Adjusted profit	14,000
Less: Capital allowances	(5,000)
Taxable trading profit	9,000
Dividend (gross)	2,000
	11,000
Less: Tax losses brought forward	(10,000)*
Chargeable income	1,000

	S$' 000
Tax at 33%	330
Less: Tax deducted at source	(660)
Tax refund	(330)

* To be agreed.

(iv) On 30 June 1988, Company A paid a gross dividend of S$ 1m to its shareholders.
(v) No notice of assessment had been issued to Company A for YA88 as the prior year's assessments had not been finalized.

Solution 3

Before

Sec. 44 account is prepared by Company A at the end of each YA.

At the end of YA88, the Sec. 44 account of Company A will appear as follows:

	S$ '000
Balance at 31 December 1987	NIL
Tax payable for YA88	330
	330
Less: Tax deducted from dividends paid on 30 June 1988	(330)
Balance at 31 December 1988	NIL

Now

Sec. 44 account is prepared by Company A on payment of a dividend and at the end of each YA. When Company A makes a payment of dividend on 30 June 1988, the Sec. 44 account will be as follows:

	S$' 000
Balance as of 31 December 1987	NIL
Add: Tax assessed during the period 1 January to 29 June 1988	NIL
Less: Tax deducted from dividends paid on 30 June 1988	(330)
Sec. 44 charge	(330)*

* This must be paid to the CIT within 14 days by 14 July 1988 notwithstanding that the company has a potential tax refund of S$ 330,000, because no assessment for YA88 has been raised.

Illustration 4

Facts

(i) Company X, which has a September 30 year-end, was incorporated on 1 January 1985.

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(ii) On 31 December 1987, the company's Sec. 44 credit balance was calculated as follows:

	S$ '000
Tax provisionally assessed and paid for YA86 based on computation submitted	20,000
Less: Tax deducted from dividends paid in 1986	(NIL)
Balance as of 31 December 1986	20,000
Tax payable for YA87 – provisionally assessed and paid in 1987	5,000
Less: Tax deducted from dividends paid in 1987	(NIL)
Balance as of 31 December 1987	25,000

(iii) The following dividends were paid during 1988:

	Date of payment	Gross dividend $S '000	Tax deemed deducted $S '000	Net dividend paid $S '000
1st	9 Oct. 1988	100,000	33,000	67,000
2nd	9 Dec. 1988	10,000	3,300	6,700

(iv) The following assessments were received during 1988:

Date of assessment	Type	YA	Tax assessed $S '000	Status
1 Oct. 1988	Original	1988	5,000	Provisional
15 Nov. 1988	Additional	1986	2,000	Agreed
1 Dec. 1988	Original	1989	6,000	Provisional
15 Dec. 1988	Amended	1987	3,000	Agreed*

* Refund of S$ 2,000,000 due under Sec. 93(1).

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Solution 4

		Payment/ (Refund)
	S$ '000	S$ '000
Step 1		
1 October 1988 – YA88 Original assessment of S$ 5m		
Sec. 44 balance as of 31 December 1987	25,000	25,000
Add: Tax assessed for YA88 (1 October 1988)	5,000[1]	5,000
Sec. 44 balance as of 1 October 1988	30,000	
Step 2		
9 October 1988 – Gross dividend of S$ 100m paid		
Sec. 44 balance as if 1 October 1988	30,000	
Less: Tax deducted from dividend (9 October 1988)	(33,000)	
Sec. 44 charge as of 9 October 1988	(3,000)[2]	3,000
Step 3		
15 November 1988 – YA86 Additional assessment of S$ 2m To restate 31 December 1986 Sec. 44 balance		
Sec. 44 balance as of 31 December 1986	20,000	
Add: Additional tax assessed for YA86 (15 November 1988)	2,000[3]	2,000
Revised Sec. 44 balance as of 31 December 1986	22,000	
Add: Tax payable for YA87 – provisionally assessed and paid in 1987	5,000	
	27,000	
Add: Tax assessed for YA88 (1 October 1988)	5,000	
	32,000	
Less: Tax deducted from dividend (9 October 1988)	(33,000)	
Revised Sec. 44 charge as at 15 November 1988	(1,000)[4]	(2,000)
		Payment/ (Refund)
	S$ '000	S$ '000
Step 4		
1 December 1988 – YA89 Original assessment of S$ 6m		
Sec. 44 balance as of 15 November 1988	NIL	
Add: Tax assessed for YA89 (1 December 1988) 6,000		
Less: Revised Sec. 44 charge as of 15 November 1988 (1,000)		
	5,000[5]	5,000
Sec. 44 balance as of 1 December 1988	5,000	

Step 5

9 December 1988 – Gross dividend of S$ 10m paid		
Sec. 44 balance as of 1 December 1988	5,000	
Less: Tax deducted from dividend (9 December 1988)	3,300	
Sec. 44 balance as of 9 December 1988	1,700	

Step 6

15 December 1988 – YA87 Amended assessment of S$ 3m (Reduced from S$ 5m to S$ 3m)		
Sec. 44 balance as of 9 December 1988	1,700	
Add: Sec. 44 charge in respect of reduced YA87 tax (15 December 1988)	2,000	
Sec. 44 net charge as at 15 December 1988	300[6]	(1,700)
		36,300

1. Although the tax is not due for payment until 31 October 1988 under Sec. 86, Company X will now have to pay it immediately to the CIT on 9 October 1988 (the date of payment of dividend) (see Step 2).
2. The Sec. 44 charge has to be paid to the CIT by 23 October 1988 (within 14 days).
3. Sec. 44 charge overpaid of S$ 2,000,000 will be used to offset the YA86 Notice of Additional Assessment of S$ 2,000,000.
4. See footnote 3.
5. If Company X has not paid the tax payable of S$ 5,000,000 by 9 December 1988 (the date of payment of dividend) (see Step 5), it has to pay S$ 3,300,000 to the CIT immediately. The balance of S$ 1,700,000 can be paid on or before the normal due date as provided for under Sec. 86 (i.e. on or before 31 December 1988).
6. The charge of S$ 300,000 would normally be payable within 14 days of the Notice of Charge to be issued by the CIT under Sec. 44(5) but as a result of the amended assessment for YA87 there is a tax refund of S$ 2,000,000 due under Sec. 93(1). The tax refund will be reduced by the net charge unutilized of S$ 300,000 so that Company X will only receive a tax refund of S$ 1,700,000 in respect of YA87.

Thus:

	S$ '000	S$ '000
Tax assessed –		
Brought forward		25,000
YA86 Additional		2,000
YA87 Amended (Amended from S$ 5,000,000 to S$ 3,000,000)		(2,000)
YA88 Original		5,000
YA89 Original		6,000
Total tax assessed and payable		36,000
Tax charge unutilized		300
Total tax deducted from dividends paid in 1988		36,300
Less: Taxes paid		
Brought forward	25,000	
YA86 (Offset charge S$ 2,000,000) (Step 3)	2,000	
YA88 (Paid S$ 5,000,000) (Step 1)	5,000	
YA89 (Offset charge S$ 1,000,000, paid S$ 5,000,000) (Step 4)	6,000	
Total payment		(38,000)
Refund due to Company X		1,700

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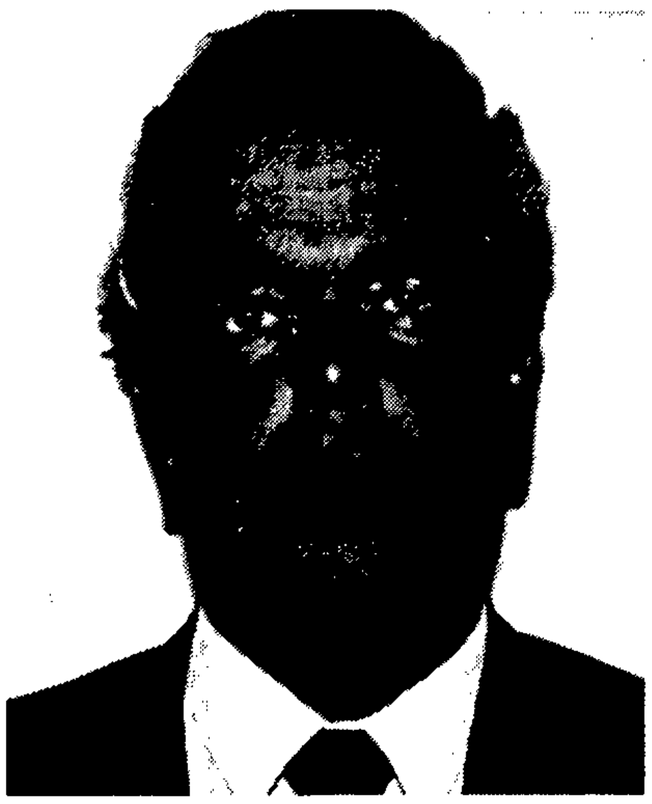

HONG KONG:

1988/89 Budget

By I.W. Harris

Mr. Harris is Group Tax Adviser of The Hongkong and Shanghai Banking Corporation.

I. INTRODUCTION

Hong Kong's Financial Secretary Piers Jacobs was in an enviable position on Wednesday, 2 March 1988 when he presented his Budget for 1988/89 by having a surplus of some HK$ 7.6 billion (US$ 970 million) compared with the original forecast surplus in the 1987 Budget of HK$ 1.4 billion. The Financial Secretary stated that the surplus had been occasioned partly due to the ability of the Hong Kong Government to contain increases in expenditure but more particularly due to the buoyant revenue which had not been unduly affected (other than in respect of stamp duty on share transactions) by the events of 19 October 1987.

In presenting his Budget Mr. Jacobs noted that he was well aware of the need for increased expenditure, particularly in relation to medical and social welfare services, but also of the fact that Hong Kong, being reliant on exports for its living, was under continued pressure from its importing customer nations. Mr. Jacobs stated that although the surplus for fiscal year 1987/88 was far greater than forecast last year, it would be most unwise to dissipate the whole of the increased surplus on either increased expenditure or reduced taxes. Consequently, his proposals had been framed with a proper amount of caution.

II. THE CURRENT ECONOMIC CLIMATE

In framing these proposals for 1988, Mr. Jacobs looked first at the economic prospects which, particularly for Hong Kong, are always a difficult task. 1988 would be no easier given the prevailing climate of uncertainty, despite a buoyant economy at present. However, he expected 1988 to be a year of consolidation with a more balanced pattern of growth between external and domestic demand. The growth in the economy of Hong Kong's major customer, the United States, was expected to be slack which, coupled with changes in the U.S. generalized system of preference, is unlikely to produce increased export in that area. However, exports to Japan, Germany and the United Kingdom are expected to increase, to give a forecast increase in domestic exports of 6%. Re-exports are expected to grow by 12% to give an overall increase in the forecast rate of exports of 9%.

Domestic consumption is expected to grow more moderately in 1988 which, coupled with a similar modest growth in capital expenditure, will provide a forecast growth rate of GDP for 1988 of 5%. This in turn provides the following scenarios:

- Given the tight labour market in 1987, the unemployment rate is likely to remain low (it was 1.8% for much of 1987).
- The rate of inflation is expected to average about 7%.
- Imports are expected to increase by 9.5%.
- The rise in GDP in money terms is expected to be about 13% in 1988 to give a per capita GDP figure of some HK$ 72,000 (US$ 9,200).

III. THE MEDIUM RANGE FORECAST

A. General strategy

The Financial Secretary highlighted 3 major features of the forecast for the period to 1991-92 as the forecast forms the basis of the Government's budgetary strategy:

1. With revenue running well ahead of expenditure, the average amount of surplus for the forecast period would be some HK$ 5.9 billion if no fiscal measures are taken.
2. This surplus is well ahead of the HK$ 2 billion required each year to maintain the real value of Hong Kong's reserves.
3. With Government expenditure remaining below the 16% mark as a proportion of total GDP, the aim of Government expenditure not shutting out private sector demand is being achieved.

B. Expenditure

Expenditure is expected to increase by 5.4% per annum in real terms over the forecast period compared

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with the revised estimate for 1987 of 5%. The 1988 Budget estimates include a higher than normal rise in the size of the civil service by some 4%. This increase, however, is largely due to the staffing impact of some major new medical facilities and the build-up of the police force in preparation for taking over the work of the British garrison in Hong Kong. The Financial Secretary was particularly aware of the need to contain the growth and size of civil service, particularly given the general labour shortage in Hong Kong.

The expenditure side, however, is likely to command additional rersources and included in the expenditure for 1988/89 are measures to improve welfare assistance for the elderly and the disabled who require constant attendance, planned expansion of various welfare services and major new facilities such as the Hong Kong University of Science and Technology, the Tuen Mun Hospital and the Pamela Youde Hospital. Taken together, these measures result in a growth rate in respect of social services which will ensure that this sector obtains an increasingly large slice of the cake in the future. Although this should be accepted as a trend to reflect the aspirations of a developing community as it grows more prosperous, it is important to bear in mind that this expenditure largely benefits the less affluent members of the community. Other major Government areas of expenditure are to be focused on transport where work is progressing on a new road and rail harbour crossing, and an additional tunnel to connect Kowloon with the New Territories.

C. Revenue

While revenue from earnings and profits tax has been particularly buoyant in 1987/88, the Financial Secretary continues to express concern about the cyclical nature of revenue from this source and his desire to look at a more stable tax base. He announced that a number of studies had been undertaken during the year towards the introduction of an indirect tax which should produce a stable and worthwhile revenue yield at a low tax rate but, at the same time, cause minimum distortion to the economy and which is also simple and cheap to administer. Although work is still progressing, the studies so far suggest that some form of sales tax, probably at the wholesale level, would meet the criteria, but further study is required before a document is available for public discussion.

IV. TAXATION REVENUE MEASURES

In preparing his draft estimate of revenue, the Financial Secretary forecast that the general revenue account for 1988/89 before any proposals for adjustments to taxation would be HK$ 55.5 billion, an increase from the revised estimate of HK$ 50.5 billion for 1978/88 of some 10%. This, together with the increased estimated expenditure for 1988/89, would result in an estimated surplus on general revenue account for 1988/89 of HK$ 5.6 billion before any revenue measures. The Financial Secretary considered that it would be in order to introduce a package of concessions which would reduce the revenue yield by HK$ 1.8 billion in 1988/89 increasing to HK$ 2.7 billion in a full financial year. Despite the overall intention to reduce taxes, the Financial Secretary introduced some revenue-raising measures to reflect the real value of the duties and charges in relation to inflation. These would produce HK$ 390 million in 1988/89 rising to HK$ 507 million in a full year. The measures proposed are as follows:

1. Motor spirit from HK$ 2.40 per litre to HK$ 2.55 per litre.
2. Motor diesel from HK$ 1.20 per litre to HK$ 1.27 per litre.
3. Cigarettes from HK$ 165 per 1,000 sticks to HK$ 175 per 1,000 sticks.
4. Cigars from HK$ 220 to HK$ 233 per kilogramme.
5. Chinese prepared tobacco from HK$ 43 to HK$ 45.5 per kilogramme.
6. Vehicle and driving licence fees to be increased by around 6%.
7. Bank and deposit taking company licence fees to be increased by 8%.
8. Sundry other charges and fees will be reviewed during the year.

V. SALARIES TAX

The major focus of the tax concessions centred on personal tax. The Financial Secretary declared that his intention was to slow down the rate at which individuals moved into higher tax brackets and, in fact, to come within the tax net at all. Therefore, he raised allowances broadly in line with inflation but it was his view that increases in real income will have the overall effect of increasing the number of taxpayers. Mr. Jacobs stated that through the combination of these features he seeks to move towards a more robust and equitable fiscal regime. Therefore, he proposed not only to reduce the standard rate, but to change the bands to provide both a lower initial rate and a more gradual progression through the various marginal rates. The changes are as follows (1987/88 rates are included for comparison):

	HK$	*HK$*
Personal allowance (single)	29,000	29,000
(married)	60,000	60,000
Additional personal allowance (single)	5,000	7,000
(married)	10,000	14,000
Working wife allowance	—	15,000
Child allowance – 1st child	11,000	12,000
2nd child	8,000	8,500
3rd child	3,000	3,000
4th-6th child (each)	2,000	2,000
7th-9th child (each)	1,000	1,000
Dependent parent allowance	9,000	10,000
Additional independent parent allowance	3,000	3,000

The Financial Secretary made a particular reference to the question of taxation of married women; although (in his 1987 Budget Speech) he had not been in favour

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of separate taxation for married women in view of the complexities of its administration and the cost to Government revenue, he now undertook to review the various options. In the meantime, he proposed an allowance of HK$ 15,000 as a measure of relief against the income of a married woman or her actual income, whichever is less.

VI. PROFITS TAX, INTEREST TAX AND PROPERTY TAX

As regards profits tax, the Financial Secretary proposed a reduction in the rate from 18% to 17% at a full year cost of some HK$ 760 million. He mentioned that a number of arguments had been put forward for concessions to stimulate various sectors of the economy, but it was his view that selected inducements were not what was needed at this time; rather the proposed reduction in the rate of tax on corporate profits would provide appropriate and proper encouragement to all those in business. It remains to be seen whether this argument is acceptable to the business community. The standard rate for unincorporated businesses and for interest tax and property tax was reduced from 16½% to 15½%.

VII. OTHER TAXES

No changes were proposed to estate duty; however, the Financial Secretary proposed an increase in the threshhold of the stamp duty at which the 2.75% rate in respect of assignments of property begin to apply from the present HK$ 500,000 to HK$ 1.5 million, and to cut the rate of duty for properties costing between HK$ 250,000 and HK$ 1.5 million. These measures are designed to facilitate wider home ownership and assist the middle income group.

VIII. AIRPORT TAX

A final measure was a proposal to reduce the rate of airport departure tax from its present rate of HK$ 120 for an adult and HK$ 60 for a child to HK$ 100 for an adult and HK$ 50 for a child.

IX. CONCLUSION

In his concluding remarks, Mr. Jacobs stated that in putting together his tax proposals, he deliberately sought a broadening of the tax base to achieve greater fiscal stability. In the context of his theme of continuity in forward planning, Hong Kong must be reminded of the need for prudence. Hong Kong is becoming increasingly complex and the range of functions required of the administration is expanding. The private sector also plays its part, particularly in the provision of infrastructure, and the Government is increasing its use of statutory bodies. Mr. Jacobs submitted that all this is evidence of dynamism and change but he remains aware of the need of the continuing vigilance regarding the growth in public sector expenditure. Experience elsewhere shows that an expanding public sector in relation to the economy as a whole is a major factor in dampening long-term economic prospects and this should not be allowed to happen in Hong Kong. His concluding remark was in relation to his theme of continuity of policies and he concluded with the words of T.S. Eliot:

What we call the beginning is often the end
And to make an end is to make a beginning
The end is where we start from.

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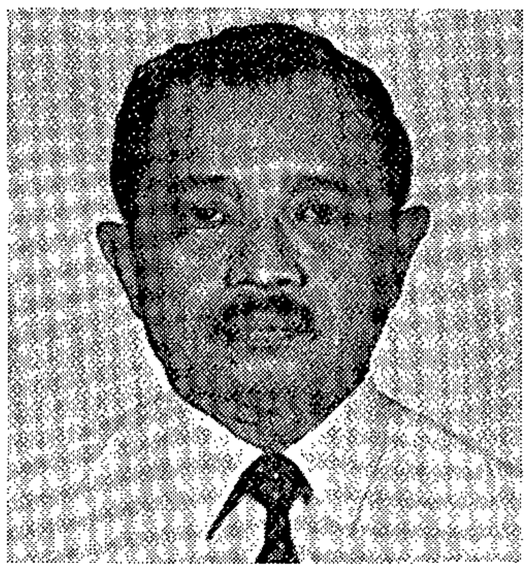

INDONESIA:

Taxation of Income from Capital: Two Issues

By R. Mansury*

I. INTRODUCTION

For income tax purposes, income is classified (according to the source from which it derives), as employment income, business income, income from capital or income derived in the form of social security benefits.[1] Income from capital can be defined as the earnings received for placing capital in the form of cash, durable goods or intellectual property at the disposal of a third party. For example, income from capital comprises:

- interest, by which is meant the remuneration a lender receives from a borrower for the use of capital;
- dividends paid on company shares, including founders' shares and other similar rights, but excluding debt-claims; dividends are the remuneration received for participating (with limited liability) in the capital of a company;
- royalties, which are the remuneration received from a licensor for the use of copyrights, patents, secret formulae and know-how; and
- rentals, which are the remuneration received by a lessor from a lessee for the use of land, buildings or equipment.

This article examines 2 significant issues relating to the taxation of income from capital in Indonesia:

- the taxability of interest received and the deductibility of interest paid; and
- the different tax treatment of interest and dividends, a difference which is closely related to the issue of integration of the taxation of distributed company income at the corporate and shareholder level.

The theoretical concepts of both issues are examined as well as practical implementation in Indonesian legislation; the author then expresses his own views.

II. TAXABILITY AND DEDUCTIBILITY OF INTEREST

A. Theoretical views

(1) Comprehensive income tax base

An income tax system which imposes tax on a comprehensive basis ideally should include all interest receipts in the taxpayer's taxable base. Consequently, as a general rule, all interest should be taxed in the hands of the recipient. For example, if a borrower participates in business activities and uses the borrowed funds to produce goods and services, he must pay a remuneration out of the gross income he earns to the owners of the factors of production.[2] He must pay interest to the lender of the funds, who, in turn, must include the interest received in his taxable income.

As a further illustration, consider the case of an individual who does not participate in a business but who borrows funds to purchase a house which he rents to a third party: the rent received constitutes taxable income but the borrower should be allowed to deduct the interest on the loan used to finance the house. The recipient of the interest should include the interest in his taxable income.[3]

In practice, however, it appears that although many tax systems profess to utilize a "comprehensive" meaning of income, they exclude certain interest from taxation. In the United States, for instance, interest receipts included in a pension plan are not taxed nor are interest receipts from insurance reserves and State and local bonds.[4] Similarly, by virtue of the Indonesian Income Tax Law 1984, interest included in payments received from an insurance company under an accident, illness, life or educational insurance contract are exempt from income tax as is interest from time deposits and other savings. Thus, tax systems may depart from the comprehensive taxation of income by exempting particular types of interest.

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1. See Cnossen, Sybren, "Agenda for Income Tax Reform in the Netherlands", 27 *Public Finance/Finances Publiques* 2 (1982) at 207-209.
2. The factors of production are land (including natural resources), labour and capital.
3. A common fallacy should be mentioned here. Some people feel that it is unfair to subject income from investments to taxation (for example, a house which is rented to a third party) because this results in double taxation, i.e. first the income from which the investment was made is taxed and then the income derived from investment is taxed. Needless to say, this is not a case of double taxation. However, income tax is levied on income regardless of whether the income is used for consumption or savings purposes. Interest or other returns from investment are subject to income tax, not because they are related to saving, but simply because they fall within the scope of the definition of income. See Goode, Richard, "The Individual Income Tax", Studies of Government Finance Washington, DC; The Brookings Institution, Revised Edition (1976) at 25-26.
4. Steuerle, Eugene: "Tax Arbitrage, Inflation and the Taxation of Interest Payments and Receipts", 30 *Wayne Law Review* 3 (1984) at 991-992.

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(2) Equal taxation of investment income

For efficiency and equity reasons, all kinds of interest should be taxed in the same manner as other income from capital.[5] A differential treatment of income from capital would result in economic inefficiency as a result of the distortion of the allocation of resources. If all interest receipts were not treated in the same manner as other income items, inequity in the distribution of income would result as well.

(3) Link between taxability and deductibility of interest

A close link exists between the taxability of interest receipts and the deductibility of interest payments. In this respect, 2 additional issues must be clarified. The first is connected with the taxability of income derived from an asset purchased with borrowed funds and the second relates to the different treatment of interest income and interest expense.

(a) *Borrowed funds*

If borrowed funds are used to purchase a house or other durable good for the private use of the owner, the benefit of using the good (under some tax systems) is translated into monetary terms and added to the taxpayer's taxable income in the form of an "imputed income". This method is utilized in Belgium, the Federal Republic of Germany, the Netherlands and Indonesia under the pre-1984 income tax system. If no income is assumed but the interest paid is still deductible for purposes of income tax, the interest is a negative item in computing taxable income because it may be deducted from income from other sources. The situation in France is illustrative. Imputed income is not added to the income of an owner-occupier but interest paid to finance the house is deductible within certain limits. This process of borrowing funds to purchase an asset when the income of the asset receives privileged tax treatment or is not taxed at all, but the interest paid is fully deductible, is known as *arbitrage*.[6]

(b) *Tax arbitrage*

Tax arbitrage can also occur in those instances where interest is taxed at a lower rate than that applicable to the income from which the interest may be deducted. For example, this would be the case if interest received is subject to a reduced flat rate of income tax or withholding tax which satisfies the recipient's tax liability, whereas the interest paid could be deducted as an expense from income which is subject to steeply progressive rates. It would then be advantageous for taxpayers to borrow money from a bank, invest the money in the pertinent assets (e.g. interest-bearing securities) and benefit from the discrepancy between the rates of income tax on the interest received and the income from which the interest may be deducted.

The following example is illustrative. Assume that an individual borrows 1,000,000 Rp. at a rate of 10% and places this amount in a time deposit from which he receives 10% interest. Assume further that the interest received is subject to a 15% withholding tax which is a final tax and that the average rate of income tax imposed on the taxpayer's other income of 500,000 Rp. is 30%.

His income tax can be computed as follows:

"Other" income	500,000 Rp.	
Interest paid	100,000 Rp.	
Income tax 30% of	400,000 Rp.	= 120,000 Rp.
Income tax on interest received		
15% of 100,000		= 15,000 Rp.
Total income tax		135,000 Rp.

If the taxpayer had not borrowed any money to place in a time deposit, he would have been subject to an income tax of 30% of 500,000 Rp. = 150,000 Rp.

Tax arbitrage will be advantageous so long as the after-tax net income is higher than the tax due in the situation in which no tax arbitrage was performed. The lower the tax on the interest income (in this case the interest received on the time deposits) the more attractive tax arbitrage becomes.

Preferential tax treatment of interest will create a tax arbitrage problem which – if accepted for tax purposes – will result in distortions in the economy and vast amounts of energy will be wasted on tax planning which, as such, has no value to the economy.[7] Steuerle offers a solution for the tax arbitrage problem by not treating interest receipts separately but rather by aggregating them. He also advocates a comprehensive tax reform by broadening the tax base and lowering the tax rates.[8] In contrast, Bird suggests a more limited action by issuing rules to allocate interest deductions between taxable and non-taxable assets and limiting the deductibility of interest only to loans used to purchase assets producing taxable income.[9]

The deductibility of interest payments can be limited by:

- Denying an interest deduction for interest paid on loans if it can be established that the loans were merely used to acquire assets producing tax-preferred income. Employing this limitation requires an efficient tracing system to link interest payments to the use of the loan proceeds; otherwise the system will be ineffective.[10]

  Deductibility of interest can also be made conditional on the purpose of the loan rather than the actual use of the loan. For instance, interest paid on loans obtained for business purposes can be made deductible whereas loans obtained for pri-

5. Steuerle, op. cit. at 1,011.
6. Ibid., at 1,002-1,003. The reverse situation would result if the income derived from the asset was taxable but the interest paid to finance the purchase of the asset was non-deductible. Holding such an asset, however, is obviously less attractive.
7. Bird, Richard, "Comments on Tax Arbitrage, Inflation, and the Taxation of Interest Receipts and Payments" 30 *Wayne Law Review* 3 (1984) at 1,017.
8. Steuerle, op. cit. at 1,012.
9. Bird, op. cit. at 1,018.
10. McIntyre, Michael J., "Symposium: Canadian and American Perspectives on the Deduction for Interest Payments. Foreword", 30 *Wayne Law Review* 3 (1984) at 941.

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vate purposes (e.g. mortgage loans for financing the taxpayer's own dwelling-house) would not be deductible.[11]

- A second method allows taxpayers to deduct interest only if it is paid on loans obtained to produce investment income or business income. For instance, the interest could be limited to the amount of taxable income which the taxpayer receives from investments acquired with the loan funds and which he reports in his return. Employing this system implies that interest paid on home mortgages may not be deducted.[12] Even if the imputed income of an owner-occupied dwelling is taxed, the deductibility of interest paid on home mortgages cannot be justified since payment of the interest is more in the nature of consumption than of acquisition of income.[13]

B. Practice in Indonesia

(1) Before 1984

Before 1984 interest income received by residents of Indonesia was not taxed in practice. Interest earned on rupiah time deposits made for at least 30 days was exempt from income tax. Interest on time deposits in other currencies, and on demand deposits, was taxable under the law, but since no effective withholding tax was levied on such interest it also escaped taxation in practice.[14]

(2) From 1984

As indicated above, under the 1984 Income Tax Law, interest included in payments made by insurance companies under an accident, illness, life insurance and educational insurance contract is not included in taxable income. On the other hand, premiums paid for these types of insurance are generally not deductible. This system was designed to simplify the deductibility of insurance premiums and taxability of insurance proceeds.[15] These insurance premiums are deemed to be income of the employee only when the premiums have been paid by the employer. Under this system, the insurance premiums represent savings which are paid from taxable income. In other words, the income is taxed when received and not when used for consumption, and the return of the savings in the form of interest on the income thus saved is excluded from the recipient's taxable base.

Under the Income Tax Law 1984, a governmental regulation explicitly exempts from taxation interest derived from time deposits and other savings. Interest paid to earn, recover or secure income is deductible when computing taxable income. However, the interest exemption is limited to the amount of borrowed funds which exceed the amount on deposit.[16]

C. Comment

(1) Insurance payments

As set forth above, insurance payments under accident, illness, life and educational insurance policies as well as the interest included in these payments are excluded from taxable income. By disallowing the premium deduction, all savings through insurance companies are taxed and the principal amounts do not escape taxation. Thus, the exclusion of interest from taxable income can be considered as a small sacrifice to collect a much higher tax revenue. Taxing the interest would impose unwarranted complications on the tax authorities, i.e. it would be extremely difficult to determine the interest element in insurance payments and the ambiguities attending such a determination pave the way for potential abuse by officials. Therefore, this author believes the current tax policy with respect to insurance payments is a sound and realistic one. A golden rule dictates that if the best option is unattainable, the second best should be chosen.

(2) Time deposits and other savings

Any receipt of interest enhances the economic power of the taxpayer so an exemption of interest on time deposits violates the equity principle. Such an exemption also reduces tax revenue which creates a conflict with the "revenue-adequacy" principle. However, if interest was subject to tax, funds now invested in Indonesian time deposits could potentially be transferred to neighbouring countries, like Singapore or Hong Kong, where interest is exempt from income tax. It is true that Indonesia may decide to tax foreign-source interest received by Indonesian residents. However, such a provision would soon prove unworkable because recipients of the interest would be required to report the income and it would be practically impossible to obtain information from the foreign tax authorities (in particular in those cases where no tax treaty exists, as is the case between Indonesia and Singapore, and Indonesia and Hong Kong). Until the Indonesian Government develops an efficient administrative procedure in this area, exempting the interest on time deposits is the second best, but the only sensible, solution.

(3) Limitation of the interest deduction

Tax arbitrage violates both the equity and the revenue-adequacy principles. The limitation of the interest deduction is an effort to eliminate or at least mitigate the effects of tax arbitrage. First, interest paid to finance expenditure on consumption is non-deductible. Sec-

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11. Goode, op. cit. at 151.
12. McIntyre, op. cit. at 941-942.
13. Goode, op. cit.
14. Other interest payments made to Indonesian residents were also taxable under the law but exempt in practice because the withholding tax could only be enforced for larger corporations in the public sector. See Internal Memo on the 1984 Tax Reform of 16 August 1982.
15. In addition, Indonesian society considers it inhumane to tax a recipient's insurance proceeds at a time when he suffers such a loss.
16. This may be illustrated by the following example: assume that a taxpayer has a time deposit of 1,000,000 Rp., at an interest rate of 17% per annum. In addition, he borrows 1,500,000 Rp. for his business at 19% per annum. The taxpayer is permitted to deduct 19% of (1,500,000 – 1,000,000) or 95,000 Rp.

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ondly, interest paid on loans obtained to finance income-producing activities is only deductible to the extent that the borrowed funds exceed the amount of time deposits. If no limitation existed, taxpayers (even those who have adequate financial resources) would be encouraged to borrow funds for investment in time deposits. In other words, the limitation of the interest deduction is an effective tool to prevent tax arbitrage and, in the author's opinion, an appropriate policy option.

From the revenue-collecting perspective, application of the equity principle and imposition of a easily-administered procedure, the provisions introduced by the 1984 Income Tax Law substantially improve the provisions of its predecessor.

III. DIFFERENT TAX TREATMENT OF INTEREST AND DIVIDENDS

A. Theoretical views

(1) Business income

Business income is earned by combining the factors of production (i.e. labour and capital (including land)). The owner of an enterprise must normally pay wages to workers, interest to lenders on borrowed capital and rental payments for the use of land. The remaining net revenue comprises the income of the entrepreneur. This system of income computation is also used to determine taxable income. However, if the entrepreneur uses his own capital in the enterprise, the interest imputed to the use of this capital is not tax-deductible. If the enterprise operates as a corporation, dividends (which, to a certain extent, are remuneration for the use of equity capital) are also not tax-deductible.

(2) Classical versus integration system

Under the so-called classical system, income of the corporation and its shareholders is taxed separately. The income is first taxed at the corporate level; then the after-tax income (to the extent it is distributed to the shareholders) is again taxed as the personal income of the shareholders. Distributed corporate profits are therefore taxed twice, a situation often described as "economic double taxation".

This double taxation can be eliminated or reduced by adopting an integration system applying the "imputation method", the dividend-paid deduction method or the split-rate method.[17] Under the imputation system, all or part of the corporate income tax is credited against the personal income tax due on the dividends received by the shareholder.[18] The dividend-paid method allows a deduction for all or part of the dividends which are distributed by the corporation.[19] The split-rate method adopts different rates for distributed and undistributed corporate profits, i.e. a lower rate applies to distributed profits.[20]

(3) Elimination of "economic double taxation"

The view that double taxation of distributed corporate income must be avoided (at all costs) by integrating corporate and personal income taxes seems to be an oversimplification of the problem. The following considerations also bear on the issue:

(a) The mere fact that an enterprise is conducted as a corporation offers a certain benefit to the shareholders.

(b) So long as corporate profits are not distributed to the shareholders no personal income tax is due. It should also be noted that most equity capital is raised by accumulation of the corporation's retained earnings which have not suffered double taxation. In this respect, there is no bias in favour of equity capital formed by accumulating profits over debt financing. Dividend relief is only necessary for *new* equity capital which is not raised by accumulating retained earnings. By granting the dividend relief only with respect to new equity capital, the revenue loss and the distributional impact in favour of equity holders would be much smaller than under an integration system (under which a relief is given for all distributed dividends).

Therefore, relief measures limited to dividends on shares issued under new share issues could eliminate the bias against equity financing which otherwise would exist under the classical system. The relief could be provided by granting a deduction for dividends paid, but the deduction should be limited to the amount of a reasonable rate of interest on the new equity.[21]

(4) Tax neutrality

If the policy is to realize tax neutrality between debt and equity financing, all distributions to shareholders (including redemption distributions) should be subject to income tax in the same manner. Accumulated earnings converted into equity capital (and thus not subject to personal income tax) should be subject to tax at a later date when the pertinent shares are redeemed. Under some tax systems, redemption gains are subject to capital gains tax rates which are lower than the general tax rates applicable to ordinary income.[22] If interest on debts used to acquire assets producing non-taxable income (e.g. tax-exempt bonds) or income subject to a preferred rate is disallowed as a deduction, a similar disallowance should apply to dividends on newly-issued equity.[23]

17. McLure, Jr., Charles. E., "Must Corporate Income be Taxed Twice", Studies of Government Finance, Washington DC: The Brookings Institution (1979) at 2-3.
18. A partial imputation credit is granted in Belgium, Denmark, France, Ireland, Italy and the United Kingdom. A full credit is given by the Federal Republic of Germany. The Sri Lankan 1988 Budget proposals contain a 50% imputation credit.
19. Under Greek law, distributed dividends are fully deductible.
20. Austria subjects distributed corporate income tax to a rate which is 50% of the rate applicable to undistributed income.
21. Andrews, William D., "Tax Neutrality Between Equity Capital and Debt", 30 *Wayne Law Review* 3 (1984) at 1,057-1,071.
22. Ibid. at 1,066-1,067.
23. Ibid. at 1,068-1,071.

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The views set forth above suggest that a tax system favouring a method of raising additional capital by accumulating its earnings, should be neutralized. Those views could be challenged because they are based more on value judgements rather than on a realistic perspective. Admittedly, the economic behaviour of a system which does not impose tax would be different from that in our society because we have created a bias in favour of a particular type of behaviour by introducing income tax. Inevitably, introduction of an income tax system creates bias affecting market behaviour and there are no guarantees that eliminating one bias will not create another. Only tax biases which create major problems in broad sectors (with considerable economic, political or social consequences) offer sufficient justification for a change in the tax system.[24]

B. The practice in Indonesia

(1) Before 1984

Under the (old) Individual Income Tax Ordinance 1944, a taxpayer computed his net taxable income by deducting from gross income all interest payable (provided that the interest was legally due to a creditor). However, interest could be deducted regardless of whether the loan was obtained for business or private purposes. Consequently, interest on loans for consumption purposes was also deductible. Because there was no actual interest due when an enterprise owner used his own funds as capital for the enterprise, no interest deduction could be taken.

Under the (old) Corporation Tax Ordinance 1925, interest paid was also deductible if it constituted part of the cost of producing income. However, the interest deduction was limited when payment was made to a related enterprise in that the rate of interest paid could not exceed the prevailing market interest rate. No deduction was allowed for a distribution of income, except for distributions to the State not acting in its capacity as a shareholder. Corporate taxpayers were not permitted to compute interest on their equity capital for deduction from their taxable income.

(2) As of 1984

The Income Tax Law 1984 contains similar provisions for the calculation of net taxable income of individuals and corporations. The only interest which is deductible in computing net taxable income is interest paid as a cost of earning, recovering or securing income. Interest paid on personal loans for purposes other than producing income cannot be deducted for purposes of computing net taxable income.

The Director General of Taxation is authorized to recompute the amount of income or deductions and he may also consider debt as equity in calculating net taxable income if a special relationship exists between 2 taxpayers. For individuals, a special relationship refers to family relations by blood or marriage in the direct line or in the second degree of consanguinity. For corporations, a special relationship exists if a corporation owns 25% or more of the capital of another corporation or 2 or more corporations are under the common ownership or control of a third corporation or individual.

The Minister of Finance has authority to issue a decree concerning the ratio of debt and equity of a firm for purposes of income tax. The Minister exercised this authority in 1984 but the decree was repealed before implementation as a result of strong taxpayer resistance.

As stated earlier, interest from time deposits is not taxable, but the interest deduction is limited if the taxpayer simultaneously invested money in a time deposit and obtained a loan. In such a case, interest is only deductible to the extent that it relates to the part of the loan which exceeds the amount of the deposit. Finally, in determining net taxable income, payments of dividends or other profit distributions by a corporation to its shareholders, dividends paid by an insurance company to its policy holders, and costs incurred for the benefit of shareholders are not deductible.

C. Comment

Certain biases inevitably follow in the wake of new tax systems. These biases often affect economic behaviour. Every income tax system establishes primary objectives, but certain side-effects may emanate when the system is implemented. The side-effects may be positive or negative. Positive effects can be construed as additional goals. If a tax system can achieve its objectives but the system gives rise to negative effects, the system should be reconsidered since the negative effects may outweigh the advantages and even ultimately prevent fulfilment of the goals. Undesirable effects may also be created in that the final outcome of the income tax is completely different than anticipated. This author believes that a minor bias should not be too hastily eliminated.

If the objective of imposing income tax is to tax the income of the owner of an enterprise and if this owner uses his own capital in the business, the interest which may be imputed to the owner's capital should not be deductible (if the tax base is to be comprehensive). Thus, if the enterprise operates as a corporation, the owner of the equity capital is legally the owner of the corporation. Consequently, imputed interest for using this capital should not be deductible for purposes of determining the corporation's net taxable income. However, one could also reason that, economically, the shareholders are the owners of the equity but their earnings in the form of distributed dividends cannot be considered as a deductible item for computation of the corporation's income tax.

The architects of the classical system had good reason to design it.[25] Features which are relevant to the Indonesian situation include:

24. Khan, Douglas A., "Comments on Tax Neutrality Between Equity Capital and Debt", 30 *Wayne Law Review* 3 (1984) at 1,081-1,085.
25. These reasons were enumerated in McLure, op. cit. at 28-38.

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- The system can be justified on the basis of elementary tax principles, especially because it enhances the progressivity of the income tax. Distortions which allegedly result from its implementation have never been proven.
- Full integration involves considerable practical problems. Even dividend relief schemes (considered to be less equitable) also create many problems.
- The interests of the corporation may substantially differ from those of the shareholders, in particular where the corporation's dividend policy is involved. Thus the corporation cannot normally be viewed as a conduit through which earnings pass on the way to the shareholders.
- Under the separate entity approach, the corporate income and personal income taxation are separate kinds of taxation. It is a basic misconception to consider them as a joint system because they have their own existence, nature and level of tax.
- The corporate income tax might be shifted to consumers or workers, rather than be borne by shareholders. Such shifting implies that the corporate income tax should be reduced rather than be integrated in the personal income tax.
- If it is accepted that the incidence of the corporate income tax is shifted to the shareholders and that the ownership of the equity is concentrated in the upper income groups, the reduction in progressivity which the dividend relief would entail must be condemned.

The Indonesian legislature also relied on other justifications to defend the classical system. The current income tax system was carefully designed, inter alia, to be simple and easy to implement. Simplicity in this context means that, once the method is explained, computation of taxable income and the tax due can be effectuated without major difficulties by the average Indonesian taxpayer. This simple calculation also facilitates the ease with which the taxpayers can be audited and increases the speed with which the tax officials can perform their tasks and the speed with which the officials' performance can be monitored.

These objectives were selected because:
- taxpayer knowledge of tax laws is minimal;
- the knowledge, skill and professionalism of the tax officials need to be improved; and
- the bargaining practices between tax officials and taxpayers should be eliminated.

This author is of the opinion that Indonesia should maintain the classical system and not attempt to introduce an integration system or other schemes providing tax relief for dividends, because such systems are not yet feasible in Indonesia. If the legislature opts for a classical system but also wishes to provide tax relief for dividends distributed with respect to new equity capital, complicated machinery would necessarily need to be introduced. Dividend relief would not result in more tax neutrality but it would reduce revenue and complicate the system. This author counsels against introduction of such relief measures and advocates maintenance of the classical system.

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VENEZUELA:

Consolidation of Net Income and Losses

By Armando Montilla

I. IN GENERAL

As of October 1986, certain groups of companies which receive income in Venezuela must submit consolidated income tax returns, i.e. file a return as only one taxpayer.[1] To this effect, the national Government passed a regulation[2] relating to the consolidation of net income and losses for the payment of income taxes. Decree 1,739/87 implements the principles established in Arts. 75, 76, 78 and 110 of the new Income Tax Law (hereinafter the "Law").[3]

An examination of the statute and new Regulation relating to consolidation for tax purposes reveals the following definitions and procedures.

II. CONDITIONS REQUIRED FOR CONSOLIDATION

Corporations[4], taxpayers considered as corporations for tax purposes[5], limited liability companies, or those entities having the characteristics of corporations or limited liability companies, must consolidate (for corporate tax purposes) their profits or losses if the following conditions are cumulatively met:

1. if 50% or more of the registered capital is held by the same shareholder or group of shareholders or if less than 50% of the registered capital is held by the same shareholder or group of shareholders, that shareholder or group, directly or indirectly, manages and controls the company; and
2. if the business activities of the companies are interrelated; i.e. vertically or horizontally integrated companies. For example, a vertically integrated group exists in a situation where Company A manufactures a product and Company B markets or sells it. A horizontally integrated group exists in a situation where Company A engages in the sale of household furnishings and Company B engages in the sale of lamps, i.e. the companies sell related products.

If either of these requirements are missing, the tax return cannot be consolidated.[6]

Armando Montilla is a partner in the tax division of the public Accounting firm of Krygier, Morales y Asociados. He graduated from the Universidad Central de Venezuela with an accounting degree in 1960, and earned a law degree from the same university in 1965. He began his professional accounting career in 1959 in the audit division of Krygier, Morales y Asociados where he rose through the ranks to occupy the position of Audit Manager. Upon receiving his law degree, Mr. Montilla transferred to the firm's tax division and presently is the partner in charge of the division which provides tax consulting services. As head of this division, Mr. Montilla has acted as tax consultant to many of Venezuela's important companies and economic groups.

At present, Armando Montilla is President of the Tax and Legislation Committee of the Venezuelan Institute of Finance Executives (IVEF) and Professor at the Administration and Accounting School of the Universidad Católica Andres Bello, where he specializes in income tax courses.

1. Petroleum enterprises and enterprises engaged in activities ancillary to oil enterprises (i.e. refining and transportation), however, are expressly excluded from consolidation by Art. 75 para. 1 of the Law. Oil enterprises are therefore taxed under Tariff No. 3(b) at the proportional rate of 67.7%.
2. Published in the Official Gazette of 16 September 1987.
3. Law of 16 October 1986.
4. Under Venezuelan law, a corporation and joint stock company are considered the same form of business organization, i.e. they are known as SA (Sociedad Anónima) or CA (Compañía Anónima) and the terms are interchangeable.
5. This includes any type of foreign company or entity operating through a branch in Venezuela, partnerships limited by shares and civil associations adopting the legal form of SA, SRL (Sociedad de Responsabilidad Limitada) or partnership limited by shares.
6. The regulation contains no special provisions indicating whether or not a non-domiciled company engaging in activities in Venezuela must consolidate its income with that of its related Venezuelan company. Art. 75 of the law requires taxpayers to consolidate whether or not they have a "different name or are domiciled in the country". This author is of the opinion that this phrase may be interpreted to mean that consolidation will apply only to taxpayers domiciled in Venezuela. If this were not the case, there would be no purpose for including the phrase in the legislation. The

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III. INCOME TO BE CONSOLIDATED

The total aggregate income of each of the companies subject to consolidation, less qualifying fiscal losses, if any, determines the total net taxable income of the group during the taxable period.

IV. FISCAL LOSSES

A. Losses during the taxable period

Losses incurred during the taxable period by one or more of the consolidated companies may only be included in the consolidated return, up to the aggregate amount of the income of the rest of the consolidating companies. If the losses of one of the group's companies exceed the aggregate of the remaining companies' income, the net loss arising from consolidation may be carried forward for up to 3 years. Such losses must first be set off against income of the company which incurred them and then against consolidated income.

Where several companies have incurred losses and the aggregate amount of the losses exceeds the income to be consolidated, each loss company must apportion a proportional amount of its loss for set-off against the consolidated income, in conformity with the following formula:

$$\frac{\text{aggregate income} \times \text{loss of the company concerned}}{\text{aggregate losses}}$$

Example:

Assume the following situation in a certain assessment year

Company A: loss	500	
Company B: loss	700	1,200
Company C: income	300	
Company D: income	600	900
Aggregate loss in excess of aggregate income		300
Company A may set off $\frac{900}{1,200} \times 500 =$		375
Company B may set off $\frac{900}{1,200} \times 700 =$		525
		900

Obviously, several companies now have losses to be carried forward in the same manner indicated as above.

B. Losses during years prior to a first consolidation

Should there be losses to be carried forward from years prior to the first consolidation, such losses will first be set off against the income of the companies which incurred them. In the event that the losses cannot be utilized in this manner, they must be set off against the aggregate of the income of the remaining consolidating companies for the same taxable period. Should such losses still not be exhausted, they can be carried forward individually for 3 years following the year in which they were incurred (Art. 74 of the Law).

V. TAX REBATES

Each company should calculate the amount of any tax rebate to which it may be entitled in accordance with the pertinent Decrees. The amount of any rebate due will reduce the tax based on consolidated income. Should the amount of any rebate exceed the tax payable by the group, it will be allocated in the same proportional manner established for losses.

Generally speaking, the same rules apply to fiscal losses and rebates as regards taxes payable by the group. The only difference is that losses may be carried forward for 3 years and rebates for only 2 years.

VI. PRESUMPTIONS

To prevent companies from attempting to evade consolidation through stockholder or member combinations, the Law and Regulation create certain presumptions. Consequently, unless facts to the contrary are proven, the following are considered to be one stockholder or partner:

(1) individuals who are related by ties of up to the third degree of consanguinity and second of affinity;
(2) parent companies or subsidiaries which (as partners or stockholders) directly or through third parties, exercise the management or administration of the companies consolidating income; or
(3) a group of legal persons who are stockholders or partners in other companies, when 50% or more of the capital stock of each of the consolidating companies belongs to such legal persons, or to a similar group of natural and legal persons.

The variety of combinations which may arise from application of the above paragraphs requires a case-by-case determination.

VII. RATES

Total net consolidated income will be taxable according to Tariff No. 2.[7] Mining enterprises and enterprises engaged in activities which are ancillary to mining whose annual profits do not exceed 30 million Bs.[8] are

opinion of the tax authorities, however, is different (although as yet not in writing). The tax authorities have mentioned that if certain non-domiciled companies have taxable income in Venezuela and meet the conditions set forth in "1" and "2" of the text, such income must be consolidated with that of its subsidiary or of another related company operating in Venezuela.

7. Tariff No. 2 (i.e. income tax rates for companies in general and for mining enterprises whose income from mining related activities does not exceed 30 million Bs.) is a 3-bracket tax scheme under which corporate income is assessed at progressive rates as follows: 15% on the first 500,000 Bs.; 35% on the next 2.5 million Bs.; and 50% on the excess over 5 million Bs.

8. See footnote 7.

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taxed at the proportional corporate rate of 60% under Tariff No. 3(a) if the consolidated profits of the group exceed an annual 30 million Bs.

VIII. THE REPRESENTATIVE

The company within the group which has the highest amount of paid-up capital or the largest net income during a taxable period may represent the group (at the group's discretion) for the following purposes:
(a) filing of the group's estimated and final tax returns;

(b) determination or settlement of the taxes payable;
(c) payment of the tax and any additional costs; and
(d) audits conducted on the basis of the Law, its regulatory provisions and other instructions of the Tax Authorities.

IX. RETURNS

Returns must be filed when any one of the companies of the consolidating group falls within parameters set by the Law.

X. FISCAL PERIOD

When all the group's companies have the same fiscal period, there is no problem in determining the taxable period for which the final return should be filed. However, if the fiscal periods differ, certain rules must be followed:

1. The fiscal period for filing the first return is that of the company which first initiated its fiscal period within the terms of the reformed law.
2. A company which is obliged to consolidate and which, on the date specified for the fiscal closing according to "1" above, has not completed 12 months of activity, must include in its return the tax results obtained at that date.
3. For the second period, the companies must modify their fiscal periods so that all fiscal periods end on the same date. No prior authorization from the tax authorities is required to make this change.

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XI. NOTIFICATION OF TAXPAYERS

The company representing the group must notify (in writing) the Fiscal Control Administration of the Sectorial Income Administration of the Ministry of Finance and the Finance Office of its jurisdiction:

(1) when any one of the companies forming part of the consolidating group leaves the group; and
(2) of any change in the consolidated group's representation.

Notification must be made as close as possible to the term specified for filing an estimated or final return of consolidated income.

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TAX REFORM IN HUNGARY:

Excerpts of the Information Material of the Ministry of Finance

1. OBJECTIVE OF THE TAX REFORM

As an integral part of upgrading the economic management system, preparations are under way to implement a price and tax reform pursuant to the resolution taken by the Central Committee of the Hungarian Socialist Workers' Party in April 1984, which set forth the tasks concerning the intensive development of the Hungarian economy, as well as the improvement of the external and internal balance position also from the aspect of the set of instruments. It specified the need for concerted actions which cover all elements of the economic management system, promote an autonomous, entrepreneurial, active, dynamic and innovative enterprise management, help to mobilize the inherent resources of the economy, and provide incentives for managers, collectives and workers to improve economic efficiency. The resolution defined the period of the 7th Five-Year Plan starting in 1985 to implement the changes.

In implementing the resolution, new enterprise management forms[1] have been introduced, a two-tier banking system[2] has been established, the forms of direct capital flow among enterprises have been expanded, the modernization of planning has continued, the local councils' management has been improved[3], and the procedures and legal framework concerning the enterprises' insolvency problems have been created[4].

However, all these actions have provided insufficient to unfold or to accelerate the intensive phase of economic development. Stabilization and subsequent recovery require a more definite action programme of economic policy; a new, comprehensive and well-coordinated process is to be started and consistently pursued in the years to come, relying primarily on long-term, permanent instruments but yielding short-term results as well. The way towards stabilization and recovery mainly leads through restructuring production, accelerating technological development and strengthening adjustment to changes in the world economy. The implementation will require the whole society to join forces, to reach a consensus that is constructive, while it is equally important to face transitional difficulties and endure the resulting tensions.

The new programme calls for *an efficient set of instruments* in all fields of economic management. From this viewpoint, the imminent task is to improve and coordinate the conditions under which existing measures and systems introduced in the process of upgrading economic management operate, as well as to step up the reform process so that a more up-to-date economic mechanism relying on the linking of plan and market can become a decisive factor in influencing economic process and the market. It is considered as a major objective to widen the elbowroom for enterprises, to promote their active involvement, initiatives and entrepreneurship and to increase the economic pressure to improve efficiency.

At the beginning of 1987, the Government passed decisions on the principles of the reform, its institutional conditions and the ways of organizing work with a view to preparing the new system for introduction on 1st January, 1988. The Minister of Finance was appointed to control the exercise and to act as head of a Coordinating Committee which was set up to ensure the involvement – in addition to several enterprise managers – of state and social organizations as well as interest-representing bodies and to support through its activities the reconciliation of the emerging proposals in a wide scope with government agencies. The Committee's work has been backed up by an advisory team of academicians and experienced practical experts.

The Government subsequently dealt with the progress of preparations in several instances, passed decisions on the principles of the tax reform, on establishing a uniform tax authority and on the principles of legal regulation. The work was based on comprehensive modelling, which at the same time formed a basis for the Government to modify the set of conditions through a series of operative decisions and to discuss at two meetings the drafts of the Acts and decide on open issues.

At the request of the Government, discussions about the drafts and their preambles were held with the social and interest-representing organizations, the Presidium of the Hungarian Academy of Sciences, the Presidium of the Hungarian Economic Association, the Federation of Hungarian Scientific Associations (MTESZ), the sections and the Presidium of the Hungarian Chamber of Commerce, etc., as well as with the Budapest and country councils. The Parliamentary committees were also informed on the progress of work in several instances.

The experience gained during the exercise, the conclusions of the debates, the principles and intentions expressed in statements and decisions can be summarized as follows:

Under the present price and tax systems, it is not their own performance and the market conditions that basically determine the development potentials of enterprises. The State budget withdraws and re-distributes an increasing proportion of the income generated. There is a confusing multitude of subsidies and exemptions which conceal the profitability as well as the deficiencies of business activities. All this considerably aggravates our economic problems and hampers the effectiveness of reform actions already taken.

Owing to the burden of direct taxes, the enterprises' efforts centre around bargaining for exemptions and preferences, and efficiency improvement, as an aim, is pushed into the background. The fact that the tax burden of the population is also incorporated in the taxes paid by enterprises, results in the distortion of real relative costs. Instead of aiming at reducing wage costs and thus at a more efficient labour management, enterprises focus on achieving wage preferences and wage-tax reliefs. Realizing the bulk of the net income in the process of production, coupled with a distorted turnover tax system[5], has an adverse impact on the structure of final consumption and is a significant factor in preserving the existing production structure.

The new prevailing personal tax system[6] itself is inconsistent and unfair. The regulations in force treat different activities and sectors differently and do not ensure taxation that is proportional to income. This fact together with the system of earnings regulation[7] leads to the degradation of full-time employment and to the withholding of performance, granting more favourable treatment to income earned form several small sources.

The accumulated problems of the price and tax systems cannot be handled with additional patchwork solutions any longer – overall changes are needed. There is a need for such price and tax systems which would

- eliminate the excessive direct tax burdens on producers, remove a significant portion of the direct taxes from production and make it possible and unavoidable to eliminate the bulk of subsidies;
- help to reduce the level of producers' prices as well as the profit element realized in producers' prices;
- provide the budget resources necessary to finance public expenditure and welfare actions in a greater volume than at present through turnover taxes – essentially tied to the final consumption – and the taxation of personal incomes.

1. See Vol. 21 *Public Finance in Hungary.*
2. See Vols. 33 and 34.
3. See Vol. 26.
4. See Vol. 32.
5. See Vol. 24.
6. See Vol. 9.
7. See Vols. 22 and 36.

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To achieve this, it is necessary to introduce a general turnover tax (in the following: GTT) system which would ensure the two-tier nature of consumer and producers' prices and a personal income tax system (in the following: PIT) which would be applicable to personal incomes in the widest possible scope and operate with a minimum of privileges, while individual and associated entrepreneurs would pay a 'venture' tax under a system which would be harmonized with the income regulation of enterprises.

In addition to the price and tax reforms, the tensions that can be observed in relative income positions would also require the reform of *(a) wages* and *(b) social benefits.*

(a) According to the statements and decisions that have been approved, the system to be introduced is based on the requirement that the employees' net nominal earnings from full-time employment cannot change significantly, assuming an unchanged performance. At the time of transition, they will have to receive in their gross wages an additional amount which they pay as personal income tax. Its source will be the taxes currently paid by the enterprises and to be abolished or reduced in the future, and central sources will be available in the case of non-profit institutions financed by the budget. Wages will be grossed-up – besides the aim to safeguard the attained level of net wages – with a view to making business entities uniformly and increasingly aware of the social costs of reproducing labour and identifying activities which are unable to bear the costs of labour they employ. Enterprises which may run into liquidity problems because of grossed-up wages can receive credits with a State guarantee to finance wages in 1988 until they are able to settle such problems from their own means.

However, *we cannot reckon to date with a wage reform* that would basically transform existing relative wages, because:

- it is impossible to create socially fair relative income positions which reliably reflect qualification, working conditions, age, etc. solely on theoretical grounds; they could only be the result of a genuine labour market;
- a significant central modification of relative wages would involve an upward move requiring considerable wage increases which cannot be undertaken with the present performance of the economy. Since, if we were to implement a wage reform without sufficient resources, it would have to be defined whose wage would be reduced to give it to someone else, or wages could only be increased parallel with further excessive price increases.

On the other hand it should be obvious that changes encompassing the overall financial system will result in shifts in income positions. There may also be some slight wage corrections, first of all in order to prevent an unreasonable levelling of net earnings.

(b) It is also impossible to take reform actions to ease the tensions of the socio-political system, because for lack of additional resources, any rearrangement that would satisfy social expectations would imply impairment of vested rights. Irrespective of the tax reform, this cannot be undertaken in the present position of our economy. We have therefore adopted the principle that the tax reform should not result in major shifts in the income positions as they have developed under the social benefit system. To this effect, the income of certain groups (old-age pensioners, families with children) will be increased to compensate for rising prices in order to safeguard social security. In addition, relative incomes will also be shifted to some extent as people with several sources of income will pay higher taxes, due to their being summarized, and the resulting incremental fiscal revenue will fully be spent on increasing the allowances given to families with children (over and above the increase to compensate for rising prices).

Initial steps have been made to modernize the pension scheme comprehensively, but it can only be implemented in gradual phases.

We shall, however, come back to this question below, in point 4.

2. FAMILY INCOME TAX AS AN ALTERNATIVE

There are several developed, as well as developing, countries which have adopted *family income taxation* to tax personal income. Hence, there have been arguments that we should also introduce a similar tax in Hungary. It must be remembered, however, that wherever such systems operate, they have evolved "naturally". The tax system in those countries has developed together with the social security system and it has taken the family position into account, in close relation to the given level of economic development over time (differently in each country). The delay in similar gradual development could only be made up with a major rearrangement which, as we have already pointed out, cannot be undertaken for lack of sufficient resources at present. Besides, there is a noticeable recent trend of moving away from a uniform family income taxation to the individual personal income taxation.

A family income tax would adversely affect families with more than one income earner as a result of adding up incomes (e.g. due to the scale of progression). In the given position, when most families badly need the income earned by every family member of working age, such a change would be received unfavourably by the public, just as much as many believe the solution lies in family income taxation. On the other hand, the social benefits to be given to dependents would either require the revision of the existing overall system of socio-political objectives and instruments, which we are not prepared to accomplish, or they would be sufficient to grant tax reliefs while the present instruments were maintained. Such additional funds are, unfortunately, not available. Nevertheless, the Government wishes to leave open the way for a possible move towards family income taxation at a later stage.

An issue was raised during the preparation that tax reliefs should be attached to the costs incurred in rearing children under the personal income tax system. If the rate of such reliefs were proportional to income, it would strongly favour higher income groups, which is, on the one hand, unfair and would, on the other hand, require to maintain a system of allowances for low income groups. Apart from problems of principle, this fact would also imply the distribution of additional income that is not available. In addition, a considerable proportion of taxpayers do not pay taxes because their income is below the tax-free limit. Hence, there would be no resources to give allowances from. Consequently, the same allowance that high income groups receive as tax relief should be given to such low income groups as a "negative tax", which would only increase administrative burdens and lead to the same result as if everyone who is eligible were to be given the allowance in question through the existing system of family benefits. (In the course of the final discussion an exception has been made for families having three or more children.)

3. THE IMPACTS OF THE TAX REFORM

The GTT, the PIT and the 'venture' tax[8] to be introduced in the framework of the price and tax reforms, as well as the change of the enterprise income regulation to be expected the 1988, will make the *financial (monetary) management* more systematic and transparent for economic management, business entities and individuals alike. Performance-related differentiation will be strengthened, there will be an increasing pressure to make unprofitable operations efficient or eliminate them, the elbowroom for enterprises will widen as the processes evolve and they will have greater freedom in making decisions on the use of their own resources from the very start.

The contemplated changes will, however, have their impact felt gradually since the general difficulties inherent in our economic situation – and the tensions resulting to some extent from the transition – will not allow us to remove restrictive conditions immediately. The market elements of the price mechanism and the autonomy of enterprise policies may be strengthened, the restrictions of earnings regulation eased and the rules preventing competition abolished only in keeping with the pace of the reform process and the improvement of conditions. *A key requirement for continuing the economic reform is to implement the price and tax reforms,* which however cannot *substitute for the overall reform process in a broad sense* that the Government is continuously working on.

* * *

The Government's intention to create more stable and better computable conditions for

8. It is intended to introduce this tax later in 1987 in the form of a Law-Decree. (The Editor intends to publish this Law-Decree in one of the next volumes of this series.)

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business activities is clearly reflected at the very start by the fact that the new tax system will be introduced at a superior level of legislation (as an Act) and at the same time it is also initiated that all substantial elements of the *enterprises' relations with the budget should be regulated in an Act,* in a not distant future.

The new taxes will demand extra efforts from both the enterprises and the population. Centrally controlled computer programmes, the enquiry offices of the new tax authority and a systematic consulting service will all help to understand and to administer those taxes which are more complicated than the present ones.

The new taxes and the transitional provisions are described in volumes 39/A and 39/B of the series.

* * *

The tax reform and the related price reform will be implemented at a time when the country is facing the difficulties of stabilization and the economy is in the phase of recovery and not in that of evolution.

The Government programme presented to the Parliament simultaneously with the tax reform constitutes a lengthy and often painful programme for consolidating the economy. It requires the improvement and modernization of all elements of the economic control and management system. But it would be impossible to implement even the best programme without the active support and involvement of the society and without a proper set of instruments and incentives. The tax and price reforms are possible instruments in carrying out the programme.

In addition to the need for a long-term and permanent regulation due consideration had to be given to the short-term balance position and the given features of our economy.

The taxes now adopted are, first of all, to promote an evolvement and technological as well as intellectual progress, but they also serve the purposes of consolidation and equilibrium.

Both the economic situation and the stabilization programme make it an imperative to increasingly focus not only on continuous restructuring and greater labour mobility but also on the issue of equilibrium, primarily the equilibrium of the national economy in 1988. This becomes necessary in order to maintain external solvency on the one hand and to avoid uncontrollable price trends, on the other.

The appropriate management of the transition to the new systems and the due maintenance of financial processes are crucial to the balance position in 1988 and in the subsequent years.

As our present estimates show, the subsidies given to enterprises should, in line with our original plans, be reduced significantly in order to ensure a financial equilibrium. This is an extremely difficult step to take, as it will violate sectoral, regional, etc. interests. As, however, the concerns of 5 or 10 thousand people cannot prevail over the interest of 10 million Hungarians, an effective support is needed from the Parliament for the success of the Government's policy to reduce subsidies and improve the balance position. The same applies to the issue of loss-making or inefficient enterprises.

Unless we achieve satisfactory results in cutting back subsidies, in transforming – or winding up, if necessary – inefficient activities, we may have to resort to two sets of measures:

- either consumer prices will have to be increased over and above the planned level; or
- we will have to adopt measures in the enterprise income regulation (e.g. increasing the profit tax, narrowing the scope of taxes proposed to be removed, etc.) which would ensure the required balance.

Such measures are, however, to be avoided, if possible.

As it is planned, within the enterprise income regulation we shall – as far as possible – uniformly value labour costs, and but a single linear tax will be levied on profit.

The practice of treating different kinds of enterprise assets as separate funds will be abolished and the aggregate enterprise property fund will become the major regulator of management and liquidity. In addition to the profit orientation, a perspective thinking and interest orientation of enterprises will be strengthened. Owing to the uncertainties of the transition and the strict balance requirements a central regulation will have to be applied to earnings in 1988 and this will mean a significant improvement over the existing system which is based on the tax-bearing capacity and operates with numerous exceptions. The regulation will only apply to wages and not to earnings[9] and concerning the latter the enterprises will have a greater freedom to determine them in harmony with their performance. Our aim for the future is to further liberalize the enterprise wage regulation and to strengthen its incentive function. The final rates may only be presented later, but the latest in October, in accordance with the national economic plan and State budget for the year 1988.

In line with the Government programme, of course, the financial balance and economic stability will also require, as an integral element, a reasonable transformation of budgetary institutions and organizations, as well as the reduction of their expenditure. The necessary actions are under preparation.

The tax and price reforms, as well as the new system of enterprise income regulation will change the economic environment, by *creating new conditions for national economic planning and central economic management.*

The tax schemes governed by high-level legislation will – in accordance with our aims – narrow the scope of budgetary (fiscal) regulation and will automatically increase the possibilities and responsibilities of *monetary regulation* of economic processes using financial and credit instruments. Parallel with computable and durable tax schemes, the regulation of production, consumption, investment and export processes with credits and by changing the money supply in the whole economy will come to the fore. *The role of the Bank of Issue in influencing central economic management and that of commercial banks in influencing businesses will increase dramatically.*

These tasks need appropriate interest rate and credit policies and call for a new kind of coordination of fiscal and monetary instruments.

The changes will equally affect national economic planning and the Government's economic management functions together with their full set of instruments and institutions.

In preparing the new tax system, we have fully considered the possible impacts on the standard of living (e.g. the wide scope of "0"-rated goods and services in GTT, including housing, etc. which are basic items in household consumption, furthermore the reliefs granted in PIT for housing). Nevertheless, a separate socio-political package has also been complied with a view to possibly stabilizing the position of social groups most in need, such as old-age pensioners, families with children and to easing the difficulties in the year of introduction (see Section 4).

It should clearly be understood, however, that – irrespective of the tax and price reforms – the 1988 balance requirements and the launching of the stabilization programme will anyhow necessitate measures which adversely affect the standard of living as they are consequences of having distributed more than produced and of insufficient performance of the national economy in the past.

The two types of impacts cannot be segregated, but it is important to *explain to the public the origin of deliberate, however unpleasant, measures* arising from the present economic situation, so that the price and tax reforms be accepted by the public and its long-term benefits become effective.

4. SOCIO-POLITICAL MEASURES RELATED TO THE TAX REFORM

Besides the preferences included in the PIT for families educating at least 3 children, as well as for other socio-political reasons (a personal income tax relief amounting to 12,000 Forints/year and per child has also been accepted for those families having at least 3 children; see Vol. 39B), the following measures are intended.

(a) Compensating measures

The introduction of the tax and price reforms on 1st January, 1988 will be accompanied by consumer price increases. According to current estimates, the rate of this

9. The notion of earnings comprises – beside the regular wages – premiums, rewards, profit-sharing, etc.

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increase will be 6% for the total price level. However, adding the impacts of the 1987 price increases spreading over (2%) and other expected changes in 1988 not initiated by the authorities (5-7%) it will amount to about 15%.

It should be considered that
- as a result of adding up incomes under the PIT the nominal income of those with several sources of income and the incomes not taxed so far (e.g. gratuities)[10] will be reduced;
- the consumer price increases due to the transition on 1st January, 1988 and the overall expected increase in the price level for 1988 will result in a reduced income in real terms for those concerned.

When we considered the compensation for such impacts, our basic approach was that the *price changes as of the day of transition* (1st January) must be offset by all means in the case of those in need (i.e. children and old-age pensioners) and sufficient compensation should also be provided to cover the consumer price increases in the course of the year.

Accordingly,

- *for families with children*
  - = the amount of family allowances should be raised in proportion to the price increases as of 1st January (as we estimated, this would mean 400 Forints increase per month and per child),
  - = the amount of child-care pay[11] and child-care aid[12] is 500 Forints/month, and the child-care pay will in the future be granted until the child reaches 3 years of age,
  - = the one-off maternity benefit should be raised by 2,000 Forints (from 4,000 to 6,000 Forints),
- *for old-age pensioners*
  - = *full* compensation should be given to old-age pensioners over 70[13] for the price increases as of the day of transition as well as over the whole year 1988 (the increase should be at least 330 Forints per month),
  - = those under 70 will be granted 330 Forints increase per month all across the board.

The funds allocated to *local councils* to give benefits *to those in need* (emergency allowance, child care allowance, social catering, etc.) will also be increased by about 500-700 million Forints.

In line with the tax reform, we also plan to upgrade the *schedule of charges paid for child and student care in institutions*. This will not influence the average level of charges significantly, and its impact on rearranging relative proportions will also be mitigated as *families with three or more children* will only pay *50%* of the charges (which equal the raw material cost of catering). This system will be introduced in the 1988-89 school year.

Further, it is planned that in case the actual 1988 consumer price index *exceeds the estimated level* by at least 1 percentage point, that increment will be compensated for accordingly in the family allowances. (In the case of old-age pensioners over 70, this possibility is automatically granted.)

The above concepts on compensation will moderate the unavoidable decline in the standard of living in 1988 for families with children and for old-age pensioners.

(b) Some issues of social insurance

In view of the introduction of the PIT and the change from the present progressive schedule (3-15%) to a linear pension contribution (10%), the base of calculation should be regulated anew as regards income-related benefits. Accordingly, it is foreseen that
- the *sick-pay and* other social security benefits compensating labour income foregone will be calculated on a *gross* basis;
- the calculation of *pensions* requires a transitional regulation in 1988 (and in subsequent years, depending on the introduction of a new pension law); hence, pensions will be calculated on the basis of the net earnings after deducting PIT, but not deductive the pension contribution.

5. PRINCIPLES OF TREATING EXISTING PREFERENCES (SUBSIDIES, EXEMPTION, ETC.)

The present enterprise (and partly the personal) income regulation system includes a variety of subsidies, subsidy schemes, preferences, exemptions and provisions for special treatment.

The following procedure is required to handle them:
- the preferences, exemptions, special provisions, etc. which are attached to taxes *to be removed* (wage tax, property tax, tax on turnover tax, municipal and communal contribution, general income tax, tax on accumulation, association tax, etc.) or to those *to be newly regulated* (profit tax, tax on earnings, etc.) will *automatically* cease as of 1st January, 1988;
- each subsidy scheme (e.g. for agricultural co-operatives operating under unfavourable natural conditions) should be *revised* and newly regulated in compliance with the new income regulation system;
- *revision* should also be undertaken in the case of agreements and special provisions between the state and enterprises based on resolutions of Government committees. They should be adjusted to the conditions of the new income regulation system and they can remain in effect only if they are linked to the Government programme to priority projects (e.g. World Bank financed projects), or to specific socio-political objectives (e.g. employment of the disabled).

The guiding principle of the revision and the new regulation can only be based on the requirements of the 1988 national economic and financial equilibrium which should be observed strictly in this field as well.

6. PRINCIPLES OF TREATING ENTERPRISES FACING FINANCIAL DIFFICULTIES AS A RESULT OF THE TRANSITION

The tax and price reforms are intended to serve our long-term economic policy goals, and we aim at a stable and computable regulation. For this reason, the "momentary" difficulties and short-term interests of the individual sectors and operations cannot be taken into account.

One of the key issues of the transition is to strengthen the economic environment which promotes the autonomy and risk-taking attitude among enterprises (and partly of the population), to make relative values more realistic and transparent, ensuring thereby or even forcing the process of restructuring to evolve.

The tax and price reforms, which imply the transformation of these elements of the economic environment, cannot be brought in a direct and definite relation with the operating results of any enterprise or co-operative in a given year. Enterprises have to respond to the changes in the price and tax regulations autonomously, just as to the changes in any other economic conditions (market, technological development, credit policy, labour market, etc.). (The reason for revaluing the costs of labour is not just to have them offset with central subsidies, and if an enterprise is not efficient today, we are even less willing to take it for granted under the new conditions.)

Therefore, the Government intends to declare no central principle with regard to offsetting or even mitigating the economic impacts of the change with central intervention. The impacts of the change may even be assessed realistically only after all the results of 1988 will be known.

The impacts are expected to manifest themselves primarily in the financial position of enterprises (liquidity problems), insolvency, financial loss). Liquidity problems should first and foremost be settled through commercial banks since they are in a position to judge the actual financial position, prospects and changes of recovery in the case of *individual enterprises*.

As regards permanently loss-making enterprises, their case should be settled according to the rules applicable to insolvency such as economic rehabilitation[14] and winding-up procedures.

We should, however, also be prepared to apply settlement procedures for socio-political rather than economic considerations in the case of certain sectors or regions with

10. See in Vol. 39/B.
11. An allowance proportional to the mother's income, granted from birth of the child for one and a half year.
12. An allowance granted as a flat sum until the child reaches 3 years of age.
13. The old-age pension of those over 70 years has been increased for some years linear with the planned price increases.
14. See Vol. 32.

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unfavourable endowments. An appropriate central fund should be ensured for this purpose.

7. SOCIAL AND ECONOMIC IMPLICATIONS

The tax and price reforms will bring about major shifts in the position of all income holders – i.e. of the enterprises, the population and the State budget – and will also reshuffle the major economic processes (production, consumption, accumulation, export and imports).

1. Computations performed with centrally fixed price indexes show that producers' prices *will go down* in the whole economy by 3%, including a 5% decline of the producers' prices in the productive sectors as of 1st January, 1988.

In the case of goods for final consumption, the price index investments will be reduced by 6 and that of stock-piling by 3-4%.

As a result, the relative proportions of consumption and accumulation will change in the national economy. The share of consumption will increase due to rising prices and that of accumulation will decrease due to reduced producers' prices.

2. The positions of the individual income holders are characterized by the following:

(a) The tax and price reforms will have different impacts on the *population.*

For those with only a single source of income i.e. full-time employment, the new tax system will not affect the net earnings because of grossed-up wages.

The income position of entrepreneurs will basically remain unchanged: the aggregate – average – impact of the new 'venture' tax and the PIT will equal the present tax payments.

Those with several sources of income will, however, get into a less favourable position – whether the income is earned from supplementary activities outside the full-time employment or the income earned by artists, etc. –, since they will pay taxes on their summarized income.

The position of small-scale agricultural producers will improve as compared to the present, because the increased tax-free threshold in terms of their sales receipts will amply offset the impact of income summarization.

The real income position is – as always – determined by two factors: the increase of consumer prices and the increase of nominal income. The real income of the population is planned to decrease by 3-4 percentage points in 1988, which will be moderated – as discussed earlier here – by the compensation given to those in need (families with children and the old-aged).

The position of those saving up for housing purposes will considerably improve as the tax system gives a particularly favourable treatment to this group. Their position will be further strengthened by the exemption of such savings from the taxation of incomes from interest.

(b) The income position of *enterprises* will, in line with the original goals, become differentiated, reflecting the efficiency and profitability differentials.

A major improvement of more than 25% as compared to the present interestedness funds[15] will take place for about one third of economic units. Such an improvement will not be sector-specific; it will equally affect large-scale agricultural farms, enterprises in the light industry, engineering industry or trading companies. Typically, this group will mostly comprise enterprises which are already among the most efficient and most profitable exporting ones.

The position of about a quarter of economic units will significantly worsen. This mainly includes enterprises operating in the crisis sectors (i.e. coal-mining, metallurgy, some foodprocessing industries) and those enterprises operating in the manufacturing industries and agriculture which are even now inefficient or loss-makers.

One reason why such unfavourable positions will become manifest is that the present tax system has concealed the deficiencies in a company's profitability by allowing the inclusion of depreciation allowances in tax payment (taxes to be paid from the interestedness fund are: the tax on earnings, on accumulation, etc.).

In general, the enterprises' positions will improve for the following reasons:

- labour costs will be valued more uniformly in the different sectors of the economy, as to the social security paid by enterprises;
- the level of enterprise profits will fall to about half of the present one and this will be subject to a single linear profit tax of 50% (which will be appropriately moderated for basic agricultural activities and public utilities);
- the relative proportions of capital and labour costs will become more realistic; the GTT favours technological development and scientific research;
- finally, the incentives for exports accounted in Roubles will remain unchanged (the Rouble exchange rate will namely change parallel with producers' price changes), while the incentives for exports against convertible currencies will improve (producers' prices will be reduced, but the given exchange rates of convertible currencies will remain unchanged).

Beside the favourable impacts, considerable uncertainties can still be expected – first of all as regards the financial balance position of the national economy. Such general tensions could mostly be mitigated if the reduction of subsidies were consistently implemented; although it may lead to mounting tensions in some areas, it will improve the overall economic balance position and thus the prospects of enterprises.

(c) The position of the *State budget* is under strain.

Although the 140 billion Forints of lost revenue due to the removal of some enterprise and individual taxes will be made up for by the additional revenue from the GTT and PIT, each representing about 70 billion Forints, this is still not sufficient to cover the necessary socio-political compensation and to finance the incremental expenditure of institutions financed by the budget (i.e. grossing-up of wages, compensation of the GTT, etc.).

It is therefore absolutely necessary to reduce enterprise subsidies and to adopt increased cost savings for budget-financed institutions.

3. Under the new system, the GTT will be a revenue item of the central budget, while the PIT (and the venture tax) will replace taxes formerly paid into the budgets of the *local councils* and now to be abolished (wage tax, municipal and communal contribution, etc.).

As it is planned, the PIT will become later a revenue item of the local council's budget to which it is paid by the place of residence, but these revenues will be allocated until 1990 on the basis of financing principles laid down in the 7th Five-Year Plan (i.e. distributed according to the number of the population living in the territory of a council).

Budapest, September, 1987.

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15. See Vol. 22.

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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 1988 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Cameroon

ANDRIEUX, J.P.; LECAT, J.J.
Afrique Centrale. Cameroun - Centrafrique - Congo - Gabon.
Guide pratique et fiscal.
Paris, Editions Francis Lefebvre, 1987. Dossiers Internationaux Francis Lefebvre. 386 pp., 460 Ffrs.
Tax and legal guide for investment in Cameroon, Central African Republic, Congo and Gabon. Covered are company law, business law and other relevant legislation on doing business in those countries involved. The taxes levied in each of those countries involved are described as of 1 July 1987.
(B. 13.358)

Central African Republic

ANDRIEUX, J.P.; LECAT, J.J.
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Am 29. Februar 1988 legte die indische Regierung dem Parlament den Haushalt für 1988/89 vor. Obwohl der Finanzminister, Herr N.D. Tiwari, seine Budgetvorschläge im Zeichen der Förderung der Landwirtschaft präsentierte, enthielt der Haushalt verschiedene andere wichtige Steuermassnahmen. Diese Massnahmen sind u.a. die Erhöhung der Steuervergünstigung für Angestellte, der 100%-ige Abzug für Einzahlungen im Nationalen Sparkontosystem, die Neuregelungen für nicht-repatriierungsfähige in Auslandswährungen ausgedrückte Schuldverschreibungen und Zertifikate für nicht-ansässige Inder, die Änderungen der Besteuerung der Vermögensgewinne, die Änderung des Vermögensteuergesetzes und der kontroverse Vorschlag, bestimmte gewerbliche Einkünfte mit einem angemessenen Prozentsatz des Betrages beim Kauf von bestimmten Waren zu besteueren.

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I.W. Harris:
Hong Kong: Taxe sur les salaires: le cas Goepfert 251
Un cas récent, **Commissioner of Inland Revenue contre George Andrew Goepfert,** conclut sur la situation d'un contribuable résidant à Hong Kong mais ayant un emploi étranger et effectuant des prestations de service en dehors de Hong Kong. Cet article est la suite de celui qui a été publié dans le **Bulletin** en novembre 1987 et qui portait sur l'assujettissement d'une personne physique à l'impôt à Hong Kong en raison des visites qu'il y effectuait alors qu'il était employé et résidait en dehors de Hong Kong.

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Dr. Erwin Spiro:
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Le Budget 1988 a été annoncé le 16 mars 1988 et le Rapport Margo déposé devant le Parlement. Le Budget 1988 mettra en application différentes recommandations de la Commission Margo; d'autres propositions seront introduites au cours de l'année fiscale 1989/90. Cet article insiste sur les différentes modifications à effectuer en 1988.

J.M. Elegido:
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Les quitus fiscaux sont des documents délivrés par les autorités fiscales aux contribuables; ils certifient que le contribuable a entièrement payé les impôts auxquels il était assujetti ou que le contribuable n'était pas soumis à certains impôts au cours d'une période considérée. Ces documents doivent être fournis avant que les contribuables nigérians puissent effectuer un grand nombre de transactions. Bien que les quitus fiscaux aient considérablement rehaussé la perception de l'impôt, ils ont également soumis les contribuables à des tactiques oppressives de la part des autorités fiscales. L'auteur indique l'expérience nigériane quant au quitus fiscal et propose plusieurs réformes permettant d'empêcher les abus et d'augmenter l'efficacité de ce quitus.

Unité de promotion du secteur privé,
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Le 10 février 1988, le Ministre des finances a présenté son budget "fédéral". Aucune nouvelle mesure fiscale n'a été introduite dans le budget à l'exception de modifications concernant la taxe sur le chiffre d'affaires et d'accise fédérale et de modifications techniques proposées dans les articles de la loi de l'impôt sur le revenu des entreprises associées. Cet article présente un commentaire détaillé des mesures budgétaires et nous donne un aperçu de l'avenir économique du Canada.

Gebre Hiwet Tesfagiorgis:
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de l'imposition 274
Cet article présente une analyse descriptive de la répartition des revenus avant et après impôt dans 5 pays industrialisés/développés à partir de laquelle on a tiré des conclusions quant à l'importance de l'imposition comme instrument de répartition des revenus. L'auteur essaie, à partir de cette analyse, de tirer des leçons pour les pays en voie de développement dans le traitement des problèmes de répartition des revenus.

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Das Goepfert-Urteil 251
Das jüngste Gerichtsurteil, **Commissioner of Inland Revenue vs. George Andrew Goepfert,** betraf einen in Hong Kong ansässigen Steuerpflichtigen, der bei einem ausländischen Arbeitgeber im Lohndienst war und der ausserhalb Hong Kongs seine Tätigkeiten ausübte. Dieser Artikel ist die Fortsetzung eines Artikels, welcher 1987 im Novemberheft des **Bulletins** veröffentlicht wurde und welcher sich mit der Steuerpflicht eines ausserhalb Hong Kongs ansässigen und tätigen Angestellten in Zusammenhang mit seinem Besuch in Hong Kong befasste.

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Ali Ahmed Suliman:
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Dieser Artikel befasst sich mit Fragen betreffend das Bedürfnis afrikanischer Regierungen, ihre inländischen Einnahmequellen zu aktivieren. Der Verfasser schlägt die Gründung eines neuen regionalen Institutes vor, mit dem Zweck, eine bessere Ausbildung von Büroangestellten zu versorgen und sich mit Nachforschung, Dokumentation und Beratung zu beschäftigen.

D.G. Murphy:
Simbabwe: Die Verteilung von Liquidationserlösen an
ausländische Aktionäre 255
Herr Murphy analysiert auf herausforderende und tiefgehende Weise das Steuerlabyrinth in Bezug auf die Verteilung von Liquidationserlösen, die an ausländische Aktionäre, welche Aktien von simbabwischen Aktiengesellschaften besitzen, ausgeschüttet werden. Der Autor bespricht die Besteuerung von ausländischen Aktionären, die eventuell der Einkommensteuer, der Vermögensgewinnsteuer und der Steuer, die von nicht-ansässigen Aktionären erhoben wird (non-resident shareholders' tax), unterliegen können. Er erwähnt auch die Steuererleichterungen, die vom Steuerabkommen zwischen Simbabwe und dem Vereinigten Königreich gewährt werden.

Dr. Erwin Spiro:
Südafrika: Der Haushalt 1988 259
Am 16. März 1988 wurde der Haushalt 1988 bekannt gemacht und der Margo-Bericht dem Parlament vorgelegt. Der Haushalt 1988 beabsichtigt, bestimmte Empfehlungen des Margo-Ausschusses im Gesetz aufzunehmen; die Einführung anderer Vorschläge wird für das Steuerjahr 1989 geplant. Dieser Artikel beschreibt die wichtigsten Änderungen, die im Jahre 1988 zustandekommen werden.

J.M. Elegido:
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Steuerbefreiungszertifikate sind bestimmte Dokumente, die dem Steuerpflichtigen von Steuerbehörden ausgestellt wurden und welche nachweisen, dass der Steuerpflichtige seine Steuern vollständig bezahlt hat oder dass er für eine bestimmte Periode keine Steuern schuldig ist. Diese Dokumente müssen von nigerianischen Steuerzahlern vorgezeigt werden, bevor sie in grossem Ausmass Geschäfte abschliessen. Obwohl die Steuerbefreiungszertifikate die Steuereinziehung stark verbessert haben, führten sie doch auch manchmal zu unterdrückenden Massnahmen für den Steuerzahler vonseiten der Steuerbehörden. Der Verfasser beschreibt die nigerianischen Erfahrungen mit den Steuerbefreiungszertifikaten und schlägt eine Anzahl von Änderungen vor, um Missbrauch zu bekämpfen und die Wirksamkeit der Steuerbefreiungszertifikate zu erhöhen.

Private Sector Promotion Unit,
Ministry of National Planning:
Somalia: Das neue Auslandsinvestitionsgesetz 268
Die somalische Regierung verabschiedete im Mai 1987 ein neues Auslandsinvestitionsgesetz, welches einen Vorrang für Sektoren einräumt, in denen Somalia Wettbewerbsvorteile hat. Dieser Bericht gibt eine Zusammenfassung der wichtigsten Merkmale dieses Gesetzes.

KPMG, Peat Marwick, Canada:
Kanada: Der föderale Haushalt vom 10. Februar 1988 269
Am 10. Februar 1988 beantragte der Finanzminister den föderalen Haushalt. Mit Ausnahme der Änderungen der föderalen Verkaufsteuer- und Verbrauchsteuergesetzgebung und den vorgenommenen technischen Änderungen der Regelungen für assoziierte Körperschaften im Income Tax Act wurden keine wichtige Steuermassnahmen vorgeschlagen. Dieser Artikel gibt eine detaillierte Erläuterung der Haushaltspläne und der Wirtschaftslage Kanadas.

Gebre Hiwet Tesfagiorgis:
Vergleichende Einkommensverteilung und die
Auswirkungen der Besteuerung 274
Dieser Artikel enthält eine beschreibende Analyse der Einkommensverteilung vor und nach Besteuerung in 5 entwickelten/industrialisierten Ländern; auf deren Grundlage werden Schlussfolgerungen gemacht für die Bedeutung der Besteuerung als ein Instrument der Einkommensverteilung. Danach versucht der Verfasser, aufgrund dieser Analyse Entwicklungsländer zu lehren, mit Problemen der Einkommensverteilung umzugehen.

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INDIA:

Budget 1988/89:

May the Rain Gods Come to Our Rescue

By Kailash C. Khanna

India's Finance Minister, Mr. N.D. Tiwari, presented the Union Budget for the fiscal year 1988/89 to Parliament on 29 February 1988. As usual, the Budget has evoked mixed reactions. The Federation of Chambers of Commerce and Industry and the Associated Chambers of Commerce, the 2 apex bodies of business and industry in the country, welcomed the Budget as "pragmatic and constructive". However, eminent economists and analysts consider the Budget proposals "directionless and without depth". Political opponents describe the Budget as "a please-all Budget" by a "vote-conscious Minister". The common man, already groaning under the burden of 2-digit inflation, is extremely apprehensive of a further increase in the price of consumer goods.

Undoubtedly, Mr. Tiwari had to frame his Budget proposals in a difficult situation. India suffered a severe drought last year, one of the worst in this century, with 21 out of 35 meteorological sub-divisions receiving deficient or scanty rainfall during the monsoon months. The drought year followed 3 successive years of poor monsoon. For a country of approximately 800 million with almost ¾ of its population dependent on agriculture, this has been a real calamity. However, it goes to the credit of the Government and the people that the difficulties were faced and the problems tackled as best as possible under the circumstances. The decline in agricultural production is estimated at about 10% with a consequential reduction of the GNP growth (expected to be in the range of 1 to 2%).

Accordingly, the Finance Minister chose to give a major thrust to agriculture. The Budget's package for farmers is impressive and exhaustive. It includes interest concessions on crop loans, a fertilizer subsidy through a 7.5% discount on sales, an increase in direct financing of agriculture by banks and easier housing financing for farmers. A special programme called "Jaldhara" (stream of water) will be launched to provide pump sets for irrigation. Likewise, a massive programme named "Kutirjyoti" (light in a hamlet) has been proposed which will extend electrical connections to rural households. For these purposes, outlays for agriculture and irrigation are being increased by as much as 40%. Laudable as these measures may appear, however,[1] they are unfortunately a mere trickle in absolute terms considering the magnitude of the problem involved. Whether water will actually flow out of the pumps or whether lights will actually burn are questions which can only be answered in the future. With regard to the present, a cynical comment has coined Jaldhara and Kutirjyoti as valuable catchphrases for the mass of illiterate electorate.

In a nutshell

(In Rs. crore*)

	1986-87 actuals	1987-88 budget estimates	1987-88 revised estimates	1988-89 budget estimates
Revenue receipts	32898	36688	38122	42798
Revenue expenditure	40674	43430	46619	52640
Revenue deficit	7776	6742	8497	9842
Capital receipts	18529	20566	21959	23278
Capital expenditure	19014	19512	19542	20920
Total receipts	51427	57254	60081	66076
Total expenditure	59688	62942	66161	73560
Overall deficit	8261	5688	6080	7484
Increase in net RBI Credit to Central Government +	7091	5688**	6230	7484**

* 1 cr = 10,000,000.
\+ Including other variations in Reserve Bank of India's credit to Central Government.
** Not independently estimated.
Reprinted from the *Business Standard* of 1-3-88.

The Budget shows an overall deficit of 74,840 million Rs. The major items of receipt and expenditure for the fiscal years 1987/88 and 1988/89, as per revised and Budget estimates, are as follows:

	1987/88 revised estimates (in million Rs.)	1988/89 Budget estimates (in million Rs.)
Revenue receipts	381,220	427,980
Revenue expenditure	466,190	526,400
Revenue deficit	84,970	98,420
Capital receipts	219,590	232,780
Capital expenditure	195,420	209,200
Total receipts	600,810	660,760
Total expenditure	661,610	735,600
Overall deficit	60,800	74,840

1. The increase seems high in percentage terms.

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For several reasons, economists opine that the Budget betrays a lack of good public finance management. First, the non-planned expenditure of 478,960 million Rs. is rising faster than the plan outlay and approximately 83% of this expenditure is accounted for by 4 main heads, i.e. interest payments (141,000 million Rs.), defence (130,000 million Rs.), subsidies (73,160 million Rs.) and "general services" (52,130 million Rs.), all of which show large increases over the last year. Second, the revenue budget deficit is larger than the final overall deficit by a sum of 23,580 million Rs., meaning that the capital budget surplus is being used to meet part of the revenue expenditure requirements. This violates the basic tenets of sound economics because the capital budget is designed for asset creation and not maintenance of administration and other services. Third, the real deficit is understated due to large scale and excessive Government loans.

Government borrowing totalling 177,280 million Rs. constitutes approximately 24% of the total Government expenditure and has been necessitated by rapidly growing unplanned, non-development expenditures, "35 to 45% of which goes down the drain", according to statements of prominent public servants, both within and outside India. The largest single item of unplanned expenditure is interest on loans. Some officials of the Reserve Bank of India have warned that in due course there may be no money to borrow to pay the interest charges! Reliable sources indicate that in 1988/89 the national debt burden may reach the "dangerous" figure of 2,240,000 million Rs., but the Budget appears to treat this impending "debt trap" lightly and is complacent about it. Of course, the Government denies any injudicious borrowing or extravagant expenditure and casts aside statements of the so-called "prophets of doom". Last, but not least, the huge deficit of 74,840 million Rs. on top of the high deficits of 3 earlier years, constitutes a disturbing factor. The aggregate deficit in the first 4 years of the current Five-Year Plan has already reached a staggering figure of 270,000 million Rs. as against the projected 150,000 million Rs. deficit. Coupled with the steep hike in administered prices of petrol, coal, steel, etc. and the increase in rail freight and fares and postal charges announced earlier, the deficit fuels the flames of inflation.

Against this background, the Budget's tax proposals pale into insignificance, particularly when the net tax burden suggested for the financial year 1988/89 amounts to only 6,150 million Rs. Let us take direct taxes first. In the last session of Parliament held a few months ago, a Direct Tax Law (Amendment) Act, 1987, was passed in a devious manner and with such unprecedented haste that even a national daily of the stature of *The Statesman* was constrained to comment in an editorial that "the integrity of the legislative process was as important as the legislation itself". The Finance Minister very fairly conceded the original error and promised an amendment bill in the near future to modify the Amendment Act. This may be a novel method of generating additional employment but it is hoped that now the valid arguments of the taxpayers will be taken into account and genuine grievances redressed.

Once in the statute books, taxes have a notorious tendency to remain in place. Only the inexperienced taxpayer would have expected the drought surcharge which was imposed last year to be withdrawn in the current Finance Bill. As early as 1963, a tax on "super profits" of companies was levied for a one-year period in order to meet an emergency. The tax remained in the statute book, however, for 2 decades (albeit with slight modifications and under a different title). The drought surcharge is, in fact, not being withdrawn and Mr. Tiwari is simply following the traditional path!

The Finance Minister has proposed that the standard deduction for salaried taxpayers be increased from the existing 30% to 33⅓%, subject to a monetary ceiling of 12,000 Rs. According to Mr. Tiwari, approximately one million taxpayers will benefit from this change but the advantage is likely to be negated by the inevitable rise in prices. One point worth noting is that the proposed change manifests a distinct bias against the self-employed, particularly when the so-called "fixed income" group are the beneficiaries of regularly increasing dearness allowances and rising values of perquisites.

The rapid erosion of the tax base of the salaried individual calls for an upward revision of the threshold of taxable income for non-salaried assessees to take account of falling currency values. Discriminatory legislation only encourages "taxpayer revolt" and makes full compliance difficult. Surely, the taxpayers engaged in the noble professions are not so ignoble in the discharge of their tax obligations as to forfeit any claim to relief!

Currently, the remuneration payable to a foreign technician employed in India is exempt from tax up to 4,000 Rs. per month for a period of 24 months. In addition, the tax paid by his employer on the taxable part of the remuneration is not liable to tax. It is intended to withdraw this exemption in respect of a foreign technician employed on or after 1 April 1988, "so as to check the brain drain from the country". While the withdrawal of the exemption may be justifiable, the rationale behind it is peculiar. Far more varied and complex causes lead to "brain drain" than the mere presence of a few foreign technicians in the country. To reduce the cost of projects, it is proposed that, with effect from the assessment year 1988/89, the tax paid by the Government or an Indian concern on the income of a non-resident will not be included in the income of such non-resident.

With a view to encouraging savings, a 100% deduction (as opposed to the present 50% deduction) from total income of deposits made under the National Savings Scheme is proposed. The monetary ceiling will be increased from 20,000 Rs.to 30,000 Rs. Interest on deposits will also increase from 9% to 11%. To induce further investment in shares of Indian companies, it is intended to allow an additional deduction of up to 3,000 Rs. of dividend income received from such com-

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panies. The additional deduction will include the existing deduction of 2,000 Rs. available in respect of the national deposit scheme, so that in certain cases the extra benefit will be restricted to only 1,000 Rs.

Exporters and their manufacturing supporters have cause to be happy provided the minimum tax on "book profits" is either withdrawn or modified. Subject to prescribed conditions and limitations, 100% of export profits are to be exempt from income tax. Likewise, a 5-year tax holiday is proposed for 100% export-oriented units. Regrettably, these tax benefits are not being extended to the export of services although liberalization in this respect is warranted. Linked to these changes is the proposal to offer individual projects protection from exchange rate fluctuations. As stated by the Finance Minister in his Budget speech, "sharp fluctuations in international exchange rates have posed problems for exporters as well as for Indian industry". Financial institutions will introduce a new scheme whereby promoters of projects can have their foreign currency loans designated in rupees. The interest on such loans will be variable and will include an exchange premium.

Replacement and rejuvenation subsidies for rubber, coffee and cardamon plantations are intended to be exempt from tax.

The existing tax concession for investment in equity shares of new industrial undertakings will also be available for direct investment in special units of mutual funds where the resources are earmarked for investment in new projects. These are steps in the right direction and will help improve exports as well as investment in new ventures. Mention may also be made at this juncture of a proposed concessional tax treatment for capital gains on investments made by venture capital companies to funds in new companies. The objective of this tax concession is to encourage new entrepreneurship.

"Government attaches considerable importance to strengthening economic and cultural ties with Indian nationals settled abroad", stated the Finance Minister; he went on to offer assurance that "no changes will be made in the tax treatment which might adversely affect investments already made by non-resident Indians". The Minister also announced the Government's intention of introducing a new scheme of non-repatriable foreign currency denominated bonds/certificates for non-resident Indians. The maturity period of these bonds/certificates will be 7 years and will carry an interest rate higher than that applicable to the repatriable foreign currency non-resident deposits. These bonds/certificates will be free from income tax, wealth tax and gift tax.

Some changes are proposed with respect to the taxation of capital gains. The income from the transfer of a capital asset by a holding company to its subsidiary and vice versa will be subject to capital gains tax if the capital asset is taken over as stock-in-trade at the time of transfer. This amendment is considered necessary to check tax avoidance. Under existing law, a non-resident Indian is not liable to capital gains tax on long-term capital gains arising from the transfer of a "foreign exchange asset" if the net consideration is deposited in a non-resident (external) account. It is intended to exclude the said account from eligible modes of investment. A controversial topic is the Finance Minister's proposal to provide for assessment of income of persons engaged in certain trades[2] at a reasonably fixed percentage of the amount payable when purchasing certain goods. The tax will be collected at source. In short, it is intended that 60% of the amount paid or payable by the purchaser shall be deemed to be the profit and gain of such purchaser from the business of trading in the relevant goods. Tax at the rate of 20% of the purchase price shall be collected by the seller as income tax. Apparently, the proposal aims to overcome difficulties in properly assessing such income but the proposal is contrary to all accepted canons of income taxation and, in addition, is possibly unconstitutional. Strong protests have been voiced against the proposal.

A proposed amendment to the Wealth Tax Act seeks to bring debentures and bonds issued by public sector companies within the overall exemption of 500,000 Rs. Such an amendment is patently against the terms of issue wherein the said companies have specifically highlighted a "total exemption from wealth tax". The proposal warrants serious reconsideration.

In the words of the Finance Minister, "there is a strong case on grounds of social justice for taxing the transfer of wealth through inheritance especially where the volume of wealth involved is large". He has accordingly proposed levying a modified estate duty on the transfer of wealth which will apply to all wealth tax assessees. The tax will be charged in respect of assets subject to wealth tax. The method for valuation of the assets will be the same as for wealth tax. The rate of the wealth transfer tax will be 5 times the applicable wealth tax rates. While detailed comment must await introduction of the promised separate legislation in this respect, it must be said at this stage that the proposed tax runs counter to the long-term fiscal policy and adversely affects the State's credibility.[3]

In the area of indirect taxation, in the proverbial fashion of the honey bee, Mr. Tiwari has politely given a sting in the form of a special excise duty which is best explained in his own language: "In addition, it is now proposed to levy a surcharge by way of special excise duty at the rate of 1/20 of the basic duty of excise. The incidence of this surcharge will generally be small; for example, it will be only one quarter of 1%, i.e. 0.25%, where the basic duty is 5% ad valorem and 1% where the basic duty is 20%". Yet, this apparently innocuous levy will fetch to the exchequer a hefty sum of 6,500 million Rs.!

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2. Alcoholic beverage contracts, trading in forest products and scrap or waste products are among the trades included in this proposal.
3. *Editor's note:* The Finance Minister recently stated that the proposed wealth tax limits with respect to debentures and bonds issued by public sector companies will only apply to issues made after 1 June 1988.

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We need not dwell further on the numerous trifling reductions in indirect taxes over a host of items. While collectively, these may be of significance from a revenue angle, it is a moot point whether the individual impact will be of much consequence to the consumer. As a former Finance Minister of a state government commented, the excise reliefs constitute "titbits" and are of no substance. Citing an example of meager relief, the eminent jurist and chairman of one of the largest cement manufacturing units, Mr. Nani Palkhivala, observed that "no Indian coin was small enough to pay out the per unit relief as will accrue to the consumer of cement"!

Finance Ministry officials quote chapter and verse to assert that the deficit is within manageable limits, that prices will not rise and that the poor will benefit. Mr. Tiwari has, no doubt, tried to project himself as a benevolent Finance Minister out to improve the lot of impoverished farmers, landless labourers, jobless artisans, harassed housewives and disgruntled children by promising them more water, power, jobs, cheaper utensils and inexpensive toys. Regrettably, an unbiased analysis of his budgetary allocations and tax proposals leads to the inevitable conclusion that, by and large, most of the promises may remain unfulfilled. The need of the hour is increased productivity and optimum utilization of resources and not a proliferation of pet schemes or extravagant programmes.

Mr. Tiwari's maiden Budget is a good exercise in public relations but not so good in public finance. It confirms the view that political factors will always impinge on economic decisions and that statistics can tell many lies. It provides no positive thrust for industrial growth, and if past experience is any guide, agriculture will not receive the desired boost because only a small percentage of the allocated funds will reach the target groups due to seepage en route. A whopping deficit, preceded by a steep hike in administered prices of petrol, coal, steel, etc., may add agony to misery unless the rain gods come to our rescue!

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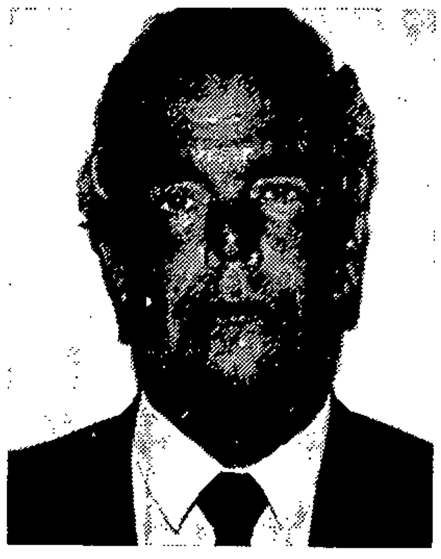

HONG KONG:

Salaries Tax: The Goepfert Case

By I.W. Harris*

Regular readers of the *Bulletin* will recall a recent article[1] concerning an individual's liability to Hong Kong taxation in respect of visits to Hong Kong while employed and residing outside Hong Kong. In a more recent case (*Commissioner of Inland Revenue vs. George Andrew Goepfert*[2], Sec. 8 of the Hong Kong Inland Revenue Ordinance once again received the attention of the High Court.[3] However, this time the issue related to an individual residing in Hong Kong but who spent part of his time outside Hong Kong conducting business for his employer. This is a frequent occurrence in Hong Kong, which is used as a regional base by many multinational enterprises.

The crucial issue in this (and many similar) cases was whether the individual had a Hong Kong employment and thus fell under the general charging section (Sec. 8(1)) or whether he had a foreign employment. In addition, whether Mr. Goepfert came within the extended charging section (Sec. 8(1A)(a)) was also at issue.

If the taxpayer had a Hong Kong employment, all services in connection with that employment would be subject to Hong Kong tax unless the services were rendered outside Hong Kong (for this purpose, certain visits to Hong Kong are ignored). On the other hand, if a foreign employment existed, only so much of the remuneration as is related to services rendered in Hong Kong are subject to Hong Kong Salaries Tax. This is the so-called "days in and days out" or "time basis" method of assessment which has caused considerable problems for both taxpayers and the Revenue for more than 10 years. An authoritative judgment of the Court has therefore been most welcome.

The facts of the case are as follows: Mr. Goepfert was employed by a major U.S. corporation, incorporated in the United States. His contract of employment was entered into outside of Hong Kong. During the relevant years of assessment, Mr. Goepfert was seconded to a U.S.-incorporated subsidiary of the U.S. corporation but which was also registered as an overseas corporation in Hong Kong. The taxpayer's salary was paid to him in the United States, in U.S. currency and was borne by the U.S. parent. The master and servant relationship existed with the parent company and not with the subsidiary. Mr. Goepfert's duties in the Far East were for the benefit of the various affiliated companies of the parent in the Far East outside of Hong Kong. Although Mr. Goepfert performed much of his work in Hong Kong, this location was merely a matter of convenience; the local company rendered only secretarial services and provided Mr. Goepfert with technical advice for the Far Eastern-affiliated companies of the parent.

In March 1987, the case came to the High Court of Hong Kong before Mr. Justice Macdougall. The lower tribunal (Board of Review) had found as a matter of fact that Mr. Goepfert did not have a Hong Kong employment. In the course of his judgment during the 3-day hearing, Mr. Justice Macdougall stated that in order for the Commissioner to succeed, it must be shown that the income arose in, or was derived from, Hong Kong. In other words, the Commissioner would have to show that the taxpayer had a Hong Kong employment, and therefore the extension of the charge under Sec. 8(1A)(a) was not relevant.

In support of his arguments, the Commissioner relied on previous Hong Kong Board of Review decisions and some Australian cases. The Revenue argued that because the bulk of Mr. Goepfert's services were carried out in Hong Kong he had a Hong Kong employment; the fact that some time was spent outside Hong Kong was irrelevant.

Counsel for Mr. Goepfert, on the other hand, argued that it was first necessary to determine whether the income fell within Sec. 8(1), and if not, whether the income fell within the extended definition of Sec. 8(1A)(a). To ascertain whether Sec. 8(1) applied, Mr. Goepfert's counsel relied on a number of United Kingdom cases, including *Pickles vs. Foulsham*[4] in contend-

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* Mr. Harris is Group Tax Adviser of The Hongkong and Shanghai Banking Corporation.

1. See I.W. Harris, "The So-Called Kwong Case", 41 *Bulletin for International Fiscal Documentation* 11 (1987) at 523.
2. Inland Revenue Appeal 5 of 1986.
3. Sec. 8, in relevant part, reads as follows:
   (1) Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from the following sources –
   (a) any office or employment of profit; and
   (b) any pension.
   (1A) For the purposes of this Part, income arising in or derived from Hong Kong from any employment –
   (a) includes, without in any way limiting the meaning of the expression and subject to paragraph (b), all income derived from services rendered in Hong Kong including leave pay attributable to such services.
4. 9 Tax Court 261.

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ing that the totality of the circumstances should be the governing factor in determining the source of the income.

The judge reviewed a number of other Board of Review decisions on the same subject in an effort to determine whether the relevant criteria to determine source is the income or the employment. Mr. Justice Macdougall concluded that it was incorrect to determine that if the income itself falls within the wording of Sec. 8(1) then it cannot fall within the wording of Sec. 8(1A)(a).

The judge rejected the law set forth in the Australian cases and also sought to distinguish the facts in the Board of Review cases quoted on behalf of the Revenue. Mr. Justice Macdougall found support in United Kingdom case law which held that the source of employment income did not depend on the locality where the employment was carried out; rather the real issue in ascertaining the source of income is to look at the place where the income actually comes to the employee. In *Foulsham vs. Pickles,* the court held that "the locality of the source of income is not the place where the activities of the employee are exercised, but the place either where the contract for payment is deemed to have a locality, or where the payments for the employment are made which may mean the same thing".

In rejecting the Australian cases quoted by the Revenue, Mr. Justice Macdougall remarked that the Master of the Rolls Wilfred Greene succintly dealt with the problem in *Bennet vs. Marshall:*[5] "In my opinion if there is one thing that [*Foulsham vs. Pickles*] did, it was entirely to negative the proposition that the locality of the employment depended upon the place where the employment was in fact carried on".

Mr. Justice Macdougall concluded that since the place where services are rendered is not relevant to the enquiry under Sec. 8 as to whether income arises or derives from a Hong Kong employment, it should be completely ignored. He held that the correct approach (which is entirely consistent with Sec. 8) is the approach adopted by the U.K. courts, i.e. the place where the income really comes to the employee, which is where the source of income for the employment is located (in this case, in the United States). The originating cause must be the contract of employment, and although this is capable of manipulation, the Commissioner is clearly required to examine the surrounding circumstances to determine where the real source of employment arises.

Consequently, the Court found in favour of the taxpayer and held he did not fall within the basic charge imposed by Sec. 8(1) since Mr. Goepfert did not have a Hong Kong employment. The taxpayer was therefore only liable under Sec. 8(1A)(a) to the extent that services were rendered in Hong Kong.

It is hoped that publication of this case and the subsequent Statement of Practice issued by the Revenue will settle once and for all the innumerable time apportionment cases which have caused the Revenue and the taxpayer considerable problems in Hong Kong. Clearly, multinationals considering locating an employee in Hong Kong but requiring the employee to also render services outside Hong Kong will need to study this case carefully to ensure that any necessary planning takes place in light of this decision.

5. 22 Tax Court 73.

Conference Diary

MAY 1988

14th ITPA Annual Conference. Cannes, 26-27 May (English):
Elizabeth Walters, International Tax Planning Association, Membership and Conference Liaison Office, 33A Warwick Square, London, SW1V 2AQ, United Kingdom.

Hamburger Seminar zur internationalen Besteuerung. Hamburg, 30 May - 16 June (German):
Institut für ausländisches und internationales Finanz- und Steuerwesen, – Int. Steuerseminar – Grindelhof 38, 2000 Hamburg 13, Federal Republic of Germany.

JUNE 1988

The Use of Tax Havens and Low Tax Finance Centres in International Planning. Geneva, 6-7 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

U.S. Taxation: Partnerships, Trusts & Estates. Arundel, Sussex, 6-11 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Fundamental Elements of U.S. Federal Taxation. Arundel, Sussex, 6-11 June (English and French):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom.

Controlled foreign companies – Four years' practical experience of anti-tax haven legislation. London, 7 June (English):
European Study Conferences Limited, Douglas House, Queen's Square, Colby, Northants NN17 1PL, United Kingdom.

Internationaal zaken doen en de fiscus. Noordwijk 13-14 June (Dutch):
Euroforum BV, Postbus 845, 5600 AV Eindhoven, the Netherlands.

Taxation of Branches and Subsidiaries. Brussels, 20-21 June 1988 (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Leveraged buy-outs – Latest developments in Europe. London, 21 June (English):
The Conference Organiser, Business Research International Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Transcontinental trusts – The new dimension in planning. London, 23-24 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

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AFRICA:

Management of Government Finance in Africa

By Professor Ali Ahmed Suliman

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The purpose of this article is to illustrate the need for African governments to mobilize domestic resources in order to improve management of their public finances. As African States continue to develop, they will require more sophisticated tax systems and tax administrations. This article emphasizes the new role of public finance and advocates establishment of regional facilities to develop management of government finances, primarily through training, research, documentation and consulting services.

AFRICAN PUBLIC FINANCE

A reformulation of the development strategies of the 1960s (or even the 1970s) seems inevitable. Acceleration of economic and social development through medium or long-term plans financed by foreign loans is no longer the most pressing issue; rather the focus has shifted to determining methods of mobilizing domestic resources (public or private) as effectively as possible.

Obtaining foreign loans in the 1980s has become increasingly difficult and African countries are facing the well-known debt crisis. Direct private investment is waning. Various governments, lacking adequate public revenue and confronted with other serious internal obstacles (such as war), have resorted to deficit financing. These approaches have resulted in an excess money supply and aggravation of inflationary pressures.

Broad and sweeping political changes are occurring all over Africa and creating a new awareness and popular demand for increased and improved public services. These demands, coupled with inadequate revenues, have forced African governments to attempt reforms in the hope of reducing budget deficits. The reforms basically aim to improve accounting systems, re-examine public enterprises (in particular those incurring losses), reduce subsidization and public investment in new projects and engage in more rational budgeting. On the whole, these reforms have not been very successful, particularly those which attempt to raise revenue or improve budget policies. Several reasons underlie the failure of the reforms but this article focuses only on one of the causes, i.e. the lack of well-trained administrative staff and advanced applied research.[1]

A good tax administration is an essential prerequisite to enforcement of an income tax regime. Tax administration in Africa is ineffective because administrators are not trained adequately or effectively.[2] A combination of other factors, such as the shortage of support facilities (e.g. suitable buildings, computers, transportation), also contribute to the dilemma.

THE NEW ROLE OF INCOME TAXATION IN AFRICA

In their efforts to mobilize domestic resources, many African governments have attempted to further develop income taxes.[3] However, in practice, and as a consequence of weak administrations, regressive indirect taxes have been utilized whereas equity required progressive taxes.[4] Governments have therefore had to rely on customs duties, sales taxes and excise duties in spite of their regressive nature. Even in those cases where income taxes were introduced, taxpayer compliance was minimal. Only government employees and large companies paid their taxes in full; a large sector of the population evaded the tax.[5] The actual tax-paying sector of the country assumed a heavy tax burden.

Striving to increase revenue from income taxes, governments also increased the tax rates themselves, which led to even more inequity without a consequent increase in revenue because the tax laws could not be applied effectively. Again, the lack of efficient tax administrations undermined any measures the government implemented.

The contribution from income tax (on individuals and companies) as a percentage of GNP varies greatly among African countries. For example, individual in-

1. To cite one example of the deficiencies in this area: there is no coordination between fiscal and monetary policies. Consequently, the measures adopted by governments to stabilize their economies have been rendered ineffective.
2. Currently, some countries provide advanced training in Europe or the United States. However, the costs of this training are extremely high.
3. This trend has been strengthened by increased political awareness and the quest for more social justice.
4. Mtatifikolo, P. Fields, "An Economic Analysis of Tanzania's Tax Performance: Experience Since the 1973 Tax Act"; paper presented at an Economic Research Bureau seminar, 9 July 1985 at 1.
5. Suliman, Ali Ahmed and de Brauw-Hay, Elizabeth, *Income Taxation in Eastern Africa,* International Bureau of Fiscal Documentation, Amsterdam, 1980 at 11-13.

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come tax contributes 1% of GNP in Uganda while it contributes 6.59% in Zimbabwe.[6] This disparity may indicate that some excess taxable capacity exists which can be studied and potentially tapped. However, hard-to-tax groups such as small retail establishments, professionals and agriculture may be involved.[7] Well-trained staff, a competent tax administration and meaningful research are pre-conditions to developing methods of bringing hard-to-tax segments of the economy into the tax net.

Urbanization has accelerated in the last 10 years; some towns have doubled (Dakar) and some have even quadrupled (Leopoldville) in size.[8] In more recent years, the influx of persons into the cities has reached an annual rate of 6% (8.5% for 35 major African capitals). If these percentages are maintained, the cities will double in size every 9 years. Currently, 28 African cities have a population of more than 500,000; 20 years ago only 3 cities had such a large population.[9]

The urbanization and modernization of African economies provide a wider base upon which to impose income tax. Concomitant with urbanization is an increase in the number of services offered to the public which in turn creates additional income. In fact, the share of services of the GDP in Africa has substantially increased. For example, in the Sudan, the share of trading in the GDP has increased from approximately 4% to approximately 15% in the past 10 years.

The industrialization of Africa continues and it, too, has contributed to urbanization. Industrialization has also played a role in the development of commercial agriculture and agri-business.

Income generated in the agricultural sector has caused serious problems for tax administrations primarily because this sector of the economy has not been adequately taxed (for example, the agricultural sector may be subject to export tax (e.g. Uganda); it may not be highly taxed as an incentive for development or to encourage improvement or investment (e.g. Zambia)). Various reasons are advanced to explain this deficiency. However, one of the principal reasons for the lack of revenue from the agricultural sector is the weak tax administrations which are unable to competently deal with the complex problems of taxing this sector of the economy, i.e. issues concerning taxpayer identification, assessment of the value of output, costs, rental values, net taxable income, etc.

Large-scale commercial agriculture is being developed in Africa (in part by industrial concerns in search of raw materials). Coupled with the promotion of commercial agriculture is the fact that small farmers, attracted by higher prices in urban areas, are marketing more of their surplus in urban centres. Consequently, despite the fact that taxation of agricultural income remains cumbersome, it is becoming more feasible and can potentially yield large amounts of revenue.

The combination of all of these circumstances emphasizes the urgency of the problem and supports the proposition that African governments should devote more attention to development of substantial and well-planned training programmes for their respective tax administrations.

REGIONAL TRAINING AND RESEARCH FACILITIES

Training institutes now exist at both the national and regional levels. These institutions are generally broadly-based and concern themselves with various aspects of public administration and management. Some institutions specialize in the areas of accountancy and materials management. As a general rule, however, these facilities are not equipped to meet either national or regional needs for training in Africa, particularly in the area of public finance. The institutions lack qualified personnel, their libraries are inadequate, they lack equipment and even the premises of the institutions are not always suitable. Because the institutions engage in little or no research, their training programmes are conducted without an awareness of changing needs and conditions in a dynamic world; consequently, the institutes are unable to effectuate any substantial improvement in the training process.

The question of whether to expand existing training institutions into new regional ones or to establish completely new institutes is controversial. Looking objectively at the resources at the disposal of these institutions, however, it would appear that they are far from satisfying national or regional training needs. If an existing national institute is expanded to cover regions, national needs and objectives may suffer because they diverge from regional needs and objectives. On the other hand, existing regional training facilities are rather limited and may be unable to cope with specialized training in public finance or management of government finance.

This author is of the opinion that the above factors militate against expanding existing institutions. An entirely new regional facility would best fulfil the need for improved management and administration of finances. The primary method to achieve the objectives of such an institute would be to prepare a long-term plan for training based on surveys of the needs of the African countries.[10] In addition, the institutes should

[continued on page 283]

6. David Newberry and Nicholas Stern (eds.), *The Theory of Taxation for Developing Countries,* World Bank, Oxford University Press (1987) at 224, Table 8-1.
7. Taxing this segment of the economy in less developed countries presents an acute and well-known problem. In addition to the administrative deficiencies involved, "the structure of the economy is such that it affords fewer and less adequate "handles" on which to attach taxes", i.e. imposing withholding tax is difficult because most income is derived from self-employment and accounting practices are inadequately utilized. See Musgrave, Richard A., *Public Finance In Theory and Practice,* McGraw-Hill Book Company (1973) at 131.
8. "Social Implications of Industrialization and Urbanization in Africa South of the Sahara", The International African Institute, Greenwood Press Publishers, London (1956) at 495.
9. "Accelerated Development in Sub-Saharan Africa: An Agenda for Action", World Bank (1981) at 115.
10. A variety of subjects such as economics, law, accountancy, auditing, statistics, taxation, budgeting, computer studies, public administration, etc. must be offered and each subject must include a number of courses in

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ZIMBABWE:

Foreign Shareholders' Liquidation Dividends

By D.G. Murphy

The purpose of this article is to highlight and examine the tax complexities that can arise in connection with liquidation dividends in respect of shares held by foreign shareholders in companies incorporated in Zimbabwe. The taxes involved are income tax, capital gains tax (CGT) and the non-resident shareholders' tax on dividends (NRST). Any mitigating provisions of the double taxation convention between Zimbabwe and the United Kingdom (U.K.) will also be examined. This convention and the convention with the Republic of South Africa are the only 2 double taxation conventions that Zimbabwe has acknowledged as being operative at the time this article was written. No doubt Zimbabwe will enter into many more conventions with other countries in the future; it is understood that a number of treaties are currently being negotiated.

INCOME TAX

Liquidation dividends which accrue in respect of shares held as capital assets are not subject to income tax, regardless of who the shareholder is because liquidation dividends represent accruals of a capital nature. Accruals of a capital nature can only become subject to income tax if they are expressly included in taxable income in terms of a specific provision contained in the Income Tax Act [Chapter 181]. Liquidation dividends are not the subject of any such provision.

Liquidation dividends which accrue in respect of shares held as trading stock are income subject to income tax but only if the liquidation dividends are from a source in Zimbabwe. A foreign sharedealer would not be subject to income tax if none of his business activities were conducted in Zimbabwe since the source of the sharedealer's profits, including the liquidation dividends, would be located outside Zimbabwe. Mere ownership of shares in Zimbabwean companies could not, by itself, be regarded as carrying on a business activity in Zimbabwe.

Dividends distributed by taxable Zimbabwean companies which are not in liquidation are expressly exempt from income tax in the hands of all shareholders.

The 1988/89 rates of income tax for individuals are: 20% for taxable income in excess of Z$ 1,800 but less than Z$ 4,501; 30% on the next Z$ 4,500; 40% on the next Z$ 4,500; 50% on the next Z$ 9,500; and 55% on the next Z$ 10,000 with each dollar of taxable income in excess of Z$ 33,000 suffering 60%. Companies pay a flat 50% of their taxable income with foreign companies paying a further 8.4% of their taxable income.

CGT

CGT is levied as a flat 30% on capital gains from sources within Zimbabwe in respect of sales and deemed sales of immovable property, deeds of sale and marketable securities. The latter term is defined to mean any debenture, share or stock or right possessed by reason of a taxpayer's participation in any unit trust, whether or not capable of being sold in a share market or exchange. Sec. 16 of the CGT Act deals with receipts and accruals, whether by way of recovery or recoupment or otherwise, relating to the cost of a chargeable asset. Under Sec. 16, shares are deemed to have been sold for the total amount received or accrued by way of liquidation dividends from a source within Zimbabwe that are not subject to income tax. In calculating the amount of any capital gain or loss, the deductible cost of the chargeable shares is increased by an amount equal to 5% of such cost for each tax year, or part of a year, from the date of acquisition of the shares. This notional cost factor is clearly intended to soften the effects of inflation. The question is clearly intended to soften the effects of inflation. The question of source in relation to proceeds of a capital nature is now before the Courts in Zimbabwe. Suffice it to say for present purposes that the practice of the Commissioner of Taxes has been to treat capital proceeds from the sale or deemed sale of shares in companies incorporated in Zimbabwe as having a Zimbabwean source. Unless this practice is changed by a ruling of the Courts, the foreign shareholder is liable for CGT on the capital gain calculated in terms of Sec. 16 in relation to liquidation dividends from Zimbabwean companies.

NRST

NRST is a withholding tax and is levied at the statutory rate of 20% on gross dividends distributed by companies incorporated in Zimbabwe to foreign com-

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panies and non-residents. Shareholders exempt from NRST are pension funds, benefit funds and medical aid societies.

The word "dividend" is defined for NRST purposes to mean any amount which is distributed by a company incorporated in Zimbabwe to its shareholders, but excluding any amount so distributed: by a building society and subject to a separate withholding tax of 10% as if it were interest; as bonus shares; as an amount which is a return of the amount received by the company for its shares; by the Industrial Development Corporation of Zimbabwe Limited in respect of its issued share capital; from profits subject to branch profits tax; by the Zimbabwe Development Bank; to the International Finance Corporation; to a foreign life insurance company in respect of any shareholding acquired from funds arising from its life insurance business in Zimbabwe; and to the Commonwealth Development Corporation in respect of its operations that are connected with specifically approved projects.

Dividends distributed in specie by Zimbabwean companies are quantified in relation to their market value at the time of their distribution. A dividend is deemed to be distributed when it is paid to the shareholder, credited to the shareholder's account or so dealt with that the shareholder becomes entitled to it, whichever occurs first. Thus NRST is levied when the dividend becomes a debt owing to the shareholder regardless of the fact that it is not payable until some future date. The NRST is payable to the receiving officer in the Department of Taxes within 30 days from the date of distribution unless, upon a showing of good cause, a longer period of time is allowed. The penalty for default can be as high as 15% of the tax and, in addition, the company distributing the dividend becomes liable for the tax itself. The dividend chargeable to NRST is reduced if more than 15% of the total gross receipts (as defined) of the company distributing the dividend are from sources outside Zimbabwe.

POSSIBILITY OF DOUBLE TAXATION

As can be seen from the above discussion liquidation dividends in respect of shares held as trading stock can possibly involve the foreign shareholder in a liability for both income tax and NRST, although the liability for income tax could only arise if the foreign sharedealer were carrying on a business activity in Zimbabwe. The foreign owner of shares in Zimbabwean companies who holds the shares as capital assets is in greater danger of incurring a liability for both CGT and NRST. It is important to note that whereas the capital gain that is subject to CGT is calculated in relation to the cost of the shares, the liquidation dividends that are subject to NRST are calculated as the excess over and above the amount received by the Zimbabwean company for its shares. The cost of the shares and the allotment price need not necessarily be the same; the foreign shareholder may have acquired the shares from the original allottee for a purchase price which is more or less than the allotment price. Liquidation dividends in respect of bonus shares would incur NRST on their full amount and, in the case of the shareholder who is the original allottee, the capital gain subject to CGT would be the full amount of the liquidation dividends.

There is no provision in the legislation which could provide any relief should double taxation actually be suffered. The Commission of Inquiry into Taxation, whose Report was published on 5 August 1987, examined the question of the levy of both a withholding tax and CGT in respect of liquidation dividends and the Commission's response, which appears at paragraph 10.48 of its Report, is reproduced below in full:

> Companies in Liquidation
>
> 10.48 When a company is closed down or liquidated, the return to the shareholders by way of share capital, reserves and undistributed profits is subject to shareholders' taxes except for the amount representing the originally subscribed capital. In addition, the total amount of the liquidation proceeds is deemed to represent the selling price of the company's shares for capital gains tax purposes. For owners who purchased the shares at a lower price, a capital gains tax liability can therefore arise as well. It has been suggested to the Commission that this brings about the possibility of double taxation and an anomaly which should be removed. This seems incorrect. Capital gains tax liability results because one has bought something at one price and sold it at a higher one. Shareholders' taxes arise because a company is distributing funds which can be used by its shareholders. The value of a company to its shareholders is determined by the future dividends which it is expected to distribute. In the normal course of events, shareholders will be liable for taxes on these proceeds. There is no obvious reason why, if the company pays out everything it can by way of liquidation, such proceeds should not be subject to taxes payable by shareholders. Capital gains tax and shareholders' taxes serve different purposes and their both being levied cannot be considered as double taxation. To exempt liquidation proceeds from either would open the way to avoidance of capital gains tax or shareholders' taxes by means of liquidating a company (possibly simply to form a new company running the same business with the same assets and owners). *We therefore recommend against changing the current treatment of liquidation proceeds.*

With not so much as the hope of even a credit to relieve an actual case of double taxation – say, by allowing the lesser of the 2 taxes chargeable against the higher – it is up to the companies themselves to take whatever steps they can to avoid this trap of double taxation the existence of which is officially recognized, as evidenced by the above extract from the Commission's Report (although not as a classic example of double taxation). The unfortunate shareholder who suffers the charge of 2 lots of taxes on the one amount received by way of liquidation dividends may not be able to appreciate the subtle distinction made in the Report between classic double taxation and actual double taxation. This author also finds difficulty in making the distinction and is only grateful for

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the fact that the foreign sharedealer's income by way of liquidation dividends from a source within Zimbabwe is expressly non-accountable under the CGT legislation and cannot therefore be subject to triple taxation, i.e. income tax, NRST and CGT. It should be noted that the Commission did not comment on the levy of both income tax and NRST. Admittedly, the foreign taxpayer who would suffer both of these taxes is something of a rare bird. However, the local sharedealer who does not operate as a company is less uncommon and he is open to the double charge of income tax and a 20% withholding tax, which is called resident shareholders' tax (RST). Since the Commission did not consider this taxpayer's situation it is not known whether the Commission could or would have justified his charge to double taxation on the basis of the purpose of the 2 different taxes.

The number of steps which might be available to avoid or lessen the effects of the charge to double taxation by way of NRST and CGT would depend on the circumstances that existed in any particular case. Common to all foreign shareholders would be the desire to avoid the higher charge for CGT if this could be achieved by the company distributing a sufficient amount as dividends before the company went into liquidation. Any such distribution would reduce the amount receivable by way of liquidation dividends for CGT purposes. In a case where the cost of the shares exceeded their allotment price it might be better to sell the assets so as to avoid the liability for NRST. A suitable purchaser would be a local company since local companies are not subject to any withholding tax on their receipts and accruals. Similar considerations would apply in the rare case of a foreign sharedealer who encounters a possible liability for both income tax and NRST.

DOUBLE TAXATION CONVENTION WITH THE U.K.

The U.K. resident that is subject to U.K. tax on liquidation dividends and capital gains in respect of shares in Zimbabwean companies is always entitled to double taxation relief, against the U.K. tax, for any Zimbabwean tax suffered. And in the case of a U.K. company which by reason of its shares controls directly or indirectly 10% or more of the voting power in the Zimbabwean company, the U.K. will, in respect of dividends, also grant relief for the Zimbabwean tax payable on the profits out of which the dividends are paid (Art. 23).

The convention contains certain special provisions which can reduce the rate of Zimbabwean taxes chargeable or grant exemption from some of the Zimbabwean taxes. Income tax is not chargeable on a U.K. sharedealer's profits if the profits are not earned through a permanent establishment operated by the sharedealer in Zimbabwe (Art. 7). If the U.K. sharedealer is a company and has profits that are attributable to a Zimbabwean permanent establishment, the rate of income tax is reduced from 58.4% to 52.5% (Art. 24(2)).

Exemption from CGT is granted in respect of the alienation of shares in a company if the company is one whose assets do not consist principally of immovable property, as defined in Art. 6, provided that the shares are neither business property of a Zimbabwean permanent establishment nor property pertaining to the operation of ships or aircraft in international traffic which has its effective management situated in Zimbabwe (Art. 14). The word "alienation" is not defined in the convention. However, Art. 3(2) stipulates that a term not defined in the convention shall, unless the context otherwise requires, have the meaning assigned to it in the legislation relating to the taxes concerned. Since Sec. 16 of the CGT Act deems the liquidation to be a sale of the shares it seems clear that Art. 14 applies to liquidation dividends since the word "alienation" is wide enough to cover all disposals including sales.

The rate of NRST is reduced from 20% to 5% in the case of a U.K. company for dividends and liquidation dividends from shares which are not effectively connected with a permanent establishment operated by the U.K. company in Zimbabwe provided that the U.K. company controls directly or indirectly 25% or more of the voting power in the Zimbabwean company paying such dividends. (It is understood that the Zimbabwean authorities have initiated negotiations with the U.K. authorities for the purpose of securing a chargeable rate of NRST higher than 5%.) The rate of NRST cannot exceed 20% (Art. 10).

If a local individual receives liquidation dividends which take the character of income because the shares were held as trading stock, it can be seen from what was explained earlier that the individual is open to a charge for both income tax and RST in respect of the liquidation dividends. The U.K. individual who is similarly caught for both income tax and NRST would not, therefore, appear to have grounds for arguing that the charge by way of 2 lots of taxes on his liquidation dividends is in any way discriminatory in the sense that his Zimbabwean permanent establishment (one is required before there can be an income tax liability on his profits) is treated less favourably than that of his Zimbabwean counterpart. However, Art. 24(2) would appear to prohibit the levy of Zimbabwean tax on the profits of a Zimbabwean permanent establishment of a U.K. company which is more than 2½% above the rate of tax chargeable on the profits if the company were resident in Zimbabwe. A Zimbabwean company is not liable for any withholding tax on liquidation dividends. It would therefore appear that the U.K. company which is subject to Zimbabwean income tax on its profits at 52½% – the company rate of tax for a local company is 50% with a further 8.4% chargeable on the taxable income of a foreign company with the latter being reduced to 2½% in the case of a U.K. company by virtue of Art. 24(2) – could successfully contend that NRST is not leviable on its income by way of liquidation dividends. However, no locally recorded decision or ruling lends authority in support of this point of view.

In the case of the levy of both CGT and NRST on liquidation dividends, the U.K. individual, again, for

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reasons similar to those given in relation to a charge for both income tax and NRST, would not appear to have grounds for relying on the non-discrimination provisions of Art. 24 for relief. In Art. 24 the word "taxation" is defined to mean taxes of every kind and description and the Article covers not only the income of the Zimbabwean permanent establishment of a U.K. company, but also the subjection to Zimbabwean taxation of a U.K. national. The word "national" is defined and includes any legal person, association or other entity deriving its status as such from the law in force in the U.K. The word "person" is defined and includes a "company" and this is defined to mean any body corporate or entity which is treated as a body corporate for tax purposes. Art. 24(1) can therefore be read as saying that U.K. companies or bodies corporate shall not be subjected in Zimbabwe to any taxation which is other or more burdensome than the taxation to which Zimbabwean companies or bodies corporate in the same circumstances are, or may be, subjected. In the context of a charge for both CGT and NRST on the liquidation dividends which accrue to a U.K. company as capital gains, it would appear that the U.K. company could successfully contend that the levy of NRST (which as a tax has no counterpart in relation to a recipient of liquidation dividends which is a Zimbabwean company) by way of addition to an existing liability for CGT is prohibited by Art. 24(1), whether the U.K. company operates through a Zimbabwean permanent establishment or not. However, again, there is no locally recorded decision or ruling to lend authority in support of this point of view.

If shares that are subject to the Art. 14 exemption from CGT are sold before any liquidation dividends accrue, the seller clearly avoids both CGT and NRST. The shares could be purchased by a local company. The local company is not subject to any withholding tax on dividends or liquidation dividends. The local company's liability for CGT one would expect to be minimal, or non-existent due to the 5% allowance, if liquidation commenced shortly after the purchase of the shares; the purchaser would not normally expect to receive a great deal more, by way of liquidation dividends, than the purchase price. As was pointed out earlier, dividends distributed by a Zimbabwean company which is not in liquidation are exempt from income tax. Dividends distributed before liquidation obviously decrease the amount receivable as liquidation dividends. This decrease would be valuable if the liquidation dividends were subject to either income tax or CGT which gave rise to a liability greater than the NRST payable on the dividends distributed before liquidation commenced.

COMPANY RECONSTRUCTIONS AND MERGERS

Sec. 14 of the CGT Act allows for the transfer of chargeable assets between companies under the same control on a no-profit no-loss basis for CGT purposes if the transfers are made in the course of or in furtherance of a scheme of reconstruction of a group of companies or a merger or other business operation which, in the opinion of the Commissioner of Taxes, is of a similar nature. Control is determined in relation to share voting rights. The no-profit no-loss basis applies for CGT purposes regardless of the actual consideration passing in respect of the transfers. The foreign controlling company, or companies, planning the liquidation of a Zimbabwean company for the purposes recognized by Sec. 14 should consider the provisions of Sec. 14 since they could possibly operate to reduce or extinguish accumulated profits and reserves and thereby reduce or avoid the NRST and CGT in respect of the shares in the liquidated company. The accumulated profits and reserves would be decreased by any loss that arose from the transfers made under the protection of Sec. 14.

In conclusion, it must be pointed out that there are exchange control regulations governing the transfer of Zimbabwean assets where a party to the transfer is non-resident. Local professional or banking advice should be sought in this connection.

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SOUTH AFRICA:

The 1988 Budget

By Dr. Erwin Spiro

I. THE BUDGET AND THE WHITE PAPER ON THE MARGO REPORT

16 March 1988 was not only Budget day but also the day the Government's White Paper on the "Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa" (the Margo Report)[1] was laid upon the table in Parliament. One of the outstanding events of 1987 was the release (in August) of the Margo Report. Some of the more than 300 proposals contained in the report are already being implemented via the Budget. Other proposals (but, by no means, all of them) will be implemented in the 1989/90 tax year.[2] According to the Minister of Finance, Mr. Barend du Plessis, the time is not yet ripe for large-scale tax concessions aimed at further structural adjustments. More particularly, the introduction of a value added tax will not take place before 1989. The reform action will continue for the next year or 2 while the Government's decisions on the Margo Commission's proposals are implemented, as indicated in the White Paper.

II. POLICY

Last year's Budget was described as a "non-event". However, the present Budget seeks to facilitate the creation of a sound and well-disciplined economy in which the private sector (in particular) necessarily plays a vital role and which promotes the welfare of all the people of South Africa.

III. INDIVIDUAL INCOME TAX

A. Standard income tax on employees (SITE)

In accordance with a recommendation of the Margo Commission, the following provision will be implemented this year: the tax liability of a man or a single woman earning remuneration not exceeding R 12,000 per annum (or R 20,000 in the case of a married woman) will be finally determined by deductions in accordance with the PAYE system. These taxpayers will no longer be required to submit tax returns.

If a married woman's income exceeds R 20,000 (less 22.5%, so the existing tax concession remains intact), it will be added to her husband's income and be taxed at his marginal rate. The joint tax burden will be considerably higher in this case than if the woman had been subject to the SITE system. To ease the impact of this transition, a system of shrinking deductions is provided for so as to allow a gradual phasing-in of the higher tax rate which would have been payable above R 20,000.

B. Rebate for medical expenses and expenses in connection with physical disability

Implementing another recommendation of the Margo Commission (with effect as of this year), the Minister of Finance proposed that medical costs be allowed as a deduction only if they exceed 5% of taxable income, with no restriction on the amount deductible. The current system of unlimited deductions for taxpayers older than 65 years will be retained.

The existing separate deductions for physical disability and medical expenses will be combined. Apart from the 5% rule, there will be no limit to the deduction a physically disabled individual can claim for expenses arising from the disability.

C. Rebate for insurance premiums and contributions to provident and benefit funds and to the unemployment insurance fund

The present rebate (maximum R 75) for insurance premiums will be abolished as per the recommendation of the Commission.

D. Dependant's rebate

This rebate will also be abolished.

E. Rates and rebate adjustments

With the objective of granting at least some relief in connection with the impact of bracket creep on the taxation of individuals, the Minister of Finance proposed:

- to increase the primary rebate for married taxpayers from R 920 to R 1100, and for other taxpayers from R 650 to R 750; and
- to reduce the rates so that the maximum marginal rate of tax now becomes payable at a taxable income of R 80,000 instead of the existing R 60,000.

The interaction of the various concessions must not be overlooked.

F. Taxation of long-term insurers

Long-term insurers are taxed on 40% of their investment income and receipts from affiliated companies. In comparison with other sectors of the economy, and given the magnitude of the investment funds which have been and which are being channelled to the insurance industry, the Minister was of the opinion that the

1. For a discussion of the major recommendations of the Margo Report, see Dr. Edwin Spiro, "The Margo Report", 42 *Bulletin for International Fiscal Documentation* 1 (1988) at 37.
2. These proposals are not yet final and will not be dealt with in this article.

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long-term insurance sector should make a larger contribution to the fiscus. He proposed that with effect from years of assessment ending between 1 April 1988 and 31 March 1989, the 40% factor should be increased to 70%.

IV. COMPANIES

A. Minimum tax on companies

The Margo Commission Report referred to widespread criticism of companies which earned substantial profits (and declared dividends out of those profits) by availing themselves of existing concessions and incentives but failed to contribute to the fiscus. As more or less proposed by the Commission, tax is to be levied on companies at the rate of 25% or so much of the dividends declared during a year of assessment as exceeds the sum of the normal tax paid for that year and the quantum of dividends received or accrued in that year.

To ensure an income flow from this source in the 1988/89 financial year, companies will be obliged to make a payment on the basis of figures for the most

Table I

Taxable income	Rates of tax in respect of married persons
Where the taxable income–	
does not exceed R 12,000	14% of each R 1 of the taxable income;
exceeds R 12,000 but does not exceed R 13,000	R 1,680 plus 15% of the amount by which the taxable income exceeds R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 1,830 plus 17% of the amount by which the taxable income exceeds R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,000 plus 19% of the amount by which the taxable income exceeds R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,190 plus 21% of the amount by which the taxable income exceeds R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,400 plus 23% of the amount by which the taxable income exceeds R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 2,860 plus 25% of the amount by which the taxable income exceeds R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 3,360 plus 27% of the amount by which the taxable income exceeds R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 3,900 plus 29% of the amount by which the taxable income exceeds R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 4,480 plus 31% of the amount by which the taxable income exceeds R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 5,100 plus 33% of the amount by which the taxable income exceeds R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 5,760 plus 35% of the amount by which the taxable income exceeds R 28,000;
exceeds R 30,000 but does not exceed R 35,000	R 6,460 plus 37% of the amount by which the taxable income exceeds R 30,000;
exceeds R 35,000 but does not exceed R 40,000	R 8,310 plus 39% of the amount by which the taxable income exceeds R 35,000;
exceeds R 40,000 but does not exceed R 50,000	R 10,260 plus 41% of the amount by which the taxable income exceeds R 40,000;
exceeds R 50,000 but does not exceed R 60,000	R 14,360 plus 42% of the amount by which the taxable income exceeds R 50,000;
exceeds R 60,000 but does not exceed R 70,000	R 18,560 plus 43% of the amount by which the taxable income exceeds R 60,000;
exceeds R 70,000 but does not exceed R 80,000	R 22,860 plus 44% of the amount by which the taxable income exceeds R 70,000;
exceeds R 80,000	R 27,260 plus 45% of the amount by which the taxable income exceeds R 80,000.

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recent year of assessment ending on or before 29 February 1988. The tax for a particular year should be based on the figures for the immediately preceding year; the tax is payable on 30 September 1988 upon submission of a declaration.[3]

B. Company cars

As a result of urgent requests from the automobile industry, the values for company cars in the Seventh Schedule to the Income Tax had been scaled down, but with the understanding that they would be adjusted upwards once warranted by circumstances. The necessary adjustments will be made. The Minister of Finance was anxious to point out that this decision also accords with the recommendation of the Margo Commission.

V. NON-RESIDENT'S TAX ON INTEREST

In the view of the Minister, so long as South Africa

3. The tax is not a final tax but will constitute a credit retained against the company's future liability for normal tax.

Table II

Taxable income	Rates of tax in respect of persons who are not married persons
Where the taxable income– does not exceed R 10,000	14% of each R 1 of the taxable income;
exceeds R 10,000 but does not exceed R 11,000	R 1,400 plus 15% of the amount by which the taxable income exceeds R 10,000;
exceeds R 11,000 but does not exceed R 12,000	R 1,550 plus 17% of the amount by which the taxable income exceeds R 11,000;
exceeds R 12,000 but does not exceed R 13,000	R 1,720 plus 19% of the amount by which the taxable income exceeds R 12,000;
exceeds R 13,000 but does not exceed R 14,000	R 1,910 plus 21% of the amount by which the taxable income exceeds R 13,000;
exceeds R 14,000 but does not exceed R 15,000	R 2,120 plus 23% of the amount by which the taxable income exceeds R 14,000;
exceeds R 15,000 but does not exceed R 16,000	R 2,350 plus 25% of the amount by which the taxable income exceeds R 15,000;
exceeds R 16,000 but does not exceed R 18,000	R 2,600 plus 27% of the amount by which the taxable income exceeds R 16,000;
exceeds R 18,000 but does not exceed R 20,000	R 3,140 plus 29% of the amount by which the taxable income exceeds R 18,000;
exceeds R 20,000 but does not exceed R 22,000	R 3,720 plus 31% of the amount by which the taxable income exceeds R 20,000;
exceeds R 22,000 but does not exceed R 24,000	R 4,340 plus 33% of the amount by which the taxable income exceeds R 22,000;
exceeds R 24,000 but does not exceed R 26,000	R 5,000 plus 35% of the amount by which the taxable income exceeds R 24,000;
exceeds R 26,000 but does not exceed R 28,000	R 5,700 plus 37% of the amount by which the taxable income exceeds R 26,000;
exceeds R 28,000 but does not exceed R 30,000	R 6,440 plus 39% of the amount by which the taxable income exceeds R 28,000;
exceeds R 30,000 but does not exceed R 36,000	R 7,220 plus 41% of the amount by which the taxable income exceeds R 30,000;
exceeds R 36,000 but does not exceed R 42,000	R 9,680 plus 42% of the amount by which the taxable income exceeds R 36,000;
exceeds R 42,000 but does not exceed R 48,000	R 12,200 plus 43% of the amount by which the taxable income exceeds R 42,000;
exceeds R 48,000 but does not exceed R 54,000	R 14,780 plus 44% of the amount by which the taxable income exceeds R 48,000;
exceeds R 54,000	R 17,420 plus 45% of the amount by which the taxable income exceeds R 54,000.

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requires foreign debt financing and is simultaneously constrained by foreign debt arrangements, the non-resident's tax on interest is an obstructive and cost-raising factor. Its base has already been eroded by many exceptions. With effect from 17 March 1988, interest accruing to foreign lenders will no longer be taxed.

VI. DONATIONS TAX AND ESTATE DUTY

The Government accepts the Margo Commission's recommendation that a capital transfer tax replace the existing donations tax and estate duty. The capital transfer tax will be imposed at a flat rate of 15% on the value of transfers of capital for which full consideration has not been paid. However, the Government proposal is more generous than that of the Commission, i.e. the deduction for the annual lump sum is R 20,000 and for an estate R 1,000,000. If the estate is not worth more than R 1,000,000, the tax is not attracted. The amended provisions will apply to the estate of any person who dies on or after 16 March 1988.

VII. RATES OF NORMAL TAX

A. Persons other than companies

Taxable income derived from sources within or deemed to be within the Republic for the year of assessment ending on 28 February 1989 or 30 June 1989 (whichever is applicable) is subject to (normal) income tax calculated in accordance with Tables I and II.

B. Companies

Taxable income derived from sources within or deemed to be within the Republic for every year of assessment ending during the period of 12 months ending on 31 March 1989 is subject to the following rates of (normal) income tax:

1. On each rand of the taxable income (excluding taxable income derived from mining operations and taxable income referred to in "2(c)" below), 50 cents.

2. In respect of taxable income derived from gold mining:
   (a) in the case of any mine other than a post-1966 gold mine, an amount determined in accordance with one of the prescribed formulas plus a surcharge equal to 25% of such amount;
   (b) in the case of post-1966 gold mines, an amount determined in accordance with one of the prescribed formulas plus a surcharge equal to 25% of such amount;
   (c) for excess recoupment over capital expenditure accruing to companies, the average rate of tax as determined in accordance with the Act or 35 cents per rand, whichever is higher (the average rate is to be determined as prescribed).

3. In respect of taxable income derived from diamond mining, 45 cents per rand of taxable income plus a surcharge equal to 25% of such amount.

4. In the case of mining companies, other than gold or diamond mining companies, 50 cents on each rand of the taxable income so derived plus a surcharge equal to 15% of such amount.

The taxes determined in accordance with these rules are cumulative, i.e. one tax does not exclude any other tax.

VIII. RATES OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

The non-resident shareholders' tax is 15% of the amount of dividend (or interim dividend) in question. The undistributed profits tax is 33⅓ cents on every rand by which the "distributable income" (as defined) exceeds the amount of dividends distributed during the "specified period" (as defined).

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The Nigerian Experience with Tax Clearance Certificates

By J.M. Elegido

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I. INTRODUCTION

A Tax Clearance Certificate (TCC) is a document issued to a taxpayer by the tax authorities certifying that the taxpayer either has paid in full the tax to which he was liable for the period indicated in the document or that the taxpayer was not liable to pay tax for that period. In Nigeria, the presentation of a TCC is a prerequisite to entering into a wide range of transactions with the Federal or State Government and many of their agencies. The document must also be presented prior to obtaining certain permits and licences and for certain registration purposes.

TCCs have been of great assistance in tax collection matters but they have also exposed taxpayers to oppressive tactics by the tax authorities. This article reports on the main results of the Nigerian experience with TCCs in the hope that this experience will be of value to other countries already using TCCs or considering introduction of such documents.

In Nigeria, TCCs disclose (in respect of the last 3 years of assessment) the chargeable income of the taxpayer, the tax payable by him, the tax paid and any tax which remains outstanding or, alternatively, a statement to the effect that no tax is due.[1] The presentation of a TCC is a prerequisite in relation to:[2]

(a) application for Government loan for industry or business;
(b) registration of motor vehicles;
(c) application for firearms licence;
(d) application for foreign exchange or exchange control permission to remit funds outside Nigeria;
(e) application for certificate of occupancy;
(f) application for award of contracts by the Government, its agencies and registered companies;
(g) application for approval of building plans;
(h) application for trade licence;
(i) application for transfer of real property;
(j) application for import or export licence;
(k) application for a plot of land;
(l) application for buying agent licence;
(m) application for pools or gaming licence;
(n) application for registration as contractor;
(o) application for distributorship;
(p) confirmation of appointment by the Government as Chairman or members of a public board, institution, commission, company or to any other similar other position made by the Government [sic];
(q) stamping of guarantor's form for Nigerian passport;
(r) application for registration of a limited liability company or of a business name;
(s) application for allocation of market stalls.

In addition, an applicant for exchange control permission to remit funds to a non-resident recipient in respect of income accruing from rents, dividends, royalties or any other similar income must produce a TCC which states that tax on the funds has been paid or that no tax is payable.[3]

II. HISTORY OF TCCs IN NIGERIA

This author maintains that many of the problems caused by the introduction of TCCs derive from the informal manner in which their use was prescribed. The ill effects of the free-for-all which ensued after TCCs were introduced are still present and it will probably take several years to remedy these effects. To fully understand the issues involved, a brief history of the introduction of TCCs in Nigeria is necessary.

TCCs appear to have been pioneered by Bendel State.[4] As far back as 1969, the State Ministry of Finance issued a directive to all ministries stating that contract awards would be contingent on the production of *tax receipts* (not TCCs) for the previous 3 years. In fact, this directive was never fully implemented and the practice quickly died out. A new directive was issued in 1976 which required all ministries and departments of the State to demand TCCs from self-employed individuals prior to entering into any financial transactions with such persons. This directive was contained in the Military Governor's budget speech and in the published memorandum on the approved estimates for the 1976/77 fiscal year. This directive was enforced and it had a dramatic impact on the tax revenue collected from self-employed individuals in that State. Other States soon followed suit.

In the wake of this experience, the Federal Government decided to adopt this method of tax collection in

1. Sec. 33 Income Tax Management Act, 1961 (hereinafter referred to as ITMA 1961), introduced by Decree No. 4 of 1985. Sec. 74A Companies Income Tax Act, 1979 (hereinafter referred to as CITA 1979) introduced by Decree No. 4 of 1985.
2. Sec. 33(4) ITMA 1961; Sec. 74A CITA 1979.
3. Id.
4. Omorogiuwa, P. Ada, "Using Tax Clearance Certificates as an Instrument of Tax Enforcement in Nigeria: the Experience of Bendel State", a paper presented at the National Conference on State Taxation, Zaria (November 1984).

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a more limited manner. A 1977 Decree[5] empowered the Commissioner for Stamp Duties to demand TCCs from companies before stamping certain documents. The Federal Military Government, which at the time was implementing a programme to return the country to civilian rule, also enacted a provision making presentation of a TCC a prerequisite to running for election in the Constituent Assembly.[6] This provision was later strengthened by a clause stipulating that a candidate would be disqualified if he had "paid his income tax in arrears for any 2 of the last 3 financial years preceding the date of the election or for all of those 3 years during this financial year".[7] A number of candidates were disqualified because they belatedly discharged their duties to pay tax.

Finally, the 1977 Electoral Decree[8], which regulated the forthcoming parliamentary election, provided that any person running for office was required to have "fully paid as and when due, in respect of each of the 3 financial years preceding the date of the election, income tax anywhere in the Federation". In one of the States, for example, only 9 out of the more than 40 candidates for seats in the Federal House of Representative met the tax requirements. Two of the governorship candidates in that same State failed to qualify because they failed the tax test.[9] As set forth below, this provision caused serious problems and the requirement for TCCs in these instances was not carried over to the Electoral Act 1982.[10]

In 1979, following the report of a Task Force on Tax Administration set up by the Federal Government, TCCs were introduced throughout the country and were required for a wide variety of transactions. Legal backing, however, was not provided for until 1985.[11]

III. EFFECT OF TCCs ON TAX ENFORCEMENT

The effectiveness of tax administration in Nigeria prior to the introduction of TCCs was undoubtedly very low. There are no data for many areas of the country but data which are available reveal a dismal story at least as compared to developed countries. The overall range of personal income tax evasion for the former Western Region[12] has been estimated to be 61 to 73% for the years 1965/66 to 1971/72[13], and 70% for the year 1971/72.[14] These percentages can be compared to a 1980 estimate of approximately 14% in the United Kingdom.[15] Similarly, another study yielded an estimate of personal income tax effort of under 2% compared to 14% and 15% in the United Kingdom and the United States, respectively.[16] These results can be put in perspective by observing that the tax rates prescribed by Nigerian law were steeply progressive at the time (i.e. they reached percentages of more than 50% at relatively low levels of taxable income). The low level of personal income tax effort was clearly attributable to a weak tax administration.

The effect of TCCs on tax compliance by self-employed individuals was quite dramatic. Although only sporadic data are available, these are conclusive. Coinciding with the introduction of TCCs, the tax revenue collected from this tax group in Bendel State increased from ₦ 543,060 in 1975/76 to ₦ 1,469,306 in 1977/78.[17] It has also been reported that in other states the income tax collected almost doubled following the introduction of TCCs.[18] On several occasions tax officials have reported how effective TCCs have been in reducing tax evasion in Nigeria.[19] Specifically, it has been reported (as expected) that the introduction of TCCs has been especially effective in identifying non-residents deriving income in Nigeria who previously escaped taxation and in bringing into the tax net many self-employed individuals whose names were not listed on the Revenue's taxpayer rolls.[20] Such a conclusion is hardly surprising since tax administration problems of less-developed countries typically include identification of assessees and their addresses. Measures (like TCCs) which force taxpayers to come forward are bound to produce a positive effect on tax administrations.

IV. PROBLEMS POSED BY THE USE OF TCCs

It is unanimously recognized that the introduction of TCCs has enhanced tax collection and reduced the disparity in the incidence of tax as between employees whose tax is deducted at source through the PAYE (pay as you earn) system and the self-employed. However, TCCs have also raised serious issues, most of which relate to an erosion of the rule of law in tax matters.

As noted above, many problems appear to have de-

5. Finance (Miscellaneous Taxation Provisions) Decree No. 42 of 1977.
6. Constituent Assembly Decree No. 50 of 1977.
7. Sec. 1 Constituent Assembly (Special Provisions) Decree No. 60 of 1977.
8. Electoral Decree No. 73 of 1977.
9. See footnote 4.
10. Electoral Act No. 8 of 1982.
11. Sec. 34 Finance (Miscellaneous Taxation Provisions) Decree No. 4 of 1985.
12. One of the 3 regions into which Nigeria was divided at the time of independence. The country is now composed of 21 states and a Federal Capital Territory.
13. See Omorogiuwa, P. Ada, "An Evaluation of Personal Income Taxation in the Mid-Western and Western states of Nigeria"; an unpublished Ph.D. thesis, University of Ibadan, Department of Economics, Ibadan (1977).
14. See Orewa, G.O., "Problems and Prospects of Tax Administration at the Local Level in Western and Mid-Western Nigeria", a paper presented at the Conference on Tax Enforcement in Nigeria, Zaria (May 1973).
15. Binghan, Tom, "Tax Evasion: The Law and the Practice", London, Alexander Howden Financial Services Ltd. (1980) at 7.
16. See note 13; see also Omorogiuwa, P. Ada, "Tax Administration in Nigeria", in *Proceedings of the National Symposium on Taxation,* Lagos (1981) at 14-38.
17. See footnote 4.
18. Sulaimon, I., "The Phenomenon of Tax Clearance Certificates", *Proceedings of the National Symposium on Taxation,* Lagos (1981) at 62-67.
19. Majola, E.T., "Tax Clearance Certificate: Its Impact on the Ordinary Taxpayer", *Proceedings* of the 10th Annual Senior Officers' Conference of the Federal Inland Revenue Department, Lagos (1981) at 42-44. See also, in the same publication, the "Board's Secretary Annual Report" at 14, on the effect of TCCs on the International Tax Division of the Department. See also "Final Report of the Task Force on Tax Administration", Lagos (1979), para. 9.30.
20. Ibid.

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rived from the fact that TCCs were introduced via administrative directives with no legal backing. Tax officials found themselves in possession of a powerful weapon which they could wield almost at leisure without the threat of legal sanctions. As a past president of the Institute of Chartered Accountants of Nigeria graphically stated, "the result, of course, has been everybody for himself and God for us all!"

The first striking effect of TCCs was the belief among Government officials that lack of a TCC was sufficient to disqualify a taxpayer from the enjoyment of amenities or rights to which he was legally entitled. While the original Federal Government directive prescribed a TCC only in respect of a limited number of transactions, many States (and even some departments on their own initiative) felt free to add to the list. The Final Report of the Task Force on Tax Administration had occasion to complain that "in some states, tax clearance certificates are demanded, for example, before pupils are admitted into schools or before scholarships are granted".[21]

A similar example can be seen in the case *Fairlakes Hotels Ltd. vs. The Registrar of Companies and Others*[22], in which the plaintiff requested a court declaration that it was entitled to have a company registered notwithstanding the fact that one of the subscribers to the memorandum had been unable to produce his TCC. The Court held that because the TCC requirement lacked statutory force, the Registrar of Companies was not entitled to refuse company registration on the basis that the document had not been produced. The Registrar lacked discretion to take this fact into consideration. *Fairlakes Hotels* is the only known case where a citizen successfully challenged denial of a right because he lacked a TCC; in countless cases the matter ended with the official's denial.

The victimization of innocent employees by the tax authorities due to employer misconduct is another area of conflict. A common occurrence is for employers to make PAYE deductions from the salaries of the employees and then fail to pay the amount deducted to the Revenue. To force the employers to settle their PAYE accounts, the tax administration refuses to issue TCCs to any employee of an enterprise which is not current in its PAYE remittances in the hope that the employees will pressure the employer to settle its debts. Such practices constitute a flagrant abuse of power. The law is clear that when the employee pays his tax liability to the employer (the lawfully appointed agent of the Revenue)[23], he has discharged his liability. To hold the employee to ransom in order to force the employer to fulfil its own legal obligations is blackmail; this practice is even more unjustifiable when considering that the Revenue is endowed with more than adequate legal authority to compel the employer to pay. Even though the Joint Tax Board condemned this type of procedure in its 50th meeting held in Calabar in 1986, the practice has not yet been eradicated.[24] Insult is added to injury by the fact that the defaulting employers are often public bodies or agencies such as local government councils or Government-owned companies.[25]

An even more significant result of TCCs is the fact that the requirement to obtain the document for an urgent transaction tends to exert immense pressure on taxpayers to accept imposed assessments even if they would otherwise contest the assessment. This, in turn, appears to have encouraged some tax authorities to impose outrageous assessments in the confident expectation that no challenge will be raised. A well-known example is the practice of demanding payment of a minimum amount of tax of ₦ 400 from each taxpayer who requests a TCC. If it is realized that the tax payable (according to law) by a married taxpayer with 4 children and a dependent and whose total income is ₦ 2,700 is only ₦ 27, the injustice implicit in such a practice can be better appreciated. For such a taxpayer to have a tax liability of ₦ 400 his total income would have to be at least ₦ 6,900.[26] If the taxpayer must send his children to school, he must pay the tax.[27]

A similar difficulty (involving far higher amounts) was faced by many banks when a special levy was imposed on their "excess profits" in 1978. A dispute arose between the banks and the Federal Board of Inland Revenue concerning the first year in which the levy was to be payable. The banks had an arguable case but a senior tax official reported they were forced to abandon their objections and accept the Revenue's interpretation of the statute because of the banks' pressing need to obtain the TCCs.[28]

In their eagerness to maximize revenue, some states have refused to recognize TCCs issued in other states, even in cases where, according to law, the taxpayer was resident for tax purposes in that other state. As has been reported: "The result, of course, is that the Nigerian taxpayer pays as much tax as he can afford in

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21. At para. 9.30.
22. Suit No. FRC/L/74/79, decided by the Federal High Court in Lagos on 11 November 1982 (an unreported decision).
23. The Revenue appoints each employer as collecting agent for the purpose of operating the PAYE system, either specifically (e.g. under the Finance Law 1962, in force in Eastern states) or by a general direction in the Gazette to a class of employers (e.g. under the Personal Tax Act 1961 in force in Lagos).
24. The Joint Tax Board is a body established by the ITMA 1961. Its members are composed of the Chairman of the Federal Board of Inland Revenue, one representative of each state, usually the Director of the respective Board of Internal Revenue or equivalent body and a Secretary who is not a member. The primary functions of the Board are to advise the Federal Government in respect of tax matters having effect throughout Nigeria and promote uniformity in the application of tax laws throughout the country.
25. See footnote 4.
26. The rules in force on 31 December 1987 were used as the basis for this computation. The Nigerian GNP per capita is estimated to be approximately ₦ 1,800 ($ 450).
27. Apparently, many taxpayers were of the opinion that a better option was to obtain the TCC by fraudulent means. During the admission period to Lagos State Primary Schools in September 1984, 6,200 forged TCCs were identified (see *New Nigerian* of 13 September 1984). It should also be noted that no law has ever required the presentation of a TCC as a prerequisite for registration in a school.
28. Ejenobi, A.O., "The Taxation of Foreign Companies Operating Ships and Aircraft in Nigeria, Life Assurance Companies and Commercial Banks", *Proceedings* of the 10th Annual Conference of the Senior Staff of the Federal Inland Revenue Department, Lagos (1980). The author of this article was an Assistant Chief Inspector of Taxes in the Federal Inland Revenue Department at the time.

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as many states as necessary for his operations. He then uses the relevant tax clearance certificates in appropriate circumstances".[29] This practice, however, appears less prevalent nowadays.

Another grave issue consequent to the introduction of TCCs has been the administrative inconvenience to taxpayers. Immediately after TCCs were introduced, huge crowds were reported to have surrounded the tax offices in an effort to obtain the indispensible documents. The phenomenon became especially acute at the beginning of the school year when it became known that several states were demanding the presentation of current TCCs by parents as a prerequisite to school registration. Even now, businessmen bitterly complain of the inconvenience caused by frequently having to travel to Lagos to contact the International Division of the Federal Inland Revenue Department. This Division (which has no office outside Lagos) ensures that the tax due has been paid before TCCs are issued for the purpose of remitting management fees, dividends, royalties, etc. abroad.

The introduction of TCCs has also imposed an administrative burden on the Revenue Department itself. As a Senior Revenue official reported, "routine work on examination of accounts and attention to other normal tax work were disrupted as almost all hands were on deck to deal with the massive demand for tax clearance certificates".[30]

At an even more basic level, the use of TCCs has caused most harm by tending to pervert the tax assessment procedure. Many officials have come to regard the request for a TCC as an invitation to issue additional or best of judgement assessments, and, in some cases, advance assessments. These practices became so prevalent that the Federal Board of Inland Revenue issued an official declaration to remind the over-zealous State officials of the provisions of the Nigerian tax laws.[31] The warning, however, appears to have had only a limited impact.

Finally, the requirement that candidates for election should have paid tax "as and when due" in respect of the 3 financial years preceding the date of election deserves comment. The phrase "as and when due" proved hopelessly ambiguous when tested in litigation. A presidential candidate who was initially disqualified successfully argued before the High Court and the Court of Appeal[32] that tax is only "due" after a notice of assessment has been served on the taxpayer and no objection has been raised by him. Accordingly, even though the taxpayer had not fully paid his income tax in respect of the financial year 1977/78 (which ended in March 1978) until March 1979, it was held that because he filed a timely objection to the assessment and negotiations with the tax authorities had been on-going the taxpayer had paid his tax "as and when due". Similarly, the additional assessment imposed on him in 1979 in respect of the 1976/77 financial year did not mean that tax in respect of that assessment had not been paid "as and when due".

If a court must reach a decision on the basis of such a confused test in the emotionally-charged atmosphere of a presidential campaign (whatever the final verdict may be), supporters of the losing party will be convinced that legal technicalities have been manipulated to cover up a political decision. In the end, the entire affair only succeeded in raising the political tension of the country and it was probably wise that the requirement of proof of payment of tax was dropped in the 1982 Electoral Act.

V. IMPROVEMENTS ALREADY EFFECTED IN THE REGULATION OF TCCs

Reform legislation has already been enacted to cope with some of the above problems. The legislation aims to give a clear legal status to the requirement of TCCs.[33] As a result, there is now a precise definition of the transactions which require TCCs. The provisions also prescribe that whenever a tax authority is of the opinion that the tax assessed on the income of any person has been fully paid or that no tax is due on such income, the tax authority is obligated to issue a TCC "within a reasonable time" after a TCC has been requested. On the basis of this provision, the High Court may issue an order of mandamus to the tax authority if the administration unreasonably refuses or delays the issuance of a TCC. No doubt this provision will curb the arbitrary manipulation of TCCs by some tax officials. The fact that the transactions for which TCCs are required are now clearly defined in the law, together with the *Fairlakes* decision, will make it more difficult for Government officials to demand TCCs on their own initiative for transactions in respect of which there is no legal requirement for the document.

Finally, it must be mentioned that a 1987 amendment[34]

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29. Sulaimon, I., footnote 18 at 65.
30. See Majola, E.T., footnote 19 at 43.
31. Guidance Notes on Individuals' Requests for Tax Clearance Certificate, Federal Inland Revenue Department, Lagos (1981). A relatively lengthy quotation from this document best conveys the situation:

> "(b) Relevant Tax Authorities are not expected to raise additional Best of Judgement Assessment other than the one which might have been settled before an application for a tax clearance certificated is lodged.
> (c) Arbitrary Best of Judgement assessments quickly raised only after the taxpayer has requested a tax clearance certificate are not in accordance with proper procedure and should be discouraged...
> (d) Tax Clearance Certificates should be issued on demand and as promptly as possible if the taxpayer who is requesting it has in fact paid all existing assessments and no further assessments need be raised except on substantiated evidence warranting an additional assessment, e.g. new evidence of rental income not previously included in the original assessment.
> (e) The request for a tax clearance certificate should not be regarded as an invitation to raise. . .assessments in advance. It has been observed that some taxpayers have been asked to pay 1981 tax in January 1981. This amounts to assessing in advance, because the taxpayer is expected to be given an opportunity to make a return of his income up to December, 1980 and has a right to object to the assessment when raised. Because of this normal process of assessment, which is clearly stated in the Income Tax Laws, the Tax Clearance Certificate which is valid for 1981 is that which shows that all taxes have been paid for the 3 assessment years up to 1980. . .

32. *Zik vs. FEDECO*, PLR 531 (1980). The judgement of the Court of Appeal was delivered on 24 July 1979.
33. See Sec. 33 ITMA 1961 and Sec. 74 CITA 1979, both of which were introduced by Decree No. 4 of 1985.
34. Sec. 5 of the Finance (Miscellaneous Taxation Provisions) Decree No. 12 of 1987.

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has made it impossible to use a taxpayer's request for a TCC to justify making a tax assessment in advance. The amendment provides that "the payment of current year tax shall not be made a condition for the issuance of the certificate unless the applicant is leaving the country finally".

VI. FURTHER SUGGESTED REFORMS

It is suggested that further reforms are necessary to overcome the drawbacks of TCCs. Although it is useful to have access to the judicial system to obtain an order of mandamus for the issuance of a TCC, in many cases cost and time considerations will render this course of action impractical. If the Appeal Commissioners were given jurisdiction to issue TCCs when the tax authority refuses to do so, another avenue of redress would be open to the ordinary taxpayer. Of course, such an improvement is merely cosmetic so long as the states do not establish bodies of Appeal Commissioners (as they are enjoined to do by law).

Leaving aside this circumstance which is believed to be peculiar to Nigeria, a point of more general interest to other countries is that the power conferred on the tax authorities to deny a TCC can only be compatible (in practice) with the preservation of the rule of law if rapid and inexpensive channels of appeal are available to the taxpayers. It is submitted that only an administrative tribunal similar to the Appeal Commissioners which exist in many of the Commonwealth countries can fulfil this need.

A further improvement could be attained by providing that a taxpayer who has appealed an assessment should be entitled to obtain a TCC as soon as he has paid a portion of the tax assessed. The tax laws of many states prescribe that the entire tax must be paid before an appeal to the Commissioners can be filed.[35] This would remove the pressure which now exists on the taxpayers to abandon their objections to the assessments in order to obtain the TCCs.

Finally, specific statutory provisions should be introduced to the effect that a taxpayer from whom deductions have been made pursuant to PAYE regulations is entitled to a TCC even if his employer has failed to pay the deductions to the Revenue.

VII. CONCLUSION

While TCCs have proved to be a most effective means of increasing voluntary tax compliance, the system lends itself to great abuse. The Nigerian experience suggests that this problem will be exacerbated in the absence of specific legislation. The purpose for which TCCs can be legally demanded must be specified and a duty must be imposed on the tax authorities to issue the TCC when the conditions are fulfilled. A clear framework will prevent arbitrary conduct on the part of the Revenue or other Government authorities. To minimize abuses, a rapid and inexpensive channel of appeal must be available to taxpayers who are denied a TCC.

In conclusion, if TCCs are introduced without appropriate safeguards, the damage to the professional and ethical standards of the tax officials and the confidence of the public can easily outweigh the gains which TCCs can undoubtedly make in many developing countries.

35. Under Sec. 24(5) of the Finance Law 1962, a taxpayer who appeals from an assessment must pay half of the amount of the tax in dispute. Sec. 54 of the Income Tax Law 1957 and Sec. 29 of the Personal Tax Law 1962 require payment of the entire tax assessed. Under Sec. 47(2) of the Personal Income Tax Law 1961 and Sec. 36(2) of the Income Tax (Armed Forces and Other Persons)(Special Provisions) Act 1972, the Revenue may enforce the payment of the portion of tax which is not in dispute. Under Sec. 54(7) of CITA 1979, the Appeal Commissioners may order the appellant to deposit with the Revenue an amount equal to that paid by the taxpayer in the last year or one-half the tax charged by the assessment under appeal, whichever is less, plus 10% of the said deposit.

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SOMALIA:

NEW FOREIGN INVESTMENT LAW: RATIONALE AND HIGHLIGHTS

Private Sector Promotion Unit, Ministry of National Planning

The new Foreign Investment Law No. 19 of May 1987 replaces the previous Investment Law No. 7 of 29 January 1977. There are basically 3 reasons this legislation was enacted:

- the Government's decision and effort, since about 1980, to involve (in a much larger degree than in the past) the private sector in the country's socio-economic development process;
- renewed awareness of the contribution private investment can make to the country's development and of the mutual benefits that foreign marketing, technical and managerial know-how and risk capital can create; and
- the necessity to revise, in both substance and language, the previous legislation in order to harmonize it with Somalia's new economic policies and objectives.

The new Foreign Investment Law establishes clear priorities for foreign investment in areas where Somalia has competitive international advantages, i.e. agriculture, raising livestock, fishing, mining and tourism, as well as industrial and service activities linked to these sectors or strongly supporting them.

The highlights of Somalia's new Foreign Investment Law are as follows:

1. Besides the transfer of convertible currency, investment can also be made in the form of machinery, equipment, current production input and intangibles (e.g. patent rights, trade marks and studies and documentation prepared in connection with the intended investment).

2. There are no outright ownership and sectorial restrictions to foreign investment or any phase-out provisions, nor does the law preclude the possibility of participating in, or acquiring stock in, an existing Somali enterprise.

3. In each case, proposed foreign investment is reviewed for approval within a 60-day period by the 10-member Foreign Investment Board. The Board has the supreme decision-making authority over all matters concerning foreign investment. The Board is composed of the Permanent Secretaries of the Ministries of Planning, Foreign Affairs, Finance, Industry, Commerce, Revenue, Labour and the Governor of the Central Bank and the Chairman of the Chamber of Commerce.

4. The Foreign Investment Board is assisted by the Foreign Investment Promotion Office which, apart from performing other duties, provides advice and guidance to the foreign investor on Somalia's legal, regulatory and institutional framework, and assists in the incorporation and setting up stages.

5. The original foreign investment and any reinvested profit will be registered in convertible currency.

6. There are no restrictions to reinvestment of profit.

7. Profit is freely transferable and profit not transferred, or portions thereof, may be transferred in any following year.

8. Foreign investment (original investment plus any profit reinvested) can be freely repatriated 5 years as of the date of registration of the original investment. Repatriation is to be effected in convertible currency or, at the investor's option, in the form of physical assets. The Foreign Investment Board may reduce the 5-year period.

9. Capital gains resulting from the sale of shares or liquidation of assets are freely transferable after payment of normal taxes.

10. The law restricts the possibility of expropriation to the situation where the public interest cannot be satisfied by measures other than expropriation. In such a case, prompt and freely transferable compensation is payable in an amount which reflects the investment's fair market value as a going concern.

11. Investment disputes are to be settled in a manner to be agreed upon with the investor or in the absence of such an agreement, under the agreements in force between the investor's home country and Somalia or, if no such agreements exist, under the 1985 World Bank Convention for the Settlement of Investment Disputes. If neither option is available, the law provides for a 3-member arbitration board whose chairman is to be appointed by agreement or, in the absence of an agreement, by the President of Somalia's Supreme Court.

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CANADA:

Federal Budget 10 February 1988

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I. "MINI BUDGET 1988"

On 10 February 1988, the Honourable Michael H. Wilson, Minister of Finance, handed down his fourth budget – with no substantive tax changes proposed. While it was thought that this might be an election budget with some goodies for individual taxpayers, Mr. Wilson effectively stole his own thunder by introducing, on 16 December 1987, a Notice of Ways and Means Motion to implement Tax Reform including significant personal tax cuts.

With the exception of federal sales and excise tax changes and proposed technical amendments to the associated corporation provisions in the *Income Tax Act,* no significant tax measures were introduced.

By adroitly manoeuvering to accelerate remittance of payroll withholdings, personal income tax instalments and federal sales tax collections, Mr. Wilson has been able to contain his budgetary deficit estimate for 1987-88 to $ 29.3 billion and budgetary deficit forecast for 1988-89 to $ 28.9 billion, still enormous amounts considering the overall Canadian economy.

The Department of Supply and Services said it all. When delivering the budget papers to the Department of Finance the label on their box read "Mini Budget 1988".

II. ECONOMIC ASPECTS

A. Overview

Mr. Wilson provides considerable detail on both the Canadian economic outlook and the performance of the Canadian economy since the Progressive Conservative Government took office on 4 September 1984. He provides parallel comments on his Government's past and expected fiscal performance. Lastly, he provides a number of perspectives on the magnitude of and trends in the budget deficit – the general thrust suggesting that the Government's approach toward the budgetary deficit is the appropriate one in the circumstances.

In our comments below, we focus on the economic outlook, particularly over the short term, and the associated budgetary projections.

B. The near term economic outlook

Mr. Wilson presented the Department of Finance's view of the Canadian economic outlook over the next 5 years, and it is generally rosy. Finance's views have not changed substantially from those expressed at the time of the 18 June 1987 Tax Reform proposals. In Finance's view, Canada faces several more years of good, solid, middle-of-the-road economic growth, at rates a little slower than the surprisingly strong 1987 one. Mr. Wilson expresses the view that the Canadian economy remains fundamentally sound and that there are few signs of the domestic imbalances which normally suggest that a down-turn is imminent. Thus, Finance's projection actually shows a pickup in growth in 1989.

The generally optimistic viewpoint extends across the other key economic indicators as well:

- In Finance's view, inflation is generally under control, and will average about 4% annually over the next 2 years, with a mild decline in the early 1990s.
- Continued slow improvement is anticipated in the unemployment rate.
- Interest rates are projected to decline as well, reflecting both improvements in inflation and lower real interest rates.

Information on recent economic forecasts provided with the budget documents indicates that Finance's views are more optimistic than the "consensus forecast". Finance believes that both Tax Reform and the proposed Free Trade Agreement will buttress economic activity in the period from 1989 onward. This is consistent with the views that Finance has previously expressed, both in the papers accompanying the Tax Reform proposals and in its recently released study on the impact of free trade.

C. The fiscal position

Mr. Wilson's estimates of the budget deficit this year and next are unchanged from the estimates provided with the Tax Reform proposals. There have been some significant increases in estimated budgetary revenues, particularly in the forecasts for the 1988-89 fiscal year, but these are offset by anticipated increases in program expenditures, and, more importantly, higher than anticipated public debt charges. The increase in program expenditures primarily reflects the $ 1.1 billion Special Canadian Grains Program, as well as additional policy initiaves such as child care. Public debt charges are up throughout the forecast, primarily due to upward revisions in Finance's projections of interest rates.

On balance, very small reductions are expected in the Government deficit, which is projected to remain in the area of $ 29 billion annually for the fiscal years 1987-88, 1988-89 and 1989-90. The extent to which this should be a cause for concern depends on one's perspective. As noted above, Mr. Wilson goes to some length to illustrate that the impact of the federal deficit on the economy, for example measured as a percentage of GDP, has declined significantly since the peak

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years of 1984-85. However, it is a legitimate reason for concern that, in the sixth year of an economic expansion, the budget deficit remains very high by historical standards and is expected to improve only slightly in the near term.

This concern is accentuated by an element of sleight of hand in recent budgets. Budgetary revenues will have been enhanced by $ 3.9 billion through a number of once-only changes, including:
- the acceleration of remittances of personal income tax source deductions by large employers;
- the acceleration of quarterly personal income tax instalment payments;
- the acceleration of federal sales and excise tax payments.

D. Conclusion

The biggest structural problem which Mr. Wilson has faced in recent years is the apparently intractable budget deficit, even after several years of strong economic performance. Despite relatively optimistic economic projections, a significant improvement in the situation is not anticipated in the near term. If any combination of forecasted real growth, inflation, or interest rates turns out to be overly optimistic, the magnitude of the federal budget deficit could quickly re-emerge as a crisis issue.

III. INDIVIDUALS

A. Alimony and support payments

Following a Department of Finance release in December 1987, amendments are being proposed to alleviate hardship to the beneficiaries of certain alimony and support payments. This hardship might arise as a consequence of a Supreme Court of Canada decision. The amendments relate to the tax treatment of certain support payments made by an individual to a third party, such as a mortgage payment on the house in which the spouse resides.

As a result of this court decision, the beneficiary will be required to include any such payments in income although the tax consequences of these third-party payments could not have reasonably been contemplated before the decision was rendered.

The amendments will provide that for the 1986 and 1987 taxtion years, these types of third-party payments made under arrangements concluded on or before 27 March 1986 – the date on which the decision was rendered – will be deductible by payors without having to be included in the beneficiary's income.

For separation agreements and court orders made after 27 March 1986 and before 1 January 1988, allowances paid to a third party will be deductible by the payor and included in income of the beneficiary.

Finally, for separation agreements and court orders made after 31 December 1987, third-party payments will be deductible by the payor and included in the income of the beneficiary only where both parties so agree, thus restoring the status quo that existed prior to the court decision.

In a related measure, it is proposed that allowances paid pursuant to provincial court orders made after 10 February 1988 for support of common law spouses may be deducted from the income of the payor and shall be inlcuded in income of the payee. This measure will also apply for orders made on or before 10 February 1988 where the parties jointly elect to have this treatment apply.

B. Child care expenses

It is proposed that for 1988 and subsequent taxation years the annual deduction for child care expenses will be increased from $ 2,000 to $ 4,000 in respect of each child who is under 7 years of age or who is disabled. In addition, the current annual family limit of $8,000 will be eliminated entirely.

C. Other

Minor changes have been proposed to the refundable child tax credit system. Social insurance numbers will be required to be shown on tax returns claiming refundable child and federal sales tax credits. A new National Labour-Sponsored Venture Capital Corporation will be introduced entitling the purchaser to a tax credit equal to 20% of the cost of the shares, limited to the overall $ 700 per annum maximum for labour-sponsored venture capital corporations. Finally, amendments will ensure that, for 1982 and subsequent years, third parties who receive social assistance payments directly will not be entitled to a deduction for the amounts received, as are the beneficiaries of the payments. An exception will exist to allow foster parents to exclude these payments from their income.

IV. CORPORATIONS

The ability to multiply access to the small business deduction, which reduces the corporate rate of tax from 40% to 20% on the first $ 200,000 of active business income earned annually by an "associated" group of Canadian-controlled private corporations, will be severely restricted as a result of the changes proposed in the budget. What constitutes a group of "associated" corporations for purposes of sharing the small business deduction will be much broader as a result of the budget proposals.

To prevent corporations from implementing arrangements to avoid being considered "associated", the following changes have been proposed to the rules governing whether or not corporations are associated:
- The meaning of control will be extended from *de jure* control, under which the most important single factor considered is the voting rights attached to shares, to circumstances of factual con-

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trol. This change is intended to prevent corporations from using special voting agreements or special classes of shares to circumvent the association rules.
- In order to prevent the use of indirect ownership arrangements, shares of a corporation held by a holding corporation will be treated as being owned by the shareholders of the holding corporation in proportion to their fair market value shareholdings in the equity shares of the holding corporation. Similar changes are proposed for ownership through partnerships and trusts.
- To prevent the avoidance of the association rules through the ownership of shares by minor children, shares of corporations owned by children under the age of 18 years will be treated as being owned by each parent.

The rules are, however, to be somewhat relaxed in the determination of association of corporations controlled by related persons. The present 10% cross-ownership test is to be increased to 25%.

Although the concept of association is relevant primarily for purposes of the small business deduction it also has relevance in the following areas:
- investment tax credits – 35% rate vs. 20% rate;
- capital tax minimum thresholds;
- Specified Financial Institution status;
- character of income flowing from one corporation to another.

Other changes to the small business deduction eligibility rules include:
- introduction of an anti-avoidance rule to prevent eligibility by virtue of carrying on a business through a partnership instead of a corporation;
- denial of the small business deduction for businesses carried on by a partnership that is effectively controlled by non-residents or by public corporations.

V. CAPITAL COST ALLOWANCE (Class 34)

It is proposed that the accelerated capital cost allowance in respect of Class 34 equipment, currently a 3-year write off, be restricted to taxpayers who use the equipment primarily in the course of earning income from their own business or property, other than earning income from selling the product derived from the equipment. This change will prevent non-taxable and tax-exempt entities from entering into arrangements by which passive taxable investors provide after tax financing in respect of the acquisition of such equipment and in exchange the investors gain access to the accelerated capital cost allowance deductions for tax shelter purposes.

However, the accelerated capital cost allowance will continue to be available to corporations whose primary source of income is from selling the product derived from such equipment or from selling other similar products.

Class 34 includes equipment used for the generation of electricity or the production or distribution of heat, active solar heating equipment, heat recovery equipment, small-scale hydroelectric projects and wind energy equipment.

This change will be applicable to property acquired after 9 February 1988. Transitional provisions will exempt property acquired after 9 February 1988 pursuant to an obligation in writing entered into before 10 February 1988 or pursuant to the terms of a prospectus or offering memorandum filed before that date.

VI. RESOURCE TAXATION

Two measures were announced affecting the resource sector.

It is proposed that the definition of "Mineral Resource" be extended to include a deposit where Kaolin is the principal material extracted. (Kaolin is a white clay used in porcelain, paper, paint, plastics and medicine.) The exploration, development and production of Kaolin will now be treated as are other mining ventures and its exploration and development will be able to be funded with "flow-through shares".

The second change affecting the resource industry is to treat production income from tar sands as oil income rather than mining income. This will allow the producers to claim a larger resource allowance since the calculation of that allowance will be on income before the deduction of royalties (other than "production royalties"). Presumably this will also result in the loss of the resource allowance to the recipients of these resource royalties.

VII. NON-RESIDENT WITHHOLDING TAX (Interest payments)

The *Income Tax Act* generally requires that a withholding tax of 25% (reduced to 10% or 15% under Canada's various income tax treaties with other countries) be applied to interest paid to non-residents of Canada. However, an exemption has been available for a number of years on certain Government-guaranteed obligations and long-term (5 years) corporate arm's length debt obligations to allow Canada and Canadian businesses access to foreign capital. This exemption was scheduled to expire for such obligations issued after 1988. The Government proposes to eliminate this expiry date.

VIII. ADMINISTRATIVE MEASURES

A. Provincial deductions at source

The budget proposes that in the future, income taxes deducted at source on behalf of a provincial government will be held in trust for that government similar to the favourable treatment currently afforded

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amounts withheld for the Federal Government. Thus, the province will be protected from the provisions of the *Bankruptcy Act* in the event of the liquidation, assignment, receivership or bankruptcy of the person withholding.

B. Jeopardy collection

The jeopardy collection provisions of the *Income Tax Act* allow the Minister of National Revenue immediately to collect tax owing where a delay might jeopardize its collection. This budget proposes to limit the exercise of this power to cases where prior judicial approval has been obtained.

C. Limitation period on prosecutions

The *Income Tax Act* provides that criminal prosecution must be initiated for an offence under the Act within 5 years from the offence occurring unless the Minister of National Revenue is aware of sufficient evidence to justify prosecution for the offence. Where the Minister of National Revenue has personal knowledge of this evidence he must prosecute within one year of the day on which he became aware of the evidence. The budget proposes to extend this power to the Deputy Minister and other prescribed officials to avoid the necessity of the Minister becoming involved with all such cases.

D. Certificates for unpaid amounts

Revenue Canada can register a certificate with the Federal Court specifying an amount payable by a taxpayer. Under the *Income Tax Act* this certificate is then filed or registered against any land owned by the taxpayer. A proposed amendment will ensure that this charge against a taxpayer's land is enforceable in all provinces.

IX. FEDERAL SALES AND EXCISE TAXES

It comes as no surprise that the Government has again turned its attention to federal sales tax in the current budget. The second stage of the 1987 Tax Reform proposals on the multistage sales tax appears to have become bogged down in pre-election jitters. While it does not appear to be safe to introduce a new tax in a potential election year, it pays to tinker with the grande dame of taxes – the 68 year old federal sales tax.

A. Taxes at the wholesale level

The proposal to shift the sales tax to the wholesale level for household chemicals, toys, games and sporting goods and records and tapes (to have been implemented 1 January 1988, then postponed to 1 July 1988) will not be implemented.

The sales tax on pet foods, snack foods; candy and confectionery, microwave ovens, television and video recorders and players, moved to the wholesale level prior to 1988, will be shifted back to the manufacturer's trade level effective 1 November 1988. It is unclear what the tax disposition of affected goods will be where such items are held by a wholesaler at 1 November 1988. Transitional provisions should ensure the ability of wholesalers to pay tax only on the cost of goods on hand at 1 November 1988 when they are ultimately sold at a later date.

Because of "structural problems" in applying the sales tax at the manufacturer's level on motor vehicles, cosmetics, health goods, prerecorded video cassettes and pet litter, these items will continue to be taxed at the wholesale trade level, in perpetuity (we assume).

B. Increased sales tax base

In order to correct problems with the manufacturer's tax, the Government attempted to introduce related-party taxing provisions in the 18 June 1987 Tax Reform proposals effective 1 January 1988. These proposals appeared unduly complex, unfair and unworkable.

Temporarily postponed to 1 July 1988, the related-party proposals are "out of business" for good. In their place, however, the Government is proposing an alternative that at first glance appears to be cumbersome and, in the long run, possibly unworkable.

Instead of attempting to tax all marketing and distribution ("M & D") endeavours, the new proposals attempt to strip the tax base to its lowest common denominator for both manufacturer and importer alike.

The proposed formula to compute the tax liability is deceptively simple:

$$\text{Tax payable} = [(\text{Sale price} - \text{M \& D costs}) \times 1.25] \times 12\%$$

Items taxed at the wholesale level, as well as construction materials, alcoholic beverages, tobacco products, gasoline and diesel fuel, are not covered by the above formula and tax will continue to be computed under the old method.

The sale price in the formula is the full amount charged by the Canadian manufacturer of finished goods to its customer. In the case of imported goods, sale price is duty-paid value. M & D represents the actual Canadian marketing and distribution costs of the manufacturer and importer for taxable goods only.

However, where the manufacturer or importer has difficulty determining this M & D amount, he will be permitted to deduct a standard 25% of the sale price on the first $ 250,000 of annual taxable sales and 7% on subsequent sales. This has the effect of allowing a small manufacturer with less than $ 250,000 of annual taxable sales to be exempt from using the formula.

"Costs reasonably attributable to the marketing and distribution of taxable goods" will be deductible. These include: discounts and allowances, samples, outbound freight, warehousing beyond manufacturing premises, sales department, salaries and commissions of sales personnel, advertising expenditures, warranty, after-sales service, installation costs, customer relations and some indirect costs – administrative, data processing, personnel.

The legislation will provide specific lists of certain

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costs not deductible. Examples include: product liability, pre-production market research, engineering/product research and development, royalties, financing charges and profits.

Before preparing regulations and guidelines the Government will consult with taxpayers – they will have 33 days. To be considered, written submissions are expected by the Department of Finance no later than 15 March 1988.

C. Determined and established values

Revenue Canada has built a system of administrative guidelines to reduce the variation of sales tax payable where goods are sold at different prices to wholesalers, retailers and users. These rules are often outdated, arbitrarily administered, not provided for in law and therefore not subject to appeal. These notional valuation systems will be terminated effective 31 October 1988 for all goods subject to tax at 12% and will be replaced by the formula discussed above. The Government believes the allowance for M & D costs will eliminate the inequity of differing prices at different trade-levels.

D. Alternative M & D deductions

In certain situations the 25%/7% deductions will be replaceable by certain industry wide determined values. The tax reform proposals do not clearly indicate how such determined values will be established, legislated and utilized.

E. What is the impact?

The Government claims two-thirds of domestic manufacturers will be below $ 250,000 per year in taxable sales. They should not be impacted by these changes.

For domestic manufacturers with M & D costs greater than 20% of taxable sales, tax liability should decrease. Conversely, with lower M & D costs, tax liability will increase.

Importers will suffer the most. Their federal sales tax liability will increase by 16.25% effective 1 November 1988. This represents an increase in the nominal federal sales tax rate from 12% to 13.95%.

F. Other details

The proposals expect that where manufacturers sell both taxable and non-taxable goods, M & D costs are to be allocated in a manner that is reasonable in the circumstances.

As for imports, since it is difficult to determine when an importer has reached the $ 250,000 plateau, a standard 7% deduction in the computation will be allowed during the year with a refund claimed for the other 18% on the first $ 250,000 of imported goods at the end of the year. Because of the 25% mark-up, this has the effect of overstating the tax base by 22.5% or $ 56,250 with a maximum refund of 12% of that or $ 6,750 per importer.

The associated company rules in section 256 of the *Income Tax Act* will ensure that the $ 250,000 deduction is allocated only once to an associated group.

G. Wholesale licence provisions

The *Excise Tax Act* provides that wholesalers who make a majority of sales under federal sales tax-exempt conditions can obtain all taxable goods on a tax-free basis by use of a wholesaler's licence.

To obtain a wholesaler's licence the only current requirement is that 50% of an applicant's sales in any previous 3-month period are made under tax-exempt conditions. Once granted it is difficult to lose a wholesaler's licence. Bonding requirements for licence holders are also minimal.

Effective 1 November 1988 it is proposed that licence applicants will have to sell at least 50% of their taxable goods under exempt conditions in any 6-month period ending in the 12 months preceding application. In addition, licensees will be required to file an annual report by 15 February in each year to account for exempt or taxable goods in the preceding calendar year. To retain a licence at least 45% of their taxable goods must be sold under exempt conditions in any 6-month period ending in the reported year. Upon licence cancellation tax-free inventory must be tax-paid in 6 equal instalments over the coming year.

Security for such licences will be increased to a maximum of $ 100,000. Transitional rules will be in place and where taxpayers do not meet new criteria, licences will be cancelled 1 April 1989 with tax repayments occurring during the following 12 months. The cancellation of such licences is expected to bring in a one-time $ 200 million of revenue in the 1988-89 and 1989-90 fiscal years.

H. Miscellaneous sales tax matters

Effective 10 February 1988 it is proposed that original prints such as serigraphs, woodcuts, lithographs and engravings will be exempt from federal sales tax.

Effective 11 February 1988, the *Excise Tax Act* will be amended to liberalize the transportation deductions. All transportation costs incurred to ship goods from a manufacturer's plant to last storage site will now be deductible from the manufacturer's sales tax base.

The annual threshold for quarterly or semi-annual filing of federal sales tax returns will be doubled to a new tax threshold of $ 4,800 per annum. The Government promises that 2,000 licensees will benefit from this change.

I. Excise tax

Effective 1 April 1988 the excise tax on gasoline and aviation gasoline is increased by one cent per litre. The fuel tax rebate for farmers, fishermen and other primary producers will also be increased by one cent per litre. This cosmetic change will result in additional revenues of approximately a third of a billion dollars!

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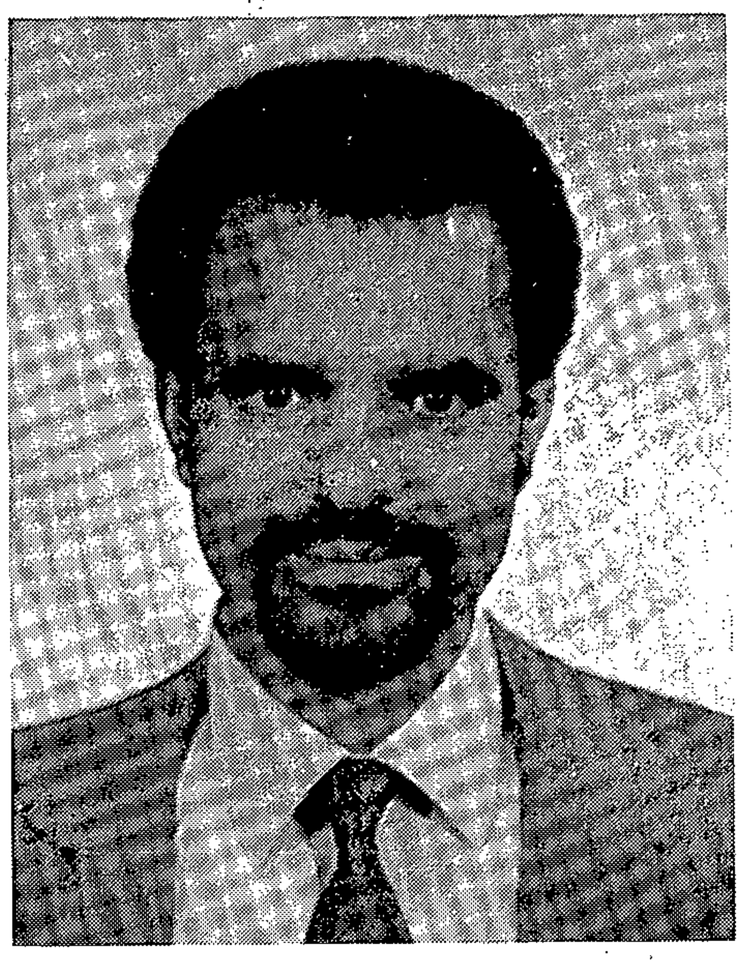
Comparative Income Distribution and the Impact of Taxation

By Gebre Hiwet Tesfagiorgis, Ph.D.*



Gebre Hiwet Tesfagiorgis received a Bachelor of Business Administration from Haile Selassie I University, Addis Ababa in 1971. He earned a Ph.D. in Educational Administration, with an emphasis on the Planning and Economics of Education, from the University of Wisconsin at Madison in 1978. Currently Mr. Tesfagiorgis is a Senior Policy and Planning Analyst with the University of Wisconsin System Administration. He is studying law on a part-time basis and expects to earn a J.D. in December 1988.

I. INTRODUCTION

The subject of income distribution is a key problem in any society and failure to deal with it in a satisfactory manner can lead to social upheaval.[1] The problem of income distribution is closely linked to the issue of inequality, a concept that is highly controversial. As Pen states, "The inequality of incomes has been debated for centuries without passions waning or a clear picture emerging".[2] There are those who contend that an equal distribution of income may not be a socially desirable social objective so long as there exist individual differences in skills and productivity.[3] On the other hand, there are those who advocate equal treatment in the sense of equality of economic welfare as the goal of distributive justice.[4] Still others, perhaps the majority of policy framers, forward the notion of acceptable degrees of inequality, i.e. the degrees of inequality which different societies will find tolerable.[5] They think in terms of some range of inequalities, rather than unrealizable ideal of egalitarianism, that can be set up as a practical objective.

The systematic analysis of the subject of income distribution goes back to Aristotle.[6] The subject has lately become of great international interest as part of a general revival of interest in inequality.[7] This is partially due to the situation in the economically-underdeveloped countries, where the plight of the majority of the population appears to be worsening: witness the recent widespread draught and famine in several African regions. Most studies on the so-called developing countries, if indeed they are developing, indicate that the rich tend to benefit more than the poor from any increases in national income.[8] International and national agencies and scholars have responded to this interest by studies and data compilations purporting to show comparative distribution of income in various countries (World Bank, the International Labor Organisation and United Nations Statistical Office). Such data are intended to influence perceptions of policy-makers and development analysts.

Notwithstanding the controversies surrounding its operational definition, income distribution as a societal goal exists in all countries. The degree of emphasis accorded income distribution may vary depending on the prevailing socio-political factors. Some countries have taken revolutionary paths to achieve the goal, perhaps at the expense of other equally desirable societal values. Others have opted for less dramatic means, such as public ownership of major productive resources. Still others have employed control mechanisms through fiscal policies to achieve some degree of the same goal. Prominent among these policies is taxation, which is employed by all countries although its primary purpose may not necessarily be income distribution.

The primary purpose of this article is to provide a descriptive analysis of pre-tax and post-tax income distribution in 5 developed/industrialized countries which will enable inferences on the importance of taxation as an instrument of income distribution. A secondary purpose is to attempt to draw lessons for developing countries in dealing with income distribution problems.

A general background is first provided which discusses: (1) conceptual and definitional problems, (2) scope and source of data and (3) measures of income inequality. This is followed by a descriptive analysis of income distribution of 5 developed/industrialized countries. The article concludes by inferring lessons which developing countries can learn from the experiences of the developed countries in the area of income distribution.

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1. M. Schnitzer, *Income Distribution: A Comparative Study,* New York: Praeger, (1974) at (v).
2. J. Pen, *Income Distribution,* at 23 (1971).
3. See, generally, E. Sadka, *Social Welfare and Income Distribution,* Madison: Institute for Research on Poverty, University of Wisconsin-Madison (1976).
4. See e.g., L.O. Ericsson, *Justice in the Distribution of Economic Resources: A Critical and Normative Study,* Stockholm: Almquist & Wiksell International (1976).
5. See, generally, I. Bowen, *Acceptable Inequalities: An Essay on Distribution of Income,* Montreal: McGill Queen's University Press (1970).
6. See L.O. Ericsson, supra note 4, at 27.
7. See M. Sawyer, *Income Distribution in OECD Countries,* Organization for Economic Cooperation and Development (1976).
8. See J.C.H. Fei, W. Ranis and J. Park (eds.), *Growth with Equity: The Taiwan Case,* New York, published by the World Bank, Oxford University Press (1979), at (v).

II. GENERAL BACKGROUND

A. Comparability problem

Data on income distribution are not readily available especially for most developing countries. Those which are available generally suffer from several limitations for international comparison purposes.[9] There are basically 2 major problems which make inter-country comparison of income distribution difficult. The first is related to the definition of income and the second to the definition of the income unit.

Defining the term "income", appropriate for income distribution, is far from settled. Income distribution data are rarely collected for the purpose of distributional analysis. They are usually collected through income tax returns, census, or household surveys.[10] Each purpose has its own definition of income. For example, the income tax definition of income is usually a political-legal definition rather than an economic or social one. Thus different national definitions set different standards of reportable income for tax purposes.[11] The traditional approach of estimating income for distributional study purposes has been the monetary value of goods and services that satisfy individual needs, i.e. the consumption expenditures.[12] However, this limited definition leaves many problems unresolved. For example, there is no consensus as to what length of time income should be measured nor as to the expansion of the composition of income from the monetized to the in-kind types.

The definition of the "income unit" further complicates the comparability problem. To estimate income distribution, there must be a common income unit, i.e. a common recipient of income upon which the measure of inequality is based. The 2 most commonly used income units for distributive analysis purposes are an individual (e.g. an individual taxpayer) and a household. The latter is the generally preferred unit. A household is defined as "a single person or group of 2 or more persons who share a common dwelling and make common provisions for food or other essentials for living".[13]

Some argue that the present state of income distribution statistics does not permit valid cross-country comparisons.[14] Others, while not denying the problems, argue that some inroads have been made that enable analysts and policy-makers to draw tentative inferences and conclusions albeit with great caution.[15] It is the latter view which influenced the undertaking of this article.

B. Scope and source of data

The problem of international comparability of data on income distribution mainly arises from differences among countries in economic and socio-political structures. Five developed/industrialized countries – the United States, the United Kingdom, West Germany, Sweden and Japan – have been selected for this study hoping there exists sufficient similarity, at least in their economic structures, to make a comparative analysis not unreasonable.

In spite of the comparability problems outlined in the preceding section, reasonably standardized concepts and definitions do exist, mainly through the efforts of international organizations such as the United Nations Statistical Office (UNSO), the Organization for Economic Cooperation and Development (OECD), the World Bank and the International Labor Organization (ILO). In some instances, some of these agencies have undertaken joint projects aimed at developing reasonably comparable data definitions for international comparison purposes. (e.g. the World Bank and the ILO). In many instances, they have taken data, obtained through national survey studies, made adjustments to make them internationally comparable and published them. For these reasons, and more importantly, because of their relative ease of availability, data from such organizations have been relied upon for the analysis here.

Reliance on these sources, however, does not eliminate the comparability problems discussed above. All that it means is that the sources are the best available in the area of cross-country comparison of income distribution. The specific sources are cited with each set of data used in the analysis, but in general, the following criteria were applied in selecting the sources: (1) the latest available data were used for each country, (2) income included both monetized and in-kind incomes to the extent possible and available, (3) pre-tax and post-tax incomes from the same source were used to the extent possible and (4) the income unit used is the household unit with no adjustment for size.

C. Measures of income inequality

There are many measures of income inequality. The Lorenz curve and Gini coefficients have been chosen for the analysis in this article. The 2 measures were chosen for 2 reasons: (1) they are the most commonly used methods in inter-country comparisons, and (2) they are relatively easy to apply to the available data which are reasonably comparable.

1. The Lorenz curve

The Lorenz curve (which bears the name of its deviser) is a mathematical representation which depicts the degree of income distribution. It relates percent of income recipients and percent share of total income.

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9. See The World Bank, *Handbook on Income Distribution Data,* at 1-4 (1981).
10. See D. McGranahan, *International Comparability of Statistics on Income Distribution,* United Nations Research for Social Development (UNRISD), Geneva (1979), at 1.
11. Id., at 5-20.
12. The World Bank, supra note 9, at 3.
13. Id.
14. See, generally, McGranahan, supra note 10.
15. See, generally, T. Stark, *Distribution of Income in Eight Countries,* Background Paper No. 4, Royal Commission on the Distribution of Income and Wealth, London, (1977).

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The starting point of a Lorenz curve is the assumption of income equality. Equality exists when every income-receiving unit (in this case household) receives its proportionate share of the total income.[16] For example, if incomes were uniformly distributed, the lowest 20% of households would receive exactly 20% of the total income. In the Lorenz curve, the curve of absolute equality would actually be a straight line extending from the bottom left-hand corner of the box to the top right-hand corner (see Chart 2). The measure of the degree of inequality in income distribution is represented by the concavity of the Lorenz curve relative to this straight line of complete equality.

The Lorenz curve carries the advantage of enabling visual presentation of inequalities in the distribution of income. More importantly, it can measure the effects of changes in distributive policy measures, such as taxation, on the distribution of income. This attribute was a major consideration in choosing the method for the purpose here.

2. Gini coefficient

The Gini coefficient is a measure of income distribution closely related to the Lorenz curve. It is a ratio of (a) the area on a graph that lies between the Lorenz curve and the line of perfect equality to (b) the area of the entire triangle formed by the line of perfect equality and the x-and-y axes (Chart 1). The Gini coefficient ranges from 0 to 1. The larger the coefficient, the larger the inequality. Thus, zero represents perfect equality and 1 represents perfect inequality. The advantage in Gini coefficient is that it can be calculated directly from the data used for the Lorenz curve.[17]

III. ANALYSIS OF INCOME DISTRIBUTION IN 5 DEVELOPED COUNTRIES

The 5 selected countries (the United States, the United Kingdom, West Germany, Sweden and Japan) are characterized as industrial market economies.

Pre-tax and post-tax income distribution data are presented and discussed for each country. The specific data presented in this section were selected through the following procedure. First, available data on income distribution, measured in terms of percentage share of household income by percentile, were compiled for each country and categorized into pre-tax and post-tax (see Appendices 1-5). The sources consulted were reports by the international and regional agencies cited in the introductory section or by individuals associated with those agencies. Then, from the data compiled for each country, a specific set was selected for presentation and analysis in this section. The selection criteria, in the order of their importance, were as follows: (1) pre-tax and post-tax income distribution data existed from the same source, (2) the most recent ones were preferred, and (3) the data which included Gini coefficients were preferred.

The analysis of income distribution by country starts with the United States, and the procedure followed there serves as a general frame of reference for the analyses of the other countries. Following the by-country analyses of income distribution, the data on individual countries are brought together in summary charts in order to aid summary conclusions from which distributive policies are inferred as lessons to developing countries.

Chart 1

Income distribution in the United States, 1972

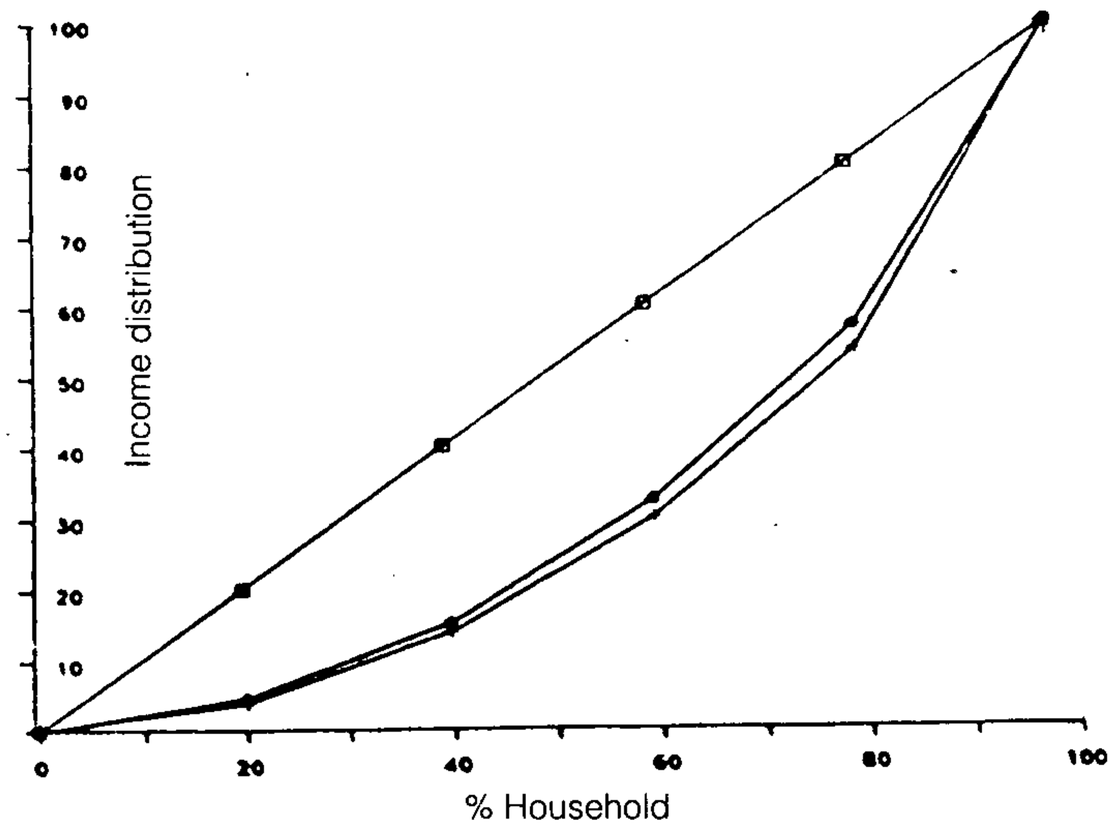

Table 1

Income distribution by percentile household in the United States, 1972

Percent household	Pre-tax	Post-tax
Lowest 20%	3.8	4.5
Second quintile	10.0	10.6
Third quintile	16.1	17.3
Fourth quintile	23.7	24.7
Highest 20%	46.4	42.9
Gini coefficient	0.404	0.381

A. The United States

Two sets of data are used for the United States: (1) data for 1972, which are comparable to the period in which latest pre-tax and post-tax income distribution data are available for the other countries, and (2) data for 1980, the latest available for the country. The use of 2 periods provides an opportunity to determine whether there has been significant change in the country's pattern of income distribution in the last decade.

16. See Schnitzer, supra note 1, at 25-27.
17. S. Jain, *Size Distribution of Income: A Compilation of Data,* Washington: World Bank, (1975), at (xiv).

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Table 1 presents the pattern of pre-tax and post-tax income distribution in the United States in 1972. The pre-tax data show that the income share of the lowest 20% of the 1972 households was 3.8%, while the share of the highest 20% was 46.4%. The post-tax data show that the income share of the lowest 20% of the households in the same year was 4.5%, while the share of the highest 20% was 42.9%. This means, taxation had the effect of increasing the income share of the lowest 20% from 3.8% to 4.5% (an increase of about 18%), and of decreasing the income share of the highest 20% from 46.4% to 42.9% (a decrease of 8%). It is also observable that marginal increases had occurred in the relative income share of the 3 intermediary household quintiles. The overall impact of taxation on income distribution is reflected in the decrease of the Gini coefficient from 0.404 to 0.381. The Gini coefficient, it is to be recalled, ranges from 0 to 1, and the larger the coefficient, the larger the inequality.

Chart 1 is a graphic presentation of the same data shown in Table 1. The 2 Lorenz curves, representing pre-tax and post-tax, measure the overall income inequality. The area between the diagonal line of complete equality and each of the 2 curves represents the degree of inequality. The area between the 2 curves themselves, the pre-tax and post-tax, represents the overall change in income inequality due to taxation.

Table 2 presents the pattern of pre-tax and post-tax income distribution in the United States in 1980. The inclusion of the 1980 data was not for the purpose of intercountry comparison but, as previously mentioned, for the purpose of obtaining some indication as to whether any change has occurred in the pattern income distribution in the United States over the decade. The literature on income distribution in the United States indicates that the degree of income inequality in the country had not improved in the previous 2 decades.[18]

A comparison of the data in Tables 1 and 2 shows that the pre-tax income share of the lowest 20% of the households in the United States increased from 3.8% in 1972 to 4.1% in 1980, while the share of the highest 20% decreased from 46.4% to 44.2% between the same 2 years. Likewise, the post-tax income share of the lowest 20% of the households increased from 4.5% to 4.9%, while the share of the highest 20% decreased from 42.9% to 40.6%. Whether this change is significant enough to refute what the literature indicates is a matter of opinion. Nevertheless, it can reasonably be claimed that the data show a tendency for a slow, gradual improvement in the income inequality in the United States. A comparison of the Lorenz curves in Charts 1 and 2 does show this tendency; it is almost difficult to tell there is a difference in the size of the area between the line of complete equality and the curves in the 2 charts. A comparison of the Gini coefficients might have been more revealing. However, coefficients were unavailable in the 1980 data.

Another aspect of interest in the comparison of the data of the 2 years is that there does not seem to be any difference in the distributive impact of taxation between 1972 and 1980. This is reflected in area between the 2 Lorenz curves in the 2 years.

Chart 2

Income distribution in the United States, 1980

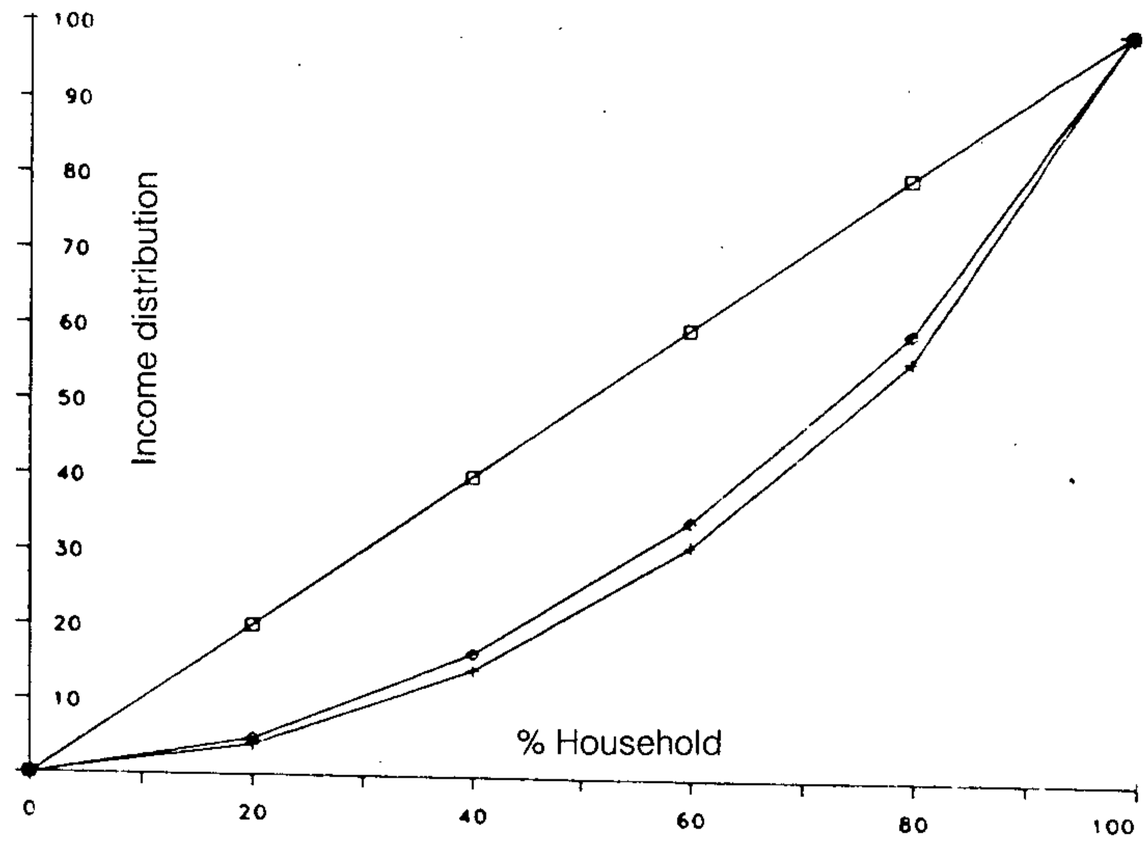

Table 2

Income distribution by percentile household in the United States, 1980

Percent household	Pre-tax	Post-tax
Lowest 20%	4.1	4.9
Second quintile	10.2	11.6
Third quintile	16.8	17.9
Fourth quintile	24.8	25.1
Highest 20%	44.2	40.6
Gini coefficient	N.A.	N.A.

B. The United Kingdom

Table 3 presents the pattern of pre-tax and post-tax income distribution in the United Kingdom. The latest available data are for 1973. The pre-tax data show that in 1973, the income share of the lowest 20% of the households in the United Kingdom was 5.4%, while the share of the highest 20% was 40.3%. The post-tax data show that during the same year, the income share of the lowest 20% of the households was 6.3.%, while the share of the highest 20% was 38.7%. This means taxation had the effect of increasing the income share of the lowest 20% from 5.4% to 6.3% (an increase of about 17%), and of decreasing the income share of the highest 20% from 40.3% to 38.7% (a decrease of 4%). It is to be noted that the change in the relative share

18. See, e.g., M. Reynolds and E. Smolensky, *Post-Fisc Distribution of Income, 1950, 1961 and 1970,* Madison: Institute for Research on Poverty, University of Wisconsin-Madison (1977),

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of income of the 5 quintiles as the result of taxation is almost symmetrical – the lowest 2 quintiles as the result of taxation is almost symmetrical – the lowest 2 quintiles positive, the third almost constant and the highest 2 negative. The overall impact of taxation on income distribution is reflected in the decrease of the Gini coefficient from 0.344 to 0.318.

Chart 3 is a graphic presentation of the data shown in Table 3. The 2 Lorenz curves, representing pre-tax and post-tax, measure the overall degree of income inequality in the United Kingdom, as represented by the area bound by the straight line of complete equality and each of the 2 curves. The impact of taxation on redistribution of income is represented by the area bound by the 2 curves themselves.

C. West Germany

Table 4 presents the pattern of pre-tax and post-tax income distribution in West Germany. Again, the latest available data are for 1973. The pre-tax data show that the income share of the lowest 20% of the German households in 1973 was 5.9%, while the share of the highest 20% was 46.8%. The post-tax data show that the income share of the lowest 20% of the households was 6.5%, while the share of the highest 20% was 46.1%. This means, taxation had the effect of increasing the income share of the lowest 20% from 5.9% to 6.5% (an increase of about 10%), and of decreasing the income share of the highest 20% from 46.8% to 46.1% (a decrease of a mere 1½%). It is interesting to note that with the exception of the first quintile of households, the redistributive impact of taxation in West Germany was marginal. The 10% increase in the share of income of the lowest quintile was accomplished through the mere 1½% decrease in the share of the highest quintile. The overall impact of taxation on income distribution is also reflected in the decrease of the Gini coefficient from 0.396 to 0.383.

Chart 4 is a graphic presentation of the data shown in Table 4. The marginal effect of taxation on income distribution in West Germany is reflected in the 2 Lorenz curves, which represent the pre-tax and post-tax measures but are almost indistinguishable from each other.

D. Sweden

Table 5 presents the pattern of pre-tax and post-tax income distribution in Sweden in 1972. The pre-tax data show that the income share of the lowest 20% of the households in 1972 was 6.0%, while the share of the highest 20% was 40.5%. The post-tax data show that the income share of the lowest 20% of the households in the same year was 6.6%, while the share of the highest 20% was 37%. This means, taxation had the effect of increasing the income share of the lowest 20% from 6% to 6.6% (an increase of about 10%), and of decreasing the income share of the highest 20% from 40.5% to 37% (a decrease of about 9%). It is interesting to note that of the 5 quintiles of households

Chart 3

Income distribution in the United Kingdom, 1973

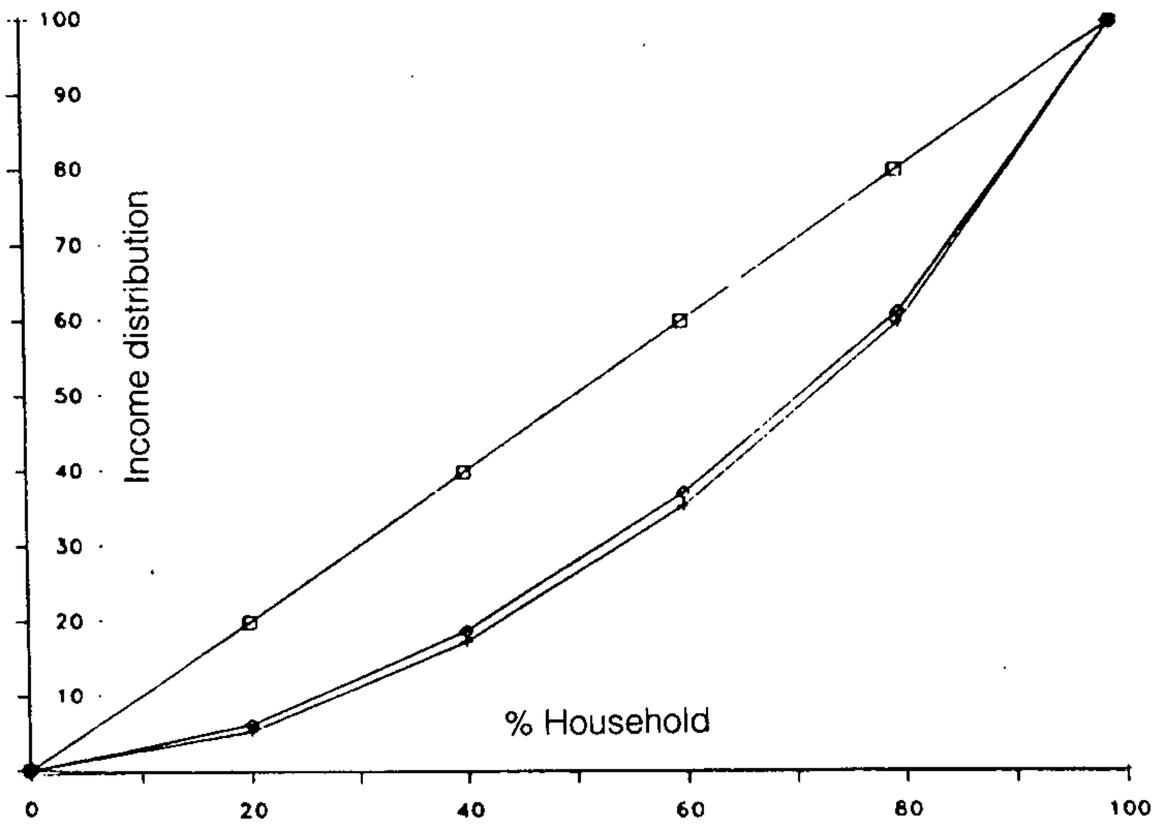

Table 3

Income distribution by percentile household in the United Kingdom, 1973

Percent household	Pre-tax	Post-tax
Lowest 20%	5.4	6.3
Second quintile	12.0	12.6
Third quintile	18.1	18.4
Fourth quintile	24.2	23.9
Highest 20%	40.3	38.7
Gini coefficient	0.344	0.318

in Sweden, only the income share of the highest one showed a decrease as the result of taxation. This means the tax burden in Sweden tended to be on the households with the highest income. This may be a reflection of the effective progressive income taxation often cited in the literature on Sweden's income distribution. The overall impact of taxation on income distribution is reflected in the decrease of the Gini coefficient from 0.335 to 0.302.

Chart 5 is a graphic presentation of the data shown in Table 5. Again the 2 Lorenz curves, representing pre-tax and post-tax, measure the overall degree of income inequality in the country. Particularly noticeable is the rather significant size of the area between the two curves themselves, which represents the overall impact of taxation on income distribution in Sweden.

E. Japan

Japan presented a particular problem in that the latest available data, with pre-tax and post-tax information in one source, were for 1969. Even then, the compara-

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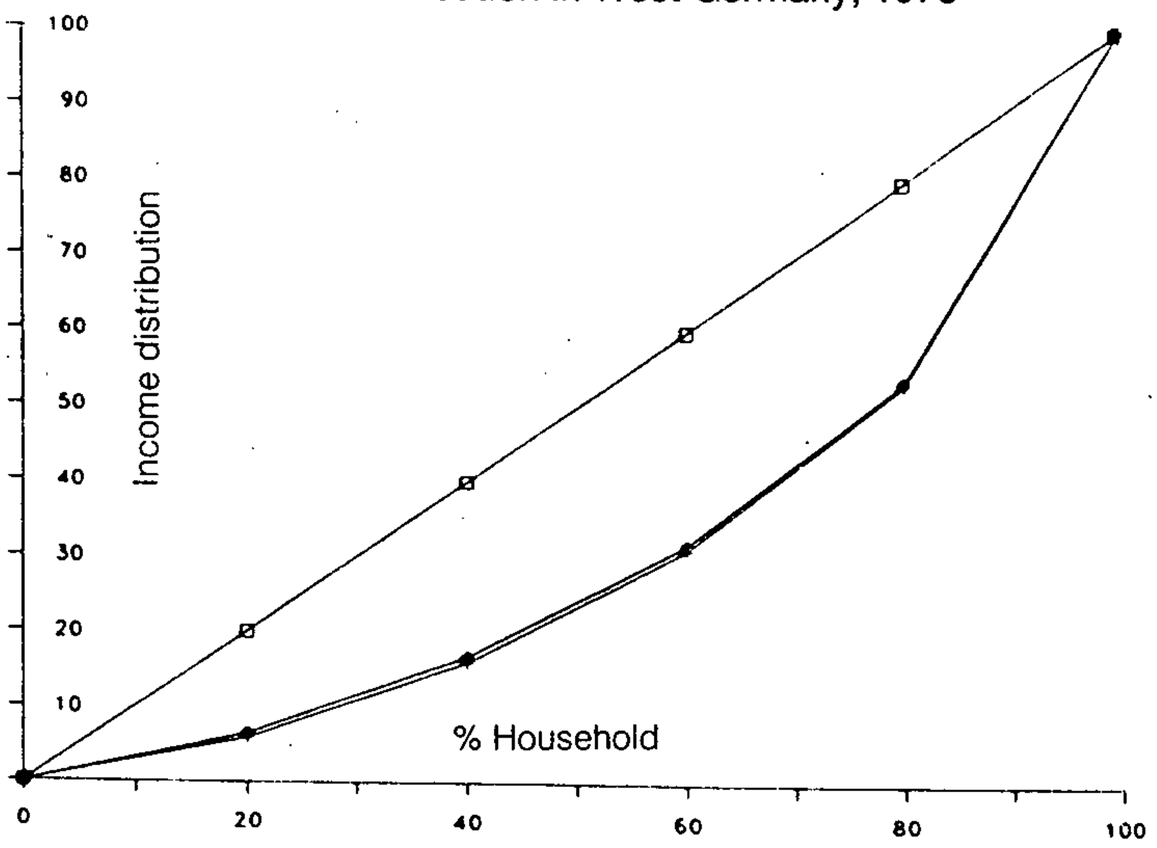
Chart 4

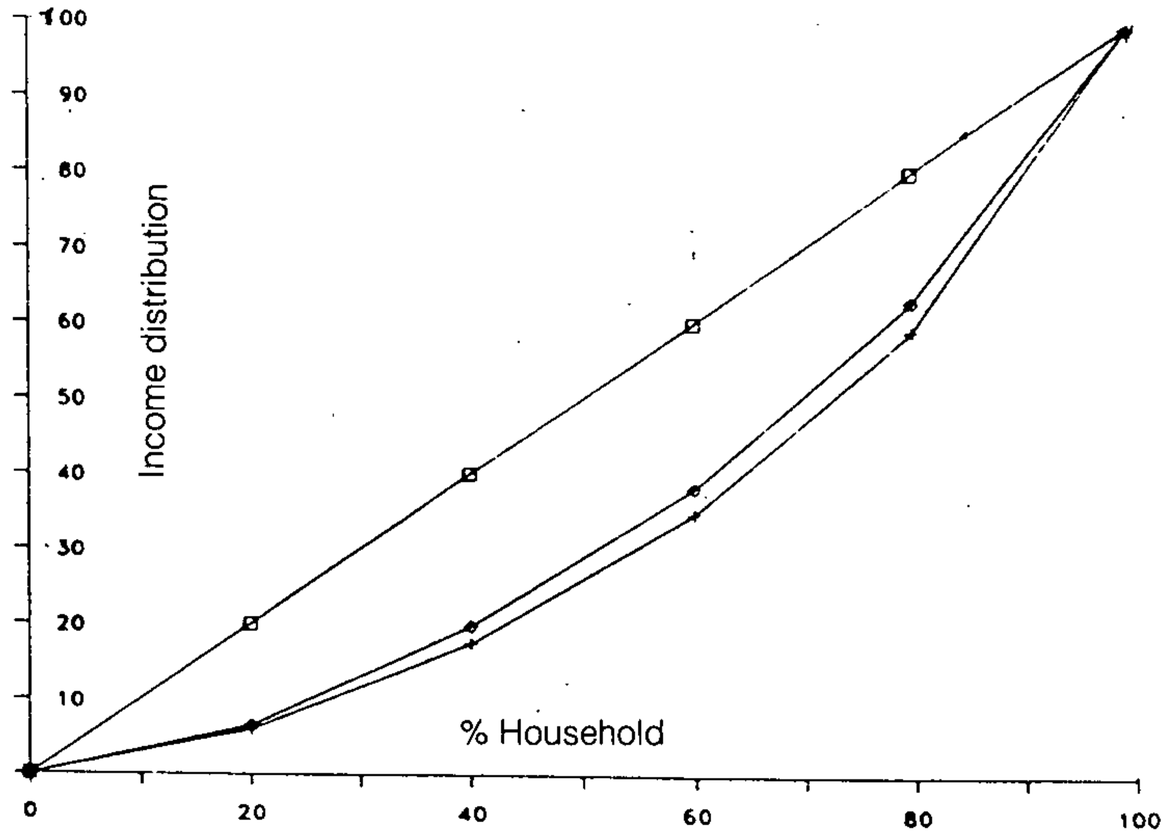
Income distribution in West Germany, 1973



□ Complete equality + Pre-tax ◇ Post-tax

Chart 5

Income distribution in Sweden, 1972



□ Complete equality + Pre-tax ◇ Post-tax

Table 4

Income distribution by percentile household in West Germany, 1973

Percent household	Pre-tax	Post-tax
Lowest 20%	5.9	6.5
Second quintile	10.1	10.3
Third quintile	15.1	15.0
Fourth quintile	22.1	21.9
Highest 20%	46.8	46.1
Gini coefficient	0.396	0.383

Table 5

Income distribution by percentile household in Sweden, 1972

Percent household	Pre-tax	Post-tax
Lowest 20%	6.0	6.6
Second quintile	11.4	13.1
Third quintile	17.4	18.5
Fourth quintile	24.3	24.8
Highest 20%	40.5	37.0
Gini coefficient	0.346	0.302

bility of the data with those of the other countries was not very convincing. Nevertheless, these data are presented in Table 6. The pre-tax data show that the income share of the lowest 20% of Japan's households was 7.6% in 1969, while the share of the highest 20% was 42.5% for the same year. The post-tax data show that the income share of the lowest 20% of the households in the same year was 7.9%, while the share of the highest 20% was 41%. This means, taxation had the effect of increasing the income share of the lowest 20% from 7.6% to 7.9% (an increase of about 4%), and of decreasing the income share of the highest 20% from 42.5% to 41% (a decrease of about 4%). The pattern of the impact of taxation on income distribution is similar to that of Sweden, although not as dramatic, in that the tax burden seems to have been on the highest 20% of the households. The remaining 4 quintiles showed some increases in their relative share of income as the result of taxation. The impact of taxation on income distribution is also reflected in the decrease of the Gini coefficient from 0.335 to 0.316.

Chart 6 graphically presents the same data shown in Table 6. The 2 Lorenz curves, representing pre-tax and post-tax, measure the overall degree of income inequality in Japan. The area between the 2 curves, which represents the impact of taxation on income inequality in Japan, appears to be marginal.

F. General comparisons

The specific data pertaining to each of the 5 countries discussed above have been pulled together in Table 7 and are graphically presented in Charts 7 and 8. This was done in order to facilitate a comparison among the countries as well as a generalization on the pattern of income distribution in those countries.

It was previously stated that the 5 developed/industrialized countries were selected with the hope of finding sufficient similarities so as not to render the attempt at comparison unreasonable. Indeed similarities do exist as can be observed from Table 7 and in particular Charts 7 and 8, which provide the added advantage

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Chart 6

Income distribution in Japan, 1969

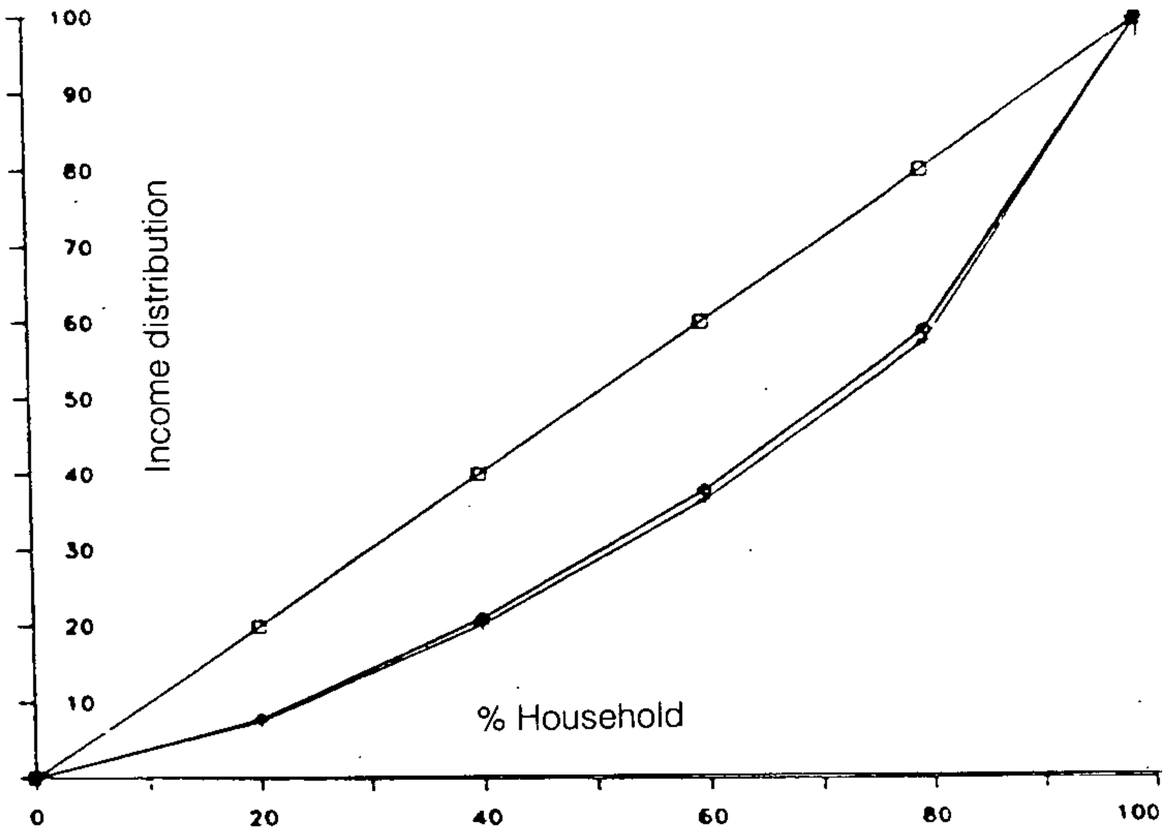

Chart 7

Pre-tax income distribution

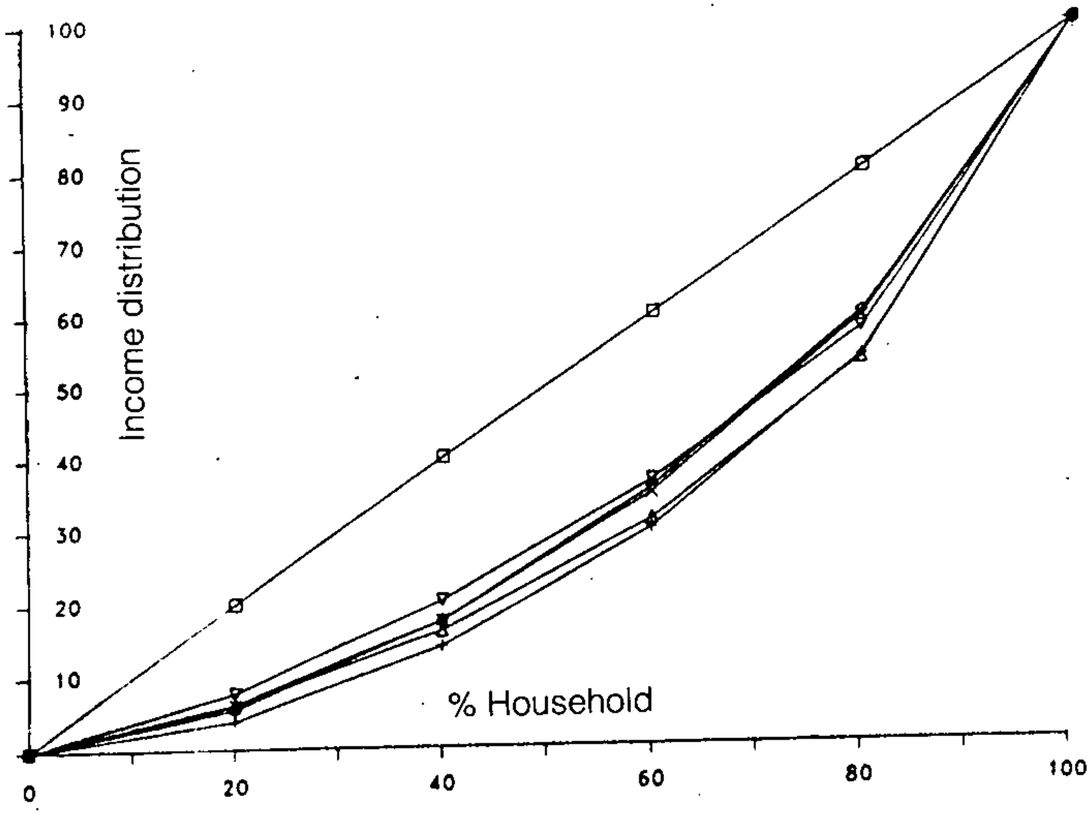

Table 6

Income distribution by percentile household in Japan, 1969

Percent household	Pre-tax	Post-tax
Lowest 20%	7.6	7.9
Second quintile	12.6	13.1
Third quintile	16.3	16.8
Fourth quintile	21.0	21.2
Highest 20%	42.5	41.0
Gini coefficient	0.335	0.316

Table 7

Income distribution in selected five developed countries

Pre-tax income
Percentage share of household income by percentile

Countries	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Gini coeff.
United States	1972	3.8	10.0	16.1	23.7	46.4	0.404
United Kingdom	1973	5.4	12.0	18.1	24.2	40.3	0.344
West Germany	1973	5.9	10.1	15.1	22.1	46.8	0.396
Sweden	1972	6.0	11.4	17.4	24.3	40.5	0.346
Japan	1969	7.6	12.6	16.3	21.0	42.5	0.335

Post-tax income
Percentage share of household income by percentile

Countries	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Gini coeff.
United States	1972	4.5	10.6	17.3	24.7	42.9	0.381
United Kingdom	1973	6.3	12.6	18.4	23.9	38.7	0.318
West Germany	1973	6.5	10.3	15.0	21.9	46.1	0.383
Sweden	1972	6.6	13.1	18.5	24.8	37.0	0.302
Japan	1969	7.9	13.1	16.8	21.2	41.0	0.316

of visual effect. The similarity of the patterns in the distribution of income in those countries is depicted in the similar curvature of the Lorenz curves. It is also depicted in the closeness of the Gini coefficients, which range from 0.335 in Japan to 0.404 in the United States in pre-tax income and from 0.302 in Sweden to 0.383 in West Germany in post-tax income.

In general, the lowest 20% of the households in these developed countries controls about 5.5% of the total household income before taxes, while the highest 20% controls about 43%. Does this reflect a high income inequality? The answer depends on how one perceives the concept of inequality and how one views the desirability of the attainment of equality as a social goal. To those who believe in the equality of economic welfare as a goal of distributive justice, the situation described may be unjust. To those who believe in the legitimacy of inequal distribution to the extent that differences exist in individual skills, abilities and other attributes, the situation may be about right. Finally, to the realists, who believe in the desirability of a tolerable degree of inequality, the situation may be just tolerable.

How about taxation as an instrument of income distribution? Again if we look at the lowest and the highest quintiles in the distributional patterns of post-tax income, we observe that their relative shares have changed as the result of taxation. On the average, the share of income for the lowest 20 percentile has increased from about 5.5% to about 6.5%, while that for the highest 20 percentile has decreased from about 43% to about 41%. The impact of taxation on income distribution can be observed by comparing the Lorenz curves in Charts 7 and 8, which were drawn from the pre-tax and post-tax incomes respectively.

In spite of the similarities, there are also marked differences in the patterns of income distribution among the

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Chart 8

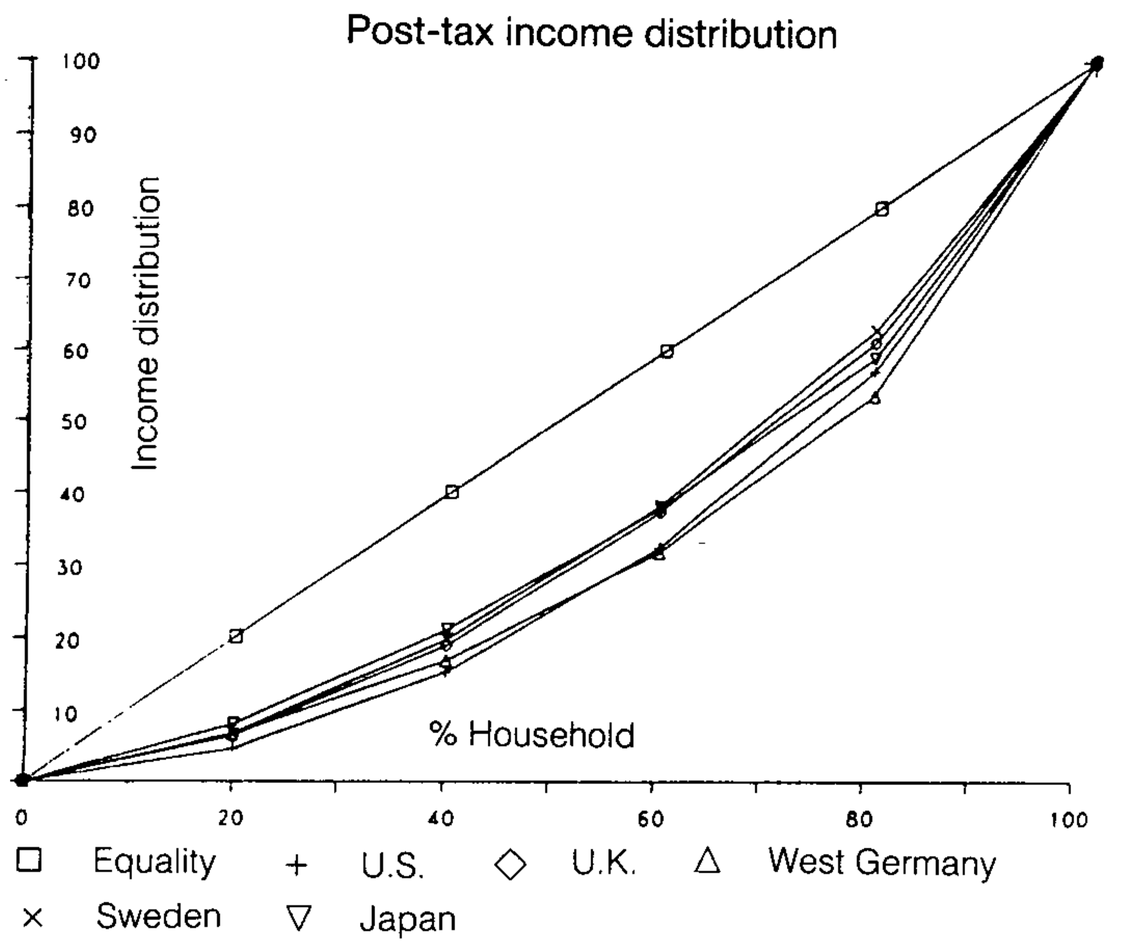

Table 8

Income distribution in selected countries

Percentage share of household income by percentile

Low-income countries	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 10%
Bangladesh	1973-74	6.2	10.9	15.0	21.0	46.9	32.0
India	1975-76	7.0	9.2	13.9	20.5	49.4	33.6
Kenya	1974	2.6	6.3	11.5	19.2	60.4	45.8
Middle-income economies							
Zambia	1976	3.4	7.4	11.2	16.9	61.1	46.3
Mauritius	1980-81	4.0	7.5	11.0	17.0	60.5	46.7
Egypt	1974	5.8	10.7	14.7	20.8	48.0	33.2
Indonesia	1976	6.6	7.8	12.6	23.6	49.4	34.0
Thailand	1975-76	5.6	9.6	13.9	21.1	49.8	34.1
Philippines	1970-71	5.2	9.0	12.8	19.0	54.0	38.5
Peru	1972	1.9	5.1	11.0	21.0	61.0	42.9
Costa Rica	1971	3.3	8.7	13.3	19.9	54.8	39.5
Turkey	1973	3.5	8.0	12.5	19.5	56.5	40.7
Upper middle-income econs.							
Korea (South)	1976	5.7	11.2	15.4	22.4	45.3	27.5
Malaysia	1973	3.5	7.7	12.4	20.3	56.1	39.8
Panama	1970	2.0	5.2	11.0	20.0	61.8	44.2
Brazil	1972	2.0	5.0	9.4	17.0	66.6	50.6
Mexico	1977	2.9	7.0	12.0	20.4	57.7	40.6
Argentina	1970	4.4	9.7	14.1	21.5	50.3	35.2
Yugoslavia	1978	6.6	12.1	18.7	23.9	38.7	22.9
Venezuela	1970	3.0	7.3	12.9	22.8	54.0	35.7
Hong Kong	1980	5.4	10.8	15.2	21.6	47.0	31.3
Trinidad/Tobago	1975-76	4.2	9.1	13.9	22.8	50.0	31.8
Industrial market econs.							
Spain	1980-81	6.9	12.5	17.3	23.2	40.0	24.5
Italy	1977	6.2	11.3	15.9	22.7	43.9	28.1
United Kingdom	1979	7.0	11.5	17.0	24.8	39.7	23.4
Finland	1981	6.3	12.1	18.4	25.5	37.6	21.7
Canada	1981	5.3	11.8	18.0	24.9	40.0	23.8
Netherlands	1981	8.3	14.1	18.2	23.2	36.2	21.5
France	1975	5.3	11.1	16.0	21.8	45.8	30.5
United States	1980	5.3	11.9	17.9	25.0	39.9	23.3
Denmark	1981	5.4	12.0	18.4	25.6	38.6	22.3
West Germany	1978	7.9	12.5	17.0	23.1	39.5	24.0
Norway	1982	6.0	12.9	18.3	24.6	38.2	22.8
Sweden	1981	7.4	13.1	16.8	21.0	41.7	28.1
Japan	1979	8.7	13.2	17.5	23.1	37.5	22.4

5 countries. For example, the share of pre-tax income for the lowest 20 percentile of households ranges from 3.8% in the United States to 7.6% in Japan, while the share of the highest 20 percentile ranges from 40.3% in the United Kingdom to 46.8% in West Germany. Similarly, the Gini coefficient, which ranges from 0.335 in Japan to 0.404 in the United States, indicates the difference in the overall income inequality.

Marked differences are also observed in the impact of taxation by comparing the post-tax and pre-tax sets of data. For example, the share of income for the lowest 20 percentile of households in the United States increased from 3.8% to 4.5% (that is 0.7 percentage point) as the result of taxation. In Japan, the share of the same percentile increased from 7.6% to 7.9% (0.3 percentage point). Similarly, the share of the highest 20 percentile in Sweden decreased from 40.5% to 37% (3.5 percentage points) as the result of taxation. In West Germany on the other hand, the share of the same percentile decreased from 46.8% to 46.1% (a mere 0.7 percentage point).

Overall, the summary data show that taxation has some distributive effect in all 5 countries. The degree of its effectiveness, however, varies from country to country. Whether one should conclude that taxation, as a distributional tool, is effective or not, is again a matter of opinion. What seems to be inescapably clear, especially from the point of policy inference, is the need to examine the income and tax structures of each country at a less macro level than has been done here.

IV. CONCLUSION AND IMPLICATIONS

The primary purpose of this article was to provide a descriptive analysis of the pre-tax and post-tax patterns of income distribution in 5 developed countries and obtain an indication of how effective taxation can be as a distributive tool. It is appropriate to conclude by attempting to infer policy lessons for developing countries in view of the fact that the problem of income inequality is even more serious in the developing than in the developed/industrialized countries. Most studies on developing countries show that, even in those countries which in fact are developing – in terms of growth in gross national product – the rich tend to benefit more than the poor from the rise in national income.[19]

Data on income distribution, as previously mentioned, are, in general, rare. It is even near absent for developing countries. What is available again is attributable to the efforts of international agencies. The World Bank has over the years compiled indicators of income inequality for several countries including developing ones. Table 8 presents a compilation of data from the Bank's latest publications.[20] Post-tax distribution of total disposable household income by percentile group is shown for several countries, which are categorized by economic developmental stages, ranging from least developed to the most developed group.

19. See, generally, Fei, Ranis and Kou, supra note 8.
20. The World Bank, *World Development Report,* Washington, (1986).

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It is evident from Table 8 that in general the income inequality is higher in the less developed than in the most developed countries. If we look at the share of the highest 20 percentile, for example, there are several developing countries where the percentage is greater than 60. In contrast, none of the countries in the developed, industrial market economies show a share of income of the same percentile which exceeds 50%. Particularly noticeable are countries like Brazil, Mexico, Panama, Peru and Malaysia, which are often cited as experiencing actual economic growth, where the share of income of the lowest percentile of households is very low. This confirms an earlier statement that the rich tend to benefit more than the poor from the economic growth.

Given this situation, one of the most important questions facing many developing countries is whether governments can formulate policies capable of producing a more equitable distribution of the benefits of growth or should they initiate drastic structural changes, or worse yet, face the risk of social upheavals whose outcomes are often unpredictable? This is where the question of taxation comes.

Can governments in developing countries use taxation in order to produce a more equitable distribution of income than now exists? The answer should be a qualified yes. As was summarized in the preceding section, taxation does have a distributive effect. There are, however, serious limitations as to how far governments in developing countries can go with taxation. First, most developing countries have large non-monetized agrarian sectors which make the application of taxes difficult. Second, in most developing countries, those who earn high income are mainly foreign investors, and the governments are faced with the difficult task of maintaining a balance between the need for high taxes and the equally desirable needs for maintaining and attracting investors. Finally, there are many socio-political factors in each country which limit the government's ability to tax the rich.

It was previously stated that for policy inference purposes, one should examine the income and tax structures of each country at a less aggregate level than has been done here. That is perhaps the main limitation of this paper, but one can take solace in the challenge it presents for further investigation in the future.

APPENDICES

The sources of data indicated on the left-hand side of the appended tables are as follows:

ILO, 1984 — W. Ginneken and J. Park, *Generating Internationally Comparable Income Distribution Estimates,* Geneva: International Labor Organization (1984).

OECD, 1976 — M. Sawyer, *Income Distribution in OECD Countries,* Organization for Economic Cooperation and Development (1976).

Stark, 1977 — Thomas Stark, *Distribution of Income in Eight Countries,* Background Paper No. 4, in Royal Commission on the Distribution of Income and Wealth, London (1977).

Schnitzer, 1974 — M. Schnitzer, *Income Distribution: A Comparative Study,* New York: Praeger (1974).

World Bank, 1986 — The World Bank, *World Development Report,* Washington (1986).

1980 Census — U.S. Department of Commerce, Bureau of Census, *Current Population Survey,* (August 1983).

APPENDIX 1

INCOME DISTRIBUTION IN THE UNITED STATES

Pre-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
OECD, 1976	1972	3.8	10.0	16.1	24.5	44.8	N.A.	0.404
Stark, 1977	1974	3.8	10.0	16.1	23.7	46.4	19.9	0.412
Schnitzer, 1974	1971	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
World Bank, 1986	1980	4.1	10.2	16.8	24.8	44.2	16.5	N.A.
1980 U.S. Census	1980	4.1	10.2	16.8	24.8	44.2	16.5	N.A.

Post-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1981	5.0	10.8	16.4	23.2	44.6	N.A.	0.390
OECD, 1976	1972	4.5	10.6	17.3	24.7	42.9	N.A.	0.381
Stark, 1977	1973	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Schnitzer, 1974	1971	5.5	11.9	17.4	23.7	41.5	N.A.	N.A.
World Bank, 1986	1980	5.3	11.9	17.9	25.0	39.9	N.A.	N.A.
1980 U.S. Census	1980	4.9	11.6	17.9	25.1	40.6	14.1	N.A.

APPENDIX 2

INCOME DISTRIBUTION IN THE UNITED KINGDOM

Pre-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
OECD, 1976	1973	5.4	12.0	18.1	24.2	40.3	N.A.	0.344
Stark, 1977	1973	5.5	12.0	18.1	24.1	40.3	N.A.	0.332
Schnitzer, 1974	1967	6.3	11.9	16.8	22.5	42.5	19.2	0.332
World Bank, 1986	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
George & Lawson, 1980	1972	5.8	10.7	16.7	24.1	42.7	17.2	0.374

Post-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	7.3	12.4	17.9	23.4	39.3	N.A.	0.320
OECD, 1976	1973	6.3	12.6	18.4	23.9	38.7	N.A.	0.318
Stark	1973	6.3	12.4	18.0	24.1	39.3	N.A.	0.333
Schnitzer, 1974	1967	7.1	12.2	18.3	23.7	38.7	15.5	0.298
World Bank, 1986	1979	7.0	11.5	17.0	24.8	39.7	N.A.	N.A.
George & Lawson, 1980	1972	6.8	12.0	17.5	24.4	39.4	14.2	0.331

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APPENDIX 3

INCOME DISTRIBUTION IN WEST GERMANY

Pre-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
OECD, 1976	1973	5.9	10.1	15.1	22.1	46.8	N.A.	0.396
Stark, 1977	1973	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Schnitzer, 1974	1967	5.7	8.3	14.1	19.3	52.6	N.A.	0.419
World Bank, 1986	1978	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Post-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	6.9	11.0	15.4	21.9	44.8	N.A.	0.370
OECD, 1976	1973	6.5	10.3	15.0	21.9	46.1	N.A.	0.383
Stark, 1977	1973	6.2	13.1	17.5	23.3	39.9	N.A.	0.335
Schnitzer, 1974	1968	6.7	9.5	15.6	20.7	47.5	N.A.	0.371
World Bank, 1986	1978	7.9	12.5	17.0	23.1	39.7	N.A.	N.A.

APPENDIX 4

INCOME DISTRIBUTION IN SWEDEN

Pre-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
OECD, 1976	1972	6.0	11.4	17.4	24.3	40.5	N.A.	0.346
Stark, 1977	1972	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Schnitzer, 1974	1970	5.4	9.9	17.6	24.6	42.5	N.A.	N.A.
World Bank, 1986	1981	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Post-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	7.2	12.8	17.4	25.4	37.2	N.A.	0.300
OECD, 1976	1972	6.6	13.1	18.5	24.8	37.0	N.A.	0.302
Stark, 1977	1972	6.6	13.1	18.5	24.8	37.0	N.A.	0.302
Schnitzer, 1974	1970	7.2	13.2	21.4	24.2	34.0	N.A.	N.A.
World Bank, 1986	1981	7.4	13.1	16.8	21.0	41.7	N.A.	N.A.

APPENDIX 5

INCOME DISTRIBUTION IN JAPAN

Pre-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
OECD, 1976	1969	7.6	12.6	16.3	21.0	42.5	N.A.	0.335
Stark, 1977	1971	3.8	10.9	16.3	22.8	46.2	N.A.	0.407
Schnitzer, 1974	1972	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
World Bank, 1986	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Post-tax income
Percentage share of household income by percentile

Source	Year	Lowest 20%	Second quintile	Third quintile	Fourth quintile	Highest 20%	Highest 5%	Gini coeff.
ILO, 1984	1979	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
OECD, 1976	1969	7.9	13.1	16.8	21.2	41.0	N.A.	0.316
Stark, 1977	1971	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Schnitzer, 1974	1972*	8.4	13.4	17.8	22.2	38.2	12.9	N.A.
World Bank, 1986	1979	8.7	13.2	17.5	23.1	37.5	N.A.	N.A.

* Based on taxpayers instead of household units.

[continued from page 254]

promote an exchange of staff, documents, etc. and coordinate research techniques and results.

The proposed regional facility would combine training programmes (including the training of individuals to work at the national institutes)[11] with development of fiscal policy issues and related inter-disciplinary matters. The results of the research would keep the training programme updated and an improved training programme would cultivate a keen and analytical understanding of fiscal matters. As a result, the institute would not only upgrade the professional staff, but also promote formulation of better fiscal policies and systems and an understanding of administrative problems through applied research.

Moreover, the institute would foster other important objectives, e.g. streamlining tax policies to the advantage of African States by eliminating competition among them. Such an institute would be well-placed to conduct studies on tax harmonization among African States as well as offer valuable advice on tax treaties.

The institute would also facilitate the exchange of ideas, experience and information among African countries through the development of comparative teaching materials, adequate documentation and consulting services to both the private and public sectors. Furthermore, it would promote collaboration among African tax administrators, experts and training institutes in the field of public finance.

The development of local and regional African governments requires sound financial policies and well-trained staff. The proposed institute would assist local and regional governments and thus further the democratization and modernization of Africa.

order to achieve a comprehensive training programme. In addition, research, documentation and consulting services will also be carried out.

11. It should be emphasized that the proposed regional institute will neither replace nor duplicate existing national or regional facilities.

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On 18-20 February 1988 the first South Asia Regional IFA Conference was held in New Delhi. Of the several topics on the agenda, the discussion on incentives clearly elicited the greatest interest. This article discusses the problems which tax incentives pose for developing countries (in particular) and the measures which can be taken to minimize those problems.

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UNITED STATES: THE DEFINITION OF RESIDENCY FOR FEDERAL INCOME TAX PURPOSES – AN ANALYSIS OF THE PROPOSED REGULATIONS 324
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Le numéro de février 1988 du *Bulletin* contenait un article étudiant les règles brésiliennes sur les conversions de dettes en actions. Une nouvelle Résolution de la Banque Centrale ainsi qu'une Circulaire ont été émises depuis la date de parution de cet article. La Banque Centrale a par ailleurs conclu des accords avec les Bourses de Rio de Janeiro, de São Paulo et la Commission des Titres instituant des règlements pour les ventes publiques des conversions de dettes. Cet article fait ressortir les points importants de ces modifications.

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Amérique Latine: Résumé de la taxe sur la valeur ajoutée dans les pays membres du CIAT dans les Amériques 304
Bien que la taxe générale sur le chiffre d'affaires ait traditionnellement constitué la base de l'imposition indirecte dans les Amériques, une tendance manifeste vers une adoption du système de la "taxe sur la valeur ajoutée" peut actuellement être constatée. Cet article résume et donne les grandes lignes des structures de la TVA adoptée par différentes nations américaines. L'article offre les points essentiels de la législation sur la TVA, un catalogue des biens et/ou services soumis à la TVA, des exemptions, des taux et de la manière suivant laquelle la taxe est imposée et payée.

A.C. Ezejelue:

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M. le Professeur Ezejelue donne un aperçu des dispositions les plus importantes contenues dans le Budget Fédéral de 1988. Les nouvelles règles fiscales destinées à stimuler les investissements et la croissance économique comprennent un abaissement des taux d'impôt sur le revenu des personnes physiques et des sociétés, des modifications dans l'imposition des revenus d'investissements, des amortissements supplémentaires, des déductions spéciales pour les petites entreprises et des dégrèvements fiscaux sur certaines hypothèques.

Joanna Wheeler:

International: Problèmes et paradoxes – L'"insaissible" des avantages fiscaux: Article inspiré par la première conférence régionale de l'IFA de l'Asie du Sud, à New Delhi 319
La première Conférence Régionale de l'IFA de l'Asie du Sud s'est tenue du 18 au 20 février 1988 à New Delhi. Parmi tous les sujets proposés par l'agenda, c'est certainement les discussions portant sur les investissements qui ont présenté le plus d'intérêt. Cet article commente les problèmes que posent les avantages fiscaux aux pays en voie de développement (en particulier) et les dispositions qui peuvent être prises pour minimiser ces problèmes.

Leonard W. Rothschild, Jr. et Robert J. Magilligan:

Etats-Unis: La définition de résidence aux fins de l'impôt sur le revenu fédéral: Analyse des réglementations proposées 324
La loi de la réforme fiscale de 1984 prévoit un examen objectif pour la détermination de la résidence aux fins de l'impôt sur le revenu; à savoir: l'examen de la "carte verte" ou de la "présence suffisante". Si l'un des deux examens est satisfaisant, une personne physique non ressortissante américaine sera considérée comme résidente pour des raisons d'imposition sur le revenu, c'est-à-dire qu'elle sera soumise à l'impôt sur son revenu mondial. Le Département du Trésor a proposé en septembre 1987 des réglementations applicables à ces examens. Bien que celles-ci aient créé un certain nombre de problèmes, elles ont également fourni un critère objectif pour définir un résident américain. Cet article présente un examen détaillé des nouvelles réglementations.

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Antonio Mendes:

Brasilien: Das Programm für die Konversion von Schulden in Kapitalbeteiligungen: Eine Fortsetzung 300
Die Februar 1988-Ausgabe von *Bulletin* enthielt einen Artikel, der die brasilianischen Verordnungen bezüglich der Konversion von Schulden in Kapitalbeteiligungen analysierte. Nach der Veröffentlichung dieses Artikels wurden eine neue Verordnung und ein neues Rundschreiben der Zentralbank erlassen. Weiterhin hat die Zentralbank Abkommen, die Vorschriften für Schuldenauktionen enthalten, mit der Effektenkommission abgeschlossen. Dieser Artikel beschreibt die wichtigsten Merkmale dieser Änderungen.

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Inter-American Center of Tax Administrators:

Lateinamerika: Überblick der Mehrwertsteuern in den Mitgliedländern der CIAT in Nord-, Mittel- und Südamerika 304
Obwohl die allgemeine Verkaufsteuer traditionellerweise die Grundlage für die indirekte Besteuerung in ganz Amerika ist, kann man heutzutage einen Trend, der zur Einführung eines Mehrwertsteuersystems hingeht, bemerken. Dieser Artikel bietet einen Überblick der Mehrwertsteuersysteme, die in einer Anzahl von amerikanischen Ländern eingeführt worden sind. Er beschreibt die Hauptmerkmale der Mehrwertsteuergesetze, gibt eine Aufzählung der Waren und Dienstleistungen, die der Mehrwertsteuer unterliegen, sowie Steuerbefreiungen, Sätze und die Art und Weise, worauf die Steuer veranlagt und bezahlt wird.

A.C. Ezejelue:

Nigeria: Die neuesten Steueränderungen 315
Professor Ezejelue präsentiert einen kurzen Überblick der wichtigsten, im Föderalen Budget für 1988 enthaltenen Massnahmen. Die neue Steuerpolitik, welche die Förderung von Investierungen und Wirtschaftswachstum bezweckt, enthält niedrigere Sätze der Einkommen- und Körperschaftsteuer, Änderungen in der Besteuerung von Einkünften aus Kapitalvermögen, zusätzliche Sonderabschreibungen, besondere Vergünstigungen für Kleinbetriebe und eine Steuervergünstigung für bestimmte hypothekarische Darlehen.

Joanna Wheeler:

International: Probleme und Paradoxe – Die ungreifbaren Steuervergünstigungen für Investitionen – Ein Artikel geinspiriert von der Ersten Südasiatischen Regionalen IFA Tagung in New Delhi 319
Die Erste Regionale Tagung in Südasien wurde vom 18.-20. Februar 1988 in New Delhi abgehalten. Aus den verschiedenen Themen des Programmes zeigte sich deutlich das grösste Interesse für die Steuervergünstigungen für Investitionen. Dieser Artikel bespricht die Probleme, die (insbesondere) Entwicklungsländer mit diesen Steuervergünstigungen haben und die Massregeln, welche man nehmen kann, um diese Probleme so viel wie möglich zu beseitigen.

Leonard W. Rothschild Jr. und Robert J. Magilligan: Vereinigte Staaten: Die Wohnsitzdefinition im föderalen Einkommensteuerrecht – Eine Analyse der vorgeschlagenen Durchführungsbestimmungen 324
Das Steuerreformgesetz von 1984 gab objektive Bedingungen zur Bestimmung des Wohnsitzes eines Steuerpflichtigen für die Anwendung des Einkommensteuergesetzes. Diese Bedingungen sind: der Besitz einer grünen Karte (green card test) und die dauerhafte Anwesenheit in den USA (substantial presence test). Eine Person, die nicht die amerikanische Nationalität besitzt, wird für die Anwendung des Einkommensteuergesetzes als Ansässiger der USA, d.h. als unbeschränkt Steuerpflichtiger betrachtet, wenn eine dieser Bedingungen erfüllt wird. Das Finanzministerium erliess im September 1987 eine Entwurfdurchführungsverordnung, in der diese Bedingungen beschrieben werden. Obwohl die Verordnung die Lage in gewissem Masse kompliziert, bietet sie doch einen objektiven Masstab, um festzustellen, ob eine Person in den USA ansässig ist oder nicht. Dieser Artikel gibt eine tiefgehende Analyse der neuen Bestimmungen.

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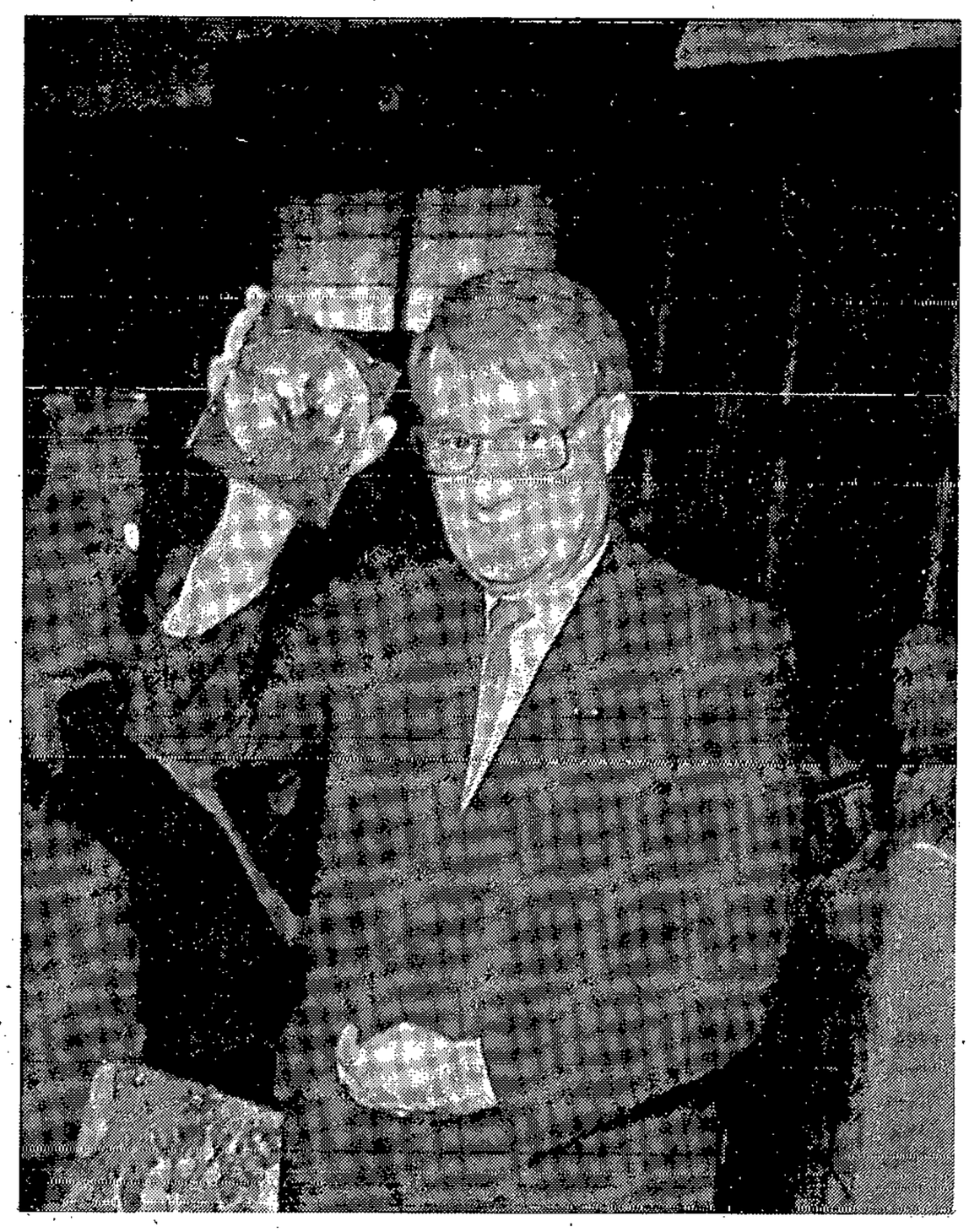
Compact Disc

IBFD LAUNCHES FIRST TAX TREATY COMPACT DISC

The annual meeting of the Board of Trustees and the Board of Directors of the International Bureau of Fiscal Documentation – held on 30 May 1988 – was an especially festive occasion. The IBFD's 50th anniversary was commemorated in the presence of a large number of trustees and members of the IBFD's multinational Advisory Council, and the first compact disc (CD-ROM) was launched as well. This compact disc contains a data base with the text of nearly all tax treaties concluded by countries all over the world. It was presented to the Dutch Under Minister of Finance, Mr. H.E. Koning, at the luncheon concluding the annual meeting, during which the Under Minister complimented the IBFD on its achievements of the last 50 years. The IBFD has grown from a very small operation into a healthy organization employing a multinational staff of 25 lawyers and economists.

The IBFD considers the CD-ROM as the ideal vehicle for bulky information which is now compiled in its loose-leaf publications. Preparation for a data base containing the texts of the tax treaties which are now to a great extent spread over the IBFD's loose-leaf publications began in 1987. These treaties are presented in the English language, in the original text if English, or an English translation prepared by the IBFD. A retrieval system which makes the contents of the tax treaties easily accessible to readers greatly enhances the usefulness of this new service. Users of the programme can check which tax treaties have been concluded, spot tax treaties which, for instance, contain provisions for offshore companies, for joint ventures, for computer programmes etc. Using the retrieval system will enable users to avoid overlooking crucial information contained in additional protocols to the respective tax treaties. The service will be updated twice a year; the first update will be in January 1989.



A demonstration of the Tax Treaty Compact Disc will be held during the Congress of the International Fiscal Association from 12 to 16 September 1988 in Amsterdam and the delegates are cordially invited to convince themselves of the usefulness of this new product.

The introduction of the Tax Treaty Compact Disc is only the first step towards the IBFD's goal of offering its data via electronic means. An International Tax Glossary (the explanation in English of current terms in international taxation in French, German and Spanish) will be soon available both in print and on CD. A data base on corporate taxation in Europe will follow and other data bases will follow in 1988 and 1989.

The Tax Treaty Compact Disc will be for sale as of July 1988. Its introductory price is 5,000 Dfl. (approximately US$ 2,600) with substantial discounts for large purchases. This price includes the January 1989 update. As of 1 January 1989 the price will be 6,000 Dfl. (approximately US$ 3,100). For further information please contact Mr. Robert King, publications manager c/o International Bureau of Fiscal Documentation, Postbox 20237, 1000 HE Amsterdam, phone 020-26 77 26.

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Shaping a New International Tax Order

By Richard M. Bird

Mr. Bird is Professor of Economics, University of Toronto, and Tinbergen Professor, Erasmus University Rotterdam.

SUMMARY

The taxation of international income flows in most countries and in the world as a whole is seriously deficient. The difficulty of effectively implementing the present complex system of national rules and tax treaties means that international capital flows are, as a rule, both excessive and distorted. Moreover, the weakness of international income taxation calls into question the viability of the income tax itself.

The basic problems with the present system are two. First, the rules applied to the taxation of direct investment income assume, in complete contradiction to reality, that each subsidiary of a firm operating across national borders is a completely separate entity dealing at arm's length with its parent and other subsidiaries. Secondly, the generally successful attempt by capital-exporting countries to limit source-country taxation of non-resident portfolio income, combined with the increasing tendency to reduce their own taxes on such income, means that the ease and temptation of international tax avoidance is greater than ever before.

If something is not done to rectify these problems soon, the future of the income tax is bleak. Countries acting on their own can, in the face of international competition, do relatively little. If international income flows are to be taxed effectively, a considerable degree of international consensus will be required, which will not be easy to achieve. Two essential elements in any such consensus appear to be the reinstatement of source-country primacy in the taxation of portfolio investment and a move to formula apportionment (the so-called "unitary" method) in the taxation of direct investment.

INTRODUCTION

No man is an Island, entire of itself; every man is a piece of the Continent, a part of the main.
John Donne

The world today is a small place. Technological change, improved communications and expanded international trade and investment have, for good or ill, increasingly linked peoples and nations. Whether through the effects of acid rain on the environment, AIDS on public health, drought in Africa on the public conscience, or oil crises and currency fluctuations on employment and income, we have all become aware that we live in an increasingly integrated world.

Politically, however, the sovereignty of nations remains paramount. New nations are understandably nervous about again subordinating themselves to influences from beyond their borders. Old nations are equally reluctant to give up their right to shape their own destiny. International policy coordination is sporadic, loosely if at all institutionalized, subject to substantial national variation, and at best partially effective in achieving its supposed objectives.

Nevertheless, the international dimension of economic policy has become increasingly important. Monetary interdependence, trade imbalances, international capital flows, direct foreign investment, and other transborder linkages trouble the minds and influence the actions of policy-makers in all countries, large or small, rich or poor.

The sensitivity of international capital flows to taxation for instance, has induced countries to reduce or abolish taxes on capital income going to non-residents. An example is the 1984 exemption of interest on portfolio investment from withholding tax by the United States. The stated objective was to place American borrowers on an equal footing with those in European countries who were already exempt from such taxes. This move, however, also made the U.S. a more attractive destination for foreigners with mobile capital. One result was to encourage even more capital flight from Latin America, thus weakening the economies and tax systems of that region (McLure, 1987). The consistency of this outcome with U.S. policy, let alone with world stability and well-being, seems questionable.

The fiscal aspects of international direct investment may equally be a matter of concern. A good proxy of the welfare gain to host countries from such investment is the amount of taxes paid by multinational enterprises (Hartman, 1985). Such payments may be substantial. In Canada, for example, net taxes paid by foreign firms are around 2% of GDP (Jenkins, 1979); in New Zealand, close to 40% of corporate tax revenues come from foreign firms (Bird, 1987). Moreover, to judge from the many fiscal incentives for investment that are in place throughout the world, policymakers must think that taxation also influences foreign investment decisions in the first place.

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International fiscal interaction is thus important. There is, however, no institution equivalent to the GATT or the IMF which is charged with ensuring that the tax treatment of international investment conforms to certain rules. Taxation is entirely a matter of national jurisdiction. Each country decides unilaterally how to tax international income, although such national tax rules have in recent years been increasingly supplemented by a network of tax treaties, most of which broadly follow a model set by the OECD (1977).

Unfortunately, both the OECD Model Treaty and the more important unilateral rules applied to international investment in most countries are deficient in some critical respects. Tax rules which may at first glance appear to provide for capital flows a regime equivalent to free trade – and which economists would therefore tend to consider economically efficient – may in fact induce excessive capital export (Musgrave, 1975). Tax treaties which may appear to divide the gains from foreign investment evenly between host and home countries may in fact produce outcomes that would be recognized as "fair" only in exceptional circumstances of equal taxes on evenly balanced capital flows (Sato and Bird, 1975). The combination of rules and treaties found in many countries, while ostensibly intended to achieve both efficiency and equity, may thus yield results in practice which are neither efficient nor equitable.

Revision in the international tax order thus seems needed, whether viewed from the point of view of the world economy as a whole or from the point of view of any particular country. Economic reformers, for instance, have long urged freer trade to improve world welfare. The freedom of factor markets is obviously of equal concern and, indeed, has long been a stated objective of international tax policy (Musgrave, 1969). Those interested in the efficient use of the world's resources should therefore be concerned that this aim is not now being achieved. Those who doubt the universality of the benefits resulting from the free trade prescription may equally well be unhappy at the distributional consequences of international factor flows – even when, or perhaps especially when, such flows are in fact far from free of fiscal (and other) impediments and inducements.

Those more concerned with such national policy aims as the achievement of an equitable and efficient domestic tax system also have reason to be unhappy with the prevailing international tax order. The extent to which international income flows are taxed anywhere depends largely on the voluntary compliance of taxpayers, and the evidence is that it is becoming more difficult to rely on such compliance (Karzon, 1983). As the OECD (1987, p. 15) said in 1977: ". . .tax avoidance and evasion schemes involving international transactions have become increasingly complex and more difficult to detect." Matters have not improved since. Even in the absence of the problem of asymmetric information, important aspects of the present system of taxing international investment income are conceptually untenable, as I shall discuss later (Bird, 1986a). If capital income from abroad is not properly taxed, however, it invariably becomes increasingly difficult to tax domestic capital income fully or fairly either (New Zealand, 1987). Indeed, the very rationale of the income tax itself may be called into question, as has already happened in some countries for this and other reasons. Getting international taxation right is thus an important task for tax policymakers everywhere.

THE PRESENT INTERNATIONAL TAX SYSTEM

Look round the habitable world! how few
Know their own good; or, knowing it, pursue.
John Dryden

As I noted earlier, strictly speaking, there is no such thing as an international tax system. No law limits national tax jurisdiction. Each country may adopt whatever taxing rules it sees fit (whether it can enforce the rules it adopts is quity another matter). Over the course of this century, as the importance of the income tax as a means of state finance increased and the importance of international income flows grew, countries have had to adapt their tax systems to accomodate international reality. Often, however, the key tax features affecting international income have been accidental, as when policies adopted for other reasons (such as interest deductibility) have turned out to have important international implications. Or they have been additions patched onto the system to cope with specific problems as they became apparent, such as limitations on interest deductibility through "thin capitalization" and expense allocation rules. In yet other instances, countries seem simply to have copied such complex rules as those on transfer pricing and controlled foreign corporations from the United States, which has been the dominant exporter of both capital and tax policy notions throughout most of the postwar period. The taxation of international income, although sometimes portrayed as though it is, or should be, purposeful and coherent (Kingson, 1981), has thus developed more by chance than by design. The present international tax order as a whole is a patchwork structure that makes little sense in terms of its purported objectives.

Nonetheless, a certain degree of uniformity does exist. For example, two basic jurisdictional rules have developed in capital-exporting countries: the source principle and the residence principle. Under a pure source principle, all income arising from sources within a country, and only such income, is taxed. Income arising abroad is therefore exempted. This is basically how the Netherlands taxes foreign business income, for example. This approach, however, is clearly inconsistent with the fundamental concept of an income tax as a comprehensive tax on ability to pay (Musgrave, 1969). Partly for this reason, most countries with significant investment abroad have abandoned the source principle, at least so far as their own residents are concerned, replacing it by some sort of residence principle, under which all income accruing to residents,

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irrespective of its source, is subject to tax, at least in theory.

As capital importers, however, even residence-principle countries almost invariably apply the source principle to income derived by non-residents from sources within their territory. More precisely, in line with the OECD Model Convention mentioned earlier, the general pattern among developed countries is to give primary jurisdiction to the country of source with respect to taxes on the profits of subsidiaries of multinational enterprises and to the country of residence with respect to other capital income (such as dividends, royalties and interest) going to non-residents.

The latter aim is achieved as a rule by reciprocally limiting through treaties the tax rates applied by source countries. As noted earlier, some source countries go even further and completely exempt some payments to non-residents (notably interest). Since one universal truth of tax policy is that it is much more difficult to tax capital income on receipt than by withholding at source (Steuerle, 1982), and another is that international finance is fungible in the sense that the borderline between interest, dividends, royalties and other payments between components of the same firm is vague and shiftable (Brean, 1984), the practical result of this policy is often effectively to exempt international portfolio investment income from tax. Not only are international capital flows thus encouraged by taxation, often beyond any conceivably efficient level from a world point of view, but investment abroad is favored over investment at home, to the detriment of national welfare. Indeed, a strong inducement exists to convert what may really be domestic income into foreign income, thus subverting the income tax system as a whole. Real investment may not leap around the world in response to tax differentials, but it is all too easy to create foreign subsidiaries and, with the help of friendly financial intermediaries, to rearrange the books of firms operating internationally so as to minimize taxes. An international tax system that places the main burden of taxing portfolio investment on the countries in which investors reside rather than those in which they earn their money is a system that both encourages excessive international capital flows and undermines the domestic taxation of income in general.

The other side of the prevailing international tax order, the primacy of source countries in taxing business income, is not so subject to abuse, since, as already mentioned, clearly source countries can and do tax such income. Indeed, the reason for the ready acquiescsence of capital-exporting countries to source primacy in this respect is probably less on grounds of principle, such as locational neutrality or international equity (Musgrave, 1987), than the simple reality that the source country will in any case inevitably get first crack at any profits. This is not to say, however, that it is by any means easy to tax foreign subsidiaries fairly or effectively. On the contrary, tax administrators face substantial problems in determining precisely what profits are subject to tax.

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These problems largely arise from the widespread acceptance of the "fiscal myth" (Rotterdam, 1979, at 251) that every subsidiary of a multinational enterprise is a completely separate entity operating at arm's length from its parent and other subsidiaries. That this is a myth is obvious from the very existence of such enterprises. The essence of a multinational firm, its competitive edge as it were, is its ability to operate as a single entity in world financial and technological markets, thus achieving higher net revenues from its operations as a whole than could be achieved under separate management on an arm's length basis (Caves, 1982). To attempt, as most tax systems do – and as recently codified by the OECD (1979) – to treat such intrafirm transactions as loans, management fees, and sales of intermediate products as if they took place between independent, competitive firms flies in the face of reality.

Moreover, to expect tax administrators to construct such a mythical world out of figures for which they must depend almost entirely on the firms they are trying to tax is to expect too much. At best, the result in developed countries is to turn the taxation of multinational enterprises into a game of bargaining and negotiation. At worst, the result in some developing countries is to leave the amount of tax paid up to either the conscience of the company or the arbitrary decision of the authorities. The fungibility and complexity of international financial transactions virtually guarantees that the "true" profits of any particular component of a multinational firm can never be discovered – even if it were meaningful to seek such a goal, which it is not.

Nor are the results of the present system of taxing international business more satisfactory in residence countries. In the first place, they too have the same problem of attempting to disentangle which profits are theirs to tax. If funds are borrowed by one firm in country A to be invested in another firm in country B, and both firms are owned by yet a third firm in country C, it is perfectly possible under existing rules for no tax to be paid anywhere even though the activity is clearly a profitable one for those engaged in it. Indeed, if the parent firm has its financing subsidiary in the right country, it may even end up with a useful tax loss on the transaction to offset against other taxable income. Canadian tax practitioners, for example, have long availed themselves of the friendly services of the Netherlands and the Netherlands Antilles to achieve such results. They are hardly unique in so doing, nor is this "Dutch treat" (Brean, 1984) the only route available to tax minimizers.

One reaction in some capital-exporting countries to the ingenuity of tax lawyers and accountants has been continual changes in tax law in an attempt to limit such financial maneuvers through complex legislation on controlled foreign corporations (Arnold, 1986), thin capitalization rules and other limits on interest deductibility, and so on. Another reaction has been to urge much more international exchange of tax information (OECD, 1987). The degree of success attained to date

by such endeavors in either the national or the international sphere has been, at best, limited.

Some capital-exporting countries, as already mentioned, concede primary jurisdiction over business income to source countries simply by exempting such profits from tax. A common rationale for this approach is to enable business to compete on a level playing field with its foreign competitors, in the sense that source-country firms operating in any country will be subject only to the taxes of that country. (This is sometimes called "capital-import neutrality".)

The problems with this rationale are twofold (Musgrave, 1969). In the first place, the result is obviously to encourage investment in low-tax countries, an outcome which, especially in view of the ready availability of tax havens, does not obviously accord with either world or national interests. Secondly, exemption favors investment abroad relative to investment at home, a result which is even more clearly inconsistent with maximizing national well-being. A policy which is neither nationally nor internationally efficient would seem to have little going for it. The continued existence of exemption systems in countries such as the Netherlands, France, and to a considerable extent Canada, provides strong evidence, however, of the continuing strength of the modern mercantilist doctrine that it is, for reasons economists find rather mystifying, better to export capital than to use it at home.

In the more common case where capital-exporting countries follow the residence principle, source-country primacy in the taxation of business income is attained in two stages. The first, and more important, step is by deferring any attempt to impose tax until profits are actually repatriated. The second step is by crediting against any tax due on repatriation the taxes already paid to the source country, generally both taxes withheld on dividends and the underlying foreign corporate tax.

Deferral, like exemption, clearly encourages investment abroad relative to investment at home, which has to pay tax at once. Indeed, deferral makes even less sense than exemption since by discouraging repatriation it makes it even less likely that the country of residence will get much benefit from investment abroad (Hartman, 1977). Even the crediting of foreign taxes, while more understandable than deferral in both equity and (if on a current rather than deferred basis) world efficiency terms, can only dubiously be extended to the corporation taxes paid in the source country. Such "indirect foreign tax credits" are clearly incompatible with the basic tenet underlying the determination of taxable profits (Musgrave, 1984). Either subsidiaries and parents are completely independent companies, or they are not. A system that simultaneously makes these two incompatible assumptions is as illogical in structure as its results are undesirable in practice.

The present international tax "system", if such it may be called, is of course far more complex and variegated than can be indicated here. Moreover, although more a product of accidental circumstance than is often thought, in some ways it reflects a lengthy evolutionary process begun in the 1920s under the auspices of the League of Nations and carried through to fruition in the last few decades under the aegis of the OECD (1977). It also has the strong support of most governments, business firms, and tax practitioners. Nonetheless, as I have already suggested – and developed elsewhere at greater length (Sato and Bird, 1975; Bird, 1986a; Bird, 1987) – the present treatment of international capital flows is inefficient and inequitable, almost irrespective of how one defines those words.

TOWARDS A NEW ORDER

Yes, we must, indeed, all hang together or,
most assuredly, we shall all hang separately.
Benjamin Franklin

These deficiencies might be resolved either unilaterally or multilaterally. Any one country, faced with the difficulty of containing international tax avoidance and the dubious national benefits of excessive capital outflow, might, for example, take the extreme path of imposing full exchange controls. In the unlikely event that such controls could be made fully effective, the connection between international and domestic tax policy will have been severed, and the tax system can be determined solely in accordance with domestic needs. The economic price that must be paid to attain such peace of mind for tax administrators seems too high, however, for countries to choose this isolationist path.

At the other extreme, countries always have the attractive option of doing nothing. Over time, the effective rate of taxation on international business is then likely to fall to the level of the least common denominator among the various countries competing for such investment which means, in practice, something close to zero. (Indeed, a country foreseeing this outcome might even decide to anticipate it and deliberately turn itself into a tax haven to forestall the competition. Tax haven countries, however, as distinct from a few lawyers and accountants, derive few noticeable benefits from the services they provide.)

This prospect may perhaps be applauded by those who think that business taxes are so economically damaging that the sooner they disappear the better (Walters, 1987). This extreme view, however, ignores the essential role that corporate taxes play both as a backstop for personal taxes and as the principal means of collecting revenue from the economically most efficient tax base, economic rent (Broadway, Bruce and Mintz, 1982). Corporate taxes could doubtless perform these tasks more efficiently than at present, but abolishing them completely would hamper rather than facilitate important aims of public policy. Moreover, corporate taxes are also the principal means by which the public sectors of host and home countries divide their share of the profits of foreign investment (Musgrave, 1987). Reducing the public share of such profits to nil seems

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a rather drastic way to resolve any differences of opinion as to who should get how much. Business taxation is too critical to be allowed to wither away without a struggle.

Setting aside the extremes of isolationism and acquiescence, there remain several routes that might be pursued unilaterally by countries concerned with international taxation. A radical solution would be to replace the corporate income tax by a substantially revised business tax. The investment distortion arising from the de facto exemption of much international capital income would obviously be removed if most domestic capital income were similarly freed from tax by exempting interest and dividends from tax, allowing the full deduction of all business purchases, and disallowing the deduction of interest expense.

Such a "consumption-based" business tax has been urged as more efficient, more equitable, and easier to administer than the conventional business income tax (Boadway, Bruce, and Mintz, 1982). In addition, although the effects of such a drastic change in any country on domestic and foreign investment are by no means obvious, since eliminating the interest deduction would raise the marginal tax rate on debt-financed portfolio investment abroad from less than zero to zero, the existing tax inducement to excessive international capital flows should be reduced (McLure, 1987). A move to a consumption-based rather than an income-based business tax is too important to be determined on international grounds alone, however, and the viability of introducing a consumption-based system in one country in an income tax world remains to be seen.

A less radical alternative that to some extent achieves the same international benefits would be to move to a source rather than a residence basis for taxing capital income. Such a move has been urged for two quite different reasons. One reason is to reduce tax evasion by international portfolio capital income, and especially by domestic income masquerading as international income, by giving primary jurisdiction to source countries, which can effectively tax such income through withholding, rather than to residence countries, which cannot (Karzon, 1983). The other reason is to remove the impediment to international investment created by the imperfect crediting of foreign taxes in residence-based systems (Vogel, 1987). The first of these reasons is, as I have already noted, quite legitimate. The second, however, given the importance of deferral and the ease of reducing tax burdens on international income by such methods as the judicious use of financing subsidiaries, seems greatly exaggerated. (For similar reasons, the much-discussed problem of "tax sparing", or the cancelling out of tax concessions granted in poor countries by the foreign tax credit systems of rich countries, is much less of a problem in practice than some seem to think.)

In any case, the merits or demerits of the source principle must not be confused with the desirability or otherwise of increasing foreign investment in developing countries. Although some developing countries, notably in Latin America, have long strongly advocated the source basis (Atchabahian, 1975), it is wrong to assume that all developing countries are low-tax countries (Modi, 1987) or that, especially where foreign investment is concerned, all low-tax countries are developing countries (Alworth, 1987). As I noted earlier, many developed countries levy low or no taxes on capital income paid to foreigners – and, by so doing, encourage foreigners, including those in developing countries, to invest in such countries. The interests of developing countries would indeed be served if such developed countries, some of which are already supposedly on a source basis, actually taxed all income on capital arising in their jurisdiction, although it seems unlikely that this is what most advocates of the source principle have in mind.

Since the taxation of most direct investment income is already really on a source basis in most countries, the main effect of a change to the source principle in capital-exporting countries would be to eliminate the complex foreign tax credit provisions, thus freeing from a little additional tax the unhappy few caught in their toils. Such simplification would not necessarily be efficient in either world or national terms, however. Just as the optimal tax rate for foreign investment from a national point of view is an exceedingly complex question for both large (Hartman, 1985b) and small (Gersovitz, 1987) capital-importers, so the appropriate tax treatment of domestic investment abroad is far from clear for capital-exporters also (compare Musgrave, 1969, Hartman, 1980, and Alworth, 1985).

Residence countries, such as the United States and Japan, are in any case unlikely to change to the source basis. An alternative way for such countries to cope unilaterally with some of the problems in taxing international income would simply be to eliminate deferral. Deferring taxes until income is repatriated is, as I have mentioned, equivalent to an exemption system with a bias against repatriation. It is clearly not the best possible system from the point of view of maximizing national welfare (Hartman, 1977). For this reason, New Zealand (1987) has recently proposed to tax the profits of foreign subsidiaries of New Zealand companies currently as earned, while allowing full credit for taxes paid to the source country (both corporation and withholding taxes) up to the limit of the taxes due on the income in New Zealand. This is basically how foreign branches are already taxed in most countries. From the point of view of both world efficiency and tax principle, this approach seems correct (Sato and Bird, 1975). Moreover, it has the substantial advantage of reducing the present strong incentives to adjust the financial structures of subsidiaries in order to minimize taxes (Alworth, 1985). On the other hand, international tax policy is not made in a political or international vacuum, and it remains to be seen whether the strong opposition of New Zealand-based multinationals to this system (on the grounds that they have to compete with more favored firms from other countries) can be overcome.

Short of eliminating deferral completely, an increasing

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number of countries have already done so for those foreign operations which are considered to be largely motivated by the desire to shelter income that would otherwise be subject to domestic taxation. Most major capital-exporting countries now have some form of "anti-tax haven" legislation (Arnold, 1986). Such legislation is invariably complex and generally not very effective. Nonetheless, it may serve a useful function both in protecting the revenue by raising the real costs of such international tax avoidance (in terms of the need to hire still more accountants and lawyers) and in making clearer what is, and what is not, considered to be an acceptable business practice in the eyes of the law.

Much the same purpose is served by such other possible unilateral defenses as "thin capitalization" limits on interest deductibility (as in Canada) or arbitrary allocations of expenses between different jurisdictions on the basis of factors such as the ratio of book values of assets (as in the United States). Such measures, like tax haven legislation, are inevitably both arbitrary and not all that effective. Nevertheless, they may at times be useful, even essential, in ensuring that both capital-importers and capital-exporters secure a reasonable share of the gains from foreign investment. Even source-principle countries need such rules to act as a check on the allocation of expenses between jurisdictions – unless, of course, they are prepared to accept as gospel truth whatever taxpayers tell them.

Faced with the impossibility of verifying the income and expense attributions of multinational firms, some subordinate jurisdictions in the United States have taken the logical next step in this process by applying a formula allocation approach to international operations. The worldwide profits of a firm are allocated between the jurisdictions in which it operates in proportion to such measurable factors as capital assets, payrolls, and sales (McLure, 1984). Such formulae have long been accepted as the only workable way of dividing the tax base within countries with subnational taxes on business income such as Canada, the United States, Japan, Switzerland and West Germany (Bird and Brean, 1986).

Nonetheless, the international uproar against this so-called "unitary" system subsequently induced most American states to retreat. Contrary to what many tax practitioners seem to think, however, this episode illustrates not the inadequacy of the worldwide allocation approach but rather the non-viability of any approach increasing taxes on internationally mobile capital that is applied in only a few jurisdictions (Brean and Bird, 1986). The moral of the unitary story is not that the present system is in any sense better or more workable. It demonstrably is not (Bird, 1986). The moral is rather that no substantial improvement can be expected in the international tax order so long as countries (let alone parts of countries) act on their own.

Indeed, no matter from what perspective one approaches international taxation it is difficult to avoid the conclusion that better outcomes will ultimately be attainable only through better international co-operation. It is also difficult to avoid being pessimistic about the chance of success in such co-operative endeavors, unless perhaps one is willing to make the excessively naive assumption (Mueller, 1979) that governments always act as disinterested maximizers of social welfare. Nevertheless, it is obviously important to determine the minimal level of agreement that will both let countries do what they want in the tax field to the extent possible and at the same time remove the present distortionary set of tax impediments and inducements to international capital movements.

Those who have considered these questions have sometimes, however, asked for too much. Some have argued, for instance, that what is needed is no less than a truly international tax system, probably administered by some United Nations agency (Tinbergen, 1976; Steinberg and Yager, 1978). Others have suggested that to attain economically satisfactory outcomes (whether in the world as a whole or within an economic union), countries must adopt substantially the same tax system (Commission, 1980). Indeed, some American writers have come suspiciously close to saying that the system that should be adopted is the American system (Kingson, 1981). Still others have urged increased information exchange among countries and even the creation of a sort of international tax police – Intertax! (Surr, 1966).

The "world tax system" approach seems too utopian in its idealization of the imperfect political instruments called governments, let alone those even more imperfect instruments of governments called international institutions, to be worth further discussion here. There is no explicit internationally redistributive tax system, and there is not likely to be one soon.

Nonetheless, it is important to realize that one of the major effects of the existing set of imperfect national rules is precisely that they distribute the income from international investment to different countries in a particular fashion (Musgrave, 1972). Those who want to lower taxes on capital income may think the most important question about taxes is what share of profits is taken by the public sector and that the main problems arise when taxes are too high, regardless of who gets them. Those who want more effective income taxes in any country may equally think that the main international tax problem is to ensure that the total taxes levied on incomes of a particular size are the same regardless of the source of the income. They are consequently more concerned about international undertaxation than overtaxation. Both these views, however, neglect unduly the main practical function of international tax rules, namely, the division of the tax take between source and residence countries.

Despite the emphasis commonly placed on increasing information exchange as the key to salvaging the existing international tax system (OECD, 1987), the future of this approach too does not seem too promising. One reason for this pessimism is simply that effective information exchange itself requires a high degree of international co-operation. Hence, such schemes are sub-

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ject to the same constraint as the more utopian approach in that recalcitrance on the part of even one significant country could render them unworkable. Moreover, even with the best will in the world, no one can endow most developing countries with the considerable expertise needed to make use of any information they might receive from other countries, whether through treaties or some future multilateral clearing house. Most fundamentally, however, even perfect information understood and acted upon by perfect tax officials would not rectify the basic mismatch between the underlying premise of the present international tax system – that all firms operating internationally are independent of one another and operate in a perfectly competitive environment – and the reality of international business. Indeed, the main thing the tax administration of a country would learn if it had full access to the tax files of other countries is that they too do not really know what the "proper" tax base is for firms operating across national boundaries.

The "harmonization" approach mentioned above, when interpreted as it sometime is to mean that taxes must be virtually the same in all countries is logically incorrect, as I have shown elsewhere (Bird, 1986b). When more correctly interpreted in terms of optimizing policy instruments so as best to achieve different policy objectives (Dosser, 1967), it too suffers, like the utopian approach, from postulating an unattainable degree of international agreement. Nonetheless, it is probably along these lines, if at all, that the salvation of international taxation lies. Circumstances will in any case force countries gradually to approximate their tax rules (if not necessarily rates) in order to achieve more acceptable policy outcomes. The question is whether by working together the results will be better for all concerned than by leaving the outcome entirely up to the market. As I have already suggested, unless one favors the complete demise of income taxes – as of course some do – the answer seems clear.

The fundamental aims in taxing international income flows are three: to allocate tax revenues between jurisdictions in a way recognized by each as fair (Musgrave and Musgrave, 1972); to neither encourage nor discourage international capital flows; and to enable countries, within reason, to impose the domestic tax system of their choice. The present international tax order does not succeed well at any of these objectives. It produces what all would accept as fair results only in exceptional circumstances (of equal flows between countries with similar tax systems); it both discourages and especially encourages capital flows of various sorts, thus biasing the international allocation of capital and making the world a poorer place; and it inevitably undermines the viability of domestic tax systems. It is clearly time for a change.

The precise nature of the needed change, however, can only be worked out by the interested parties over a long period of time through continued, and no doubt painful, negotiations in some appropriate international forum. The lead in launching this needed rethinking of international taxation may conceivably come from the United States, conscious as it is of its new role as the world's largest capital importer; or from Japan, the new giant of world capital markets; or even from the European Community, in the not too likely event that it can get its act together with respect to the taxation of capital income (Bird, 1986b). It may also come from the developing countries (Oldman, 1984) or some of the smaller developed countries (New Zealand, 1987). The increasingly obvious failure of the present system makes it likely that someone, somewhere will start the ball of reform rolling within the next decade or so.

As to where exactly that ball will stop, however, only time will tell. Reform of the taxation of international portfolio investment, although more needed by most criteria than that of direct investment, seems likely to prove more difficult. Direct foreign investment is visible, and often resented by significant political groups in both sending and receiving countries. Measures to ensure that such firms pay their "fair share" of taxes thus may have some chance of success. International financial flows, however, are virtually invisible, often consisting of no more than a bookkeeping entry in a computer somewhere. Moreover, the non-taxation of such flows is politically popular with three powerful (if unspoken) allies: business enterprises seeking cheaper capital, the financial institutions that run the system, and the increasingly large group of tax minimizers (evaders or avoiders, as the legal nicety may be) who supply much of the money. Change will not come easily, or soon, in the face of such opposition. But it must, in the end, occur – perhaps through a reassertion of the source principle – if anything like the present income tax is to continue to exist in this increasingly integrated world.

As for the taxation of direct investment, in my view any viable new international tax order must to a large extent rest on precisely the unitary or worldwide allocation approach that has been so vilified over the last decade. As every country which has seriously attempted to cope with its international tax problems has discovered, there is no effective way to deal with many intercountry allocation problems except through some type of formula apportionment of the tax base. What is needed to avoid distortion and to make such a system viable is primarily agreement on the formula by all parties concerned. The present "formula" of separate entity arm's length pricing has, as one of its originators, Stanley Surrey (1978) urged more than a decade ago, by now received a fair test. It has also, as he recognized might well turn out to be the case, clearly failed that test. Increasingly, this approach has had to be supplanted by separately devised formulae for specific expense items such as interest or research and development expenses and by arbitrary "cost-plus" and similar adjustments to intrafirm transactions. Such haphazard methods will produce fair, acceptable, and efficient results only by chance. As this truth becomes more widely recognized the discussion of how to go about taxing international income may at last leave the sterile realm of trying to quantify nonexistent "arm's length" prices. In the international as

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in the national context, the fiscal myth that the component parts of a multiunit firm are separate and independent has long outlived its usefulness. A central element of any new international tax order will almost certainly be a move to an agreed formula basis for allocating tax base among jurisdictions. To work out the exact nature of such a formula, let alone to secure agreement on adequate source taxation of portfolio income, will clearly be no small task. Until that task has at least been begun, however, I am afraid that, for better or worse, the future of international income taxation, and indeed of the income tax itself, looks far from bright.

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BRAZIL:

The Debt-Equity Conversion Programme: A Follow Up

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The February 1988 issue of the *Bulletin* contained an article discussing the Brazilian rules on debt-equity conversion.[1] Since that article was prepared several developments have occurred:

1. Resolution No. 1416 was replaced by Central Bank Resolution No. 1460 of 1 February 1988;

2. On 18 March 1988, the Central Bank entered into a "Convênio" (Agreement) with the Rio de Janeiro Stock Exchange (Bolsa de Valores do Rio de Janeiro – BVRJ), the São Paulo Stock Exchange (Bolsa de Valores de São Paulo – BOVESPA) and the Securities Commission (Comissão de Valores Mobiliários – CVM), establishing the rules for the auctions applicable to certain debt conversions; and

3. On that same date, the Central Bank issued Circulars Nos. 1302 and 1303, which supplement the rules of Resolution No. 1460.

This article reports on these 3 developments.

I. RESOLUTION NO. 1460

Resolution No. 1460 contains regulations for the conversion programme.[2] The regulations are simple and objective in nature. The most important amendment introduced by Resolution No. 1460 (an expected change) is abolition of 2 conditions contained in Resolution No. 1416, i.e. (i) that the original creditor of the amount being converted formally agree to the required contractual provisions to be included in the foreign debt restructuring agreements to permit issuance of securities by Brazil and implementation of the debt-equity conversion programme; and (ii) that the original creditor of the amount being converted acquire such securities.[3] This amendment will foster the success of the conversion programme which would otherwise be hampered by compliance difficulties because foreign creditors already voiced strenuous objections to these conditions.

One of the new regulations, however, provokes considerable concern. Art. 10 deals with conversions outside the auction system (Unmatured Public Sector Debt; Unmatured Private Sector Debt; and 432/230 Deposits).[4] It provides that:

(a) the investment registration will be equal to the face value of the obligations less the discount to be determined by the Central Bank;
(b) the Central Bank will establish the discount on the basis of the auctions to which the conversions of Debt Renegotiation Funds are subject; and
(c) the difference between the face value of the converted obligations and the amount of the investment registration corresponding to the discount (if capitalized) will be treated as Brazilian capital.

Once a conversion under Art. 10 is made, the investor may receive a cruzado amount greater than the equivalent of the face value of the converted obligation, less the discount.[5] If so, the foreign investor will be penalized because the investor will have Brazilian currency when capitalizing the proceeds from the conversion, i.e. Brazilian capital that is not registered for purposes of future repatriation or profit remittances. This capital is known as "contaminated capital". It is neither fair nor reasonable for an investment made according to rules promulgated by the Central Bank itself to result in contaminated capital. The rules of the former Resolution No. 1416 were more reasonable because they simply established that the foreign currency registration would be made at the face value of the converted obligations less the discount. Art. 10 of Resolution No. 1460 should be reassessed by the Central Bank.

Resolution No. 1460 makes it clear that 432/230 Deposits derived from the public sector can only be converted into public sector investments.

Any company taking advantage of the debt conversion programme must deposit with the Central Bank the amounts of any transfers on account of repatriation of capital or remittance of capital gains (up to the converted amount).[6]

Conversion proposals submitted to the Central Bank before 20 July 1987 remain subject to the rules of Central Bank Circular Letter No. 1125 of 9 November 1984. However, beginning 1 February 1988, im-

1. See Mendes, A., "The Debt-Equity Conversion Programme", 42 *Bulletin for International Fiscal Documentation* 2 (1988) at 75.
2. The same credits are eligible for conversion, i.e. Debt Renegotiation Funds, Unmatured Public Sector Debt, Unmatured Private Sector Debt and 432/230 Deposits. For a definition of these terms see footnote 1.
3. See footnote 1.
4. Id.
5. Id at 76.
6. Conditions for deposit are to be established by the Central Bank.

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plementation of the proposals must comply with the following deadlines:
(a) 75 days for confirmation of the proposals and satisfaction of the Central Bank requirements;
(b) 90 days for the Central Bank to reply; and
(c) 180 days for the withdrawal of the funds.

II. AGREEMENT – AUCTION RULES

A. Place of auction

The auctions will be alternately held in Rio de Janeiro and São Paulo on the premises of the respective stock exchanges. The first auction will be held in Rio de Janeiro.

B. Call notice

The auctions will be called by means of notices published in the Official Gazette of the Federal Executive and in other leading newspapers at least 5 days before the first auction and at least 10 days prior to all subsequent auctions.

C. Amount to be auctioned

Before each auction, the Central Bank will establish:
(a) the amount of the net discount debt to be converted, i.e. the amount of debt eligible for conversion less the discount that may be obtained at the auction;
(b) the standard lot of bids;
(c) the minimum discount rate, if the Central Bank decides to apply such a discount rate; and
(d) the order in which the auctions are to be held, according to the area of investment of funds (Circular No. 1302, item 2).

D. Participation in auction

Any individual or legal entity may participate in an auction if represented by a Brazilian brokerage company, regardless of whether the brokerage company is a current member of the stock exchange organizing the auction. It is sufficient if the brokerage company previously qualified under the rules of the relevant stock exchange.

E. Costs

The costs of the auction are as follows:
(a) brokerage fees are to be charged by the brokerage company, i.e. 0.15% of the amount of the transaction; and
(b) fees are to be paid by the brokerage company to the stock exchange which organizes the auction, i.e. 0.015% of the amount of the transaction.

F. Documentation for conversion

The Central Bank will specify the documentation to be delivered by the brokerage company to the relevant stock exchange as well as the deadline for delivery of such documentation. The current requirements are found in Circular No. 1302 and non-compliance will result in a fine of 0.1% of the amount of the transaction as well as suspension of a brokerage company's right to participate in 6 subsequent auctions. The brokerage company may charge this fine to the client if the client caused the default.

III. CIRCULAR NO. 1302

Circular No. 1302 establishes the basic rules for conversions subject to the auction system. The text of the Circular repeats some of the rules of the Agreement.

A. Documentation for conversion – deadlines

The documents to be submitted to the Central Bank for auction conversions are as follows:

1. Up to 12:00 noon on the business day following the date of the auction: notice from the stock exchange to the Central Bank, specifying the winning bids and forwarding information supplied by the brokerage company which identifies the investment corresponding to each bid.

2. Within 2 business days of the auction: notice to the investor authorizing immediate blocking of the converted deposits and debit of the discount.

3. Within 10 business days of the auction: submission of the required documentation to the Central Bank for examination of the application for conversion.

B. Disqualification

Failure to submit the necessary documents before the established deadlines will result in automatic disqualification of the bids, without prejudice to imposition of the 0.1% fine (see above).

C. Rejection of application for investment

The Central Bank may reject an application for investment if the project is incompatible with applicable rules or if its field of activity is inappropriate. In reaching its decision, the Bank will take into account rules which govern the registration of foreign investments as previously adopted by the Central Bank and now in effect. However, there are doubts as to the Central Bank's position regarding certain types of activity (e.g. real estate investments). An interested investor should take the precaution of examining this aspect of its investment project before participating in the auctions. If an application for investment is rejected, the Central Bank will release the relevant deposits and annul the debit of the discount. In these cases, the 0.1% fine will not be imposed.

D. Withdrawal of funds

The investor must withdraw the net amount of the

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funds, less the respective discounts, within a period of 30 days of the authorization for conversion. If the funds are not withdrawn within this time period, the right to conversion will automatically lapse. The funds must be withdrawn through a bank authorized to deal in foreign exchange (in the respective currency) by applying the exchange rate for onlending.

E. Hedging

The funds of an authorized conversion can be deposited in foreign currency with the Central Bank under the following conditions:

1. The deposits will not earn any interest;

2. The deposits may be made once within 30 days of the date of the authorization for conversion or the date of capitalization;

3. The withdrawal of the funds will follow a time schedule established by the Central Bank and the deposit of uncapitalized funds can only be made for capitalization of such funds; and

4. These deposits must comply with the rules of Central Bank Circular No. 349 of 23 June 1977 which governs the mechanics of voluntary deposits with the Central Bank.

IV. REGULATIONS ATTACHED TO CIRCULAR NO. 1302

The regulations establish the rules for the conversion auctions. The winning bids are those which offer the highest discount rates. The discount rates will be announced by the auction director at variations of 0.5%. The brokerage company should bid the amounts of net dollars, less the discount, that it wishes to acquire at the respective rate. The bids made at the auction shall be considered firm bids and cannot be withdrawn. When the total bids exceed the quantity offered at a given rate, the rate will be increased and the auction director will announce the change.[7]

The auction will be closed when the sum of bids at a new rate is equal to or does not reach the total quantity offered. The procedure for allocation of the funds is as follows:

- first to the bids at the highest discount rate;
- the balance will be apportioned among the brokerage companies which bid for the next lowest rate, in proportion to such bids;
- if the brokerage company is not interested in the amount allocated to it in the apportionment, it can irrevocably waive its lot. This lot will then be apportioned again among the remaining brokerage companies qualifying for this apportionment;
- at the end of the auction, the organizing stock exchange will issue a declaration to the Central Bank and the brokerage companies specifying the lots acquired and the discount rates;
- before 12:00 noon on the business day following the date of the auction, the brokerage companies with winning bids must submit to the stock exchange information which identifies their clients and the proposed investments. Failure to comply with this rule will result in the above-mentioned 0.1% penalty and suspension from participation in 6 subsequent auctions.

V. CIRCULAR NO. 1303

Circular No. 1303 sets forth the rules which apply to debt conversions not subject to the auction system, i.e. "Private Unmatured Debt", "Public Unmatured Debt" and "432/230 Deposits". The proceeds from these conversions will be invested as follows:

- in payment of the capital of new companies;
- in increases of the capital of existing companies;
- in purchases of corporate interests; and
- in "Foreign Capital Conversion Funds".

The funds of 432/230 Deposits will be released in full without any discount. The releases will be made in the order in which the proposals were submitted as from 18 March 1988, within the monthly ceilings to be established by the Central Bank. The funds are to be withdrawn within 30 days of authorization under penalty of automatic lapse of the conversion right.

The investment must be registered in the face value of the converted debt, less the amount mentioned below, whichever is greater:

- the discount negotiated between the interested parties; or
- the discount established by the Central Bank on the basis of the weighted average of the winning bids of each auction, i.e. the general auction and the auction for areas enjoying incentives. This discount will be established after each auction and will remain in effect until the business day preceding the date of each new auction.[8]

The problem already discussed in connection with Resolution No. 1460/88, i.e. the possibility of having an unregistered investment (national capital) if the capitalized sum is greater than the face value less the discount determined by the Central Bank is also relevant in this context. Interested investors should take care to avoid this situation.

The public sector debt can only be converted into investment in the public sector but not necessarily in the debtor company. The investment can be made in any other public sector company.[9]

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7. The first 2 auctions were held on 29 March and 28 April 1988. On each occasion, US$ 150,000,000 were auctioned, i.e. US$ 75,000,000 for general auction and US$ 75,000,000 for investments in areas enjoying incentives. The discount prevailing in the first auction was basically 27% for conversions for general use and 10.5% for incentives. The discount prevailing in the second auction was basically 32% for conversions for general use and 15% for incentives.

8. After the first 2 auctions (see footnote 7), the Central Bank established the following discounts for conversions for general use and for incentive areas, respectively: 26.99% and 10.5% after the first auction, and 31.98% and 15% after the second auction.

9. Transactions of onlending of loans under Central Bank Resolution No. 63 of 21 August 1967 in favour of public sector companies are included in these rules.

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The proceeds from debt conversions under Circular No. 1303 can also be deposited in foreign currency with the Central Bank according to the system described above.

Medium and long-term debts not covered by Resolution No. 1460 (basically the so-called "intercompany loans") continue to be subject to the procedures of Central Bank FIRCE Communiqué No. 28 of 10 April 1978, as follows:

- they require the prior approval of the Central Bank;
- they involve symbolic exchange transactions;
- registration is made at the full amount of the debt in foreign currency and thus without any discount.

Finally, deposits made at the Central Bank under Central Bank Resolution No. 229 of 1 September 1972 and Circular No. 600 of 22 January 1981 can be converted into investment in private or public sector companies at the investor's option. These funds can then be withdrawn according to the rules which apply to this kind of deposit.

Conference Diary

JUNE 1988

Tax Compliance; the key to modern and successful international planning. London, 15 June (English):
I.I.R. Ltd., 44 Conduit Street, London WIR 9FB, United Kingdom.

1988 Corporate Management Tax Conference – Income Tax Enforcement, Compliance, and Administration. Toronto, 20-21 June (English):
Conference Secretary, Canadian Tax Foundation, 130 Adelaide St.W., Ste. 1900, Toronto, Canada M5H 3P5.

Taxation of Branches and Subsidiaries. Brussels, 20-21 June 1988 (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Leveraged buy-outs – Latest developments in Europe. London, 21 June (English):
The Conference Organiser, Business Research International Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Transcontinental trusts – The new dimension in planning. London, 23-24 June (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Uitstel van Winstneming. Garderen, 27-28 June (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

Seminar on Transfer Pricing. New York, 27-28 June (English):
International Tax Institute, Inc., c/o John E. McDermott, Jr., 200 Park Avenue, 13th floor, New York, New York 10166, U.S.A.

SEPTEMBER

IBA 22nd Biennial Conference. Buenos Aires, 25-30 September (English):
International Bar Association, London, United Kingdom.

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Walters, A.A. (1987) "Political Realities and the Interactions of Tax Systems within the Global Economy in the 21st Century" (Paper to Conference on Taxation Policy in the 21st Century, Washington, October).

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SUMMARY OF VALUE ADDED TAX IN CIAT MEMBER COUNTRIES IN THE AMERICAS

By the Inter-American Center of Tax Administrators*

INTRODUCTION

The general sales tax has traditionally been the basis of indirect internal taxation in the Americas. In a majority of cases, indirect internal taxation has been complemented by an extended system of stamp taxes on documents, and specific taxes on the production and sale of certain goods (mainly alcohol and alcoholic beverages, tobacco, cigars and cigarettes, gasoline and fuel oil, wine, beer and non-alcoholic carbonated beverages).

In the American nations, the general sales tax was originally of a cumulative or "cascade" nature even though there are cases of single-phase taxes (frequently at the manufacturer or importer's level). However, in the mid-1960s, Colombia and Brazil adopted the "value added tax" system, and from then on, the countries of the region have shown a clear trend toward this form of taxation, which became well established by the 1970s, when 11 countries transformed or initiated their system of levying taxes on sales, based on the "value added tax" system (VAT). This trend has continued during the 1980s, when 6 countries adopted the VAT system: Guatemala and the Dominican Republic were the last to do so in 1983. Meanwhile, Canada is currently studying a project to replace the existing federal tax, levied on manufacturers and importers, with a multi-phase, VAT-type tax. Lastly, in Jamaica a proposal was submitted early in 1987 for the establishment of a VAT-type, general tax on sales, as part of a tax reform proposal which has not yet been implemented.

It should be stated that the trend toward the establishment of VAT in the American nations has been largely determined by the fiscal needs of governments and by the intrinsic advantages offered by this tax, such as its elasticity and neutrality. In general terms, the vast bibliography available on VAT acknowledges these advantages, as well as certain limitations in the structure of the tax which may affect its management such as the existence of tax exemptions and multiple tax rates. However, the possibilities offered by VAT for information crosscheck, and the special systems adopted for the treatment of small businessmen and taxpayers, have proven to be important features for the acceptance of this tax.

According to the information shown in Table I, by 30 June 1987, of the 27 CIAT member countries, 19 (i.e. 70%) levied a general sales tax at the national or federal level. One should bear in mind that the United States does not have a federal tax on sales; instead, most states and the District of Columbia levy such a tax, usually at the retail level. Likewise, Barbados and Jamaica, which do not levy a general sales tax currently tax certain services (Barbados) and the sale of specific goods at the retail level (Jamaica), respectively. Lastly, El Salvador and Venezuela, which do not levy a general sales tax, rely on broad systems of stamp taxes.

According to Table I, of the 19 countries which currently levy a general sales tax, 16 apply a VAT-type tax. The remaining 3 countries levy the tax at the manufacturer and importer levels.

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1. BASIC FEATURES OF VALUE ADDED TAX IN CIAT MEMBER COUNTRIES IN THE AMERICAS
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ARGENTINA
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BRAZIL
CHILE
COLOMBIA
COSTA RICA
DOMINICAN REPUBLIC
ECUADOR
GUATEMALA
HAITI
HONDURAS
MEXICO
NICARAGUA
PANAMA
PERU
URUGUAY

TABLE I
General sales tax in CIAT Member Countries in the Americas

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1. BASIC FEATURES OF VALUE ADDED TAX IN CIAT MEMBER COUNTRIES IN THE AMERICAS

(a) In general terms, VAT is an important component of the current revenue collected by governments, reaching levels as high as 20% in Costa Rica, 23% in Haiti, 25% in Brazil and Ecuador, 28% in Colombia, 30% in Argentina, 40% in Uruguay and 50% in Chile.

This tax is not as important in countries like Honduras, Panama and Mexico, where it ranges between 13 and 15%.

(b) All countries levying VAT use the "subtraction system", i.e. they calculate it by determining the difference between the tax on sales and the tax on purchases during the assessment period.

(c) Only Brazil levies VAT exclusively on operations involving goods. The rest of the countries levy the tax on the transfer of goods and the rendering of services, although with different exemptions and restrictions. In general, VAT affects the transfer of movable goods, although in 1987, Chile broadened the scope of this tax to include the sale of buildings (real property) built entirely by the construction companies that engage in their sale. Taking these facts into consideration, VAT may be said to have a broad tax base, mainly in Argentina, Bolivia, Chile, Mexico and Uruguay.

(d) Nine countries have adopted a single tax rate; 6 apply a rate plus additional, differential rates, while Brazil applies numerous tax rates, depending on the nature of the product.

(e) The majority of countries require that the tax be assessed and paid on a monthly basis. Among these, Argentina, Brazil, Dominican Republic, Mexico, Nicaragua and Peru require that an additional annual tax return be made, essentially for information purposes. As a general rule, Colombia requires bimonthly payments, while Uruguay requires that monthly payments be made in advance and that returns be prepared every 3 or 6 months, depending on the case, plus an annual tax return.

(f) Nearly every country levies VAT on a general basis, including small businessmen and craftsmen.

Nonetheless, Argentina, Chile, Colombia, Costa Rica, Ecuador, Mexico and Peru give said taxpayers special or "simplified" treatment. In Nicaragua, some

Table I

General sales tax in CIAT member countries in the Americas

Countries	No general sales tax	General sales tax				Comments
		VAT type		Other types		
		All stages	General rate	Single stage	General rate	
Argentina		X	18			
Barbados	X					5% specific tax applied to hotel and restaurant services
Bermuda	X					
Bolivia		X	10			
Brazil		X	Several			At the federal level, IPI at a single stage. At the state level, ICM at all stages.
Canada				X	12	Manufacturers and importers.
Chile		X	20			
Colombia		X	10			
Costa Rica		X	10			
Dominican Republic		X	6			
Ecuador		X	10			
El Salvador	X					Broad system of stamp taxes.
Guatemala		X	7			
Haiti		X	10			
Honduras		X	5			
Jamaica	X					Single stage tax on specific goods (retail sales taxes)
Mexico		X	15			
Netherlands Antilles	X					
Nicaragua		X	10			
Panama		X	5			
Paraguay				X		At the manufacturers' level.
Peru		X	10			
Suriname	X					
Trinidad & Tobago				X	10	Wholesalers and retailers (purchase tax).
United States	X					Sales are taxed at the state level.
Uruguay		X	21			
Venezuela	X					

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taxpayers pay a fixed monthly amount, and others are authorized to include VAT in the sales price while certain small businessmen and craftsmen are exempt from this tax altogether. Panama, for example, exempts small businessmen and craftsmen from the payment of VAT.

(g) To monitor compliance, Chile and Peru have established a system of periodic random drawings of forms or invoices (tax lottery). Bolivia authorizes individual taxpayers to deduct from their personal income tax any VAT they may have paid, provided that they are the ultimate buyers of the taxed product. In Guatemala, taxpayers may lose part of their tax credit if they fail to submit timely tax returns.

(h) In countries that have Tax Codes or similar tax laws, provisions relating to substantive, administrative, procedural and criminal aspects of tax law are not to be found in VAT legislation (such is the case with Argentina, Bolivia, Brazil, Chile, Costa Rica, Ecuador, Mexico, Peru and Uruguay).

2. SUMMARY OF VAT LEGISLATION IN FORCE IN CIAT MEMBER COUNTRIES IN THE AMERICAS

The following is a summary and broad overview of the structure adopted by the different American nations which currently levy VAT. In this synthesis, we have tried to identify the essential features which characterize current legislation in force in each country, such as the origin and structure of the tax, goods and/or services subject to VAT, exemptions, rates, and the manner in which the tax is assessed and paid.

As pointed out earlier, in most countries, substantive, administrative, procedural and criminal aspects of VAT, plus applicable penalties for violations of VAT legislation, are found in general tax laws (such as the Tax Code) and, consequently, are not covered in this summary.

ARGENTINA

Value added tax has been in force since 1 January 1975 and its adoption prompted the repeal of a single-phase tax established in 1935. The tax has experienced important modifications, the last of which was introduced by Act 23,349, published in the *Boletín Oficial* (Official Bulletin), dated 25 August 1986. It should be stated that, concurrently with this tax, there are a number of "Internal Taxes" levied at the national level, mainly on the consumption of tobacco, alcohol, alcoholic beverages, automobile coverings, fuel and lubricants, wine, toiletries, luxury goods, insurance, carbonated beverages and refreshments, syrups, extracts, photographic items, outboard motors and hi-fi audio equipment. Stamp taxes ares also applied at the national level. Lastly, at the provincial level, cumulative-type taxes are levied on gross income.

The basic features of VAT in force in Argentina are the following:

(a) The tax affects imports and the transfer of movable goods at all stages of merchandising. VAT is also levied on work and labor performed either personally or through third parties, on one's own or on someone else's real property, the making, construction or manufacture of movable goods, and the acquisition of the fruits of Nature, at the request of third parties.

The long list of final services taxed includes those rendered by pubs, restaurants, dance halls, hotels, game rooms, public bath houses, swimming pools, beauty parlors, parking lots, dry cleaners, water and electricity services, decorations and public entertainment in general, as well as the leasing of movable goods and real property for recreational purposes.

(b) Exemptions cover the import of merchandise and items of personal use made by individuals, associations and institutions, both secular and religious, who have obtained tax exemption certificates. Also exempt are operations carried out by persons who, during the calendar year, simultaneously have a minimum amount of capital, and a minimum volume of sales. Said minimum volume is subject to periodic revision. Lastly, tax exemptions are also extended to the sale of crude oil products and petroleum gas, special paper and cardboard, newspapers, books and periodicals in general, aircraft, ships and a few other goods identified by name.

Exports are taxed at the zero rate, and exporters can deduct any taxes paid in purchasing goods and services from taxes stemming from their taxable operations. If the above compensation cannot be carried out, or only partially so, the tax credit balance may be used to pay other taxes, or the taxpayer may obtain a tax refund, or be allowed to transfer his tax credit to other taxpayers.

(c) The general rate of taxation is 18%. A 50% reduction in tax is anticipated when dealing with taxable operations stemming from work done to real property belonging to third parties, work done to one's own real property and premises, or personal services rendered in connection with work done to real property, provided that said property is intended for housing.

The Executive Branch is empowered to reduce the general rate and to modify the list of tax-exempt goods, only with regard to personal items of mass consumption, or in order to avoid distortions arising from the competitiveness of imported goods in the domestic market.

With regard to investments in durable goods, appropriate tax credits will be calculated and spread over 3 consecutive annual installments.

(d) The tax is managed by the General Directorate of Taxation and must be assessed and paid on a monthly basis. In addition, taxpayers are required to file annual information returns.

Taxpayers are required to itemize the tax separately on every sales invoice, except taxpayers who sell goods or render services for which the ultimate consumer is taxed.

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The law establishes the "simplified system", for small taxpayers who pay a fixed tax based on their net capital and the number of employees. Tax credit is included in these taxpayers' tax return; however, they are not permitted to include the tax in their sales invoices.

The amount of tax assessed is based on an annual tax return, requiring advance payment of 11 monthly installments. To offset the amount of tax assessed, taxpayers may resort to their tax credit, which will cancel out 70%, 25% or 45% of all taxes due, depending on whether the taxpayers' activities are centered on the commercial, service or industrial sectors, respectively.

Among the taxpayers excluded from the "simplified system" are exporters, those who perform work on someone else's real property, and corporations and joint-stock companies.

The system is optional for taxpayers carrying out industrial activities.

BOLIVIA

In 1957, Supreme Decree 4592 established a tax on consumption, better known as the "tax on sales and services". Said tax was a multiphase cumulative tax, selectively levied on goods and services, at rates of 10% for goods and 3% for services.

The "value added tax on the sale of goods" has been in force since 26 October 1973. The current tax structure stems from Tax Reform Act 843, dated 20 May 1986, published in the *Gaceta Oficial* (Official Gazette) dated 28 May 1986. This law extends the scope of VAT to include services rendered; in addition, tax exemptions have been repealed, and the tax rate set at 10%.

Notwithstanding VAT, a "tax on transactions" is levied, at a rate of 1%, on gross income stemming from the sale of goods, fees for services rendered, interest on loans, and every other type of activity, whether or not for profit, regardless of who performs the activity or service.

Likewise, notwithstanding the law on value added tax, the "tax on specific consumption" sets different tax rates on local sales and on the import of beer and alcoholic beverages in general, cigarettes, cosmetics and perfume products, imported jewelry and precious stones.

In addition, individual taxpayers and estates are subject to a 10% "surtax on VAT", levied on monthly income from personal services, rent, interest, dividends, royalties, profit-sharing in partnerships, and professional fees. Taxpayers may offset from the surtax levied all the VAT paid in purchasing goods and services.

A transitory "Simplified Tax System" was established through Supreme Decree 21521, dated 13 February 1987. Said tax system has replaced VAT, the tax on transactions, the surtax on VAT, and the tax on presumptive business income, and affects individual taxpayers who meet specific requirements (small taxpayers). Likewise, Supreme Decree 21642, dated 30 June 1987, established an "Integrated Tax System", also transitory in nature, for individual taxpayers who own motor vehicles which provide public, urban transportation services between provinces and departments.

The main features of VAT are as follows:

(a) VAT is levied on the sale of movable goods, service contracts and services in general, and on imported goods.

(b) Exemptions are limited to imported goods introduced into Bolivia by members of the diplomatic corps and goods introduced by bona fide travellers (up to $ 300).

Non-traditional exports are exempt from this tax, and exporters may deduct from their taxable income any tax they may have paid for their purchases in the domestic market, and for imported goods destined to be incorporated into their exports. If it were not possible to realize this compensation, the tax credit due to the exporter shall be paid to him by means of a credit note. Regarding tax exemptions, the guarantees provided by the Law on Investments are fully acknowledged.

(c) The tax rate is 10%.

(d) The tax is levied and paid on a monthly basis. When the net sales price is less than 2 bolivianos (approximately US$ 1), there is no obligation to issue an invoice; however, taxpayers must keep a daily record of these small, retail sales and issue the corresponding tax note at the end of each day, detailing the total amount of these sales, in order to determine the tax due.

(e) Invoicing should include VAT, i.e. VAT should be incorporated into the net price of goods and services sold.

BRAZIL

Sales are currently subject to a value added tax at 2 different levels: at the federal level, there is the "Imposto sobre Produtos Industrializados" (IPI) (tax on manufactured goods); and at the state level, there is the "Imposto sobre Circulação de Mercadorias" (ICM) (tax on the circulation of merchandise).

IPI was established by Act 4,502, dated 30 November 1964; said tax replaced the previous "consumption tax". ICM arose as a result of the distribution of responsibility for tax matters set forth in Constitutional Amendment No. 18, dated 1 December 1965, and is levied in accordance with Act 5,172, dated 25 October 1966. Said tax replaced the "tax on sales and consignments", a cumulative-type tax. The latter amendment also repealed stamp taxes.

Sixty-seven percent of the tax revenue generated by IPI is set aside for the Federal Government (Uniao),

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whereas the remaining 33% goes to the states and municipalities (16% to the states and 17% to municipalities). Meanwhile, 80% of the revenue generated by ICM goes to the states themselves, while the remaining 20% goes to the municipalities within the state that collected the tax. ICM represents about 90% of all collections made by the states.

It should be pointed out that, at the present time, the National Constituent Assembly is studying a proposal to amend the Constitution, whose final approval would include a substantial restructuring of the National Tax System.

The basic features of IPI are:

(a) IPI affects goods produced by industrial manufacturers and other manufacturers comparable to the former, manufactured goods which have gone through Customs, goods acquired through auction or bids for manufactured goods declared lost or abandoned by the Secretariat of Federal Revenue. A product is considered a manufactured good, if it is the result of any operation defined as such in the Regulations, even though said operations might be incomplete, partial or intermediate. Services are taxed only when they consist of operations to assemble, renovate, improve or refurbish manufactured goods.

(b) There are various exemptions, relating mainly to the type of product and to considerations of a social, economic and political nature, which allow the manufacturer to waive his right to the exemption.

Exports are exempt from IPI, while exports of manufactured goods are also exempt from ICM.

(c) To assess the amount of tax due, products are grouped in accordance with the Brazilian Merchandise Nomenclature, itself based on the Brussels Customs Nomenclature. Rates vary greatly, depending on the nature of the product (ranging from 4%, to 365% for cigarettes).

(d) The tax is usually assessed and paid by means of a monthly tax return, which must be submitted to the bank branch where the taxpayer plans to pay the tax.

Every year, an additional tax return with economic and tax information is required.

The Secretariat of Federal Revenue, which manages IPI, has entered into agreements with the states' tax authorities to better coordinate the collection of both taxes.

Meanwhile, ICM affects all stages of merchandising, including goods produced by commercial, industrial and manufacturing plants, goods imported by the owner of commercial, industrial or manufacturing plants, and the supply of food, beverages, and other goods to restaurants, bars, cafés and similar businesses. Other items subject to ICM include services incorporated into the cost of the product. General tax rates for intra-state transactions are 17%, for interstate operations the rate is 12%, and 13% for exports. The movement of goods from states in the Southern and Southeastern regions to the states in the North, Northeast and West Central regions and to the State of Espiritu Santo is taxed at the rate of 9%. While ICM is a state tax, insofar as management and final destination of the revenue are concerned, the tax is national in scope, by virtue of the uniformity of its regulations and its fixed rates.

On the other hand, the granting of exemptions, incentives and fiscal benefits in general is subject to agreements with Federal Government authorities.

CHILE

In 1974, Decree-Law 825 established a "tax on sales and services", which went into force on 1 March 1975, thereby replacing the old, cumulative-type tax on sales and purchases.

The tax system is currently structured on a dual basis:

(1) Value added tax, affecting goods and services in general.

(2) Special taxes on sales and services. Under this heading, additional taxes have been levied on luxury items, such as color television sets and alcoholic beverages, as well as specific taxes on the sale of used cars, the purchase of foreign exchange and various other goods.

The main features of VAT are the following:

(a) Among other activities, VAT affects the sale of goods by persons habitually engaged in this activity, the import of goods (whether carried out habitually or occasionally), capital contributions to corporations, and other transfers of material movable goods, the sale of businesses and certain services, such as the staging of public entertainment events, the leasing of movable goods and furnished housing, car parking services, and the insurance premiums of insurance cooperative associations.

(b) Exemptions are limited, and basically are reserved for certain imports made by the state, a few socially-relevant, public services, passenger transportation companies, and television stations, subject to certain restrictions. Exports are subject to the zero rate.

(c) The general rate of VAT is 20%. Special taxes or surtaxes are 50% for luxury items in general, and range between 15% and 30% for alcoholic beverages and television sets. The tax on the sale of used cars is 0.5%, and 50% on the sale of foreign exchange.

Likewise, there are various rates for specific items (e.g. gasoline).

(d) VAT is managed by the Internal Tax Service and assessed on a monthly basis by means of a tax return. Payment of the tax is made through bank branches authorized to act as collection agents. The law authorizes the Internal Tax Service to require the filing of monthly or yearly returns, the latter being summaries of monthly returns.

A "simplified system of taxation" applies to small

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businessmen, craftsmen and small service businesses, who pay the tax on a monthly basis at a fixed rate set according to the type of activity or taxpayer, taking into account such factors as the real or estimated volume of sales or services, the turnover index, the value of facilities, and other factors which indicate the volume of business operations. Taxpayers covered by the system are entitled to tax credit, which they can use to offset an equivalent amount of tax paid when making their purchases, up to the limit of the fixed rate.

Taxpayers are required to issue sales invoices or forms which have been duly stamped or authorized by the Internal Tax Service, on which the tax is itemized separately. Nonetheless, in certain cases, the Service may exempt taxpayers from complying with this requirement.

In order to stimulate the issuance of sales invoices and proof-of-purchase forms by taxpayers, periodic drawings of said forms take place.

(e) Since 1 October 1987, construction activities are subject to VAT; however, it is possible to recover VAT paid when purchasing material movable goods or when obtaining services relating to building construction.

(d) The general tax rate is 10% of the total value of the commercial transaction. A rate of 35% is applied to the import and production of goods deemed to be luxury items, and a rate of 20% is applied to cars, camping vehicles and motorcycles, within certain horsepower limits. Services are also taxed at the general rate of 10%, with rates of 15% and 6% for insurance, and domestic telegram and telephone services, respectively.

(e) The tax is managed by the General Directorate of National Taxes, an agency of the Ministry of Finance and Public Credit. Taxpayers must submit an annual tax return; however, they must pay the tax bimonthly. A special system, known as the "simplified system", is available to small retailers who pay a fixed annual amount established as a proportion of their income during the previous year, which small retailers can offset against taxes paid when acquiring the goods they sell.

As a rule, the tax is not itemized separately in the sales invoice, unless the buyer happens to be liable for the payment of the tax and wishes to have the tax itemized separately, in order to deduct all VAT paid in acquiring goods and services for his business.

COLOMBIA

Originally established in 1963, the sales tax was, for a long time, a single-phase tax levied exclusively on imports, the production of material movable goods and the rendering of certain services. Decree 3541 of 1983, in force since 1 April 1984, extended coverage to include merchandising, adopting the form of a value added tax (VAT).

The basic features of the existing tax system are as follows:

(a) The tax is levied on all activities involving the transfer of ownership of material movable goods, their import and the rendering of specific services (social and sports clubs, car parking, photographic development and copying, repair services, international transportation of passengers by air or sea, leasing of material movable goods, computer services, hotels, telegram, telex and telephone services, insurance, and the manufacture of goods for third parties).

(b) The tax does not affect a series of animal, vegetable and mineral products (mainly those in their natural state), power and light, hand-rendered paintings and drawings, postage stamps, coins and other goods expressly identified.

(c) Some of the items exempt from this tax are: transactions involving prepared foods in general, pharmaceutical drugs for human and veterinary use, fertilizers, fungicides, insecticides, books and periodicals of a cultural or scientific nature, school notepads and many other goods, together with tire retreading services, repair services to foreign flag ships and aircraft, and export goods.

COSTA RICA

In 1975, the structure of the "sales tax" was changed to a value added tax, thereby replacing the single-phase tax in force since 1967. Within the broad framework of the Central American countries, all of which belong to the "Central American Common Market", Costa Rica levies an additional tax, known as the "selective tax on consumption", affecting a large number of products. A variable tax rate is applied, according to the product classification established by the Uniform Central American Customs Nomenclature (NAUCA).

The main features of VAT are the following:

(a) The tax affects all stages in the merchandising of goods and imports, as well as the amount charged for certain services, such as those rendered by restaurants, hotels, nightclubs, social and recreational clubs, telex and telephone services, dry cleaners and car paint and repair workshops.

(b) Among others, the following activities are exempt from VAT: the sale of goods identified as part of the "basic household grocery list", medicines, agricultural produce in general, and goods imported by the Government.

Exports are taxed at the zero rate.

(c) The single tax rate is 10%.

(d) The tax is assessed on a monthly basis by the Directorate of Direct Taxation, by means of a tax return. The banking network is used to collect the tax. A special system of payment is in effect for each factory producing cigarettes or beer. For small taxpayers

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who do not engage in industrial or commercial activities, the tax is assessed on the basis of their purchases, with no entitlement to tax credits.

Excluded from the tax are companies or individuals who sell goods or render services falling below a specific amount. The law requires separate itemization of the tax in each invoice; however, the tax administration is empowered to authorize taxpayers who sell at the retail level to include the tax in the sales price. No special treatment is given to small taxpayers.

DOMINICAN REPUBLIC

Act 74, dated 12 January 1983, established a "tax on the sale of manufactured goods" (ITBI), in force since November 1983. The tax adopted the VAT format, and its main features are the following:

(a) The tax affects individual or corporate taxpayers who sell manufactured goods (including goods that have been manufactured abroad) as part of their industrial and commercial activities, if their average gross monthly income from said activities during the fiscal year is equal to, or greater than, RD$ 5,000 (official rate of exchange: US$ 1 = 3.60 Dominican pesos).

The tax affects all sales of manufactured movable goods and services rendered by hotels, motels, telegram and telex services, cable or closed circuit television companies (Act 304, dated 29 September 1985).

(b) Exemptions apply to the sale of imported goods and food products in general, primary sector products, medicines, fuel oil and petroleum by-products, and certain raw materials used in agriculture. Also exempt from the tax are cigarettes, beer, alcoholic and carbonated beverages, which are subject to specific taxes. Exports are taxed at the zero rate.

(c) The single tax rate is 6%.

(d) The tax is managed by the General Directorate of Income Tax. The taxpayer is required to pay the tax on a monthly basis, but he must also submit an annual tax return for control purposes. There is no requirement for the tax to be itemized separately in the sales invoice, at the retail level.

ECUADOR

The "sales tax" established in 1941, adopted the VAT format in 1970, following the creation of a "tax on business transactions and services".

The main features of the tax in force include:

(a) The tax affects all stages of merchandising of the goods taxed, and is applied under 2 modes: sales among registered taxpayers, and sales to ultimate consumers. The tax affects the sale and import of goods, as well as various services (dry cleaners, repair shops, telecommunications, leasing of vehicles and machinery, ice cream parlors, storage and packing, hotels, restaurants, dance halls and game rooms, leasing of housing for recreational purposes, document copying services and computer services).

(b) Exemptions are limited to essential food products, pharmaceutical products and medicines for human consumption, machinery and equipment for agricultural production and the professional activities of craftsmen. Exports are taxed at the zero rate.

(c) The single rate for the transfer of goods and services is 10%.

(d) The tax is administered by the General Directorate of Revenue, and is assessed and paid by means of a monthly tax return. Small taxpayers pay every 6 months, since they are able to benefit from the simplified system. Under said system, they pay a fixed tax and are not entitled to a tax credit.

The General Director of Revenue may authorize the non-itemization of the tax on sales invoices or similar proof-of-purchase documents, when sales are made directly to the ultimate consumer.

GUATEMALA

The Law concerning a "value added tax on the sale of merchandise and services" (VAT) and Regulations were established in Guatemala through Decree-Law 72-83 and Governmental Agreement 571-83, respectively, both of which have been in effect since 1 August 1983. Value added tax replaced the "stamp tax on sales", a cumulative-type tax. A few amendments were made to Decree-Law 72-83 through Decree-Law 120-83, dated 1 October 1983, broadening exemptions for non-personal services and essential food items, as well as reducing the single tax rate from 10% to 7%.

On 1 October 1984, Decree-Law 97-84 and Government Agreement 907-84 were issued, containing the Law on value added tax and Regulations, and repealing Decree-Law 72-83 and amendments contained in Decree-Law 120-83, thereby bringing under a single text all provisions relating to this tax, for the purpose of making it easier to understand and implement said tax, and to cover various aspects which enabled its avoidance. At the same time, certain services were excluded from the tax and the zero rate was set for certain economic activities and merchandise included in the family breadbasket.

The main features of the tax are the following:

(a) The following activities are subject to VAT:

- all activities whose purpose is the transfer of ownership, or the sale of merchandise, regardless of the name given to the transaction, and the conditions agreed to by the parties involved;
- non-personal services rendered in Guatemala by companies owned by individuals or corporations, whether or not based in Guatemala, regardless of the domicile of the party served;

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- non-personal services derived from future contracts at the time that those services are actually rendered;
- import of merchandise into the country regardless of the country of origin; and
- the leasing of movable goods.

(b) Tax exemptions cover the import of merchandise carried out by the Government, diplomatic missions accredited before the Government of the Republic of Guatemala (on a reciprocal basis), international organizations of which Guatemala is a member, associations, foundations, aid or social service institutions, cultural, scientific, educational and other institutions, provided they are non-profit institutions and that they do not distribute earnings among their members. To obtain a tax exemption, the appropriate certificate must be obtained from the Ministry of Public Finance providing proof of tax-exempt status.

Tax exemptions also cover funeral services, services rendered by banking institutions, finance, insurance and similar institutions, general bonded warehouses, and services rendered to public or private teaching institutions, and the sale and leasing of real property.

Professionals and other businessmen are required to register under the Value Added Tax System, when their gross annual income is equal to or greater than Q. 12,000, or when they employ 3 or more persons. In the case of self-employed individuals who practice a profession, the 2 requirements must be met simultaneously in order to be required to register under this tax system (US$ 1 = 2.7 quetzales).

(c) Tax rates are 7% and 0%, respectively. The 7% rate is applied to all activities taxed in accordance with the law. The zero rate is applied to the following activities:

- the export of merchandise;
- transportation by land;
- building construction and civil engineering works, regardless of their nature; and
- import or sale of merchandise whose classification is given in special customs lists.

(d) The tax coverage period is 1 month. The tax is assessed each month upon submission of a tax return, no later than 20 days following the expiration of the tax period covered by the tax assessment. Taxpayers who do not submit their returns on time risk losing 10% and 30% of the tax credit to which they may be entitled.

Tax credits are available to taxpayers who purchase or import merchandise, lease movable goods or use non-personal services, in each tax period; credits are also given for capital goods, furniture and equipment acquired for production activities, provided taxpayers request that their names be included in the registry.

When a person who is not registered as a taxpayer charges his customers for the tax, he will have to pay a fine equal to said tax, and hand over to the Treasury the sum improperly collected. At the same time, a formal report will be submitted to the authorities, so that the penalty set forth in Art. 263 of the Penal Code may be imposed.

Taxpayers who are registered to pay this tax are required to issue sales invoices (or similar documents) approved by the General Directorate of Internal Revenue. When taxpayers sell a variety of merchandise, some of which is taxed at the 7% rate while the rest is taxed at the zero rate, first, they must itemize the price of the merchandise and then add the applicable rate of 7%; then, to this subtotal they will add the price of the merchandise taxed at the zero rate. In addition, taxpayers are required to maintain up-to-date registers: one for purchases, and one for sales.

(e) The General Directorate of Internal Revenue is the agency entrusted with managing the tax.

HAITI

A value added type tax, known as "taxe sur le chiffre d'affaires" (TCA), was introduced in Haiti with the enactment of a law dated 19 September 1982. Said law amended the law of 3 September 1971, dealing with specific taxes on consumption.

The main features of the above-mentioned tax are:

(a) The tax affects transactions involving sales and purchases habitually or occasionally made by individuals, other than transactions relating to labor (i.e. wages) or agricultural matters. Imports, services and personal consumption are also affected by this tax.

(b) Among the operations exempt from TCA are those performed by small businessmen and companies that render services, professional fees, financial services, services rendered by international maritime transport companies (under certain conditions), and the sale and import of food products in general, medicines, fuel oil, books and publications in general, as well as services rendered by insurance companies, schools and non-profit welfare institutions. Exports are also exempt from TCA. The right to deduct tax credits does not extend to investments.

(c) The tax rate is 10%.

(d) The tax is managed by the General Tax Administration and the Tax Inspection Directorate of the Department of Finance and Economic Affairs. The taxpayer must submit tax returns and pay the tax every month.

HONDURAS

The "sales tax" was introduced in 1964, as a single-phase tax. The tax was later restructured so that it became a value added tax, in effect since 1 January 1976. VAT is completed by an extended system of selective taxes on consumption.

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The main features of the tax currently in force are:

(a) The tax affects the transfer of merchandise at all stages of merchandising, imported goods in general, and services rendered by, among others, restaurants, advertising agencies, hotel laundry services, telegram and telephone service, nightclubs, and the leasing of movable goods. Hotel and guest house accommodation is subject to this tax.

(b) Exempt from the tax are transactions involving essential goods, those relating to agricultural machinery and equipment, goods imported by the State and by churches, and export goods. Exemptions also cover transactions involving insecticides, herbicides, pesticides, fungicides, fertilizers, concentrates for animal use, and pharmaceutical products for veterinary use. Businessmen and service-oriented businesses whose operations total less than 12,000 lempiras a year (approximately US$ 5,500) are also exempt.

(c) The basic tax rate is 5%. In addition, a special 10% rate is applied to the sale of beer, cigarettes and alcoholic beverages in general.

(d) The tax is managed by the General Directorate of Taxation (DGT) and is assessed and paid on a monthly basis by means of a tax return. Small taxpayers submit their tax return and pay the tax on an annual basis.

With regard to sales amounting to less than 0.20 lempiras, it is understood that the tax is included in the sales price. The DGT may authorize retailers to itemize the tax separately on the invoice. No special treatment is given to small taxpayers.

MEXICO

A value added tax has been in force since 1 January 1980, following the enactment of a law (Fiscal Miscelanea for 1979), dated 22 December 1978. This tax replaced the old, cumulative-type tax levied on business income, and some 29 other federal taxes.

The most significant features of the VAT are:

(a) The tax affects the sale of goods, the rendering of services, the temporal use or enjoyment of goods and the import of goods and services, without requiring that the person engaging in the activity be a businessman or that he habitually engage in the above activities (these were requirements when the old tax was in effect). VAT affects services in a broad manner, including professional services (except veterinary, and medical services), transportation of persons and goods, technical assistance and the transfer of technology, financial leasing, and in general, any obligation.

(b) Exemptions are limited, comprising mainly the sale of buildings when they are intended for use as housing, books and magazines, used movable goods, except those sold by companies and partnerships; teaching services in general, public transportation by land (except railways), life insurance, services rendered to members of labor unions, political parties and professional and employers' associations, public entertainment, not including that which has been provided by restaurants and nightclubs and professional medical services furnished by individuals, or through professional partnerships.

(c) The general tax rate is 15%. In addition, there are 3 special rates. A 6% rate is applied to the sale and import of certain goods. This same rate is also applied to sales and import of goods carried out in "border areas or zones", notwithstanding the fact that there are various operations and imported goods in said "zones" which are taxed at the 15% and 20% rates.

Likewise, a special 20% rate is imposed on the sale and import of certain items of selective consumption, such as caviar, membership dues in exclusive clubs, the temporary use or enjoyment of film or video recorder equipment for use in private viewings, etc. Lastly, there is a zero rate, applicable to the majority of essential food products, primarily those which have not been produced industrially, together with the sale of agricultural machinery and equipment, services rendered in connection with agriculture and cattle raising, the temporary use or enjoyment of agricultural machinery and the export of goods and services.

(d) The tax is paid by means of provisional monthly installments and an annual return must be submitted for adjustment purposes. Regarding imports, provisional payment is made jointly with the general import tax. With regard to services rendered or the occasional sale of goods, the tax is paid by means of a tax return submitted within 15 days, immediately following the date on which the goods or services are received, without entitlement to credit for the tax paid.

Small taxpayers, who are deemed to be those persons so categorized by the Income Tax Act, pay the tax according to an estimate made by the tax authorities, crediting the percentage fixed by the Secretariat of Finance and Public Credit, by means of a general resolution. The tax is paid in bimonthly installments, in addition to which an annual tax return is required.

Since 1 January 1985, it is no longer a requirement to itemize the tax separately in the invoice, when referring to operations involving the ultimate consumer. However, taxpayers may request separate itemization of the amount paid for the goods they purchased and the amount of VAT paid in any sales invoice.

The 31 states and the Federal District, which make up the Federation (i.e. the United States of Mexico), are in charge of managing this tax, in accordance with the Law on Fiscal Coordination. Said law establishes a national system of fiscal coordination through "administrative collaboration" agreements, which specify the powers conferred on the states, while the Secretariat of Finance and Public Credit is solely empowered to interpret the law and, consequently, to issue instructions, circulars and resolutions of a general nature. Upon joining the system, the federative entities participate in the revenue generated by VAT and by other federal taxes which make up the general fund of tax revenue, except for additional taxes generated by

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imports and exports, which are reserved for municipalities.

NICARAGUA

The general system of sales taxation was initially established through a Legislative Decree, dated 18 January 1958, separating said tax from the general law on stamp taxes. Originally, the tax was a single-phase tax, but in 1978 it was given a VAT format. At the present time, the tax is known as a "general tax on value", a value added type tax, structured according to Decree 1531, dated 21 December 1984, and in effect since 1 April 1985. In addition to this tax, a tax on selective consumption is levied on the production and import of a wide range of goods.

The most important features of the new tax are:

(a) The tax affects all stages of merchandising, the sale and importation of merchandise, the sale of real property, as well as a number of services, such as the retreading of tires, mechanized laundries, dry cleaners, automobile insurance, professional public entertainment, film rental, advertising, air fares for foreign travel, hotels, restaurants, bars, nightclubs, car rentals and the right to use or enjoy goods. Services provided by counselors, accountants, auditors and planners in the technical, economic and scientific fields are also taxed.

(b) Among tax exemptions granted are the sale of essential items, fuel oil and petroleum byproducts, books, and items with specific taxes already included in the sales price. Exports are taxed at the zero rate, and exporters can acquire raw materials free of VAT according to specific lists authorized by the DGI.

(c) The general rate of taxation is 10%, with differential rates of 15% (for services), 6% (for real property) and 25% (for airline tickets for travel abroad, quoted in local currency).

(d) The tax is managed by the General Directorate of Revenue (DGI) and is assessed and paid by means of a monthly tax return. An annual tax return is required for adjustment purposes. Individual taxpayers whose annual sales of goods and services fall below a specific amount, periodically set by the Ministry of Finance, may be subject to one of several special tax systems, should the Ministry so resolve. Under these systems, some taxpayers pay a fixed monthly sum, while others are authorized to include VAT in the price of the product, and still others who are not subject to VAT at all.

PANAMA

This country did not levy a general sales tax until 1 March 1977. Thereafter, a law dated 22 December 1976 established a "tax on the transfer of material movable goods with tax credit". This tax was structured along the lines of a value added tax. The tax is complemented by an extended system of stamp taxes and taxes on the consumption of specific goods.

The most important features of the tax are:

(a) The tax affects all levels of merchandising, essentially taxing the sale of movable goods during the course of commercial and industrial activities, importation of goods (whether done habitually or occasionally), and the leasing of movable goods. It also applies to non-labor services, meaning activities involving the transformation of raw materials and entailing the use of personnel for which an industrial license is required.

(b) Exemptions apply mainly to the transfer of essential items, fuel oil, and commodities. Small businesses are exempt from paying VAT. Sales carried out by the Government are exempt from VAT, but not the direct import of goods made by public institutions and Government departments. Exports are taxed at the zero rate, and exporters may request "Cancellation Certificates" for the VAT included in their purchases.

(c) There is a single tax rate of 5%.

(d) The tax is assessed by means of a monthly tax return and paid at the offices of the General Directorate of Revenue. Small taxpayers must submit their tax returns and pay the tax on a quarterly basis.

PERU

The tax was established in 1972; a VAT format was adopted through Decree-Law 21,070, in effect since 1 May 1975. Originally applied at the wholesale level, the tax was broadened to cover retail sales through Legislative Decree 190, dated 12 June 1981, which gave it the name "General Sales". Legislative Decree 190 also created a "selective tax on consumption" and a "special tax". The selective tax imposes differential rates of taxation on the sale of certain goods by importers and producers, as well as certain services, such as revenue from bank commissions and interests, insurance premiums, sale of airline tickets to passengers travelling abroad, telegram and telephone service, and leasing of real property. The special tax affects exports of traditional goods, with differential rates of 2% and 3%. Originally, the sales tax replaced the stamp tax and other taxes applied on the production of goods and services.

The main features of VAT are:

(a) The tax affects all stages of merchandising, including the sale of movable goods, imports, personal consumption and the rendering of various services, such as bonded warehouses, computers, advertising, cleaning and fumigation services for buildings, radio and television broadcasts, repair shops, laundries, beauty parlors, barber shops, interior decoration, photocopies, photo studios, leasing of movable goods, and so-called "manufacturing services".

(b) Tax exemptions cover the domestic sale or import of essential goods in general, mineral products, aviation fuel and partially refined petroleum, construction

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machinery, books, notebooks and similar items, agricultural machinery, the sale of used items, and the import of goods for personal use (under certain conditions), the import of goods intended for use by government institutions, or donated by foreign nationals to public or private non-profit institutions operating in Peru.

Exports are zero rated.

(c) Currently, the single rate of VAT (IGV) is 8.5%[1]; 1.5% local sales tax[2] for Municipal Promotion is also imposed in addition to VAT but it is not creditable against VAT.

(d) The tax is managed by the General Directorate of Taxation, and is assessed and paid on a monthly basis. Taxpayers are required to submit an annual tax return. Taxpayers subject to this tax, whose total sales during the previous year do not exceed 200 Tax Units, may benefit from the "simplified system", by paying 1% of the tax base, as determined by the general tax rules. Importers and business companies with economic ties to other manufacturers or businesses may not benefit from the "simplified system". Credits for purchases of durable goods can be deducted in 2 annual installments.

URUGUAY

The general sales tax system originated in 1941, and later evolved from single-phase and cumulative tax systems (at times operating simultaneously) into the current value added tax, in effect since 1 January 1973. This tax eventually absorbed the old stamp tax applied to documents relating to commercial operations. Together with VAT, there remains in effect a tax system affecting specific goods, known as the "specific internal tax" (IMESI), together with a "tax on the transfer of agricultural and livestock products" and the "tax on the sale of foreign exchange".

The most significant features of VAT are:

(a) The tax has a broad base, covering the circulation of goods acquired by purchase at all stages of merchandising regardless of the name given to the transaction, and including agricultural and livestock activities developed by taxpayers subject to the "tax on agricultural income". However, it should be pointed out, that in the sale of natural agricultural and livestock products, the tax is held in abeyance at all stages of merchandising until the product is processed. The tax also affects the habitual and occasional import of goods, professional services except those relating to human health and other services in general, the latter being all those rendered in exchange for valuable consideration, which, although they do not involve the change of ownership, provide the other party with an advantage or benefit (this includes leasing of goods and services involving civil works without delivery of materials, concessions for the use of non-material goods, insurance and re-insurance, transportation, loans and financing and middleman activities in general). Bank interests on personal loans are also included.

(b) Exemptions are limited to the sale and import (where applicable), of fruit and vegetables, foreign exchange and precious metals, public and private stocks and bonds, real property, agricultural machinery, tobacco and cigarettes, fuel oil, milk, goods to be used in agricultural production, water and electricity supply, lambsmeat and fish, when authorized by the Executive Branch, as well as interests on public and private stocks and bonds, bank deposits, transportation of passengers, leasing real property, bank operations in general, personal retributions obtained outside employment (relating to human health), and oil imports.

Exports are taxed at the zero rate, and if there is a credit balance in favor of taxpayers, it will be returned or credited to the balance of other taxes due. Exemptions also apply to the sale of newspapers, magazines and books. The tax paid in purchasing imported materials to be used in the printing of the above items will be reimbursed.

(c) The basic tax rate is 21%, with a minimum rate of 12% applied to the sale of items of popular consumption, imported medicines and fertilizers.

(d) Taxpayers are obligated to pay monthly installments in advance and on account, without submitting a monthly tax return. These returns are to be submitted every 3 to 6 months (depending on the category and location of the taxpayer) wherein the tax due for the entire year must be declared.

Taxes paid on account, from the start of the fiscal period up to the previous month, are to be deducted from the tax accrued at the end of each month, so that the net balance goes either to the Treasury or to the taxpayer each month. The tax must be itemized separately in each invoice. However, this requirement may be omitted in cases involving retail operations unless the buyer wishes to have the tax itemized separately.

1. See Legislative Decree 465 of 8 March 1988, effective 12 March 1988.
2. See the 1988 Finance Law 24,750 of 3 December 1987, retained by Legislative Decree 465.

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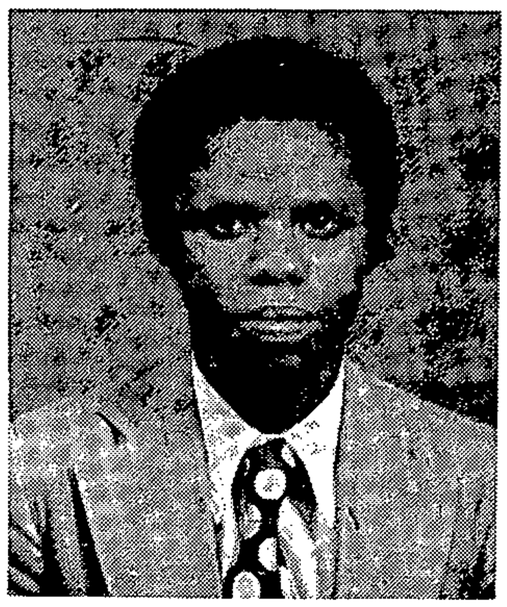

NIGERIA:

Recent Amendments to Tax Laws

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I. INTRODUCTION

Prior to the 1986 introduction of the Structural Adjustment Programme (SAP) by Nigeria's Federal Government, Nigeria "was on the edge of a socio-economic precipice".[1] The pre-SAP era was, inter alia, characterized by structural economic imbalance and a decline of investment in both the private and public sectors.[2]

SAP is the most comprehensive and rational macro-economic policy reform measure embarked upon by any administration in the country. Since its inception, material progress has been made to steer the economy to economic recovery, self-reliance and growth. However, certain problems remain unsolved, including unemployment, the reduced real income of workers, low aggregate demand and non-liquidity. These issues, therefore, comprise the primary policy elements of the 1988 reflationary federal Budget. For instance, the Budget advocates:

(1) the need to augment SAP in order to promote output, enhance capacity utilization, mitigate unemployment and improve the general standard of living; and
(2) a determined multi-pronged attack on the unemployment problem.

Various fiscal measures, such as the new tariff structure, the tax policy reassessment and amendments, and monetary and credit policies, have been introduced in the 1988 fiscal Budget. This article highlights the tax policy reassessments and recent amendments to the tax laws as contained in the Budget.[3]

II. MAIN AREAS OF TAX POLICY REVIEW AND TAX INCENTIVES

Some of the new tax policies which aim to stimulate investment and economic growth are found in the following areas: personal and corporate income tax rates and incentives, withholding tax on investment income, small business relief, additional capital allowances, tax exemptions for dividends and tax relief on mortgages for owner-occupier dwellings.

A. Lower personal and corporate tax rates and incentives

1. Personal income tax

One of the main thrusts of the 1988 reflationary Budget is to foster an improvement in the general standard of living. In order to effectuate this policy, the lower personal (and corporate) income tax rates which were introduced in 1987 have been retained. The generous personal income tax reliefs introduced in 1987 have also been retained. The former and current reliefs affected are shown in Table I.

Table I

	Relief up to Dec. 1986	Relief effective from Jan. 1987
Personal allowance	₦1,200 plus 12½% of earned income in excess of ₦6,000	₦1,000 plus 12½% of earned income
Wife allowance	₦300	₦500
Children allowance	₦250 per child up to a maximum of 4 children	₦400 per child up to a maximum of 4 children
Dependent allowance	₦400	₦600

The conditions under which these allowances may be claimed remain unchanged. In addition, the rates of personal income taxes have been amended as an additional incentive as follows:

Table II

Income to be taxed	Rate of tax	
	Up to Dec. 1986	Effective from Jan. 1987
For every naira of the first ₦ 2,000	10k per ₦ = 10%	10k per ₦ = 10%
For every naira of the next ₦ 2,000	15k per ₦ = 15%	15k per ₦ = 15%
For every naira of the next ₦ 2,000	20k per ₦ = 20%	20k per ₦ = 20%
For every naira of the next ₦ 2,000	25k per ₦ = 25%	25k per ₦ = 25%
For every naira of the next ₦ 2,000	30k per ₦ = 30%	30k per ₦ = 30%
For every naira of the next ₦ 5,000	40k per ₦ = 40%	35k per ₦ = 35%
For every naira of the next ₦ 5,000	45k per ₦ = 45%	40k per ₦ = 40%
For every naira of the next ₦10,000	55k per ₦ = 55%	45k per ₦ = 45%
For every naira of the next ₦10,000	Nil	50k per ₦ = 50%
For every naira of the next ₦30,000	70k per ₦ = 70%	—
For every naira of the next ₦40,000	—	55k per ₦ = 55%

1. Chu, P.S. Okongwu, Nigeria's Minister of Finance and Economic Development, "Statement on Nigeria's 1988 Fiscal Budget".
2. Ibid.
3. Although this article primarily emphasizes the changes implemented by the 1988 Budget, some of the amendments discussed are those from 1987 which remain unchanged.

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To stimulate research and development (with effect from 1987), a deduction equal to the total amount of the equity shareholding held by a taxpayer, or 25% of his "total income" in an assessment year, whichever is less, may be claimed by an individual taxpayer who holds equity shares in a research and development company incorporated in Nigeria.[4] The total cost of the equity shareholding may be relieved.[5]

The gratuities[6] exemption, which took effect as from 1 January 1986, for gratuities paid in the private sector, remains unchanged in 1988. By virtue of this exemption, a gratuity paid to any employee in the private sector is exempt from tax subject to a maximum amount of ₦50,000. Any amount in excess of this maximum is taxable income.

2. Companies income tax

With effect from 1987, the rate of company tax is reduced from 45% to 40% of total profits as adjusted for tax purposes, i.e. after deducting losses and capital allowances. This rate is continued in 1988.[7]

B. Withholding taxes

1. Investment income

Since 1985[8], a withholding tax of 15% of the gross amount is imposed on dividends, interest, royalties and rents paid or credited to any person by a recognized payer[9], or whenever such payment becomes due from one company to another or to any person to whom the provisions of the Income Tax Act 1972 (Armed Forces and Other Persons) (Special Provisions) apply. The tax is deducted at source and paid to the tax authorities. With effect from the 1988 year of assessment, this investment income (dividends, interest, royalties and rents) is specifically exempt from further taxation once the 15% withholding tax is deducted, i.e. the income will no longer be taxed over and above the 15% withholding tax.[10] The income will, however, be aggregated with the recipient's income from other sources in order to compute the appropriate rate of tax applicable to the recipient. The rationale behind this new policy is to reduce the tax on such income and encourage further investment. The policy of aggregating income before arriving at the appropriate tax rate probably will not affect the tax payable by companies since the present rate of company tax is 40%.

The investment income policy makes it compulsory for any organization, corporation or sole proprietor (irrespective of whether the entity is tax-exempt) which carries on investment activities through investments to pay the withholding tax. However, the principle of taxing income brought into Nigeria has been relaxed for such investment income. Henceforth, dividends, interest, royalties and rents derived from sources outside Nigeria will no longer attract Nigerian tax provided such income is brought into Nigeria through government-approved channels.

Effective as from 1988, tax exemption clauses may no longer be contained in any agreement with a government agency without prior approval from the government.[11]

2. As a method of collecting tax

With effect from 1 January 1987[12], and continuing into 1988, taxes at the rates specified below are deductible at source from gross payments made to individuals, partnerships, trustees, executors, families, and bodies of individuals in respect of the following sources of income:[13]

4. In order to qualify for the relief, the research and development company must fulfil the following conditions:
(a) the company must be a Nigerian company, incorporated in Nigeria on or after 1 January 1987;
(b) the primary objective of the company must be for the purpose of carrying on research and development activities; and
(c) the research and development project must commence within 2 months of incorporation.

5. If any part of the amount of the shareholding is not relieved in an assessment year because of the 25% restriction, it may be carried forward to the next assessment year until the total participation is relieved.

6. The term gratuities refers to the amount paid or credited to an employee for past services rendered in Nigeria for a period of not less than 10 years.

7. In view of the fact that the 1988 Budget is reflationary, it was felt that the rate should have been lower than 40% for 1988 so as to facilitate economic recovery and growth for companies which sustained heavy losses during the last few years.

8. See Finance (Miscellaneous Taxation Provisions) Decree No. 4, 1985.

9. A recognized payer or company includes any company (whether or not incorporated), government ministries and departments, statutory bodies, institutions and other established organizations approved to operate the pay as you earn (PAYE) system.

10. Previously, the 15% withholding tax on investment income was not regarded as a final tax, i.e. it constituted an interim deduction in lieu of tax on income from the investment. When determining the final assessment of tax, the interim deduction withheld at source would be set off against tax charged (at the appropriate rate of tax) by an assessment of total income for the relevant year. Under the 1988 Budget, the 15% becomes a final tax since such investment income is specifically exempt from further taxation once the 15% withholding tax is deducted.

11. A proposal for a tax exemption clause must first be cleared with the Federal Ministry of Finance and Economic Development.

12. These changes were introduced by directives, pursuant to provisions of Sec. 59C of Companies Income Tax Act 1979 (CITA), as amended by Sec. 33 of Finance (MTP) Decree 1985 and the new Sec. 21EE(1)-(7) of the Income Tax Management Act 1961 (ITMA), as amended.

13. These rates are without prejudice to the rates which, since 1985, any person or organization must deduct from gross payments made to companies, i.e.:

Payment in respect of:	*Rates of tax on gross payments*
(a) all aspects of building, construction, civil works and related activities	2½%
(b) all types of contract activities or agency arrangements other than an outright sale and purchase of goods and property in the ordinary course of business	2½%
(c) consultancy and professional services	10%
(d) management services	10%
(e) technical services	10%
(f) commissions	10%

With effect from 1985, these rates were applicable to individuals and companies. However, as from 1 January 1987, the rates mentioned in the text became applicable to individuals and bodies of individuals. The 1985 rates, as set forth in this footnote, were retained and apply to companies. See Official Gazette No. 34, Vol. 72 of 27 June 1985, Government Notice No. 450. See also, Finance (Miscellaneous Taxation Provisions) Decree 1985.

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Payments in respect of	*Rates of tax on gross payments*
(a) all aspects of building, construction, civil works and related activities	2½%
(b) all types of contract activities or agency arrangements other than an outright sale and purchase of goods and property in the ordinary course of business	2½%
(c) consultancy and professional services	5 %
(d) management services	5 %
(e) technical services	5 %
(f) commissions	5 %

These deductions are not to be regarded as additional costs of contracts or services rendered, i.e. they should not be built into the cost of the contract or services. Rather, the costs are considered as an advance payment of tax on income or profits derived from such activities. When determining the final amount of tax, the advance tax deducted at source shall be set off against the tax due for the relevant year.

C. Small business relief

Among the problems facing Nigeria (both before and during SAP) are widespread reduction in both the private and public sector, reduced production capacity and the liquidation of many businesses, in particular, small and medium-size companies. Since the policy underlying the 1988 Budget is to stimulate investment and economic growth (and the government realizes that "small and medium scale activities provide potent policy instruments for growth")[14], fiscal policies to encourage small business have also been introduced. Until recently, "the absence of a viable small and medium-scale activities subsector in our economy" has represented "a patent lacuna in public policy over the past quarter of a century".[15]

To redress this situation, a preferential lower tax rate has been introduced in 1988 to boost activities in the small business subsector. With effect from 1 January 1988, new small and medium-size companies, having a turnover of ₦500,000 or less in the year of assessment, and which are engaged either in manufacturing, agricultural production or the mining of solid minerals, shall be subject to a lower rate of company tax (20%) for 3 years from the date business activities are commenced.

A similar concession is also granted to existing companies meeting the above qualifications. No doubt this incentive will stimulate investment and growth in the affected subsector and generate employment. The incentive may also motivate self-employed individuals engaged in these lines of activities to incorporate their businesses.

D. Additional capital allowance

Nigerian tax laws, i.e. the Income Tax Management Act 1961 and the Companies Income Tax Act 1979, expressly disallow depreciation charges as expenses against taxable profits. In place of depreciation, the legislation grants a series of capital allowances.[16]

Capital allowances are composed of initial allowances, annual allowances, balancing allowances (or charges)[17] and investment allowances.[18] Initial allowances are granted in respect of all qualifying capital expenditures incurred in the year of acquisition. The allowance is available if the asset was in use on the last day of the basis period of the relevant year of assessment and is granted on a one-time basis irrespective of the length of the basis period or the period of ownership.[19]

Annual allowances are available whether or not an initial allowance has been granted in respect of a qualifying asset. Annual allowances are granted for assets used for purposes of a trade, business, profession or vocation so long as the assets are in use at the end of the basis period. Up to and including the 1984 year of assessment, annual allowances were computed on the written-down value of the fixed assets at the end of the base period for each year of assessment (i.e. declining balance depreciation). However, with effect from 1 January 1985[20], annual allowances are computed under a straight-line method. The rates of capital allowances as of 1985 were as follows:[21]

Qualifying expenditure in respect of:	*Initial allowance rate %*	*Annual allowance %*
Buildings	5	10
Industrial buildings	15	10
Mining	20	10
Plant	20	10
Motor vehicles	25	20
Plantation equipment	20	33⅓
Housing estate	20	10
Ranching and plantation	25	15

14. Okongwu, op. cit.
15. Ibid.
16. These allowances are provided for under the fifth schedule and the second schedule of the ITMA and the CITA, respectively.
17. If a company disposes of an asset on which an initial or annual allowance has been granted, a balancing allowance is deductible. This allowance is equal to the excess of the tax written-down value of the asset over the amount realized upon disposal of the asset. See *African Tax Systems,* Chapter Nigeria, Sec. 2.5.6., International Bureau of Fiscal Documentation, 1987.
18. Individuals and companies engaging in agricultural production which incur qualifying expenditures on new plants and equipment are granted, in addition to the capital allowances, an investment allowance of 10% of the expenditure incurred to acquire the asset. This is a one-time allowance. See Finance (Miscellaneous Taxation Provisions (Decree No. 4, 1985, Sec. 26(1)(c). See also CITA Sec. 27 (2A).
19. The basis period normally refers to the 12-month period ending in the previous fiscal year. See *African Tax Systems,* Chapter Nigeria, International Bureau of Fiscal Documentation (1987).
20. Finance (Miscellaneous Taxation Provisions) Decree No. 4, 1985, Sec. 36. See also, A.C. Ezejelue, "Nigeria: Crucial Amendments to Income Tax Laws", 39 *Bulletin for International Fiscal Documentation* 12 (1985) at 533.
21. Ibid.

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With effect from 1 January 1987, the classification for plant expenditure was modified by separating it into 2 categories, i.e.

(i) plant and machinery – comprising manufacturing plants, industrial machinery and plants, including equipment normally used in factories and factory warehouses; and
(ii) furniture and fittings – consisting of furniture and fittings normally used in offices, including air conditioning units, office furniture, cupboards, fans, typewriters, calculators, computers, etc.

The capital allowance rates, which also took effect as of 1 January 1987, for the modified classification are as follows:

	Initial	*Annual*
Plant and machinery	20%	10%
Furniture and fittings	15%	10%

In view of the government's desire to encourage industries in certain preferred sectors, the 1988 Budget introduced an additional 5% initial capital allowance to be available in respect of new qualifying expenditure on plants and machinery used in manufacturing, construction and agricultural production, including qualified ranching and plantation expenditures.[22]

E. Tax exemption for dividends

A tax exemption for dividends was introduced with effect from 1 January 1987 to encourage foreign currency equity participation in Nigerian companies.[23] The exemption and the prerequisites for the exemption are to continue in 1988.[24]

An individual or company, whether resident or non-resident, which derives dividends from any company in Nigeria, will be exempt from tax for a period of 3 years in respect of such dividends if:

(1) the company paying the dividends is incorporated in Nigeria;
(2) the shareholder's equity participation in the company is imported into Nigeria (either in foreign currency or by way of assets brought into Nigeria for the company's use) between 31 January 1987 and 31 December 1992; and
(3) the shareholder's equity share of the company is not less than 10% of the share capital of the Nigerian company.

If the company is engaged in agricultural production in Nigeria or in the production of petro-chemicals or liquified natural gas, the tax-free period is 5 years.[25] The exemption is granted in the year of assessment following the accounting year in which the capital is brought into Nigeria, so long as the Federal Board of Inland Revenue is satisfied that the company or importer of the capital obtained an "approved status".[26]

A further relief, also introduced in 1987 and which continues into 1988, concerns donations made to approved and recognized research institutions and centres for specific research and development projects. These donations may now be claimed as relief against income but subject to a maximum of 10% of chargeable income.[27]

F. Tax relief for owner-occupier buildings

In order to encourage house ownership, the 1988 fiscal Budget introduced a tax relief for owner-occupier dwellings. The tax relief is granted by way of a tax rebate on interest paid on mortgages used to finance such dwellings. The interest paid in the immediate preceding year is deductible and only one mortgage at a time per individual is eligible for the relief.

Although this incentive aims to make more funds available in order to increase the number of owner-occupier dwellings, it is only an amendment to a similar incentive provided for in Sec. 17(1)(aa) of the ITMA 1961. This subsection provides that interest on loans for developing an owner-occupier dwelling, where the value of the property does not exceed ₦100,000, is tax-deductible. The 1988 Budget therefore simply removes the ceiling of ₦100,000. Until the Enabling Decree is promulgated, it is not clear what the upper limit (if any) will be. However, if an upper limit is imposed, the limit will be much higher than the former ceiling in view of the inflation in the prices of building materials.

III. CONCLUSION

Although the 1988 Budget tax policy reassessment and amendments covers but few topics, it will nevertheless have far-reaching effects. The measures boldly strive to stimulate investment and achieve reasonable economic growth which have, to date, been in a depressed and imbalanced state. It is hoped that if the new policies are rigorously applied and implemented (along with the other fiscal, monetary and credit measures in the 1988 Budget), the anticipated objectives of economic growth, generation of employment and improvement of the general standard of living may be achieved.

22. A similar incentive is extended to companies or businesses operating a public transportation system with a fleet of not less than 3 buses.
23. See generally, J.M. Elegido, "Taxation of Dividends", 41 *Bulletin for International Fiscal Documentation* 6 (1987) at 271.
24. See "Notes for guidance on income tax, in particular the Finance (Miscellaneous Taxation Provisions) Decree 1987", Federal Inland Revenue Dept., Lagos at 6.
25. In all other cases, the tax-free period is 3 years.
26. An "approved status" certificate is to be obtained from the Central Bank or the Federal Ministry of Finance and it must accompany all claims for exemption in this respect.
27. See footnote 20.

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INTERNATIONAL:

Problems and Paradoxes – The Elusive Tax Incentive

An Article Inspired by the First South Asia Regional IFA Conference, New Delhi

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INTRODUCTION

The first South Asia Regional Conference was held in New Delhi on 18-20 February 1988. The conference was attended by some 200 participants, including many IFA officials and delegates from as far afield as Japan, Hong Kong and the United States. Most of the delegates, however, came from the Indian sub-continent. The conference included 3 working sessions, each dealing with a different aspect of the taxation of foreign enterprises investing in a host country.[1] It was clear that the topic of the greatest interest to participants from South Asia was that of incentives. This article examines the problems which tax incentives pose for developing countries in particular and the steps which can be taken to minimize those problems. In doing so it will try to bring together the points discussed during the conference in connection with incentives. It will not be a systematic report of the conference proceedings, but will draw on other sources of information as well. The definition of a developing country is no easy matter, but it is sufficient for the purposes of this article that all the participants from South Asia acknowledged that theirs were developing countries.

The principal concern of the delegates was the effectiveness of the incentives offered by their countries. Many of these incentives were described in the national reports presented to the conference.[2] Most of them are in the form of exemptions from tax, partial reductions of tax or generous deductions from the taxable base. The aim of most of these incentives is to attract foreign investment or to encourage various types of business. Many of them require enterprises to satisfy a number of conditions in order to qualify. There is often an approval or screening procedure involved and in some cases the incentive is discretionary.[3] The questions which concerned the conference delegates were whether these incentives attract the desired foreign investment and technology? Should other types of tax reduction be offered? Or is there a better, different way to achieve that end?

THEORIES

The most important arguments for and against tax incentives were described by Mr. Gaston Perara in a paper submitted to the conference.[4] The arguments for incentives can be summarized under 2 general headings:

(a) tax incentives encourage investment which engenders a range of beneficial consequences; and
(b) tax incentives are convenient and easy to apply.

1. The titles of the working sessions were: "Direct taxes structure with reference to provisions relating to foreign entities doing business in/with the host country"; "Situation vis-à-vis double taxation treaties"; and "Tax incentives cum high taxes vs. no incentives cum low taxes".
2. Reports were presented on Bangladesh, Bhutan, India, Pakistan and Sri Lanka.
3. For details of the incentives available in these countries, see *Taxes and Investment in Asia and the Pacific.*
4. Perara, Gaston, Commissioner of Inland Revenue, Sri Lanka, "Tax incentives vs. low taxes".

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As Mr. Perara showed in his paper, not only is neither of these arguments convincing but there are also plenty of other arguments against tax incentives.

The first argument in favour of incentives is that a low tax bill attracts enterprises to invest in countries where they would not have invested had there been a higher tax bill. The attraction of incentives is that they increase the rate of return on an investment, reduce the risk involved and release funds for reinvestment. The argument maintains that no tax is lost, because without the incentive there would have been no investment and no taxable income. Even if the income from the investment is entirely exempt from tax, the investment will still produce tax revenue from employment income, sales, etc. Incentives are also said to be necessary in order to present the image internationally of a country which welcomes foreign capital, and to stop investment from being drawn to other countries on account of their incentives.

This first argument assumes that taxation is one of the most important factors considered by enterprises when deciding where to invest. That assumption is now generally accepted to be incorrect, and it was accepted as incorrect at the Delhi conference. Taxation is one of the factors taken into account, but it is rarely true that an investment decision turns on the size of the tax bill. Unfortunately very few studies have been done on this question, but all those that have been done point to the assumption being false. Other factors, such as a stable economy, adequate infrastructure and a skilled work force, are equally, if not more, important than taxation. If those ingredients are present in a country, investment in that country is already an attractive proposition.[5]

The second argument for tax incentives builds on the first one and therefore fails if the first argument fails. Nevertheless there are valuable lessons to be learnt from examining it. Assuming that incentives encourage investment, they are said to be the most convenient way of doing so. Whereas grants and cheap loans require substantial administrative machinery, often involving yards of red tape, tax incentives are said to be virtually self-administering. This argument has been refuted many times, although it is interesting that the participants at the fifth CATA Technical Conference preferred incentives to grants for developing countries for that very reason.[6] The reason that grants must be backed up by administrative machinery is to ensure that they are policed properly, that is to say that the right people receive them and the wrong people do not. Tax incentives need policing for the same reasons and to the same extent. Many incentives are offered on conditions just as complicated or discretionary as those attaching to grants, and there is no reason that one should be inherently simpler than the other.

Another aspect of the second argument for tax incentives is their political convenience. Whether or not this is truly an advantage depends heavily on one's view of the political and legislative processes. Incentives are not as conspicuous as grants and do not appear in government accounts and budget statements. The government need not be seen to be handing out large sums of money to people who are very often among the wealthiest in the country. Herein lies the danger that tax incentives are used for purely political purposes. Because of their invisibility, incentives are not reviewed as frequently as they should be and eventually they become embedded in the tax system. After a long enough period of time they come to be regarded as a right and are even more difficult to dislodge.

The arguments against incentives do not stop at this point. There are a number of ways in which incentives can be exposed as undesirable or even damaging. Incentives offend the principle that tax should be levied equitably. In a system with tax incentives, similar groups of taxpayers are treated differently. As a line must be drawn somewhere between those who receive incentives and those who do not, and as that line is often rather a fine one, disparities appear in the tax system which are difficult to justify. The disparities increase as those who do not receive the incentive are required to pay more tax to make up the revenue lost. Matters only become worse when it appears that the people who can take advantage of incentives are often those with the greatest ability to pay, such as entrepreneurs or individuals with money to invest.

Incentives also contain in-built inequities. An enterprise suffering losses, for example, can derive no benefit from a tax exemption, although it may need benefits much more than an enterprise raking in profits. Under a system with progressive rates, deductions are much more valuable to persons with a high income than to those with a low income.

Even if an incentive manages to escape offending the principles of equity, it may very well defeat its own purpose by ending up in the wrong hands. Incentives intended to promote owner-occupied housing may principally benefit the construction industry by pushing up housing prices. Another well-known example is the problem that tax exemptions or reductions for foreign investors often benefit only the foreign investor's home country, as the tax reduction is eaten up by a corresponding reduction in the tax credit. Of course tax-sparing clauses in double taxation treaties provide a solution, but it is at best a partial solution. A tax sparing credit must be negotiated as part of a treaty, which is time-consuming and not always possible. The United States, for example, will not give tax sparing credits and it was stated during the conference that the negotiation of a new treaty with India has been held up for several years as a consequence. The authors of the general report for the 1961 IFA conference thought it very unlikely that a tax sparing credit would become part of the normal rules for unilateral credit relief and the reasons given for that statement remain to a large extent valid today.[7]

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5. See also, for example, the Report of the Fifth Technical Conference of the Commonwealth Association of Tax Administrators held on 6-12 September 1984 in Apia, Western Samoa (CATA Report) at 40.
6. CATA Report at 26.
7. The general reporter argued that the general adoption of unilateral tax sparing relief would not be accepted by developed countries for several

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Incentives can have harmful side effects which outweigh any benefit derived. The classic example is an incentive deduction for heavy machinery designed to promote industry in a country with high unemployment; the result may well be an increase in investment in machinery at the cost of employment. Even if the real result of an incentive is not so startlingly contrary to its aim, there are often many undesirable and unexpected side effects.

Finally, the economy of a country offering incentives rarely benefits as a whole from the incentives. Either the incentives attract the "wrong" type of investor, or the investments which are attracted have little effect on the economy as a whole. The wrong type of investor is one who invests in a country for as long as the incentives are available and who retreats immediately afterwards, leaving behind him nothing of enduring value to the host country. In the second case, investments of lasting benefit are attracted, but they are concentrated in some small sector of the economy and have little effect on the economy as a whole; for example, incentives to promote certain areas and incentives for certain industries, both of which create only small pockets of wealth.

PRACTICE

Perhaps the strongest argument against incentives is that in practice they generally do not work, i.e. they fail to achieve the desired result. There was strong evidence to support this conclusion at the conference from Sri Lanka, which is reducing the number of its incentives. It was reported that the results of the 2 special zones in India were not very encouraging and it was questioned whether the incentives designed to attract back to India the earnings of non-resident Indians had helped. It was noted that the world-wide trend in taxation is now away from incentives coupled with high rates of taxation to a system with low rates and few exceptions.

This trend is being followed mainly by developed countries and aggravates in several ways the problems experienced by developing countries in offering incentives to attract technology and know-how. An exemption or concessionary rate of taxation loses much of its attraction if tax rates elsewhere are not noticeably higher. If no concessionary rate applies, or the tax incentive period has expired, higher rates of tax in the host country create an obstacle for foreign investors as part of those higher rates cannot be credited against their tax liability in their home country.

As Dr. Leif Muten pointed out in his keynote address[8], the trend towards lower tax rates in developed countries can also aggravate the brain drain problem. Lower tax rates enhance the attraction for the brains from developing countries of working in developed countries. And the brains in developed countries come to expect a higher net salary which is expensive to provide in developing countries.

Administrative problems are a cause for concern in many developing countries, not only in respect of incentives but also in respect of the tax system as a whole. As stated earlier, a stable and properly enforced administrative machinery is one of the ingredients which make a country attractive to foreign investors and is at least as important as the details of the tax structure. Unfortunately many developing countries do not have the trained staff to deal with complicated tax legislation. The Bhutan delegate at the conference, for example, reported that Bhutan does not have enough adequately trained staff to deal with a tax on net income. In such a case it would be sheer lunacy to introduce tax incentives involving a detailed application procedure and the interpretation of subtle legal concepts. Large amounts of red tape are not an enticing prospect; large amounts of inefficient red tape even less so.

Some developing countries, aware of the need to keep their tax systems simple for administrative reasons, impose taxation on a gross basis. Bhutan, for example, levies taxes on gross income or turnover. This practice was called into question at the conference because, it, too, can create an obstacle for foreign investors. A credit for foreign taxes in an investor's home country is usually limited to taxes of a similar nature as the income tax in that country, and taxes on gross income may not be accepted as being similar.

Another way in which administrative burdens can be reduced is by the use of "private" incentives, that is to say an arrangement that the indigenous party to a contract pays the tax payable by the foreign contractor on the contract income. This phenomenon was discussed at the conference. In answer to the question whether it is fair to allow domestic enterprises to bear the burden of attracting technology in this way, it was concluded that the domestic enterprise bears the burden in any event; if the foreign contractor bears the tax he calculates it into the price. It was argued that this phenomenon is a purely business proposition and that it is not for government to interfere.

Discussions on tax incentives tend to concentrate on direct taxation. The point was made during the conference that in many developing countries indirect taxes are as important, or more important, than direct taxes. Although the chairman accepted the point as a good one he declined to extend the discussion to include indirect taxes, as he feared broadening its scope so much as to make it unmanageable. The general report for the 1961 IFA Conference also mentioned briefly the relative importance of indirect taxes in many developing countries in connection with unilateral double taxation relief, but did not consider it further for the same reason. There seems to be very little research

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reasons. It would allow developing countries to take the lead in tax policy matters; make the computation of tax excessively difficult; in effect mean the introduction of a general exemption system, given the higher rates which generally prevail in developing countries; deprive developed countries of the possibility of checking whether developing countries were turning into tax havens; and would not be acceptable to countries which maintain that tax should be levied on the principle of residence.

8. Keynote address by Dr. Leif Muten, senior advisor, International Monetary Fund, during the third working session of the conference.

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on this topic, and on the relationship between the functions of the different types of taxes in different countries generally. Such a lack of information is regrettable as it hampers productive discussion about incentives and many other matters.

The conference discussion was also limited to incentives in the form of tax incentives, that is to say measures reducing the amount of tax payable. This is perhaps understandable in a gathering of tax experts. Yet other types of incentives, such as grants or cheap loans, are no different in nature from tax incentives. This much was made clear by Prof. Stanley S. Surrey who introduced the idea of a tax expenditure budget in the 1970's.[9] A tax expenditure budget aims to measure the cost of tax incentives on the assumption that the cost is equal to the revenue which would have been collected from the same enterprise doing the same business if the tax reduction was not available. A tax expenditure budget as a cost measuring exercise is generally accepted to be inadequate as it takes no account of secondary effects, such as increased employment, or the cost of diverting resources to administer the incentive which could have been used elsewhere. Nevertheless the concept is valuable in that it demonstrates clearly how little difference there is between a hand-out of money and the waiver of a demand for money; both are a burden on government resources and should be accounted for as such.

MORE THEORY

Given all the problems with incentives described in this article, the best approach might seem to be to abolish them completely. As Dr. Leif Muten said at the conference, it is hard to resist the conclusion that developing countries should follow the world-wide trend in lowering their tax rates and reducing the number of incentives they offer. Yet none of the criticisms discussed leads necessarily to the conclusion that incentives should be done away with. Seen in a constructive light, these criticisms point the way to an effective use of incentives. More importantly, perhaps, incentives have too much charm for politicians for it to be likely that they will disappear in practice. Developing countries competing with each other for investment often do so by means of incentives, and even in the august circles of national government there is an urge to keep up with the Joneses.

As incentives are here to stay, the problem becomes one of ensuring that they achieve their desired effect with the minimum possible disturbance to the rest of a country's economy. The crux of the matter lies in the paradox described to the conference by Dr. Muten; the more useless an incentive is, the more expensive it is. It was stated above that investment decisions rarely turn on the size of the tax bill; in those rare cases in which an incentive is the deciding factor tax incentives cost nothing, as without the incentive there would be nothing to tax. Although this argument is not so easily applied to other forms of incentives, the cost is in any event not wasted. On the other hand, incentives given to enterprises which would have invested in any event are costly as the expenditure is simply wasted. In between these 2 extremes is a range of cases in which an incentive is increasingly worth its cost in that it is increasingly effective in attracting the desired investment or technology. The problem facing developing countries is to define adequately the margin within which the cost of an incentive is worth incurring. An incentive which is the one ingredient attracting investment and which therefore costs nothing is a desirable incentive to have, but how far along the scale towards the other extreme does a country wish to go? Just as important, in practical terms, are the problems of adequately defining the margin and policing it.

The reason that incentives are generally subject to the criticisms articulated in this article is that most of those offered, at least by developing countries, are at the wrong end of the scale. A study written for the IMF[10] lays down a number of guidelines which should be followed in order to avoid this result. The CATA report also lays down guidelines for making incentives effective and the areas in which tax incentives have been used to advantage by member countries.

Incentives should be predictable, which does not mean that they should be permanent. They should be stable, and not change with every change in a country's economy. Incentives which are continually subject to change do not form a sound basis for investment decisions and, rather than attracting investment, they become merely a windfall benefit for the lucky investors who happen to qualify for them. The CATA report adds that an incentive should be generous, and that the conditions attached should be reasonable and practicable, presumably so that the incentive is capable of influencing investment decisions.

The IMF study considers that incentives should be automatic, not discretionary, although the CATA report obviously contemplates incentives which require approval. The reason for making incentives automatic is to remove the need for lengthy application and selection procedures. Such procedures only deter enterprises which really are on the margin of investing. If the incentive is necessary to attract the investment, the cost of the application procedure may well be enough to tip the balance against the decision to invest. On the other hand, enterprises which would make the investment regardless of the incentive will be prepared to go through the application procedure. If an approval procedure is involved, it should be as cheap and painless as possible.

Incentives are economic instruments and should be directed at economic goals, not political goals. They should be removed as far as possible from political influences, also because one would expect incentives to be more changeable the more they are subject to political influences. Because incentives are economic

9. See, for example, the general report on the first subject of the 1976 annual IFA congress written by Prof. Stanley S. Surrey and Emil M. Sunley Jr.

10. Sanchez-Ugarte, Fernando, "A Supply-Side Look at Tax Incentives: Definition, Design, and Selection Criteria of Efficient Tax Incentives", Departmental Memorandum No. DM/85/35, for the Fiscal Affairs Department of the International Monetary Fund, 5 June 1985.

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instruments, they have economic side effects and these should be taken into account when the incentive is designed.

Finally, incentives should be aimed at a limited number of objectives and should be directly related to those objectives. A large number of incentives aimed at a wide range of objectives will have only a diffuse impact on a country's economy and will have undesired side effects. It is not enough simply to introduce exemptions for investment and hope that, as a result, various goodies will follow, such as increased employment, rural development and import substitution. The terms of the incentive should be carefully designed to ensure that the incentive reaches its true target. For example, exemptions which depend on a tax sparing clause in order to be effective can be made conditional on the existence of such a clause in the relevant treaty or foreign country's legislation. Incentives to increase employment should be related to the number of employees, or new employees, in an enterprise. Incentives to encourage regional development can be made conditional, not only on the location of the enterprise, but also for example on the amount of local labour used. If it is not possible for an enterprise to prove that it satisfies these conditions at the outset, when it most needs encouragement, the incentive can be granted on condition that the desired policies are formally adopted by the enterprise. A condition relating to the use of local labour is relatively easy to monitor, and the danger that the incentive will be retracted should ensure that the enterprise sticks to the policy once it has been adopted.

The inequities which are said to be built into incentives can also largely be avoided by careful design. Deductions can be given the same value for both higher and lower rate taxpayers by specifying the rate of tax at which the deduction is to have effect. A suitable alternative means of achieving the desired result might be a tax credit. If the deduction or credit is supposed to benefit new enterprises, it may well not work because many enterprises suffer losses in their first years and therefore have no tax bill to reduce. In that case, consideration should be given to making a payment to the enterprise, either in the form of a grant or a negative assessment to tax. The same alternatives apply to exemptions which fail to reach their target. The important point is not the form of any particular incentive, but the flexibility to choose the most effective form. Nor is it necessary that an incentive be restricted to one form; the most effective incentive may be one which is either a credit or a grant, depending on the financial position of the enterprise.

Some ideas were offered at the Delhi conference as to the types of incentive which developing countries could profitably use. The idea of a liaison office with a non-taxable status is not new, but it was agreed at the conference to be effective in attracting new business. Such offices are normally not taxed because they do not carry on any business in their host country. They give an enterprise an opportunity to explore investment possibilities. The borderline between liaison activities and carrying on a business is an internationally recognized one and the policing of it does not impose an intolerable administrative burden. Other ideas were incentives to encourage the indigenous development of technology and incentives to encourage the "unpackaging" of imported technology. By "unpackaging" is meant a move away from turnkey contracts towards a more piecemeal importation of technology, so that the host country is able to absorb the parts that are imported. The suggestion was also made that the South Asian countries should develop regional Caribbean-style offshore centres, although whether such centres would in fact contribute materially to the development of the region as a whole seems doubtful.

Designing incentives carefully means that existing incentives should be monitored in order to draw on past experience and learn what happens with incentives in practice. Although there are difficulties, still there are measures which a country can take to obtain some of the information it needs. The difficulties are, for example, that it is a complex matter to assess the cost of an incentive and inevitably involves some guesswork. A thorough statistical analysis of the information received may not be possible for some developing countries. Nevertheless, some basic information can be obtained, for example, by requiring enterprises enjoying an incentive to make a return of income even if it is exempt and by taking note of the number of applications received.

CONCLUSION

In order to work, incentives should be precision-made tools rather than blunt instruments. All too often a problem, such as a lack of technology, is perceived and a blunt instrument is wielded in an attempt to solve it. Further consideration of the problem would often reveal that it is not one that can be solved by the use of incentives, even of the precision-made variety. The IMF working paper argues that the use of incentives, particularly a large array of incentives, often points to fundamental flaws in the basic system. Incentives are only a means of achieving specific, narrowly-defined objectives. Fundamental flaws require a reform of the whole system. The argument has returned to the conclusion drawn by Dr. Muten and, implicitly, by the Delhi conference, that developing countries should devote most of their time and energy to following the world-wide trend and reforming their tax systems.

The title of the third working session of the conference, "tax incentives cum high taxes vs. no incentives cum low taxes", is slightly wide of the mark. Tax rates and incentives are not so closely connected that they should necessarily go up or down by a commensurate amount. Incentives need a sound, stable economy and tax system in which to work and an array of incentives is often symptomatic of a flawed economy and tax system. Nevertheless the two are separate policy questions. Developing countries should realize the limitations on the effectiveness of incentives and strive to restrict their use to a small number of carefully designed incentives aimed at specific, well-defined objectives.

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UNITED STATES:

The Definition of Residency for Federal Income Tax Purposes

An Analysis of the Proposed Regulations

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Residency status is critical to the determination of an individual's United States tax liability. United States residents, whether citizens of the United States or other countries, are taxed on worldwide income. Nonresidents, in contrast, are taxed on income from United States sources (with limited exceptions) but are denied several tax deductions allowed to U.S. residents.

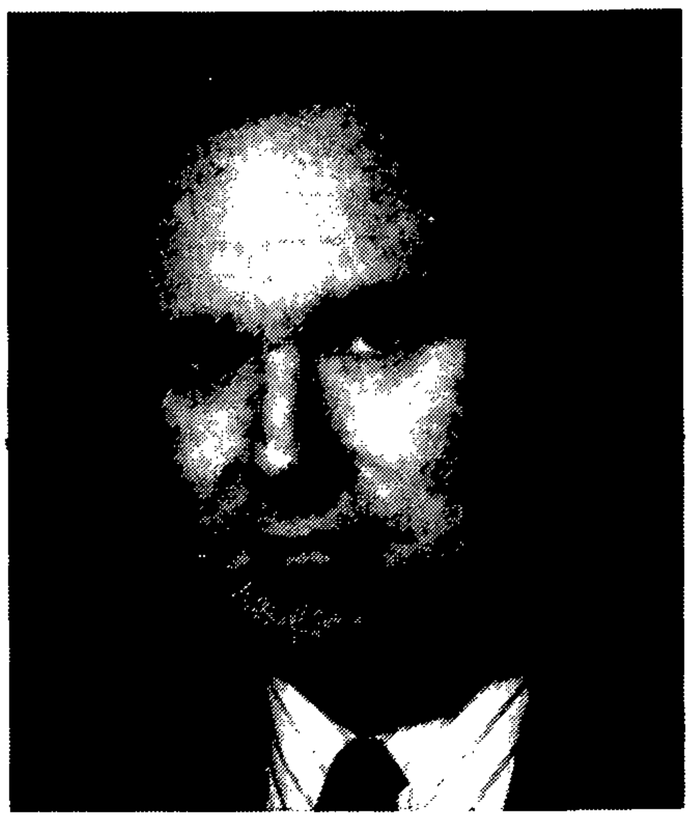
Prior to the enactment of the Tax Reform Act of 1984, the United States Internal Revenue Code provided no definition of a United States resident. Regulations issued by the Treasury Department provided a subjective test to determine United States residency which was based on the individual's intentions with regard to the length and nature of the individual's stay in the United States.

The Tax Reform Act of 1984 provided a new, objective test of U.S. residency in Internal Revenue Code Sec. 7701(b). An individual who is not a citizen of the United States is considered to be a resident if he satisfies *either* of two tests: the "green card" test *or* the substantial presence test. The "green card" test is based on immigration status, and the substantial presence test is based upon the number of days an individual is physically present in the United States during a 3-year period.

On 9 September 1987, the Treasury issued proposed regulations which discuss in detail the "green card" and substantial presence tests. These regulations have added significant complexity to this area of the law, but at the same time provide an objective criterion to determine the definition of a United States resident.

GREEN CARD OR LAWFUL PERMANENT RESIDENT TEST

Under the "green card" test an alien individual is considered a resident if the individual may lawfully reside permanently in the United States according to the immigration laws of the United States. The regulations provide detailed rules governing the rescission of resident status under the "green card" test. The individual, the Immigration and Naturalization Service (INS), or a United States consular officer may initiate a determination of abandonment of resident status. If initiated by the individual, resident status is considered abandoned when the appropriate documentation is filed with the INS or a consular officer. If the determination is initiated by the INS or a consular officer, resident status is considered abandoned upon the issuance of a final administrative or judicial order (Reg. 301.7701(b)-1(b)(2 and 3)).



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SUBSTANTIAL PRESENCE TEST

Individuals who are present in the United States for at least 183 days during a 3-year period, including the current year, are resident aliens. Each day in the current year is counted as a full day; each day in the first preceding year is counted as one-third of a day, and each day of presence in the second preceding year is counted as one-sixth of a day. Partial days of presence are counted as full days (Reg. 301.7701(b)-1(c)(1)). In counting days, an example in the regulation does not allow an individual to "round down" a mathematical fraction. If an alien spends 122 days in each of the current, first preceding, and second preceding years, the total days are 183 (122 × 100% or 122; plus 122 × ⅓ or 40⅔; plus 122 × ⅙ or 20⅓).

If an individual is present in the United States for fewer than 31 days in the current year, the individual will not be considered a United States resident for the current year, even though the total days for the current year, one-third of the days for the first preceding year, and one-sixth of the days for the second preceding year total at least 183 days. Note that each day in the first and second preceding years count, even though the individual may be present in the United States less than 31 days in either of those years (Reg. 301.7701(b)-1(c)(4)).

The term "United States" is defined to include the states and the District of Columbia, but does not include the possessions and territories of the United States. Therefore days spent in Puerto Rico or the U.S. Virgin Islands are not counted as days of presence in the United States (Reg. 301.7701(b)-1(c)(2)(ii)). Geographically, the United States also includes the territorial waters of the United States, the air space over the United States, and the seabed and subsoil of those submarine areas over which the United States has jurisdiction under international law.

DAYS EXCLUDED FOR PURPOSES OF THE SUBSTANTIAL PRESENCE TEST

Certain days of United States presence are not counted for purposes of the substantial presence test:

Foreign Government-related individuals

Days spent in the United States as a full-time employee of an international organization, or as an individual with diplomatic or consular status, are not counted as days of presence in the United States for purposes of the substantial presence test. Members of such persons' immediate families also qualify for this exception. Any individual who is present in the United States as a lawful permanent resident does not qualify for this exception (Reg. 301.7701(b)-(3)(b)(2)(i)).

Students, teachers, trainees

Days spent in the United States as a student with an F or J visa are not counted as days of presence in the United States for purposes of the substantial presence test (Reg. 301.7701(b)-3(b)(3 and 4)). There are several limitations on the use of this exception. First, the individual must substantially comply with the requirements of an F or J visa. The test of compliance is made independently by the Internal Revenue Service, which may determine noncompliance even though the visa has not been revoked (Reg. 301.7701(b)-3(b)(6)). Second, an individual will not be able to exclude days of presence if the individual has been exempt as a teacher, trainee, or student for any part of 2 of the 6 preceding calendar years. If all of an individual's compensation in the current year and for 4 of the 6 preceding calendar years is income described in Sec. 872(b)(3) the individual will not be able to exclude days of presence from the substantial presence test as a teacher or trainee if the individual has been exempt as a teacher, trainee, or student for any part of 4 of the 6 preceding calendar years.

Finally, an individual will not be able to exclude days of presence from the substantial presence test as a student if the individual has been exempt as a teacher, trainee, or student for any part of more than 5 calendar years, unless the individual establishes intent not to reside permanently in the United States and compliance with the student visa (Reg. 301.7701(b)-3(b)(7)). A transitional rule applies to individuals present in the United States as students prior to 1985. The above rules apply only for those stated periods occurring after 1984. Thus an individual who is present as a student during the calendar years 1982-1990 will not be subject to the 5-year rule for students until 1990.

Medical condition

Days spent in the United States because of a medical condition that has prevented an individual from leaving the United States are not counted for purposes of the substantial presence test (Reg. 301.7701(b)-3(c)(1)). However, the proposed regulations impose substantial limitations on the use of the medical condition exception to the substantial presence test, as this exception will not be available in the following situations:

1. Individuals who were aware of pre-existing medical conditions prior to their arrival in the United States (Reg. 301.7701(b)-3(c)(2));
2. Days spent in the United States beyond a reasonable time after recovery for making travel arrangements to depart.

Days in transit

Generally, an individual may exclude days in transit within the United States if he is present for less than 24 hours (Reg. 301.7701(b)-3(d)). However, the usefulness of this regulation is severely limited as there is no extension of time granted for transportation delays or other reasonable causes. Further, the exception does not apply if an individual attends a business meeting during the 24-hour period.

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Days spent in the United States as a professional athlete competing in a charitable sports event are excluded from the substantial presence test under the proposed regulations (Reg. 301.7701(b)-3(b)(5)). An additional exception is provided for regular commuters from Canada or Mexico (Reg. 301.7701(b)-3(e)).

CLOSER CONNECTION EXCEPTION TO THE SUBSTANTIAL PRESENCE TEST

The new regulations provide extensive rules for the application of the "closer connection" exception to the substantial presence test. The "closer connection" rules are important not only in establishing an exception to the substantial presence test, but also may allow an individual to delay his residency starting date or accelerate his residency termination date. Residency starting and ending date rules are discussed in the following section.

An individual who is present in the United States for the requisite number of days under the substantial presence test may nevertheless be considered a nonresident if the following conditions are satisfied:

1. The individual is present in the United States for fewer than 183 days in the current year;
2. The individual maintains a tax home in a foreign country during the current year; and
3. The individual has a closer connection to the foreign country in which he maintains a tax home than to the United States (Reg. 301.7701(b)-2(a)).

The possessions and territories of the United States are considered foreign countries for purposes of the closer connection exception (Reg. 301.7701(b)-2(b)).

An individual's tax home is considered to be located at his regular or principal place of business, or, if the individual has no principal place of business, his tax home is his place of abode (Reg. 301.7701(b)-2(c)(1)).

The definition of tax home is cross-referenced to IRC Sec. 911(d)(3), without regard to the second sentence of that provision. The second sentence of Sec. 911(d)(3) reads: "An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States." An alien individual may have an abode in the United States but still have a tax home in a foreign country. Further, an alien individual may be able to claim away-from-home business expenses if he is temporarily present on business in the United States and meets the requirements of Revenue Ruling 83-82.

The individual must maintain his tax home for the entire year, and further, the tax home must be located in the same foreign country for which the individual is claiming to have a closer connection.

This requirement will make the closer connection exception unavailable to many individuals who are employed in one country (tax home) yet reside in another foreign country (Reg. 301.7701(b)-2(c)(2)).

The facts and circumstances which are considered in determining whether an individual has a closer connection with another country include the following (Reg. 301.7701(b)-2(d)):

1. the location of the individual's permanent home;
2. the location of the individual's family;
3. the location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his family;
4. the location of social, political, cultural or religious organizations in which the individual has a current relationship;
5. the location of the individual's personal bank accounts;
6. the type of driver's license held by the individual;
7. the country of residence designated by the individual on forms and documents;
8. the types of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States) or Form W-9 (Payer's Request for Taxpayer Identification Number); and
9. the location of the jurisdiction in which the individual votes.

The individual's permanent home of residence must be available at all times and not solely for stays of a short duration. This implies that an individual cannot rent out his home in a foreign country and claim the closer connection exception (Reg. 301.7701(b)-2(d)).

Individuals who have applied for permanent residence in the United States may not claim the closer connection exception. This rule may be disadvantageous if there is a delay between the time the application is made and actual presence in the United States.

RESIDENCY STARTING AND ENDING DATES

Starting date

Under the "green card" test, an individual's residence is deemed to begin on the first day the individual is physically present in the United States as a lawful permanent resident. Similarly, under the substantial presence test, residency is deemed to begin the first day the individual is present in the United States during the year in which the test is satisfied (Reg. 301.7701(b)-4(a)).

If an individual satisfies both tests, residency is deemed to begin with the earlier of the residency starting dates under either of the two tests.

Ending date

Generally, the residency termination date will be the last day of the calendar year under either test, unless the individual establishes a "closer connection" to a foreign country than to the United States prior to the end of the year. Once this closer connection is established, the residency termination date for an alien meeting the lawful permanent residence test is the first

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day the individual is no longer a lawful permanent resident; and under the substantial presence test, the last day the individual was present in the United States (Reg. 301.7701(b)-4(b)).

De minimis presence

An individual may be present in the United States for up to 10 days without triggering the residency starting date for purposes of the substantial presence test or extending the residency termination date under either test, provided during this period the individual has a closer connection to a foreign country. Note that these days are included as days of United States presence for purposes of the substantial presence test (Reg. 301.7701(b)-4(c)).

First year election

An election to be treated as a full year United States resident is available to certain individuals who meet neither the "green card" or substantial presence tests. To qualify for the election in a year, the individual must satisfy the following requirements:

1. meet the substantial presence test for the immediately following year;
2. be present in the United States for at least 31 consecutive days in the current year; and
3. be present in the United States for at least 75% of the number of days beginning with the first day of the 31-day consecutive period and ending with the last day of the year of arrival. For purposes of this 75% requirement, up to 5 days of absence from the United States may be treated as presence within the United States (Reg. 301.7701(b)-4(c)(3)(iii)).

No lapse rules

Under a special "no lapse" rule residency may be extended for periods when the substantial presence test is otherwise failed. If an individual is treated as a United States resident during at least 3 consecutive calendar years after 1984, ceases to be a U.S. resident, and then again becomes a United States resident within 3 calendar years after the initial residency period, the individual is taxed as a U.S. citizen who expatriated to avoid tax. This special tax applies only if it is greater than the tax normally applicable to a nonresident alien individual (Reg. 301.7701(b)-5).

Another "no lapse" rule applies to individuals who are residents in 2 consecutive years, but who are not residents under either test for some portion of either year. In this situation, the individual is treated as a resident of the United States without interruption (Reg. 301.7701(b)-4(e)).

Tax year

The regulations generally require an alien individual to adopt a calendar year unless a fiscal year has been established prior to residency. An individual is considered to have established a fiscal year if the annual period on which the individual computes his income is a fiscal year (Reg. 301.7701(b)-(6)(a)). Accordingly, a citizen of the United Kingdom would appear to be able to continue using the United Kingdom tax year as his United States tax year, providing appropriate fiscal year books and records are maintained for U.S. tax purposes.

Tax treaties

Tax treaties are not overridden by Sec. 7701(b). Residents of countries with which the United States has income tax treaties may be able to claim treaty benefits provided the applicable treaty has a provision for resolution of conflicting claims of residence (Reg. 301.7701(b)-7).

Alien individuals who are considered nonresidents under a treaty for purposes of computing their U.S. tax liability may be considered residents for purposes of other Internal Revenue Code provisions. For instance, an alien may be deemed a resident for purposes of Subpart F which could cause a foreign corporation in which the individual is a shareholder to be classified as a "controlled foreign corporation" (Reg. 301.7701(b)-7(a)).

Individuals determined to be nonresidents under an income tax treaty are subject to special return filing requirements. Such individuals must file Form 1040 completed without regard to any treaty benefit, and attach Form 1040NR with the tax liability computed as a nonresident alien. A statement attached to the return should explain any items of income subject to a treaty benefit. The full return is filed with the local Internal Revenue Service Center, rather than in Philadelphia.

Elections

The regulations contain stringent documentation requirements for individuals claiming to be exempt individuals, claiming the closer connection exception, or claiming the 10-day exception for residency starting and ending dates. Generally an individual qualifying for any of these exemptions must file a detailed statement with the Internal Revenue Service in Philadelphia. The regulations require that these statements be filed whether or not the individual files a tax return. Whether or not a return is filed, the statements are due on or before the due date (including extensions) for filing a return, had a return been due (Reg. 301.7701(b)-8).

The penalty for failure to comply with the statement requirements is loss of the claimed exemption. Days that would not be counted as days of United States presence under an exemption are considered days of United States presence. Exempt students, teachers, and trainees are not subject to these penalties (Reg. 301.7701(b)-8(d)).

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Effective date

The proposed regulations are effective for tax years beginning after 31 December 1984. Since the regulations are retroactive, individuals claiming an exemption for the years 1985 and 1986 may be ineligible for the exemptions if the required statements were not attached to their returns for those years.

APPENDIX

UNITED STATES RESIDENT OR NONRESIDENT
(Internal Revenue Code Sec. 7701(b))

	YES	NO
I. Were you a citizen of the United States or did you have a "green card" at any time during the current year?	You are considered a resident of the United States for the entire year. The tests below do not apply.	You will be treated as a resident only if you satisfy one of the tests below.
II. Were you physically present in the United States for 31 days or more during the current year *and* does the sum of 100% of days of physical presence in the United States in the current year plus 1/3 of the days in the preceding year plus 1/6 of the days in the second preceding year equal or exceed 183 days?	You are a resident, *unless* you are a: – student – teacher – scholar – diplomat *or* you are present in the United States because you are: – ill – in transit – commuting to a job in Mexico or Canada – a professional athlete participating in a charitable event *or* you claim a closer connection to a foreign country.	You are not a resident.
III. Can you establish a tax home in *and* a closer connection to a country other than the United States *and* were you in the United States for less than 183 days in the current year?	You are a nonresident.	You may be a resident if you satisfy one of the above tests.
IV. Does your country of citizenship or residency have a tax treaty with the United States?	Consult the treaty for additional exemptions from United States residency.	The above rules apply.
V. Were you present in the United States for at least 31 days in the current year *and* do you satisfy the test in II. above for the following year, *or* were you married and were you or your spouse residents at the end of the current year?	You may be able to elect U.S. residency status for the entire current year. (See Sec. 6013(g) and (h).)	

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Finally, the author does recommendations to impose the German legislation with respect to the taking into account of inflation.
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See insert at the centre of this issue

The International Bureau of Fiscal Documentation (IBFD), founded in 1938, looks back on 50 years in which it has grown from a small operation into a healthy organization employing 65 persons of 12 different nationalities. It is now entering the computer era in which it will offer tax information via its data bases and compact discs. The first compact disc containing the text of virtually all tax treaties and a retrieval system has recently been prepared.

Richard M. Hammer:

IFA 1988 JUBILEE CONGRESS AT AMSTERDAM 341

H.E. Koning, Under Minister for Finance:

CUTTING TAXES: THE NETHERLANDS FOLLOWS THE TREND BY INTRODUCING RADICAL NEW PROPOSALS 344

The Netherlands has not enjoyed immunity from the global trend to streamline and simplify tax systems. In this article Mr. Koning discusses the current proposals to reduce the individual and corporate income tax rates.

Kees van Raad:

NETHERLANDS: ISSUES IN THE APPLICATION OF TAX TREATY NON-DISCRIMINATION CLAUSES 347

The author analyzes various issues concerning the application of the OECD Model Convention non-discrimination provision (Art. 24). The article primarily focuses on general issues arising in connection with non-discrimination clauses in tax treaties; however, specific features of Dutch fiscal legislation are also addressed. Included in the discussion are the permanent establishment clause, the nationality clause and the control clause of Art. 24.

Dr. Nico Nobel:

NETHERLANDS: MANDATORY PUBLICATION OF RESOLUTIONS AND RULINGS IS NECESSARY FOR FAIR AND JUST TAXATION 352

This article discusses the authority of the Netherlands Revenue Service to make arrangements for the taxation of groups of taxpayers as well as individual taxpayers. No legislative or governmental policy requires publication of certain arrangements, so some are made available to the public while others are kept secret. Using concrete examples to support his arguments, Dr. Nobel advocates mandatory publication of rulings and arrangements to ensure parity of treatment of taxpayers.

CONFERENCE DIARY 354

Frank van Brunschot:

NETHERLANDS: "FRAUS LEGIS" AND MULTINATIONAL ENTERPRISES 355

The legal concept of "fraus legis" and the "correct imposition" provisions set forth in Dutch tax law are the Dutch tax administration's main weapons to attack transactions entered into to avoid payment of tax. Until recently, the "fraus legis" doctrine was only applied to attack arrangements in a domestic context made by individual taxpayers which frustrated imposition of income tax. However, several recent court decisions have now raised the possibility that the doctrine will be extended to combat tax avoidance in international situations. Professor van Brunschot advances the argument that "fraus legis" is not the appropriate instrument to be employed in cases containing international elements.

J. Kooi:

NETHERLANDS: PENSIONS: A SURVEY OF RECENT DEVELOPMENTS 360

This article focuses on various international tax aspects of retirement benefits in the Netherlands, i.e. the present and future treatment of lump-sum retirement payments, international consequences of proposed changes in retirement benefits (i.e. "Brede Herwaardering") and retirement plans for expatriates transferred to the Netherlands for a limited period of time.

M. Plante-Failé and J.W. Zwemmer:

NETHERLANDS: INTEREST: WITHHOLDING OR NO WITHHOLDING TAX? 365

No withholding tax is imposed on interest in the Netherlands. Double taxation agreements concluded by the Netherlands either provide that no withholding tax will be imposed on interest payable to Dutch residents by a resident of the other State or that the rate of withholding tax will be reduced. Under Dutch law, interest income received by a Dutch resident constitutes part of his taxable income, although in the past there was no means of tracing interest payments. Consequently, many taxpayers have been able to avoid paying tax on interest. This aricle examines the issue whether imposing a withholding tax on interest would resolve this problem.

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E.A. Brood:

NETHERLANDS: THE PARTICIPATION EXEMPTION: PRESENT AND FUTURE 369

The Netherlands participation exemption ranks as one of the most well-known tax planning schemes. In its present form, companies are exempt from corporate income tax on all benefits derived from qualifying shareholdings. This article examines the current legislative basis for the participation exemption, the various loopholes existing in the legislation and some of the proposals to revise it.

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IFA NEWS **373**
– British Branch *373*

Susan M.C. Lyons and Dirk A. van Waardenburg:

SOME ASPECTS OF THE INTERNATIONAL TAX TREATY STRATEGY OF THE NETHERLANDS – Unilateral relief and tax treaties **374**

In December 1987 the Dutch Under Minister of Finance sent a letter to Parliament explaining the major issues with which Dutch tax treaty negotiators are confronted and which policy the Government wishes to follow in concluding tax treaties. The authors have attempted to make the contents of the letter accessible to an international readership and have examined the extent to which the Dutch tax treaty negotiators have been able to translate the wishes of their Government into the tax treaties which have been concluded. For a better understanding of the issues at hand a short description of the Dutch tax system and the Dutch unilateral provisions for the prevention of double taxation precede the main part of the article.

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SOMMAIRE

1938-1988

Le Bureau International de Documentation Fiscale célèbre son 50ème anniversaire

Voir encart au milieu du numéro

Le Bureau International de Documentation Fiscale (B.I.F.D.), fondé en 1938, jette un regard sur son passé et fête ses 50 ans. Ce Bureau, à l'origine très modeste, a beaucoup grandi, il est devenu une organisation prospère employant 65 personnes de 12 nationalités différentes. Il entre à présent dans l'ère de l'informatique offrant ses informations fiscales grâce à ses banques de données et ses disques compacts. Le premier disque compact contenant pratiquement tous les textes des conventions fiscales existantes et muni d'un système de recherche vient en effet d'être mis au point.

Richard M. Hammer:

Congrès-Anniversaire de l'IFA, Amsterdam 1988 ..... *341*

H.E. Koning, Ministre d'Etat chargé des Finances:

Réduction d'impôts: Les Pays-Bas suivent la tendance actuelle et introduisent de nouvelles dispositions radicales *344*

Les Pays-Bas n'apprécient pas l'exemption qui ressort de la tendance générale à vouloir rationaliser et simplifier les systèmes fiscaux. M. Koning analyse dans son article les propositions actuelles de réduction des taux de l'impôt sur le revenu des personnes physiques et des sociétés.

Kees van Raad:

Pays-Bas: Solutions données à l'application des clauses de non-discrimination contenues dans les conventions fiscales .. *347*

L'auteur analyse les différentes solutions portant sur l'application de la disposition de non-discrimination de la Convention Modèle de l'OCDE (art. 24). L'article insiste particulièrement sur les solutions offertes en général quant aux clauses de non-discrimination des conventions fiscales; des dispositions spécifiques à la législation fiscale néerlandaise sont toutefois mentionnées. Les clauses portant sur l'établissement stable, la nationalité et le contrôle de l'article 24 sont également analysées.

Dr. Nico Nobel:

Pays-Bas: La publication obligatoire des résolutions et des règlements est indispensable à une imposition équitable et juste *352*

Cet article est un commentaire sur la capacité des services fiscaux néerlandais de prendre des mesures concernant l'imposition de groupes de contribuables ou de personnes physiques. Il n'existe aucune politique législative ou gouvernementale rendant obligatoire la publication de certaines mesures, celles-ci sont parfois publiées tandis que d'autres restent secrètes. Le Dr. Nobel, en s'appuyant sur des exemples concrets, plaide en faveur de l'obligation de publier ces règlements et ces mesures afin d'assurer l'égalité de traitement des contribuables.

Carnet des Congrès *354*

Frank van Brunschot:

Pays-Bas: "Fraus legis" et entreprises multinationales *355*

Le concept légal de "fraus legis" et les dispositions portant sur une "imposition correcte" énoncées dans la loi fiscale néerlandaise représentent les armes les plus importantes utilisées par l'administration fiscale néerlandaise pour lutter contre les transactions ayant pour but d'éviter le paiement de l'impôt. Il y a encore peu de temps, la doctrine de "fraus legis" n'était utilisée que pour lutter contre les arrangements mis en place par les contribuables, personnes physiques, désirant contourner l'impôt sur le revenu. Un certain nombre d'arrêts de la Cour ont toutefois permis d'envisager la possibilité d'étendre la position de la doctrine afin de lutter contre l'évasion fiscale dans des situations internationales. Le Professeur van Brunschot considère que la "fraus legis" n'est pas l'instrument adéquat auquel il faut recourir dans des cas comportant des éléments internationaux.

J. Kooi:

Pays-Bas: Retraites: Résumé des développements récents *360*

Cet article met l'accent sur différents aspects fiscaux internationaux des versements de retraites aux Pays-Bas; à savoir: le traitement actuel et futur des versements forfaitaires de retraites, les conséquences internationales des modifications proposées en matière de versements de retraites ("Brede Herwaardering") et les plans de retraites concernant les expatriés ayant vécu aux Pays-Bas pendant une période limitée.

M. Plante-Failé et J.W. Zwemmer:

Pays-Bas: Intérêts: Retenue à la source ou absence de retenue à la source? *365*

Il n'existe pas aux Pays-Bas de retenues à la source sur les intérêts. Des accords destinés à éviter une double imposition conclus par les Pays-Bas prévoient soit qu'aucune retenue à la source ne sera appliquée aux intérêts dus aux résidents néerlandais par un résident de l'autre pays, soit que le taux de retenue à la source sera réduit. Les revenus d'intérêts reçus par un résident néerlandais constituent, de par la loi néerlandaise, une partie de son revenu imposable bien qu'il n'y ait pas eu moyen dans le passé d'identifier les paiements d'intérêts. Beaucoup de contribuables ont pu de cette façon éviter de payer un impôt sur les intérêts. Cet article examine si une solution introduisant une retenue à la source sur les intérêts résoudrait ce problème.

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E.A. Brood:

Pays-Bas: L'exemption avec participation: présent et futur *369*
L'exemption avec participation néerlandaise se range parmi l'un des programmes de gestion fiscale les plus réputés. Les sociétés sont actuellement exemptées d'impôt sur le revenu des sociétés pour tous les bénéfices tirés des actions de garantie. Cet article analyse la base législative actuelle applicable à l'exemption avec participation, les différentes lacunes de la loi en la matière ainsi que quelques-unes des propositions destinées à y remédier.

Nouvelles de l'IFA *373*
– Royaume-Uni 373

Susan M.C. Lyons et D.A. van Waardenburg:

Pays-Bas: Quelques aspects de la stratégie néerlandaise en matière de conventions fiscales internationales – Dispositions unilatérales et conventions fiscales *374*
Le Ministre d'Etat néerlandais chargé des Finances a envoyé en décembre 1987 une lettre au Parlement mentionnant les problèmes majeurs auxquels étaient confrontés les négociateurs néerlandais des conventions fiscales et la politique que souhaiterait suivre le Gouvernement lorsqu'il conclut des conventions fiscales. Les auteurs ont cherché à rendre le contenu de la lettre accessible à un public international et ont examiné dans quelle mesure les négociateurs néerlandais des conventions fiscales ont été capables de traduire les souhaits de leur Gouvernement dans le contenu des conventions conclues. Une rapide description du système fiscal et des dispositions unilatérales néerlandaises en vigueur afin d'éviter une double imposition précèdent la partie principale de l'article afin de mieux comprendre les problèmes posés.

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INHALTSVERZEICHNIS

1938-1988:

Das Internationale Steuerdokumentationsbüro feiert seinen 50. Geburtstag

Siehe eingefügten Teil in der Mitte dieser Ausgabe

Das Internationale Steuerdokumentationsbüro, welches im Jahre 1938 gegründet wurde, blickt auf einen Zeitraum von 50 Jahren zurück, in dem es von einer kleinen Organisation zu einem gesunden Büro mit 65 Arbeitnehmern von 12 Nationalitäten gewachsen ist. Es tritt jetzt ins Zeitalter der Datenverarbeitung ein, in dem es Interessenten Information durch seine Datenbanken und Compact-Discs anbieten wird. Das erste Compact-Disc welches fast alle Doppelbesteuerungsabkommen und ein Informationserschliessungssystem enthält, wurde vor kurzem hergestellt.

Richard M. Hammer:

Der IFA-Jubiläumskongress 1988 in Amsterdam *341*

H.E. Koning, Staatssekretär für Finanzen:

Senkung der Steuern: Die Niederlande folgen dem Trend mit radikalen Neu-Anträgen zur Steueränderung *344*
Die Niederlande sind nicht immun gegen den weltweiten Trend, die Steuersysteme zu straffen und zu vereinfachen. Herr Koning analysiert in diesem Artikel die derzeitigen Anträge zur Senkung der Sätze der Einkommensteuer und Körperschaftsteuer.

Kees van Raad:

Niederlande: Fragen bezüglich der Anwendung von Nichtdiskriminierungsklauseln in Doppelbesteuerungsabkommen *347*
Der Autor analysiert verschiedene Fragen bezüglich der Anwendung der Nichtdiskriminierungsbestimmung des OECD Musterabkommens (Art. 24). Der Artikel beschäftigt sich hauptsächlich mit allgemeinen Fragen, welche im Zusammenhang mit den Nichtdiskriminierungsklauseln in Doppelbesteuerungsabkommen stehen; besondere Merkmale der niederländischen Steuergesetzgebung werden jedoch auch bei der Betrachtung erwähnt. Die Analyse bezieht sich u.a. auf die Betriebstätte-, Nationalitäts- und Tochtergesellschaftklauseln des Artikels 24.

Dr. Nico Nobel:

Niederlande: Die obligatorische Veröffentlichung von Durchführungsbestimmungen und Erlässe ist notwendig für eine faire und gerechte Besteuerung *352*
Dieser Artikel bespricht die Zuständigkeit der niederländischen Steuerverwaltung, um Anordnungen sowohl für Gruppen von Steuerzahlern als auch für individuelle Steuerpflichtige zu machen. Weder gesetzliche Regelungen noch behördliche Verfahrensvorschriften zwingen die Steuerverwaltung, diese Anordnungen zu veröffentlichen, so dass manche publiziert werden und andere geheim bleiben. Dr. Nobel empfiehlt die obligatorische Bekanntmachung der Durchführungsbestimmungen und Erlässe, um eine gleiche Behandlung von Steuerpflichtigen zu gewährleisten und stützt sich für seine Argumentierung auf Beispiele aus der Praxis.

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Frank van Brunschot:

Niederlande: „Fraus legis" und multinationale Konzerne *355*
Das „fraus legis" Konzept und die gesetzlichen Bestimmungen „richtiger Besteuerung" in der niederländischen Steuergesetzgebung sind die wichtigsten Waffen der niederländischen Steuerbehörden, um Missbrauch des bürgerlichen Rechts mit dem Zweck, Steuern zu vermeiden, zu bekämpfen. Bis vor kurzem wurde das „fraus legis" Konzept nur zwecks Bekämpfung von Geschäften natürlicher Personen, die Steuervermeidung bezweckten, auf nationaler Ebene angewendet. Verschiedene neuere Urteile jedoch haben die Möglichkeit geschaffen, das „fraus legis" Konzept auf internationale Verhältnisse auszudehnen. Professor van Brunschot stellt die These auf, dass das „fraus legis" Konzept für Fälle, in welchen internationale Aspekte eine Rolle spielen, ungeeignet ist.

J. Kooi:

Niederlande: Ruhegehälter: Ein Überblick über neueste Entwicklungen *360*
Dieser Artikel befasst sich mit den verschiedenen internationalen Steueraspekten von Ruhegehältern und ähnlichen Vergütungen in den Niederlanden, d.h. der heutigen und zukünftigen Besteuerung von Rückkaufsummen an der Stelle von Ruhegehältern, internationalen Aspekten der vorgeschlagenen Änderungen bezüglich Ruhegehälter, sowie ähnlichen Vergütungen (die „breite Neubewer-

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tung") und Alterssicherungsregelungen für ausländische Arbeitnehmer, die im Rahmen ihres Arbeitsverhältnisses vorübergehend in die Niederlande versetzt werden.

M. Plante-Failé und J.W. Zwemmer:

Niederlande: Zinsen: Kuponsteuer oder keine Kuponsteuer? *365*
Zinsen unterliegen in den Niederlanden keiner Kuponsteuer. Von den Niederlanden abgeschlossene Doppelbesteuerungsabkommen bestimmen bezüglich Zinsen, die von einem Schuldner – wohnhaft in einem Vertragsstaat – an einen Ansässigen der Niederlande bezahlt werden, dass sie entweder von einer etwaigen Kuponsteuer befreit werden oder der Satz solch einer Kuponsteuer ermässigt wird. Zinsen unterliegen jedoch völlig der niederländischen Einkommensteuer, obwohl es bis vor kurzem für die Steuerbehörden fast unmöglich war, den Empfang von Zinszahlungen nachzuweisen. Viele Steuerpflichtige konnten deshalb die Besteuerung von Zinszahlungen umgehen. Dieser Artikel untersucht die Frage, ob die Einführung einer Kuponsteuer eine Lösung dieses Problems bieten könnte.

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E.A. Brood:

Niederlande: Das Schachtelprivileg: Gegenwart und Zukunft *369*
Das niederländische Schachtelprivileg ist eine der bekanntesten Ingredienzen für Steuerplanung. In seiner heutigen Form bietet das Privileg eine Befreiung von Körperschaftsteuer für alle Vorteile, die eine Körperschaft aus einer wesentlichen Beteiligung erzielt. Dieser Artikel analysiert die heutigen gesetzlichen Grundlagen, die verschiedenen gesetzlichen Mängel und die Vorschläge, um die Gesetzgebung zu verbessern.

IFA Mitteilungen *373*
– Grossbritannien 373

Susan M.C. Lyons und Dirk A. van Waardenburg:

Einige Aspekte der niederländischen Doppelbesteuerungsabkommenstrategie – Einseitige Massnahmen zur Vermeidung der Doppelbesteuerung und Doppelbesteuerungsabkommen *374*
Der niederländische Staatssekretär für Finanzen sandte dem Parlament im Dezember 1987 einen Brief in dem er die wichtigsten Problemen erläutert, mit denen die niederländischen Unterhändler der Doppelbesteuerungsabkommen konfrontiert werden, und er stellt dar, welche Politik die Regierung für den Abschluss von DBAs zu befolgen wünscht. Die Autoren haben versucht, den Inhalt des Briefes für ausländische Leser zugänglich zu machen und haben analysiert, in welchem Masse es den niederländischen DBA-Unterhändlern gelungen ist, die Wünsche ihrer Regierung in die DBAs zu inkorporieren. Die Autoren haben fur ein besseres Verständnis der betreffenden Probleme auch einen Überblick des niederländischen Steuersystems und der einseitigen Massnahmen zur Vermeidung der Doppelbesteuerung gegeben.

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In the article by Mr. Alain Akhong in the May 1988 issue, the following correction should be made:

P.217: Alain Akhong is Director of Taxes for Arthur Young Singapore.

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IFA 1988 Jubilee Congress at Amsterdam

By Richard M. Hammer

Mr. Hammer is a partner with Price Waterhouse and is the National Director of International Tax Services based in New York. He is also the Chairman of Price Waterhouse World Firm International Tax Services Panel. He is a graduate of Princeton University and the Harvard Graduate School of Business. He is a member of the American and New York Institutes of CPA's. Currently, he serves as President of the International Fiscal Association and Vice Chairman of the Fiscal Committee of the Business and Industry Advisory Committee to OECD. Mr. Hammer is a frequent lecturer and has authored many articles on the subject of taxation.

INTRODUCTORY NOTE

It is indeed fitting that the 1988 IFA Congress returns to the Netherlands, this year marking the 50th anniversary of its founding in The Hague in 1938. In effect, this year's Congress represents a "homecoming" to commemorate the golden jubilee.

The Netherlands has now hosted the Congress a record 5 times. It is also most fitting that the organization's birthplace gains this distinction. The first 2 Dutch Congresses unfolded in The Hague, the ninth Congress was held in Amsterdam, the twenty-third Congress in Rotterdam and now the forty-second, again in Amsterdam. The Netherlands trails only the United States and the United Kingdom branches in total membership (on a population base only about 5% of that of the United States). And, of course, IFA remains headquartered in the Netherlands.

The Netherlands branch has spared no effort in making the social side of this jubilee Congress something special. This will require some doing, considering recent competition. Those who were there will never forget the Goucho outing in Buenos Aires, drinks by the Rosetta Stone in London, more drinks (and music!) at the Metropolitan Museum of Art in New York and the special ballet performance in Brussels. An event that I am particularly looking forward to is the Wednesday concert and the festive supper party. The latter will be uniquely Dutch. I know you will all enjoy it.

The Dutch branch has also arranged spectacular venues for other events. The official reception of the Dutch Government at the "Beurs van Berlage" will be a treat, and the closing dinner dance at the TV studio in Aalsmeer should rival the Seventh Regiment Armory in New York as a one-of-a-kind location for this Congress wrap-up social event.

THE SCIENTIFIC AGENDA: MORE IMPORTANT THAN EVER

The global economy is here, and it is IFA's purpose to foster development of fiscal policies and laws that least impede the free flow, internationally, of goods, services, ideas, technology, capital and labour. Before I leave home for work each morning in New York, the radio reports the closing prices of the Tokyo stock exchange, the U.S. dollar/yen trading in Tokyo, how the dollar is faring in Europe and the opening gold price in London. And those outside the United States follow the U.S. trade figures and U.S. trade legislation with interest and, I must add, apprehension. If further evidence of interlocking economies were needed, "black Monday", 19 October 1987, emphatically furnished it. On that date, there were record stock market declines in every stock exchange and organized security market around the globe.

The 2 scientific subjects are timely. Subject I is "recognition of foreign enterprises as taxable entities". National standards vary. The United States and the United Kingdom are prime examples. The United Kingdom treats an "unlimited" company formed under the Companies Act 1985 as a corporation for tax purposes. But the U.S. Treasury has ruled that such an entity is not a corporation for U.S. tax purposes in cases where, in addition to lack of limited liability, shareholdings cannot be transferred without the board of directors' approval. (It is not a corporation for U.S. tax purposes because there are insufficient "corporate characteristics"). Questions for discussion, debate and hopefully resolution at the Congress include (1) whether or not there should be harmonious entity characterization as a matter of international policy; and (2) whether or not income tax treaties should deal with harmonization.

Subject II is "tax treatment of computer software", a topic ripe for tax policy analysis. It is an example of

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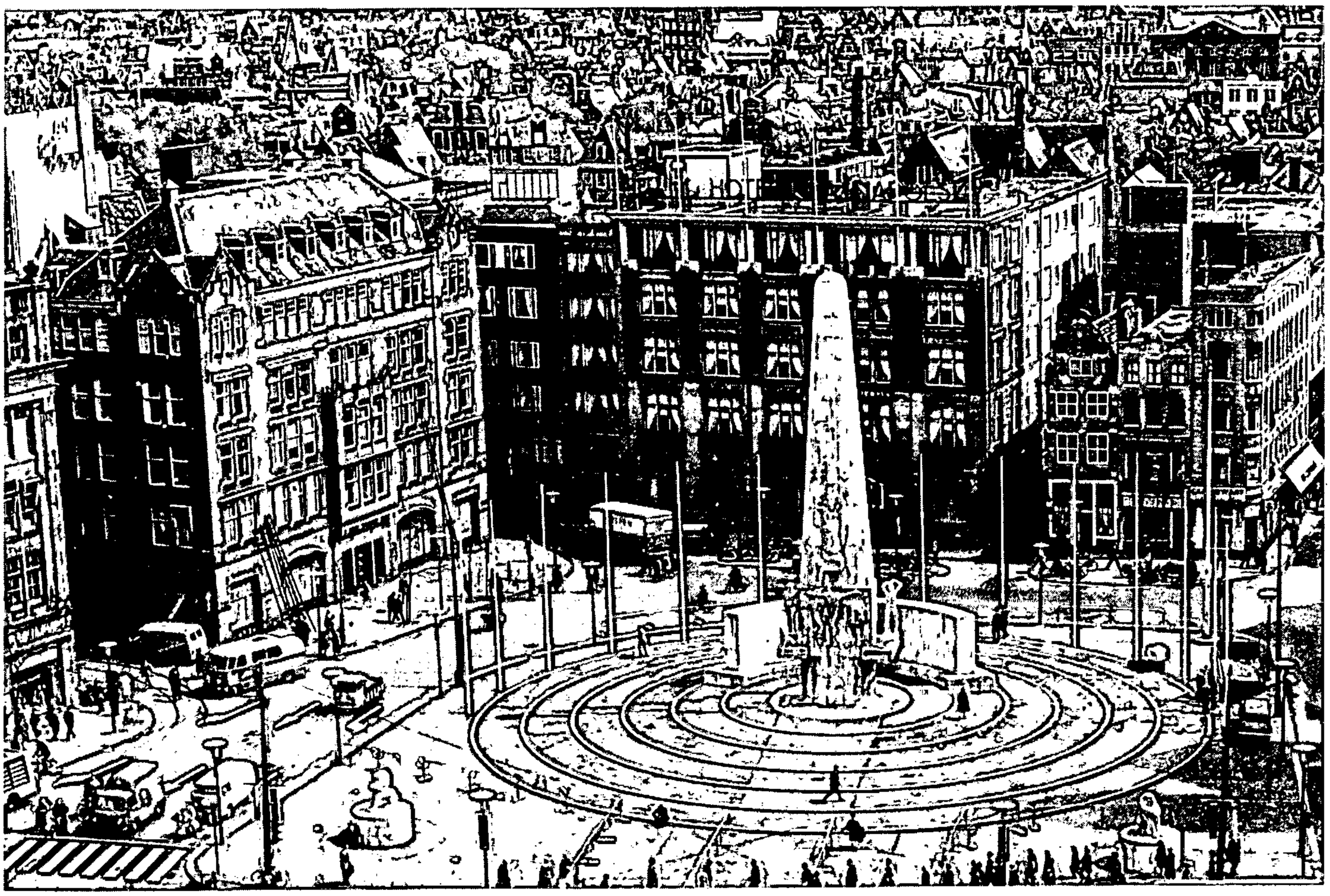
new technology not fitting comfortably into existing tax concepts (including, prominently, the customs and permanent establishment areas). I believe IFA can help in the important task facing national legislatures of bringing the tax systems up to speed with this technology explosion.

The seminar subjects are also timely. Seminar A considers "data processing in taxation" an important subject for all MNCs, and a particularly important subject for U.S. MNCs (who must deal with a tax system that virtually cannot be complied with without sophisticated computer programmes). Seminar B is on "tax consequences of pension provisions for the internationally transferred employee". The deduction of pension costs of seconded employees, often a thorny issue, will be discussed. Seminar C, on "recent issues in tax conventions", will consider topics such as how to adapt treaties to imputation tax systems. Seminar D considers "draft EC directives on parent-subsidiary, on mergers, and on arbitration", a topic of wider-than-EC interest because of the EC's central position in world commerce and its role as a trend-setter for company law and for cross-border harmonization.

TWO SAD NOTES

The death of Mitchell Carroll and the resignation of Jan Christiaanse as Secretary-General of IFA for health reasons are a loss to everyone associated with our organization. Mitchell was a founder of IFA and its second president, and has remained an important presence. Jan has been "Mr. IFA" for almost 2 decades. His energy and zest for life have been evident in all aspects of his professional career, his work for IFA and his tennis. We wish Jan a speedy recovery.

Again, welcome to what I am sure will be a fruitful and enjoyable jubilee.



National Monument at the Dam square

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Subjects and Seminar of the 1988 IFA Congress

Subject I
Recognition of foreign enterprises as taxable entities
General reporter:
Prof. K. van Raad, the Netherlands

Thème I
La reconnaissance de la personnalité fiscale des entreprises étrangères.

Thema I
Anerkennung der steuerlichen Rechtsfähigkeit ausländischer Unternehmen

Tema I
Identificación de las entidades comerciales extranjeras como contribuyentes

Subject II
Tax treatment of computer software
General reporters:
Messrs. Robert N. Mattson & J.B. Jones Jr., U.S.A.

Thème II
Le traitement fiscal du "computer software"

Thema II
Steuerliche Behandlung von Computer-Software

Tema II
Régimen fiscal de los programas de computación

Seminar A:
Data processing in taxation
Chairman:
Dr. H. Sebiger, Fed. Rep. of Germany

Séminaire A
L'informatique et l'impôt

Seminar A
Elektronische Datenverarbeitung und Steuern

Seminario A
Procesamiento de datos en impuestos

Seminar B:
Tax consequences of pension provisions for the internationally transferred employee
Chairman:
Mr. P. den Boer, the Netherlands

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Le régime fiscal des pensions des salariés envoyés à l'étranger

Seminar B
Steuerliche Auswirkung von Pensionsvereinbarungen für international versetzte Angestellte

Seminario B
Disposiciones fiscales sobre las pensiones de los empleados transferidos internacionalmente

Seminar C:
Recent issues in tax conventions
Chairman:
Mr. M.J. Ellis, the Netherlands

Séminaire C
Evolutions récentes en matière de conventions fiscales internationales

Seminar C
Aktuelle Probleme der Doppelbesteuerungsabkommen

Seminario C
Evolución reciente de los tratados fiscales

Seminar D:
Draft EC directives on parent-subsidiary, on mergers and on arbitration
Chairman:
Mr. R. Baconnier, France

Séminaire D
Propositions de directives communautaires concernant les sociétés mères et les filiales, les fusions et la procédure arbitrale

Seminar D
EG-Richtlinienentwürfe über Mutter-Tochtergesellschaften, Fusionen und Schiedsverfahren

Seminario D
Proyecto de Directivas Comunitarias sobre las matrices y sus subsidiarias, las fusiones y el arbitraje

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Cutting Taxes

The Netherlands Follows the Trend by Introducing Radical New Proposals

By H.E. Koning, Under Minister for Finance

Hendrik Elle Koning was born on 7 June 1933 in Beilen. From 1952-1958 he attended the Tax Officers College in Rotterdam, with a break for military service between 1953 and 1955. He read Dutch law as an external student at the University of Leiden, taking his final "doctoraal" examination in 1962. Mr. Koning was an assistant tax inspector from 1958 to 1961; in 1961 he became an inspector. He was employed in the General and Legal Affairs Department of the Tax Department (Ministry of Finance) from April 1962 to February 1967.

Mr. Koning was a member of the South Holland Provincial Council and leader of the VVD Party (Liberal Party) on the Rotterdam Municipal Council between 1971 and 1974, between 1976 to 1977, and from 7 September 1982 until his appointment as Under Minister. From 23 February 1967 to 28 December 1977, he was a member of the Lower House. Mr. Koning was Under Minister for Home Affairs from 28 December 1977 to 11 September 1981, after which he returned to the Lower House. Mr. Koning was appointed Under Minister for Finance on 5 November 1982 (re-appointment on 14 July 1986).

INTRODUCTION

National tax policies have been stimulated in recent years by international trends. The open Dutch economy must necessarily be aware of such trends. In the era of modern technology, in which companies operate on a worldwide scale, this awareness has emerged as an important factor in formulating Dutch fiscal policy. This development has augmented the significance of the International Fiscal Association (IFA) as a forum in which international fiscal experts can meet and confer. Accordingly, it gives me great pleasure that the year IFA celebrates its 50th anniversary, the congress should once again be held in the Netherlands.[1]

THE SIMPLIFICATION OF TAXATION

Tax legislation has evolved into a state of bewildering complexity. A multiplicity of reasons can be advanced to account for these circumstances, i.e. society itself has become more complex, the expanding tax burden has led to refinement of regulations, the level of the tax rates necessarily compels more attention to the personal circumstances of taxpayers, efforts to combat tax evasion and fraud have necessitated additional legislation and executive measures and a variety of non-fiscal objectives have become crucial factors to be taken into account in formulating taxation policies. Combined, these elements have contributed to a generation of intricate taxation systems. Gradually, however, it has become patently obvious that this pattern cannot endure, that bureaucratic overlays must be streamlined and that simplicity is the primary requirement of a tax system. A similar realization has been dawning all over the world and has led to overhauls of numerous tax systems.[2]

The Netherlands has not enjoyed immunity from this global trend. The Parliament as well as the general public have joined the bandwagon in raising clamours for simplification of the tax system (in particular the income taxes). These overtures led to the 1985 creation of the Oort Committee. The Commission, drawn from a wide political spectrum, was assigned the task of investigating possibilities of streamlining the Dutch tax system.[3] The Report, which was produced in record time, advocated far-reaching proposals on income tax, wages and salaries tax (i.e. the pay-as-you-earn component of income tax) and social security contributions.[4] The proposals included combining income tax and social security contributions and a broadening of the first tax bracket.[5]

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Under the existing system, income tax and social security contributions are structured differently. Income tax rates are progressive, while social security contributions are levied on a proportional basis. All taxpayers are granted a tax-free allowance on annual income.[6] No general tax-free allowance exists for the social security contributions. The Oort Commission proposal reduces the number of rate scale brackets, i.e. probably 3 brackets rather than the current 9.[7] Thus a uniform rate would encompass a broad spectrum of income.

Introducing a broadly-based first bracket would eliminate various complications associated with the present system. If the bracket applied to the first 45,000 Dfl. over and above the generally applicable tax-free allowance (i.e. one of the options suggested by the Oort Committee), approximately 85% of the taxpayers would only pay tax at the first rate. Consequently, more individuals would only be required to pay wages and salaries tax and not income tax.[8]

REDUCING INDIVIDUAL INCOME TAX RATES

The Oort Committee's proposals received a favourable reception. In December 1986, the Government committed itself to simplify taxation along the lines of the Committee's report. However, actual implementation of such a radical proposal is an arduous operation, requiring much time and labour. As a result, the new system is not expected to enter into force until 1 January 1990. Meanwhile, revenue from wages and salaries tax and income tax was reduced by 1.7 billion Dfl. (or about 4%) on 1 January 1988. This may be regarded as a first step towards the badly-needed rationalization of tax rates. Reducing the tax burden (which is heavier in the Netherlands than in most other OECD countries) is essential to bolster the economy.

There is a global trend towards substantially reducing the levels of income tax and the number of tax brackets. The United States 1986 Tax Reform Act paved the way in this respect. Secretary of the Treasury, James Baker III, asserted that the trend was induced by the fact that individuals generally do not want to invest or work in a country with high taxes. This might be coined the "American challenge". It is partly in the light of these international developments that the Dutch Government favours a reduction in the individual and corporate income taxes.

In particular, the marginal rates of tax should be reduced because high marginal rates of taxation have an adverse (in fact paralysing) effect on the labour market. For example, the "black market" economy tends to flourish under these conditions. The Netherlands, in an effort to adhere to its open economy policy, cannot afford to ignore measures adopted by its competitors.

Higher tax yields due to, inter alia, efforts to combat fraud, major remedial new legislation and a cut in the number of expenses which can be offset against tax would therefore be used to reduce the basic rate of taxation under the Oort Committee's proposals. Together with another measure (described below), this would make it possible to cut the basic rate from the 40%, which was originally proposed, to 35%.

It is also proposed that there should be only 2 other tax rates besides the basic rate of 35%, namely a middle rate of about 51% and a top rate of 60%. This change would be implemented in such a way that the reduction in number of tax-deductible expenses and allowances and the reduction in tax rates more or less balanced out against each other overall. Naturally, individuals would gain or lose as a result of the changes. Taxpayers with large incomes and few tax-deductible expenses would gain. Taxpayers with numerous tax-deductible expenses might be worse off in spite of the lower rates of taxation.

REDUCING CORPORATE INCOME TAX

In contemplation of the increasing mobility of investment and skilled labour and the continuing integration of the European Community, it is imperative that the Netherlands respond to relevant international developments. The question has arisen as to how the burden of taxation and social security contributions on business could be reduced.

The Government has concluded that the funds allocated under the 1978 Investment Account Act (Wet Investeringsrekening, hereinafter "WIR") should be put to different use.[9] Reform plans for WIR were premised on the idea that if economic growth and employment were to be stimulated, the full amount previously allocated under WIR should continue to be used to assist trade and industry. In view of other fiscal trends (notably in the EC) and because the Dutch Government is anxious to maintain the country's competitive position in fiscal terms (in which WIR played an important role), a substantial cut in corporate income tax is considered vital. A reduction in corpora-

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1. IFA was established on 12 February 1938 in The Hague. Its first international congress was also held in The Hague, from 13 to 16 July 1939.
2. For example, tax reforms have taken place in the United States and the United Kingdom. Reforms are under way in the Federal Republic of Germany and Belgium.
3. For a discussion of the Report of the Oort Commission, see van den Broek, P., "A Step Towards Simplicity", 26 *European Taxation* 7 (1986) at 226.
4. Five general social security funds exist in the Netherlands, i.e. the retirement pension fund (AOW), the widows and orphans pension fund (AWW), the disability pension fund (AAW), the child allowance fund (AKW) and the fund for extraordinary medical expenses (AWBZ).
5. Other proposals related to deductions and special provisions. Certain limits were imposed on the Oort Committee's outlines, i.e. its proposals should have no effect on the budget. Thus, the Committee was unable to propose a rate reduction.
6. The current tax-free allowance ranges between 7,392 and 18,185 Dfl.
7. Actually, the Commission proposed 2 options for reducing the rate scale brackets, i.e. one scale with 4 brackets and one with 3 brackets. See, "A Step Towards Simplicity", 40 *Bulletin for International Fiscal Documentation* 6 (1986) at 260.
8. Far fewer people would have to complete an income tax return and the taxpayer's financial obligations vis-à-vis the State would be clarified.
9. The law was repealed on 29 February 1988. However, the premium for small investments remains in force.

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tion tax should also be considered in connection with the more general reductions in tax rates and tax-deductible allowances referred to above.

Both labour and management organizations were consulted in an effort to determine the most effective method of utilizing the available funds. Both concurred that wage costs could be best reduced by cutting social security contributions. The final decision was to abolish child allowance contributions, which will lead to an approximate 2.5% reduction in wage costs. As a result, the basic rate of the combined levy of income tax and premiums can be 1.5 percentage points lower.

It has also been proposed that the corporate income tax rate for profits exceeding 250,000 Dfl. should be reduced from the present 42% to a top level of 35%, a percentage more in line with international standards. The rate for profits up to 250,000 Dfl. is to be reduced to 40% in order to discourage abuse of the "besloten vennootschap (BV)" form of company by entrepreneurs liable to income tax, who set up BVs for purely fiscal reasons. The assets allowance for purposes of corporate income tax will be reduced to zero. The changes in corporate income tax should become effective on 1 October 1988.

CONCLUSION

The Netherlands was in the vanguard in 1984 and 1986, when it was one of the first countries to reduce corporation tax. The new proposals for changes in tax rates are radical measures, but essential ones: the Dutch economy is vulnerable to foreign competition and the country cannot afford to be out of step with other countries. Companies must not be discouraged from operating in the Netherlands and skilled labour must not be deterred from seeking employment in the country. From an international perspective, the new corporation tax rates are still highly competitive, while the changes in wages and salaries tax and income tax rates will bring the Netherlands more into line with the international trend. In conjunction with structural tax reforms, these measures will foster a flexible economy.

The recent fiscal developments in the Netherlands outlined in this article emphasize the unavoidable necessity for individual countries to tailor their tax policies to international developments. IFA and the International Bureau of Fiscal Documentation can perform an extremely useful function in assisting countries to achieve such goals in the years ahead.

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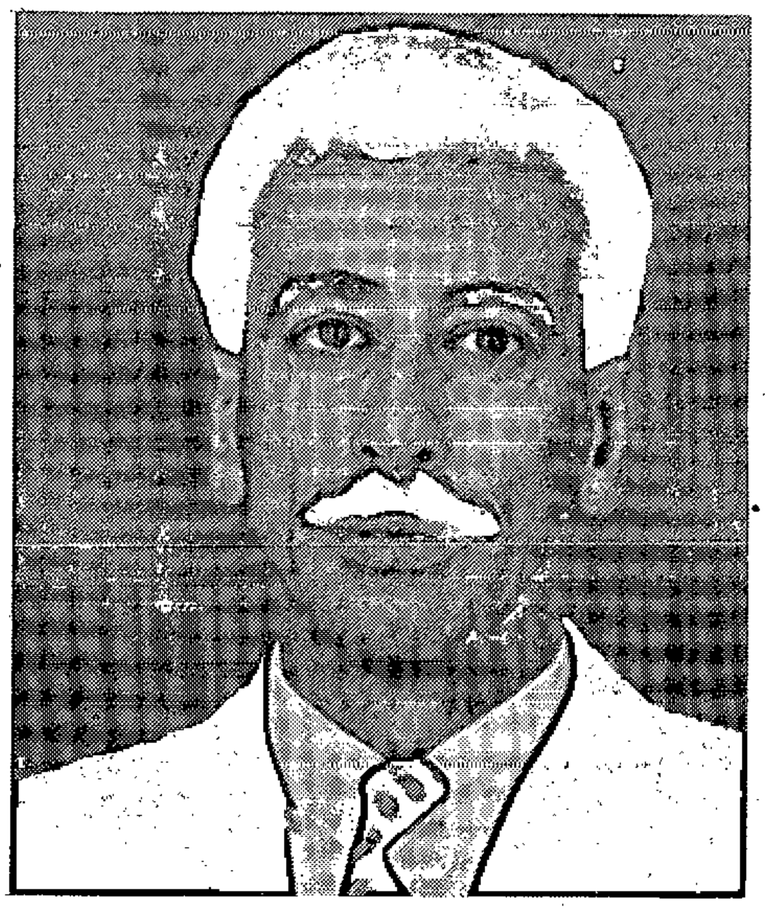
NETHERLANDS:

Issues in the Application of Tax Treaty Non-Discrimination Clauses

By Kees van Raad

I. INTRODUCTION



Non-discrimination is a relative subject. It concerns the treatment of one person or object in comparison to that of another person or object: the former person (object) may not be treated differently from the latter. In tax treaty non-discrimination clauses, "not differently" is usually interpreted to mean "not less favourably".

When the concept of non-discrimination is applied to international taxation, one would expect that (since tax law distinguishes among taxable persons and taxable objects on the basis of being "domestic" or "resident" vs. "foreign" or "non-resident"), tax treaty non-discrimination rules would focus primarily on tax treatment differences between such 2 persons or objects that amount to a less favourable treatment of the foreign person or object exclusively on the basis of "foreignness". This statement needs clarification. If a country taxes *non-resident persons* only on certain income from domestic sources but taxes resident persons on their world-wide income, non-discriminatory taxation of non-resident taxpayers would, of course, not imply that they too should be taxed on their world-wide income. Rather, to the extent that non-residents are subjected to taxation, they should be taxed not less favourably than resident taxpayers. For instance, if resident taxpayers with employment income are entitled to a standard deduction for employment expenses, non-resident employees should be allowed the same deduction.

Similarly, non-discrimination in respect of *foreign* vs. *domestic* income would mean that if a taxpayer has a choice between e.g. straight-line depreciation and the declining balance method in determining income from domestic business activities, a taxpayer with foreign business income should, in computing his foreign profits for purposes of double taxation relief, be entitled to the same choice.

In addition to these jurisdiction-related clauses, a non-discrimination provision should also take into account undesirable differentiations in tax treatment countries sometimes make in respect of, for example, deductibility of certain payments (interest, pension premiums) to non-residents.

The existing non-discrimination clauses of tax treaties which are based on the 1977 OECD Model Convention do not take a broad neutrality approach in respect of either taxable persons (non-residents vs. residents) or taxable income (foreign income vs. domestic income) nor do they effectively deal with the entire catalogue of foreign-unfriendly practices of many countries. Rather, the non-discrimination Article as laid down in Art. 24 of the OECD Model Convention constitutes an incoherent collection of fairly narrow clauses.

This article examines a few of the issues concerning the application of the OECD non-discrimination provision. Some of these issues arise in respect of specific features of Dutch tax law whereas others are of a more general nature. References to treaty provisions are to Articles of the OECD Model Double Taxation Convention of 1977 unless otherwise indicated.

Mr. van Raad received his legal training at the law school of the University of Leiden. Following his graduation, he studied international tax law (M.C.L.) at Georgetown University in the United States. Upon his return to the Netherlands, Mr. van Raad worked in the Department of International Tax Affairs of the Ministry of Finance until 1975 when he joined the tax faculty of the University of Leiden. From 1979, he also served as a part-time tax inspector and counsel for international tax affairs at the Amsterdam office of the Corporate Income Tax Division of the Netherlands Revenue Service. In 1982, Mr. van Raad was a visiting professor at the University of Florida School of Law where he taught a course on tax treaties. He earned his doctorate in law in 1986 at the University of Leiden (dissertation: "Nondiscrimination in International Tax Law") and shortly thereafter he was appointed Professor of International Tax Law at the same university. In September 1986, he joined the tax law firm of Loyens & Volkmaars in an "of counsel" position. Mr. van Raad has written extensively on subjects of international tax law.

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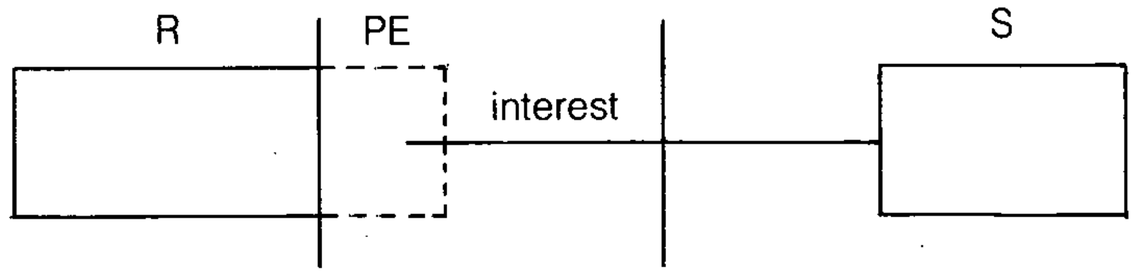
II. THE PERMANENT ESTABLISHMENT CLAUSE OF ART. 24(4) OECD

The only clause in Art. 24 which (to an extent) fits in the broad non-discriminatory approach to exercising jurisdiction as described in the preceding paragraph, is the permanent establishment (hereinafter referred to as "p.e.") clause of para. 4. The first sentence reads:

> The taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

Such a clause in a Dutch tax treaty entitles a non-resident of the Netherlands (who as a resident of the other treaty State carries on business through a Dutch p.e.) to Dutch taxation of the income of the p.e. not less favourable than the taxation of similar enterprises carried on by Dutch residents. Although the clause provides for non-discriminatory tax treatment of non-residents in comparison to residents, this treatment is restricted to the business income the non-resident derives through a Dutch p.e. Despite the limited scope of this clause, States which have concluded double taxation conventions containing this non-discrimination provision still appear to be reluctant to fully accept its consequences. Many States (the Netherlands included) have difficulty in accepting that the restriction in the personal scope of their unilateral double taxation relief rules to resident taxpayers cannot be applied in respect of foreign income derived by Dutch p.e.'s of companies residing in treaty States. Typically, whereas under the p.e. non-discrimination clause of Art. 24(4), a non-resident company operating a Dutch p.e. with which real property situated in a third country is effectively connected, is undeniably entitled to unilateral relief in respect of any income derived from the third country real property. This result may not be readily accepted by some countries. However, to exculpate these countries it must be admitted that they do not meet much opposition. Taxpayers who are denied unilateral relief rarely take their case to court, and as a result, even on a world-wide scale, the number of court decisions involving application of non-discrimination clauses remains very small.

Application of the p.e. non-discrimination clause may evoke questions which are not easy to answer. For example, assume that a corporation which is a resident of State R maintains a p.e. in State PE. Among the assets attributable to the p.e. is a debt-claim on a debtor who is a resident of State S. Further assume that States R and PE have concluded a tax treaty which contains a p.e. non-discrimination clause and that there is no treaty between the States R and S. States PE and S have concluded a treaty providing for a reduction to 10% of the 25% withholding tax State S applies to outgoing interest payments. Under the p.e. non-discrimination clause of the R-PE treaty, State PE is required to treat the p.e. as if it were the enterprise of a resident taxpayer. Under the PE-S treaty, a resident of State PE who receives interest income from State S will be entitled to (i) a reduction by State S of its tax on the interest to 10%, and (ii) a credit by State PE of the 10% S-tax.



Under the generally accepted relative effect of treaties[1], State PE cannot unilaterally expand the category of persons who are entitled to invoke the treaty with State S in order to include residents of State R. Under Art. 1 of the PE-S treaty, application of the treaty is restricted to persons who are residents of State PE and/or State S. It would be unacceptable to State S if State PE, on the basis of an obligation assumed under a treaty concluded with a third State (State R), could expand the group of persons in respect of whom State S would have to reduce its source tax. Therefore, no reduction of S-tax can be claimed under the non-discriminatory treatment of p.e. income under the R-PE treaty.

The second effect of the PE-S treaty is the credit that State PE must grant for the reduced S-tax. Under the p.e. non-discrimination clause of the R-PE treaty, this credit must also be granted in respect of the p.e. income. If under its unilateral double taxation relief rules, State PE either does not grant a foreign tax credit to non-resident taxpayers or grants it under conditions which produce a less favourable result than under the PE-S treaty, then under the p.e. non-discrimination clause of the PE-R treaty, State PE is obliged to grant (in respect of the p.e. profits) the same foreign tax credit as it grants under the PE-S treaty to its own residents. However, since these residents would be taxed by State S under the PE-S treaty at a rate of only 10%, the credit granted by State PE in respect of the p.e. profits would equally be limited to 10%, whereas State S, as a result of the inapplicability of the PE-S treaty, imposes an unreduced 25% tax. State PE must apply its unilateral relief rules to the remaining 15% even if these rules are reserved to resident taxpayers because State PE is obliged to place the p.e. on a non-discriminatory footing with resident taxpayers.

A peculiar consequence arises at this point with regard to the Netherlands. Until 1970 the Dutch unilateral relief rules were restricted to, generally, active foreign income such as business income and employment income. The Netherlands grants a "tax exemption" (a proportional reduction of the tax on the world-wide income) for these types of income.[2] In 1970, the Netherlands, which traditionally favours exclusive residence State taxation of interest and royalties, included

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1. See Sec. 54 of the 1977 OECD Commentary to Art. 24.
2. Decree for the Avoidance of Double Taxation of 4 April 1965 (as amended). For a discussion of this Decree, see in this issue, Lyons, S.M. and van Waardenburg, D.A., "Some Aspects of Dutch International Tax Treaty Strategy".

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in its unilateral relief rules foreign tax credit provisions for these types of income if derived from sources in developing countries.[3] Countries qualifying as developing countries are enumerated in a ministerial decree.[4] This decree, issued in 1970, was updated in 1984.[5] The update removed from the list all developing countries with which a treaty had been concluded since 1970. In the preceding example, if State S had been one of the countries removed from the list of qualifying developing countries because a treaty had been concluded with it, no credit would be available in respect of the p.e. income, as such unilateral credit is restricted to interest, etc., derived from a developing country listed in the decree.

A similar issue arises if the income from State S attributable to the p.e. is derived from business activities in State S which may qualify as a p.e. in itself, i.e. a "sub-p.e.". The phenomenon of a sub-p.e. has received scant attention in legal literature on taxation. If the State S sub-p.e. fulfils the requirements of a p.e. as defined in the treaty between the States PE and S, State PE must (under the non-discrimination rule provided by the R-PE treaty), grant double taxation relief in respect of the sub-p.e. income. The outcome would be the same in the absence of a PE-S treaty if the unilateral relief rules of State PE apply to foreign p.e. income.

III. THE NATIONALITY CLAUSE OF ART. 24(1) OECD

The nationality clause, which is a remnant of a biblical commandment (Leviticus 19:34: "The stranger who sojourns with you shall be to you as the native among you, and you shall love him as yourself") and 19th century trade treaties[6], is laid down in the first sentence of Art. 24(1) of the 1977 OECD Model:

> The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

Art. 24(2) reads:

> The term "nationals" means:
> (a) all individuals possessing the nationality of a Contracting State;
> (b) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

In modern tax treaties, the prominent position of this clause in the provision on non-discrimination can be considered slightly odd since, apart from States which employ nationality as a jurisdictional basis for full tax liability, nationality does not score high among circumstances on which States base differentiations in taxation.

For States which use nationality as a criterion for personal tax liability in respect of world-wide income, unrestricted application of the OECD nationality non-discrimination clause would result in extending all attributes of full tax liability (e.g. consolidation privilege, dividend received deduction) to restricted liability taxpayers. Some States employing nationality as a full tax liability criterion (like the United States) recognized fairly early that unrestricted application of nationality non-discrimination clauses would enhance such undesirable effects. Consequently, the United States has limited application of the nationality non-discrimination clause where individuals are concerned to foreign citizens who are subject to unrestricted U.S. tax liability, i.e. U.S. residents.[7] Such a deviation from the OECD Model non-discrimination clause to prevent unwanted equal treatment claims has not been made by the Netherlands thus far. As a result, non-residents of the Netherlands who are subject to Dutch taxation may in certain cases reduce this tax by applying the nationality non-discrimination clause of the treaty between their residence State and the Netherlands. One of these cases is discussed below.

Under Dutch tax law, a corporation is subject to unrestricted tax liability if it is resident in the Netherlands.[8] According to Art. 4 of the General Act on Taxation[9], residence is determined on the basis of the circumstances. Under Dutch case law, the place from which a corporation is effectively managed ranks high among these circumstances. In addition, a company is *deemed* to reside in the Netherlands if it is organized under Dutch law.[10]

Consequently, a corporation which is effectively managed abroad but incorporated in the Netherlands is treated as a resident corporation. If a resident corporation receives a dividend from another (resident or non-resident) corporation, the dividend is not taxable for corporate income tax purposes if the dividend qualifies for the so-called participation exemption.[11] More important in this context, the dividend is not subject to withholding tax.

Let us assume that a second corporation which is also effectively managed abroad and which receives similar dividends from the Netherlands is incorporated under foreign law. The difference from the first-mentioned foreign-managed Netherlands-organized corporation is only the law under which it is incorporated, i.e.

3. The credit was extended to dividends in 1976.
4. Ministerial Decree of 28 May 1970. See also article cited in footnote 2.
5. Ministerial Decree of 17 May 1984.
6. See Sec. 2 of the Commentary on Art. 24 of the 1977 OECD Model.
7. Under U.S. tax law, the term "resident" has no meaning with respect to corporations. Therefore, it appears that treaty non-discrimination clauses which apply only to taxpayers who are *"residents"* of the United States rather than *persons who are subject to unlimited tax liability* in the United States, are not effective in excluding foreign corporations from the nationality non-discrimination clause. See Kees van Raad, *Nondiscrimination in International Tax Law (with special reference to The Netherlands and the United States)*, Kluwer, Deventer (1986) Part IV.2, Sec. 3.3.2.
8. Corporate Income Tax Act, Art. 2(1) (Wet op de Vennootschapsbelasting 1969, hereinafter referred to as "CITA").
9. Algemene wet inzake rijksbelastingen.
10. Art. 2(4) CITA.
11. For a discussion of the participation exemption, see in this issue, Brood, E.A., "The Participation Exemption: Present and Future" at 369. See also, Hamulyák, A., "Revision of the Participation Exemption", 27 *European Taxation* 10 (1987) at 311.

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foreign versus Dutch. This, however, is precisely the difference neutralized by the nationality non-discrimination clause of Art. 24(1). Consequently, the foreign-managed foreign-organized corporation also qualifies for the exemption from withholding tax. The imposition of any withholding tax the Netherlands may levy under an OECD-type Art. 10 (Dividends) of its treaty with the foreign country concerned is prohibited by the non-discrimination provision of the same treaty. This application of the nationality non-discrimination clause effectively eliminates all Dutch withholding tax on dividends distributed to companies which hold at least 5% of the outstanding shares of the Dutch distributing company and which are resident in a country with which the Netherlands has concluded a tax treaty providing for a nationality non-discrimination clause.[12]

To escape this consequence one may try to argue that the "same circumstances" requirement of Art. 24(1) is not met in the above situation since the former corporation, incorporated under Dutch law, is a resident taxpayer and subject to world-wide tax liability whereas the second corporation, not incorporated under Dutch law (nor effectively managed in the Netherlands) is not subject to world-wide taxation. This difference, so the argument goes, amounts to a dissimilarity in circumstances with the result that the non-discrimination clause is inapplicable.

The question arises whether this argument based on the "same circumstances" requirement is valid. According to the OECD Commentary[13], the "same circumstances" requirement refers to taxpayers who are, "from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact". As explained below, this requirement is conceptually incorrect. For purposes of discussion, the required "similar circumstances in fact" will be distinguished from the "similar circumstances in law".

With regard to "similar circumstances in fact, the following should be noted. If one wants to determine whether, in a given situation, the prohibited type of discrimination occurs, one must construe in the abstract a situation in which all facts are identical to the given situation except for the very aspect (e.g. nationality, age, sex) protected under the non-discrimination clause. If the construed situation is subject to a more favourable treatment than the existing situation, discrimination takes place. Identity of all facts except for the aspect protected by the non-discrimination provision is a postulate for determining whether discrimination occurs. The requirement of similarity in factual circumstances is therefore superfluous. The required similarity flows from the very concept of specific non-discrimination.

The requirement of "similar circumstances in law" is of a different nature. Only if a given basis for non-discrimination (e.g. hair colour) has no legal consequences whatsoever, will persons differing from each other in this respect (e.g. red-haired persons and blond persons) be in identical "circumstances in law". However, if the law does make a distinction in respect of a specific ground for non-discrimination, such as nationality, by providing, for example, that nationals may not be extradited whereas foreign citizens may be extradited, then a foreign citizen is *not* in a similar legal position to a national. Consequently, for purposes of this nationality non-discrimination rule, the treaty language does not permit the foreign citizens to invoke this rule because the law provides a type of differential treatment based on nationality; the result is impossibility of "similar circumstances in law". As this would not make sense, the requirement of "similar circumstances in law" must be dismissed.

The drafters of the OECD Model and the Commentary possibly had something else in mind. They may have thought that with regard to specific grounds for non-discrimination (e.g. nationality) differential treatment should be permitted if the differentiation is *reasonable*. For instance, it may be considered reasonable to base extradition policies on the nationality of the person concerned whereas taxing foreign citizens at rates double that of nationals may be considered unreasonable. If this is what the drafters of Art. 24(1) had in mind, they were unsuccessful in expressing their actual intentions. The drafters could have thought that "nationals of a Contracting State shall not be treated in the other Contracting State with regard to any taxation or any requirement connected therewith unreasonably different from nationals in that other State". Alternatively, and more in line with non-discrimination provisions in international human rights instruments and constitutions, the drafters could have written that "nationals of a Contracting State shall not be discriminated against in the other Contracting State with regard to any taxation or any requirement connected therewith", with "non-discrimination" meaning differential treatment based on an irrelevant or unreasonable ground.

If exceptions must be permitted in a specific non-discrimination clause such as Art. 24(1), it is preferable that the exceptions be enumerated. Only then can a non-discrimination clause serve the purpose for which it was designed, i.e. to offer security to "foreign" persons, and in respect of objects and relations. A criterion which inevitably needs a court in order to determine its applicability is inadequate.

IV. THE CONTROL CLAUSE OF ART. 24(6) OECD

In addition to rules against less favourable treatment of taxpayers who are subject to limited taxation (Art. 24(1), foreign nationals; Art. 24(4), certain non-residents), tax treaties may contain clauses against tax differentiations based on other factors as well. Examples include non-deductibility (for individual income tax purposes) of pension premiums paid under foreign

12. See van Raad, Kees, "Netherlands Withholding Tax on Dividends Paid to Foreign Parent Companies and Nondiscrimination Clauses", Intertax (1982) at 183.
13. See Sec. 3 of the Commentary to Art. 24.

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pension plans[14] and denial of tax benefits to subsidiaries if the parent company is non-resident rather than resident. This latter clause is laid down in Art. 24(6) of the 1977 OECD Model Convention:

> Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

The provision is poorly drafted. The taxation of a resident-controlled enterprise of one State must be compared with the taxation of an "other similar" enterprise. Comparison of this clause with the other non-discrimination clauses of Art. 24 and consultation with Sec. 57 of the OECD Commentary shows that the "object [of the provision] is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital . . . to identical treatment applied to *domestic* capital" (emphasis added). Although this explanation primarily indicates that the provision aims at equal treatment of resident enterprises (irrespective of whether they are resident- or non-resident-controlled) rather than equal treatment of the non-resident and resident persons controlling them, the Commentary makes clear that a non-resident-controlled resident enterprise should not be taxed less favourably than a resident-controlled resident enterprise. The provision should explicitly state this by replacing the words "other similar enterprises" with "enterprises the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the first-mentioned State".[15]

The issue to be discussed here, however, does not concern the poor drafting of this OECD provision but rather its application to Dutch taxation. Arts. 32-39 of the Dutch Legal Transactions Tax Act (hereinafter referred to as "LTTA")[16] provide for capital duty to be levied on corporations resident in the Netherlands when capital is contributed in any form. In accordance with the EC Directive of 17 July 1969[17], Art. 35(4) LTTA, read in conjunction with Art. 12(2) of the LTTA Implementing Decree, provides for an exception from this duty in case of an "internal reorganization". If, in a reorganization, shares are transferred to a company resident in the Netherlands, the capital duty due in respect of this transfer is reduced by the amount of tax computed over the nominal value of the shares transferred provided the transferring company is a resident of an EC Member State. This reduction aims to prevent the capital duty otherwise imposed from cumulating with the duty levied upon formation of the company whose shares are transferred. If the transferor is the parent company of the transferee corporation and not a resident of an EC Member State (and therefore does not qualify for the reduced capital duty under Dutch national tax law), the parent still appears to be entitled to the tax reduction under a non-discrimination clause similar to Art. 24(6) of the OECD Model. Because a transfer by a parent company *resident in the Netherlands* and thereby a resident of an EC Member State would qualify for the capital duty reduction, a parent company resident of a State that has concluded a treaty with the Netherlands which contains an Art. 24(6)-type non-discrimination clause, may claim the same reduction (irrespective of EC membership).[18]

According to Art. 2 OECD (Taxes covered), capital duty is generally not one of the taxes to which treaties apply. Art. 24(7), however, provides that the non-discrimination clause of Art. 24 applies to "taxes of every kind and description".

It appears that similar non-discrimination claims can be brought against the application of capital duty legislation of other EC Member States.

V. CONCLUSION

In his comparative analysis of the U.S. and OECD Model Conventions, Robert J. Patrick, Jr. observes in respect of the non-discrimination clauses of Art. 24 that "the ramifications [thereof] are probably more uncertain than those of any other article".[19] The 10 years that have passed since this pronouncement was made have proven its correctness. Non-discrimination is a concept sympathetic to subscribe to. Still, most States apparently fail to recognize the commitments they make when signing a treaty with the – narrow but at the same time far-reaching – OECD Model non-discrimination clauses. Given the growing awareness on the side of taxpayers of the rights they are entitled to under these clauses, it may be fair to assess that in the next decade the focus will shift from theoretical analysis to courtroom action.

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14. See Art. 24(4) of the 1986 tax treaty between the Netherlands and Canada.
15. Many treaties concluded by the United States contain this more accurate language. See footnote 12 at 197, note 28.
16. Wet op belastingen van rechtsverkeer of 24 December 1970.
17. Council Directive of 17 July 1969 concerning indirect taxes on the raising of capital.
18. This application of Art. 24(6) was brought to my attention by Dick Hund, Senior Vice President Taxes, Douwe Egberts Royal Factories (Utrecht, The Netherlands).
19. Patrick, Robert J., Jr., "A Comparison of the United States and OECD Model Income Tax Treaties", 10 *Law & Policy International Business* 613 (1978) at 705.

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NETHERLANDS:

Mandatory Publication of Resolutions and Rulings is Necessary for Fair and Just Taxation

By Dr. Nico Nobel

The Netherlands Revenue Service (Rijksbelastingdienst)[1] has authority to make arrangements for the taxation of groups of taxpayers as well as for individual taxpayers. In this respect three categories may be distinguished.

1. In certain instances the authority of the Revenue Service is derived from legislative provisions delegating competence to it. In such cases the Dutch legislature[2] has given only the general framework of the legislation and stipulated that it will further be implemented by the Minister of Finance. Regulations based on such legal provisions are of a collective nature and are always made public in the official State Gazette (Staatscourant).

2. Art. 63 of the General Code of Taxation (Algemene wet inzake rijksbelastingen) contains a unique feature. Art. 63 authorizes the Minister of Finance to enter into special arrangements in order to "meet injustices of a predominant nature which may appear in the application of the tax laws in certain individual cases or groups of cases". By virtue of this provision[3], the Minister is permitted to deviate from (other) legal provisions and grant appropriate relief from implementation of the laws if such provisions would lead to "injustices of a predominant nature". However, there is no firmly established (governmental or legislative) policy with respect to publication of rulings entered into on the basis of Art. 63. Sometimes they are made public and sometimes they are kept secret.

3. The third and most important category of situations in which the Revenue Service may make arrangements is the interpretation and implementation of existing legal provisions. These may consist of general arrangements for important groups of cases, but also other arrangements, some of a collective nature but others – which are most numerous – applicable to one or a few persons. Again, no formulated policy dictates whether these resolutions and arrangements must be officially published.

Among the general arrangements for important groups of cases are those rulings which are issued for the allocation of profits of Dutch holding, finance, royalty and support companies belonging to multinational groups of companies. Rulings can be granted as a result of negotiations between the corporate income tax inspector[4] and the tax consultants of the multinational as to the proper allocation of the profits of the group to such Dutch companies. These rulings are valid for a certain period of time and are binding on both parties.[5]

Another facet of Dutch ruling policy which has vital significance for multinational groups of companies is the so-called "35% arrangement" which applies to foreign employees, i.e. non-Dutch nationals who are posted temporarily to the Netherlands.[6] Under this arrangement qualifying employees may benefit from a fixed 35% expense deduction from their income. The rationale for this deduction is that expenses incurred by these individuals as a result of their temporary stay in the Netherlands (e.g. education of their children) are generally considerably higher than those of their Dutch counterparts.

Dr. Nico Nobel studied law at Leiden University (1950-1955) and received his doctorate in law from Amsterdam University in 1970. He has been practicing national and international tax law in Amsterdam since 1960. He recently accepted the position of counsel for Caron & Stevens, a Dutch law firm, which operates internationally as the Amsterdam office of Baker & McKenzie, United States. Dr. Nobel contributes articles to tax periodicals on a regular basis and often lectures on international taxation.

1. The Revenue Service falls under the jurisdiction of the Ministry of Finance.
2. Taxes are imposed on the basis of the Constitution of the Netherlands, Chapter 5, Sec. 2, Art. 104. Fiscal legislation is passed through the cooperative efforts of the responsible Minister, the Queen and both Houses of Parliament.
3. Art. 63 is sometimes called the "hardship clause".
4. Tax inspectors engaging in these activities (they are called "ruling inspectors") consult each other on a regular basis to coordinate their policies. The consultations are held under the supervision of the Ministry of Finance.
5. For a discussion of "advance rulings", see Hamulyák, A., "Administration's Policy Concerning Advance Rulings Disclosed", 27 *European Taxation* 6 (1987) at 191.
6. An official translation of the 35% ruling is reproduced in 26 *European Taxation* 6 (1986) at 303.

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It is often problematic to ascertain whether these individuals have "fiscal residence" in the Netherlands. To avoid difficult and lengthy arguments between the tax authorities and these foreign individuals, the Ministry of Finance issued a ruling by virtue of which (under certain conditions) (i) a foreign employee is deemed to be non-resident in the Netherlands[7] and (ii) a 35% deduction is available as a reduction in the foreign employee's gross salary for the first 5 years of his stay in the Netherlands.

The "35% arrangement" may also be used to illustrate the approach the Revenue Service may take vis-à-vis a matter which it believes to be sensitive. As of the 1950s, a fixed deduction[8] has been available on a substantial scale albeit only to American, British or Canadian nationals employed in the Netherlands and the fact that such a deduction was granted by the Revenue Service was not made public until 1986. Multinational groups and their employees could obtain information about the existence and contents of the concession only through indirect and informal channels (e.g. embassies, contacts with tax advisers or chance information from other sources). It was not until 1970 that certain aspects of the fixed deduction ruling became public knowledge when a Member of Parliament specifically addressed the Minister of Finance about the matter. Even then only the general outline of the arrangement was disclosed since the Minister of Finance's response to the queries did not reveal the details of the arrangement or its practical application. In 1985, Parliament pressed the issue with the result that the arrangement was publicized in more detail in 1986. However, many details significant for the practical application of the arrangement remained hidden. Application of the 35% deduction is continually changing and these alterations are not made public.

A similar development is discernable with respect to the arrangements called "rulings". These rulings were not made public until 1985 when Parliament initiated a series of penetrating questions. The general outlines of rulings were publicized but, like the 35% deduction, many changes have occurred which have not been made public.

If such rulings remain unpublicized (or are only published in part) qualifying taxpayers may remain ignorant of the existence and/or contents of favourable arrangements. If a taxpayer is required to make a specific request to obtain the benefits of a particular ruling, he will be at a marked disadvantage if he is denied access to essential information. Consequently, these taxpayers are taxed differently (and usually less favourably) than other taxpayers similarly situated but who have obtained sufficient information to avail themselves of the benefits of the ruling. In addition, lack of or defective publication and rigid adherence to secrecy also leads to inequality in taxation and – because taxpayers cannot invoke non-published rulings – the Tax Courts are unable to intervene.

Until about 20 years ago, the Dutch Tax Courts took the position that an appeal had to be founded on an alleged misapplication of the law or regulations[9] issued by the Ministry of Finance (on the basis of a delegation of powers). Since the 1970s, Tax Courts have granted more appeals based on arrangements stemming from other categories of arrangements[10] and even ruled in favour of taxpayers on the basis of arrangements which contravene legislation.

The Courts only allow these appeals provided stringent conditions are fulfilled. The most important condition generally requires that the taxpayer prove the arrangement has been promulgated by the Revenue Service. Specifically, the taxpayer must demonstrate that a reasonable interpretation of the resolution would lead one to expect that it would be applied in the particular case (the confidence principle).

The taxpayer's appeal may in certain cases be accepted if he is able to prove that the tax office in his jurisdiction applies certain arrangements as a matter of policy to individuals in the same or similar circumstances (the equality principle). Proof of the existence and contents of such regulations and rulings is onerous (if not impossible) when the arrangements have not been made public.

An interesting case was decided by the Tax Court in The Hague in 1987.[11] In that case a barge skipper obtained access to information contained in a secret Inland Revenue Bulletin which described a particular policy of the Revenue office, i.e. that the tax office in the taxpayer's jurisdiction treated barge skippers in a certain (favourable) way for the VAT. He had also been able to make a photostat of the pertinent Bulletin. When the tax office refused to accord the same treatment to this taxpayer, he appealed to the Court requesting that the arrangement be applied to him. The Court granted the appeal. Of course, the decisive factor in this case was the fact that the taxpayer proved the existence and contents of the regulation. This case patently demonstrates how the lack of or defective publication spawns arbitrary behaviour and injustice.

An Act was passed in 1978 (Open Access to Information Act)[12] which obliges the administration to supply on demand information to the public on its policy decisions unless sound reasons compel secrecy. This Act led to the publication of a number of rulings promulgated by the Revenue Service. Simultaneously, Parliament exerted pressure on the Revenue to exercise more openness with respect to its policies. However, the Ministry of Finance has stubbornly refused to yield, i.e. it has only published its policies after censure by the Administrative Court, after repeated pressure from Parliament and after considerable delays.

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7. This will generally result in the exemption of non-Dutch-source income from Dutch individual income tax.
8. The rates of this deduction have varied over the years.
9. Discussed under Category 1 at the beginning of this article.
10. Id.
11. Decision of the Court of the Hague of 20 February 1987, No. 2346/84-MI, published in *Fiscaal Up to Date* 1987/396.
12. "Wet Openbaarheid van Bestuur" of 9 November 1978, 55/581 (WOB). See also Beukers-van Dooren, A.F.M.Q., "Access to Information in the Netherlands", 26 *European Taxation* 9 (1986) at 281.

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Moreover, as already mentioned, changes implemented to already-published resolutions are often either not published at all or published after considerable procrastination.

Although noticeable improvements have been achieved as a result of the introduction of the Access to Information Act and the intervention of Parliament, accessability to the affairs and policies of the Revenue Service in the Netherlands remains deficient. Vast numbers of policy decisions are known only by experts with inside information, which results in preferential treatment for such experts, inadequate intervention by the judiciary and consequently arbitrary and unjust taxation. Mandatory publication of rulings and arrangements is indispensable for fair and just taxation.

Conference Diary

SEPTEMBER 1988

Joint Seminar of the Canadian and British Branches. London, 9-10 September (English):
British Branch of IFA, Att.: Mr. Eric Tomsett, Touche Ross & Co., Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom.

42nd Congress of the International Fiscal Association; subject I: Recognition of foreign enterprises as taxable entities; subject II: Tax treatment of software. Amsterdam, 11-16 September (English, French, German and Spanish):
Secretariat of the 42nd Congress of the International Fiscal Association, c/o Holland Organizing Centre, Lange Voorhout 16, 2514 EE The Hague, the Netherlands.

Praktiker-Seminar zur Steuerreform. Stuttgart, 16 September, or Frankfurt, 17 September (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

Inhoud en Consequenties Commissie Oort. Rotterdam, 21 September (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

Franchising. Amsterdam, 23 September (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

IBA 22nd Biennial Conference. Buenos Aires, 25-30 September (English):
International Bar Association, London, United Kingdom.

U.S./International Taxation: Tax Strategies for Cross Border Activities. Lesigny, 26 September-1 October (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

Fundamental Elements of U.S. Federal Taxation. Lesigny, 26 September-1 October (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

U.S. Corporate Taxation – Advanced Subjects. Lesigny, 26 September-1 October (English).
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

OCTOBER 1988

Disclosure to the Tax Authorities Home and Abroad – United States, United Kingdom, France, Germany, Switzerland. Geneva, 3-4 October (English):
Conference Organiser, Business Research International, 57-61 Mortimer Street, London W1N 7 TD, United Kingdom.

Praktiker-Seminar zur Steuerreform. Kiel, 7 October, or Würzburg, 8 October (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Federal Republic of Germany.

Congres Belastinghervorming – Noodzaak en gevolgen van het Rapport Oort. Utrecht, 10 October (Dutch):
Vermande studiedagen, Antwoordnummer 234, 8200 VB Lelystad, the Netherlands.

International Tax Planning. Amsterdam, 13-14 October (English):
Seminar Services S.A., Blvd. de Pérolles 7a, CH-1700 Fribourg, Switzerland.

How to Set up and Operate Holding and Finance Companies – Switzerland, Liechtenstein, Luxembourg, Anglo-Saxon jurisdictions, the Netherlands, the Netherlands Antilles. Zurich, 20-21 October (English):
Seminar Services SA, Blvd. de Pérolles 7a, CH-1700 Fribourg, Switzerland.

Treasury Management 1988. Amsterdam, 25-26 October (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, the Netherlands.

NOVEMBER 1988

Belasting-Controle – Spelregels in praktijksituaties. Noordwijk 3, 10 and 17 November (3-day course) (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

Doing Business between the European Community and the Comecon (CMEA) Countries. Budapest, 10-11 November (English):
Seminar Services SA, Blvd. de Pérolles 7a, CH-1700 Fribourg, Switzerland.

Planning and Executing Successful International Acquisitions and Divestitures – An insight into the techniques. Brussels, 28-30 November (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, the Netherlands.

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NETHERLANDS:

"Fraus Legis" and Multinational Enterprises*

By Frank van Brunschot

Mr. van Brunschot studied civil law and tax law at Amsterdam University. Since 1969 he has held the position of professor of international tax law, Amsterdam University. He worked as tax attorney for the Dutch Ministry of Finance from 1979-1984. He is a partner in the law firm of Stibbe, Blaisse & De Jong, Amsterdam.

I. INTRODUCTION

The Dutch tax administration has long been equipped with 2 sharp-edged weapons to attack tax avoidance schemes: the "fraus legis" principle (abuse of law doctrine) and the "correct imposition" provisions (richtige heffing) as set forth in the General Law on State Taxes.[1] Basically, both devices serve the same purpose. However, before the tax authorities can invoke either doctrine, several conditions must be met: (1) the taxpayer must have entered into a sham or relatively sham transaction; (2) the primary purpose of the transaction is to avoid imposition of tax; and (3) the acts of the taxpayer, although apparently in conformity with the law, frustrate the spirit and purpose of the tax legislation.[2]

The "correct imposition" provisions are set forth in Art. 31 of the AWR[3] and its use is limited to direct taxes.[4] Art. 31 empowers the tax administration to scrutinize a particular transaction in order to ascertain whether a tax avoidance motive exists, and if such a motive is established (i.e. if it is likely that the taxpayer would not have otherwise entered into the transaction), the entire transaction can be disregarded.[5] For instance, correct imposition has been used to adjust situations where individual taxpayers contributed capital to a corporation to avoid imposition of income tax.[6]

The second line of attack available to the tax authorities to prevent taxpayers from abusing the law is imposition of the "fraus legis" principle which is based on Dutch jurisprudence. "Fraus legis" embraces a broader domain than correct imposition, i.e. it is not limited to direct taxes and may result in either the tax authorities disregarding a particular transaction or substituting another (normal) transaction for the taxpayer's alleged "normal" transaction. In other words, tax will be imposed as though the taxpayer did not enter into a spurious transaction but rather entered into a taxable transaction. Because of the more encompassing nature of "fraus legis", the Under Minister of Finance recently instructed tax inspectors to utilize this principle when dealing with sham or relatively sham transactions.[7]

Until recently, the "fraus legis" doctrine was only applied to attack taxpayer arrangements which frustrated imposition of income tax. However, based on 4 recent decisions of the Dutch tax courts (2 Supreme Court decisions and 2 Court of Appeal decisions), it is envisioned that the "fraus legis" doctrine will also be extended to cases with international components.[8]

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* This article is an expanded version of a note appearing in 28 *European Taxation* 1 (1988) at 29.

1. Art. 31 of the Algemene Wet inzake Rijksbelastingen (hereinafter referred to as "AWR") introduced by the Law of 29 April 1925, entitled "Law for the Correct Imposition of Direct Taxes".
2. See also van Brunschot, "Abuse of Law", 28 *European Taxation* 1 (1988) at 29.
3. Art. 31 provides:
   No regard shall be paid, for the levying of direct taxes, to legal acts of which it must be assumed, based on the circumstance that they were not aimed at bringing about any essential change in the actual relations or based on certain facts and circumstances, that they would not have been performed had they not had the effect of totally or partially frustrating the levying of tax.
4. Direct taxes include the individual income tax, the net wealth tax, the corporate income tax, the dividend tax and the gambling tax.
5. However, authorization from the Ministry of Finance must be obtained before the tax authorities can apply Art. 31. See Art. 32 AWR.
6. Although Art. 31 was originally passed in 1925, the Dutch tax authorities had relatively little success in its application until 1967. However, in 1967, the Supreme Court upheld application of the "correct imposition" in the following case: The shareholders of corporation A established a new corporation B and transferred all their shares in corporation A to corporation B. Corporation B paid the transfer price of the shares to the shareholders out of dividends received from corporation A. According to Dutch law, a taxable event (receipt of a dividend) was converted into a non-taxable event (repayment of a debt). The tax inspector applied the "correct imposition" provisions in order to disregard the incorporation of corporation B with the result that dividends were deemed not paid to corporation B but to the original shareholders of corporation A. Published in *Beslissingen in Belastingzaken/Nederlandse Belastingrechtspraak* (hereinafter referred to as BNB) 1968/80.
7. *Vakstudie-Nieuws*, 15 August 1987 at 1768-1769. The term "fraus legis" shall be used, for purposes of this article, to include the correct imposition principle as well.
8. Decision of the Supreme Court of 8 January 1986, published in BNB 1986/127; decision of the Supreme Court of 15 October 1986, published in BNB 1987/72; decision of the Court of Appeal of Amsterdam of 14 January 1986, No. 5187/82 and decision of the Court of Appeal of Amsterdam of 29 January 1986, published in *Fiscaal Weekblad FED* of 11 December 1987/464.

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II. THE ACCEPTABILITY OF "FRAUS LEGIS" IN INTERNATIONAL SITUATIONS

Traditionally, "fraus legis" has involved an individual taxpayer; application of the doctrine in such cases is reasonable and enhances the credibility of the tax system. Whether "fraus legis" is an appropriate instrument to be employed in international situations with respect to corporations is an issue yet to be decided. Based on the arguments advanced below, this author contends that the answer to that question is in the negative.

A. International group structures

In principle, multinational enterprises constitute an economic unity and thus there is no need to separate an international enterprise into several legal entities all doing business with each other. Legally, however, it may be necessary to establish different entities. One decisive motive in group structuring (in one form or another) is taxation.[9]

If a multinational is structured in such a way so as to minimize its tax liability and this structure is deemed to conflict with the intent of the legislature, almost all multinational groups will be susceptible to application of "fraus legis". The tax administration would be able to decide, at its discretion, which group structures would be attacked. An appeal to the tax court would be of no avail since the "fraus legis" test would always be met.[10]

B. Arm's length dealing

Transfer pricing is another area of fiscal importance, i.e. the price of goods, services and capital between associated enterprises. If the price put on a particular transaction is less than that which would have been expected had the parties been independent persons dealing at arm's length, the Dutch tax authorities have the power to adjust intercompany transfers. Artificial (or irregular) financing structures or conditions may also be adjusted.[11] The "fraus legis" doctrine is superfluous if Dutch international tax law provides mechanisms to adjust transactions failing to meet the "arm's length" requirements.[12]

C. Profit connected to the Netherlands

Applying "fraus legis" to tax profits which, economically, are not connected to the Netherlands may result in adverse consequences. The Dutch tax authorities do not approve of structures in which Dutch groups establish a foreign subsidiary (fully capitalized with equity), which in turn finances its own Dutch subsidiaries with debt. The administration maintains the position that these financing structures are prime candidates for application of "fraus legis". Clearly, however, a non-Dutch group financing its Dutch subsidiary in this manner would not be at risk. A potential exodus of parent companies could reasonably be anticipated if "fraus legis" is used against Dutch enterprises.

D. The Dutch ruling practice[13]

The Dutch ruling practice towards multinational enterprises is based on the premise that these enterprises should have freedom to establish their group structure in a tax-efficient manner. Application of "fraus legis" to international group structures which are unacceptable to the tax authorities is difficult to justify in situations which are normally covered by the ruling practice.[14] Prohibiting undesirable structures is a legislative function rather than the function of the tax administration.

III. CASES

A. Leveraged buy out

A foreign parent company has a wholly-owned Dutch subsidiary. The parent company establishes another Dutch company and transfers the stock in the subsidiary to the new company while the purchase price remains due against interest. In principle, interest payments are tax-deductible in the Netherlands. In this case, a fiscal unity will have been created between the new subsidiary and the subsidiary in which the enterprise is carried out. The interest payments will thus be deductible from the profits of the enterprise.[15]

The above-mentioned situation is roughly analogous to the case adjudicated by the Court of Appeal of

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9. See also the annotation of van Brunschot, F. to *BNB* 1987/72.
10. See also Verburgh, M.J.P., "Eenvoud en doeltreffendheid" at 240. Verburgh argues that broad application of "fraus legis" could have a negative impact on the independence of tax court judges.
11. See the decision of the Court of Appeal in *BNB* 1978/252 with accompanying note of Hofstra, H.J. See also the decision of the Supreme Court of the Netherlands of 27 January 1988, No. 23,919 (not yet published). In that case, the Supreme Court held that under certain circumstances (e.g. the expectation that money loaned to the subsidiary would not be repaid), a loan to a subsidiary must be characterized as a capital contribution. The approach adopted by the Supreme Court, however, is a tax law qualification (i.e. the transaction was characterized for tax purposes) and not application of the "fraus legis" doctrine.
12. The University of Groningen in the Netherlands reached the same conclusion in its report on Dutch case law *Nederlandse belasting-jurisprudentie op vier internationale gebieden,* published by the International Bureau of Fiscal Documentation, Amsterdam (1987) at 299-302.
13. Because of the availability of the Dutch participation exemption in combination with the extensive treaty network and the arrangement between the Netherlands and the Netherlands Antilles ("Belastingregeling voor het Koninkrijk" see footnote 24), many international (sub)holding companies are established in the Netherlands. Under certain conditions, it is possible for international enterprises contemplating the establishment of a Dutch company to obtain an advance ruling on important tax issues from the corporate tax inspectors. Advance rulings often confirm the applicability of the participation exemption. See also, Hamulyák, A., "Revision of the Participation Exemption", 27 *European Taxation* 10 (1987) at 311.
14. In at least one case (not yet published), the tax authorities attempted to invoke "fraus legis" where a structure that would normally be covered by an advance ruling was not.
15. For a discussion of the "fiscal unity" concept, see Betten, R., "The Fiscal Unity – International Aspects and Recent Developments", 27 *European Taxation* 3 (1987) at 78.

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Amsterdam.[16] The Court concluded that the loan agreement was entered into "in fraudem legis" and that the interest payments had to be ignored when assessing the corporate income tax.

This case occasions some interesting ideas. Assume that no subsidiary had been interposed but that a dividend had been paid to the foreign parent company. Assume further that the dividend had been financed through a loan from the parent to the subsidiary or through a loan from a third party to the subsidiary. In the above case, it was argued that payment of a dividend would have been the "normal" method. It is noteworthy that in this particular case some doubt existed as to whether the parent company qualified as a resident of the Netherlands Antilles, a relevant point with respect to the withholding of dividend tax. The interesting issue, however, is whether the Court would be inclined to apply "fraus legis" in situations described as "normal".

In accordance with the reasoning of the Court, there is no sound reason why "fraus legis" would not apply to all 3 situations since, economically, very little difference is discernable between them.[17] It is therefore inconceivable why any distinction need be made for application of "fraus legis". If the primary goal of the 3 situations is to create tax-deductible interest payments, then the dividend distribution made possible by the loan is as sham as interposing a subsidiary in the way described.

On the basis of this analysis, Dutch subsidiaries which enter into loan agreements to finance dividend distributions violate the spirit and purpose of the tax laws. This author is of the opinion that the Court is totally incorrect with respect to this particular point. Neither civil law nor tax law impose restrictions on dividend distributions. In principle, a company is free either to retain or distribute earnings. Even adhering to the Court's decision, part of the interest payments would be acceptable if, in a normal situation, a dividend distribution would be made. The test should be whether and to what extent a loan agreement entered into by the subsidiary assumes the character of equity rather than debt. This is not a "fraus legis" test but rather an "arm's length" test.

Application of "fraus legis" in the described case is also doubtful because in "fraus legis" cases the relevant transactions must be compared to "normal" transactions (in order to substitute the "normal" transaction for the sham transaction). The only normal transaction one could envision concerning the loan is one in which no dividend distributions are made. It is hardly conceivable that distributing dividends not derived from the cash flow of the company conflicts with the spirit of the law.

In addition, the question could also be raised whether the Court of Appeal's decision has any impact on international takeovers and mergers.[18] The following case might be instructive.

Recently, a U.S. multinational enterprise sold its nutrition division to another U.S. enterprise. More than 95% of the takeover was financed with junk bonds. A Dutch company (also part of the group) was involved in the takeover. The purchasing company established a subsidiary in the Netherlands which purchased the shares in the Dutch part of the enterprise of the seller and financed the acquisition with a loan from a group finance company established in the United States. Caught off guard by the above-mentioned Court decision, the purchasing company requested the Dutch tax inspector to render an opinion with respect to the deductibility of the interest. The tax inspector refused.

The Under Minister of Finance has instructed the tax inspectors[19] to inform the Ministry of any structure in which interest payments are made by a Dutch company (which is part of a fiscal unity) to a Dutch non-taxpaying legal entity, a company established in a tax haven or a company sustaining consecutive losses. Why this instruction is limited to the aforementioned lenders is unclear. From an economic point of view, the destination of payments is irrelevant for Dutch tax purposes. Furthermore, what is precisely meant by the terms "tax haven" and a "company sustaining losses" is ambiguous. Arguably, the United States should now be regarded as a tax haven since the top corporate income tax rate has been reduced to 34%. "Fraus legis" is inappropriate for such cases.

Obviously, the particular arrangements in the takeover case were devised to deduct interest payments so evasion of Dutch corporate income tax was the decisive motive for the chosen structures. The takeover of a Dutch division would not have transpired if the interest payments had to be paid out of after-tax profits. Again, the substantive question is whether the loan can meet the arm's length test, i.e. whether the loan was disguised capital. It is highly unlikely that the loan agreement entered into by the Dutch fiscal unity would fail to meet the arm's length test because the parent company itself had been 95% financed with loan funds.

Restricting the obligation to inform the Ministry of Finance to cases in which the interest is paid to particular entities enhances the potential for arbitrary be-

16. Decision of 29 January 1986, FED of 12 November 1987/464. The facts of this case were as follows: X, a resident of Belgium, was a shareholder of the limited liability Company A. Company A was a 100% shareholder of Company B, a profitable company. Companies A and B constituted a fiscal unity. In 1987, X used his shares in Company A to purchase shares in Company C, a Netherlands Antilles corporation. In that same year, Company C sold its shares in Company A to Company D, a Dutch limited liability company wholly owned by C. The total purchase price of the shares was 7,500,000 Dfl.; Company D paid 500,000 Dfl. of this amount. The remainder of the purchase price was to be paid in 15 annual instalments at an interest rate of 9%. On 1 January 1979, Company D formed a fiscal unity with Companies A and B. As a result of this structure and in particular the fiscal unity concept, almost the entire profit of Company B was paid to Company C (by way of interest) so that no corporate income tax could be imposed in the Netherlands.

17. The 3 situations being (1) the actual case (interposed subsidiary), (2) the hypothetical case where the dividend had been financed through a loan from the parent, and (3) the hypothetical where the dividend had been financed through a third party loan.

18. See also the note by Daniëls, A.H.M. accompanying *Fiscaal Weekblad FED* of 12 November 1987/464.

19. *Vakstudie-Nieuws*, 1987 at 2013.

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haviour on the part of the tax authorities and the issue whether the spirit and purpose of the law is violated becomes irrelevant. If "fraus legis" is to be applied at all it should be applied to all "set up" structures. Furthermore, if only interest payments to one of the entities would be sufficient to invoke "fraus legis", a non-suspect company should be interposed to secure deductibility of the interest payments.

B. Upstream loans

A Dutch-owned company finances a foreign subsidiary (e.g. a Swiss subsidiary). Because of Art. 13 para. 4 of the Dutch Corporate Income Tax Act, the parent company should not make a capital contribution with debt.[20] The Swiss subsidiary later enters into a loan agreement with the parent company or with a subsidiary which is part of a fiscal unity with the parent company. The Dutch tax authorities do not accept the loan agreement entered into between the Swiss and the Dutch company and the connected interest payments.

Economically, this situation is similar to the following scenario: a subsidiary borrows money from a bank and distributes a dividend to the parent company (with which the subsidiary forms a fiscal unity); a capital contribution is then made by the parent company to a Swiss subsidiary which deposits the funds in a bank account. If this type of structure does not invoke the "fraus legis", it is difficult to conceive why the above-mentioned structure would. In both structures, the transactions result in interest paid by the parent company and interest received by the Swiss subsidiary.

On the basis of CITA Art. 13 para. 7[21], the Dutch tax authorities could raise the argument that the Swiss subsidiary is not a real finance company but rather a portfolio investment and so the Dutch participation exemption does not apply with respect to this subsidiary. If so, Dutch tax is not being evaded, i.e. only an extension of payment is granted. In fact, the Dutch tax authorities have granted rulings in many cases concerning Swiss finance subsidiaries. If the debt : equity ratio of the Swiss subsidiary is at least 4 : 1 (external debt finance) or 7 : 1 (internal debt finance), the tax authorities will rule that the participation exemption applies with respect to the shares in the subsidiary. The lack of consistency is patently obvious: in one case the Dutch tax authorities conclude that the shares in the Swiss subsidiary constitute a portfolio investment if the subsidiary fails to meet the debt : equity ratio, whereas in the same situation the capital contribution and the (return) loan are deemed to contravene the spirit and purpose of the law. The foregone conclusion to be drawn is that application of "fraus legis" is inappropriate because abuse situations have apparently been restricted by the ruling practice.

The following example may illustrate the ineffectiveness of "fraus legis" in the described cases. A U.K. parent company owns a Dutch subsidiary which owns a Swiss subsidiary. The Swiss subsidiary distributes dividends to the Dutch subsidiary. The Dutch subsidiary contributes the dividend received to a Netherlands Antilles group finance company by way of a capital contribution. The Netherlands Antilles finance company intends to enter into a loan agreement with a U.S. subsidiary of the U.K. parent company. To avoid U.S. withholding tax, the loan is made by the Netherlands Antilles company to the Dutch company which passes the loan to the U.S. company with a spread between received and paid interest of ¼ of 1% of the principal amount. The Dutch tax authorities attack the capital contribution to the Netherlands Antilles company and the (return) loan to the Dutch company by invoking "fraus legis".

Admittedly, the dividend distribution from Switzerland and the capital contribution to the Netherlands Antilles, the (return) loan to the Netherlands and the loan to the United States are transactions with no other motive than tax avoidance. However, it is also obvious that in a "normal" situation, it would be likely that the profit would have originated in the United Kingdom and the capital needed by the U.S. subsidiary would have been provided for by the U.K. parent company. Viewed in that context, the structure does not necessarily lead to the conclusion that the intent and purpose of Dutch tax legislation is being frustrated. Economically, the interest payments from the United States through the Netherlands, have no relation whatsoever to the Netherlands. Isolated from the overall structure application of "fraus legis" to the 2 transactions would jeopardize almost every international structure.

C. Avoidance of withholding tax

In a recent case[22], "fraus legis" was applied to attack a structure set up to avoid withholding tax. On 20 November 1980, the shareholder of Dutch Company A (a BV) decided to distribute a dividend on ordinary shares. Between 20 November and 1 December, Company A's articles of association were amended and the ordinary shares held by the shareholder were converted into preferred shares. New ordinary shares were issued to a Netherlands Antilles company. The dividend was actually distributed on 15 December. The tax inspector refused to refund the dividend tax withheld to the Netherlands Antilles company on the ground that the sequence of transactions had been set up with the primary purpose of avoiding imposition of withholding tax. The tax inspector concluded that the transactions conflicted with the spirit and purpose of

20. Wet op de Vennootschapbelasting. Art. 13, para. 4 reads as follows: "Costs related to the participation or membership are only deductible to the extent it is likely that they indirectly contribute to profits taxable in the Netherlands".
21. Art. 13, para. 7 reads as follows:
Ownership of shares in a non-resident joint stock company is deemed a participation in the event a taxpayer owns at least 5% of the nominal paid-in capital of the company, unless it is likely that the shares form a portfolio investment. Ownership of certificates of participation in a non-resident mutual fund is not regarded as a participation.
22. Decision of the Supreme Court of the Netherlands of 8 January 1986, BNB 1986/127.

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the Dividend Tax Act 1965[23] and the "Belastingregeling voor het Koninkrijk"[24]. On appeal to the Supreme Court it was held that "fraus legis" in this particular structure was, in principle, possible.

Basing his arguments on a technical nature, the Solicitor General concluded that the "Belastingregeling voor het Koninkrijk" does not prevent application of "fraus legis" in such cases. However, the Solicitor General failed to ascertain whether structures set up with the sole purpose of avoiding withholding tax would (in general or in particular cases) run the risk of the tax authorities applying "fraus legis".

Mr. J. Hoogendoorn, in a thorough analysis of the case, argues that a tax court should be reluctant to apply "fraus legis" in situations where a tax treaty is involved but he does not exclude the application of the doctrine in extreme cases. He concluded that, in general, the avoidance of withholding taxes on dividends in intercompany structures does not contravene Dutch tax legislation.

The above-mentioned case is a clear case of "treaty shopping". Treaty shopping, however, is not controversial Dutch tax legislation. The Netherlands does not levy withholding tax on outgoing interest and royalties paid by Dutch debtors. Interest and royalties paid into the Netherlands are reduced as much as possible in Dutch tax treaties. In principle, dividends are subject to a levy of 25% withholding tax at source. However, Dutch tax treaty negotiators always attempt to reduce withholding tax on dividends to the Netherlands.[25] In fact, the Dutch tax authorities have never resisted routing dividends from a Dutch company through a Netherlands Antilles conduit company (until recently, this reduced the Dutch withholding tax to nil).[26]

An additional issue is whether dividend routing via the Netherlands Antilles should be attacked by the "fraus legis" doctrine. The answer should be in the negative. Creation of a Netherlands Antilles conduit company in order to avoid Dutch dividend tax is always a "sham transaction" because the sole purpose of this type of structure is to avoid the tax. It is difficult to perceive why "fraus legis" is not applied to these structures in "normal" situations, yet if the structure is a last minute creation, "fraus legis" is applied. If an Antilles structure is not the "normal" structure, all Netherlands Antilles arrangements will be susceptible to "fraus legis", a consequence obviously not in conformity with the intent and purpose of the law. The conclusion may be drawn that, under existing Dutch legislation, "treaty shopping" does not conflict with the spirit and purpose of tax law even where "last minute creations" are concerned.

Such a conclusion also accords with developments in international tax law outside the Netherlands. Methods to counteract "treaty shopping" are expressed in the OECD Model Treaty (inter alia Art. 10, para. 2). The incorporation of anti-abuse rules in tax treaties is also an appropriate mechanism to preclude treaty shopping practices. "Beneficial ownership" may be another appropriate method to combat treaty shopping. In this respect, Art. 16 of the United States Model Treaty should be mentioned, under which the place of residence of the ultimate shareholders of the paying company is the decisive factor.[27]

IV. CONCLUSION

With respect to group structures, the Dutch tax authorities should concentrate on the profits attributable to the Netherlands from an economic perspective. The profit connected to the Netherlands depends on the economic activity and the profit allocation should proceed on the basis of the arm's length principle.[28] "Fraus legis" can only be acceptable if the tax law is ineffective to prevent arrangements which conflict with the intention of the legislation. "Fraus legis" should not be applied if the taxation of profit (i.e. distributed profit) is concerned because the arm's length principle effectively addresses this issue for profit allocation purposes.

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23. Wet op de dividendbelasting 1965.
24. The Belastingregeling voor het Koninkrijk is an internal arrangement between the Netherlands and the Netherlands Antilles for the relief of double taxation. It is comparable to a tax treaty although not a treaty in fact because the Netherlands Antilles are part of the Kingdom of the Netherlands.
25. For a discussion, see in this issue, Lyons, S.M.C. and van Waardenburg, D.A., "Some Aspects of Dutch International Tax Treaty Strategy".
26. It should be noted that the introduction of the 7.5% withholding tax in intercompany structures on dividends to Netherlands Antilles companies has been caused by pressure from the United States.
27. Art. 16 reads as follows:
    1. A person (other than an individual) which is resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
    a. more than 75% of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
    b. the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and are not citizens of the United States.
    For the purpose of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.
    2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principle purpose obtaining benefits under the Convention.
    3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief bears significantly lower tax than similar income arising within that State derived by residents of the State.
28. See also the report "Thin Capitalization" of the OECD Committee on Fiscal Affairs, *Issues in International Taxation* No. 2.

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NETHERLANDS:

Pensions: A Survey of Recent Developments

By J. Kooi

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I. INTRODUCTION

This article discusses various international tax aspects of retirement benefits in the Netherlands. Although a detailed examination of all aspects of retirement benefits is beyond the scope of this article, certain recent developments warrant particular attention. The main topics covered are: the present (and future) treatment of lump-sum retirement payments; international consequences of the proposed changes in retirement benefits ("Brede Herwaardering" or "Broad Reappraisal"); and retirement plans for expatriates transferred to the Netherlands for a limited period of time.

II. LUMP-SUM RETIREMENT PAYMENTS

A. In general

For purposes of this article, a lump-sum payment is a one-time payment made in lieu of periodic pension payments. "Pension", in this respect, refers to payments made at regular intervals to which the beneficiary is entitled on the basis of past services rendered as an employee.[1]

B. Domestic taxation

Resident taxpayers are taxable in the Netherlands on their world-wide income[2], from sources indicated in the law[3] and irrespective of form. The law specifically mentions "income from past employment".[4] Consequently, Dutch income tax (and, as the case may be, wage withholding tax) will be due on lump-sum pension payments in respect of past Netherlands employment unless either domestic rules for the avoidance of double taxation or a tax treaty exempt the payment from Dutch income tax, leaving the right to tax the pension to another country.

Non-resident taxpayers are subject to tax on Dutch-source income as indicated in the law.[5] This income includes Dutch-source pensions and lump-sum payments which are taxable under Art. 49(1)(b)(1) I.B. unless protected by a tax treaty.

If certain conditions are met, a beneficiary may elect to receive a lump-sum payment either upon retirement or prior to retiring.[6] Private employers who guarantee their employees a pension upon retirement are subject to the provisions of the Pensioen- en Spaarfondsenwet 1952, as amended (Act Governing Pensions and Savings Funds, hereinafter referred to as "PSW").[7] One of the circumstances under which the PSW permits the payment of a lump sum in lieu of a periodic pension is emigration. However, payment of such a lump sum is only possible if the pension scheme contains express provisions to that effect.

If a lump-sum payment exceeds 1,000 Dfl. and if it replaces periodic payments in excess of one tax year, the taxpayer may elect to be taxed at a special rate which varies between 20% and 54%.[8] The applicable rate is computed on the base of both the amount of the lump-sum payment and the average taxable income from the past 4 years.

1. Wages Tax Law Art. 11(3)(a) (Wet op de loonbelasting 1964, hereinafter referred to as "L.B.") defines a pension scheme as "a Scheme the exclusive – or almost exclusive – purpose of which is to support employees or former employees in case of infirmity or old age and to support their spouses and minor children and foster children through a pension which may not exceed an amount which is socially reasonable considering the duration of the employment and remuneration received".
2. See Income Tax Law 1964 Art. 3(1) (Wet op de inkomstenbelasting, hereinafter referred to as "I.B.").
3. I.B. Art. 4.
4. See I.B. Art. 22(2) in conjunction with L.B. Art. 10(1).
5. I.B. Art. 49.
6. As a general rule, however, no such election is possible if the beneficiary is covered by a government pension.
7. The purpose of the Pensions and Savings Funds Act is to supervise the operation of pension funds to ensure that invested funds are not misused. The law also contains provisions to protect retired persons and certain limitations on the possibility of converting periodic payments into one lump-sum payment.
8. I.B. Art. 57.

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C. International aspects/treaty situations

Although most tax treaties contain some sort of provision for pensions, it is not always clear whether the provision also covers lump-sum payments since an express reference to such payments is lacking. A distinction should be made between 4 types of provisions found in tax treaties:

Country	Category I	II	III	IV
Aruba		×		
Austria		×		
Australia				×
Belgium		×		
Canada[1]	×			
China		×		
Denmark			×	
Finland		×		
France		×		
Greece[2]	×			
Germany (FR)		×		
Hungary[3]	×			
Indonesia[4]		×		
Ireland		×		
Israel		×		
Italy[5]				×
Japan		×		
Korea		×		
Luxembourg		×		
Malawi				×
Malaysia[6]		×		
Malta		×		
Morocco		×		
Netherlands Antilles		×		
New Zealand[7]	×			
Norway		×		
Pakistan[8]	×			
Poland		×		
Romania			×	
Singapore		×		
South Africa		×		
U.S.S.R.			×	
Spain		×		
Sri Lanka[9]	×			
Surinam		×		
Sweden		×		
Switzerland			×	
Thailand		×		
Czechoslovakia		×		
Turkey	×			
United Kingdom	×			
United States				×
Yugoslavia		×		
Zambia	special provision which results in taxation in country where services were rendered			

1. Treaty of 27 May 1986.
2. Treaty of 16 July 1981.
3. Treaty of 5 June 1986.
4. Special provision.
5. New treaty shortly expected with category I provision.
6. Treaty not yet in force.
7. Pension defined in the protocol.
8. Treaty of 24 March 1982.
9. Treaty of 17 November 1982.

1. *Category I:* Treaties containing a special provision on lump-sum payments in lieu of private pensions. In these treaties, the lump-sum payments will always be taxable in the country where the services are performed. A recently published report on treaty negotiations in the Netherlands states that all future treaties will be Category I type treaties.[9]

2. *Category II:* Treaties which do not contain a special provision for lump-sum payments but which contain a provision for "pensions and other similar remuneration" (1977 OECD Model Treaty, Art. 18).[10] These types of treaties allocate the right to tax lump-sum payments to the country of residence of the recipient.[11]

3. *Category III:* Treaties without either of the above provisions but which contain a provision for "other income" (1977 OECD Model Treaty, Art. 21(1)).[12] Treaties falling under Category III allocate the right to tax the lump sum to the country of residence of the recipient.

4. *Category IV:* Treaties which contain only a rule for pensions and no provisions for other income. According to Dutch case law[13], if the treaty article on pensions does not refer to "other similar remuneration" the lump-sum payments are not covered by the provision. The Supreme Court has held that the word "pension" denotes a *periodic* payment in respect of services rendered in the past and that a lump-sum payment received in lieu of pension rights is not a pension within the meaning of the law.[14]

The Dutch judiciary has ruled that pensions and other similar remuneration, when paid after retirement, are not covered by the article on dependent personal services because that article (i.e. Art. 15 OECD Model Convention) applies only to income from existing employment.[15]

Until recently, uncertainty prevailed with respect to lump-sum payments paid prior to the (official) retirement date. In a 1984 decision[16] the Court held that

9. Letter dated 3 December 1987, Parliamentary Papers 20365/2. This letter is discussed in this issue. See Lyons, S.M.C. and van Waardenburg, D.A., "Some Aspects of Dutch International Tax Treaty Strategy – Unilateral Relief and Tax Treaties".
10. Art. 18 of the OECD Model Convention provides that "Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State".
11. See Judgment of the Supreme Court No. 19,934 of 10 June 1981, reported in 29 *Beslissingen in Belastingzaken/Nederlandse Belastingrechtspraak* (hereinafter referred to as "BNB") (1981) at 1,1331. The case is cited as BNB 1981/242. For a discussion of this case, see 21 *European Taxation* 9 (1981) at 301. See also BNB 1986/35.
12. Art. 21(1) reads as follows: "Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State".
13. See footnote 11.
14. Id.
15. See, inter alia, *BNB* 1981/242, *BNB* 1984/249 and *BNB* 1987/207.
16. Decision of the Court of The Hague of 26 March 1984, published in BNB 1984/249. For a discussion of the case, see "Pensions", 25 *European Taxation* 2 (1985) at 56.

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lump-sum payments in lieu of periodic pension payments should be treated as "other similar remuneration", and therefore taxable in the State of residence of the recipient. Because lump-sum payments lack the periodicity characteristic, they cannot qualify as pensions.[17] The lump-sum payment in that case, however, was made after the taxpayer retired. The Under Minister for Finance did not appeal this decision to the Supreme Court. However, he did argue that, on the basis of the Court's judgement, lump-sum payments made *prior* to retirement should not be deemed a "pension or other remuneration"; instead these payments should be governed by the articles on dependent personal services (Art. 15 of the 1977 OECD Model Treaty) or directors' fees (Art. 16) because they constitute remuneration for active services carried out in the past.

In 2 recent decisions (concerning the treaties with Finland and Ireland)[18], the Supreme Court rejected the Under Minister's conclusion and held that lump-sum payments made prior to retirement did not mean that the sum was not intended to provide the taxpayer with the financial means to support himself at a later time.[19] The Court concluded that payments which can be characterized as securing the means to support the taxpayer in his old age and which are made in respect of past employment, are not governed by the article on dependent personal services but rather are governed by the article on private pensions. In the case concerning the Netherlands–Finland treaty, the Court also held that even if the article on pensions was inapplicable[20], the article on "other income"[21] would have allocated the right to impose tax to Finland.

If the treaty does not contain a provision for "other similar remuneration" or a provision for "other income" (Art. 21 of the 1977 OECD Model) allocating the right to tax such income to the country of the taxpayer's residence, the taxing rights of the Contracting States are not restricted. Consequently, a lump-sum payment may be taxed in the country where the services are performed. In 1981[22] the Supreme Court held that a lump sum paid to a resident of Australia in respect of Netherlands employment was taxable in the Netherlands. In that case, the treaty provision (Art. 18) did not contain a definition of "pension" but another provision (Art. 3(3)) stated that "any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that State relating to the taxes to which this Agreement applies". The Supreme Court held that Art. 3(3) allowed the Dutch tax authorities to interpret the term "pension" as used in Art. 18 of the treaty in the same manner under Dutch law so it did not cover lump-sum payments in lieu of pension rights.[23]

D. International aspects/non-treaty situations

To a certain extent Dutch domestic law provides rules for non-treaty situations. As mentioned above, resident taxpayers are, in principle, taxable on their world-wide income and non-resident taxpayers are taxable with respect to certain Dutch-source income. The Decree for the Avoidance of Double Taxation of 4 April 1965[24] contains unilateral measures for relief for resident taxpayers (according to the exemption with progression method). However, the income eligible for exemption must be derived from present or past employment in another country and the income must be subject or deemed to be subject to a tax on income or profits in that other State. Based on this provision it may be concluded that pensions and lump sums received in lieu of pensions would be eligible for the exemption under the Decree so long as the payments are paid by a foreign payer and are subject to tax in the country of the payer.

The Netherlands retains the right to tax pensions and lump-sum payments received by non-residents on the basis of Art. 49(1)(b)(1) I.B. (see above) when paid in relation to (past) services rendered in the Netherlands.[25]

E. Conclusion

Following the Supreme Court decisions (favouring the taxpayer), the Government took steps to preclude payments of lump sums in lieu of pensions after emigration. The PSW was, at the time, under review. The Government proposed an amendment to the PSW which would prohibit lump-sum payments after emigration without obtaining specific permission from the Ministry of Social Affairs, which would need approval from the Ministry of Finance.[26] Permission would be denied in those cases where it was expected that the foreign resident would pay a substantially lower tax than the tax which would have been due by a resident taxpayer. Strenuous objections to this amendment were raised during a debate in the First Chamber of the Dutch Parliament on the grounds that the PSW was not the appropriate vehicle to combat "tax avoidance" practices. Now, as a general rule, lump-sum payments in lieu of pensions are permissible *after* emigration so long as the interests of the spouse (or former spouse) of the taxpayer are protected.[27] Unfortunately, however, an increasing number of tax treaties will contain provisions allocating the right to

17. See also commentary to Art. 18 of the 1977 OECD Model Convention, Point 3.
18. The case concerning the Finnish treaty has been published. See decision of the Supreme Court (Hoge Raad) of 13 May 1987, No. 24,314, published in *BNB* 1987, No. 207 and in the periodical *Vakstudie-Nieuws* of 4 July 1987. For a discussion of both cases, see Dik, B.P., "Lump Sums", 27 *European Taxation* 9 (1987) at 295.
19. Id at 297.
20. See Art. 19 of the Netherlands–Finland treaty. An unofficial English translation of this treaty is published in *Supplementary Service to European Taxation,* Sec. C.
21. See Art. 23.
22. See footnote 11.
23. Id.
24. Besluit Voorkoming Dubbele Belasting.
25. As a practical matter, one could query whether the Netherlands, in such a case, would enforce its right to tax these payments if they were made by a non-resident (e.g. an international pension fund).
26. The proposed bill, however, would allow lump-sum payments before actual emigration but since the taxpayer would still be a resident of the Netherlands he would incur Dutch tax liability at the time of payment.
27. See article cited in footnote 18.

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tax lump-sum payments to the country where the services are performed.

II. INTERNATIONAL CONSEQUENCES OF THE "BROAD REAPPRAISAL"

A. In general

Research and discussions concerning rules for private pension annuities and other similar old age benefits have been conducted in the Netherlands for approximately 10 years. This procedure is generally referred to as the "Brede Herwaardering" or "Broad Reappraisal". The results of the discussions remain uncertain although some interesting proposals have been submitted which may have a substantial impact on international tax planning. This section of the article briefly examines the existing structure for retirement plans in the Netherlands and various proposed changes which may affect international tax planning.

B. Existing situation

The existing tax system for old age benefits is regulated by a comprehensive system of intricate rules. The main characteristics of the system are that certain amounts (which are tax-deductible) can be reserved out of present income to provide for future income. Since the present payments are deductible, future payments will be subject to taxation. The amounts which can be reserved are limited depending upon the type of reserve created. The 4 main types of reserve are as follows:

1. Payments, withheld by the employer and paid under a qualified pension scheme to a qualified pension fund. These payments are deductible costs for the employer and do not constitute taxable income to the employee. To qualify, however, the pension scheme may not provide for a pension exceeding a socially reasonable amount and should (except in the case of emigration) not be convertible into a lump sum.[28]

2. Payments providing for an old age annuity (lijfrente) which are made to a Netherlands entrepreneur and which do not exceed a fixed annual amount (i.e. 16,812 Dfl. for 1988).[29]

3. Part of the profit realized each year by an entrepreneur (individual) to form a special old age reserve.[30]

4. Part of the profit realized upon termination and/or sale of an enterprise provided this amount is used to provide for an annuity and provided that it is subject to certain precisely-defined conditions.[31]

As a general rule, all other payments to provide for old age with the exception of social security premiums for the State old age pension are non-deductible. This does not necessarily mean that future income deriving from the current payments is exempt from taxation. Certain types of contracts (e.g. some life insurance policies) may result in tax-exempt income but generally at least part of the accumulated interest will be taxable.

C. Proposals

The relevant proposed changes (i.e. those concerning international aspects) under the "Broad Reappraisal" are as follows:[32]

1. In principle, the limit on deductibility of payments on behalf of a future pension or annuity would be abolished. All future receipts would be fully liable to income tax at ordinary rates. The rationale behind this change is that taxpayers themselves would establish a maximum deductible amount which would be in line with their income and cash flow situation.

Obviously, this change potentially creates interesting tax planning possibilities. A resident taxpayer would deduct substantial amounts thus reducing his current taxable income. Note that non-resident taxpayers are (and would be) only entitled to very limited deductions (e.g. they would not be entitled to the deduction mentioned in II. A.). After emigration, the non-resident taxpayer would attempt to receive periodic and lump-sum payments in such a way so that little or no foreign tax would be due.

To prevent this and other similar types of constructions, it is proposed to introduce a new provision into Art. 48(3)(c) I.B. This amended provision would impose tax on non-residents on any "refund" of amounts previously deducted in respect of pension plans. In most cases, the provisions of this amended article would not actually result in the intended clawback because most tax treaties would not yet contain similar rules (see text above).

Besides taxing amounts in the hands of the non-resident beneficiary, it is also contemplated to impose corporate income tax at the level of the company making a (lump-sum) payment to the non-resident. It is questionable whether the Dutch tax authorities would be able to effectuate such a claim in the event that deductible payments were made to non-residents in the past.

III. PENSION SCHEMES FOR NON-RESIDENTS

A. In general

As previously mentioned certain payments in respect of retirement plans result in a current deduction while

28. See I.B. Art. 22, in conjunction with L.B. Art. 11. With respect to normal employees, this system may be attractive if the right to receive periodic payments can be converted (after emigration) to the right to receive a lump sum free of Dutch tax and preferably not taxed (or taxed at a low rate) in the country of residence.
29. I.B. Art. 45.
30. I.B. Arts. 44d-44l.
31. I.B. Art. 19.
32. This article does not deal with any possible changes which may be made concerning pension funds.

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future periodic (or lump-sum) payments will be taxable. The most important category of payments are those made by the employer[33] (and/or the employee) to a qualified pension scheme. Special attention should be devoted to expatriates who come to work in the Netherlands for a limited period of time.[34] As a rule, these individuals will wish to remain (insured) under their original pension scheme in order to avoid forfeiture or a reduction in pension rights.

If the employer withholds the employee's contribution to the plan from the gross salary, (as a general rule) no problems should be encountered. Such payments, however, must also be made under a qualified pension scheme. In practice, most foreign pension plans do not qualify as such, i.e. they are either excessive by Dutch standards or the provisions of the plan are too lenient with respect to the possibilities of receiving lump-sum payments.

If the pension scheme fails to qualify the tax consequences in the Netherlands may be disastrous. Payments made to the fund would be deemed income to the expatriate employee, and depending upon the type of retirement arrangement in effect, this could lead to a substantial increase of Netherlands taxable income, taxed at ordinary rates. Taking into account the fact that no actual cash has yet been received (i.e. the employee only has a future right to a pension), the expatriate may find himself in an extremely awkward cash flow position. Any reimbursement of the additional tax paid by the employer would in itself be considered income; consequently, this amount would also be subject to income tax. Obviously, the situation would worsen if, upon return to the country of residence, the pension payments received under the plan are taxed there as well.

A small, but internationally-oriented country like the Netherlands clearly cannot tolerate such a chain of events. Upon request, the Ministry of Finance may, at his discretion, issue a ruling which determines that the foreign pension scheme is deemed "qualified". Although the conditions which the Ministry will apply vary from case to case, as a general rule the following applies:

(a) the foreign pension scheme should be a qualifying scheme under the domestic legislation of the country of origin;
(b) the expatriate should be assigned to the Netherlands for a limited period of time; and
(c) both the relevant treaty (if any) and the domestic legislation of the country of origin should provide that the future payments under the foreign scheme (insofar as they relate to Dutch employment) are subject to tax either in the Netherlands or in the country of origin.

The extent to which the proposed regulations under the "Brede Herwaardering" will alleviate this difficulty cannot be predicted. However, taking into account the tendency to include special provisions in tax treaties with respect to lump-sum payments (i.e. allocating the right to tax to the country where the services were performed), a substantial number of foreign pension schemes may qualify under the above rules.

B. Conclusion

With respect to the proposed changes, it is expected that more attention will be paid to the actual circumstances of taxpayers and consequently the level of reserves formed during the taxpayer's active period of employment will be more in line with his personal requirements. On the other hand, the Dutch Government clearly will neither permit unlimited tax-deductible payments during the years of active employment nor tax-free cashing in of retirement benefits.

It is also anticipated that all new tax treaties concluded by the Netherlands will contain provisions granting the country where the services were performed (in relation to which contributions to pension funds have been made) the right to tax future lump-sum payments. Furthermore, it is likely that new provisions will be made which allow the Netherlands (subject to treaty protection) to "clawback" those taxes which have been saved by making tax-deductible payments.

33. The employer withholds the contribution from the gross salary of the employee. In most cases the pay slip will show the gross salary after deduction for pension premiums.
34. Most expatriates can benefit from the special 35% ruling under which employees can obtain a fixed 35% from their gross salary for the first 5 years of their stay in the Netherlands, and under which the employees are deemed to be non-residents. For an official translation of the "35% ruling", see 26 *European Taxation* 6 (1986) at 303.

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NETHERLANDS:

Interest: Withholding Tax or No Withholding Tax?

By Marianne Plante-Failé and J.W. Zwemmer

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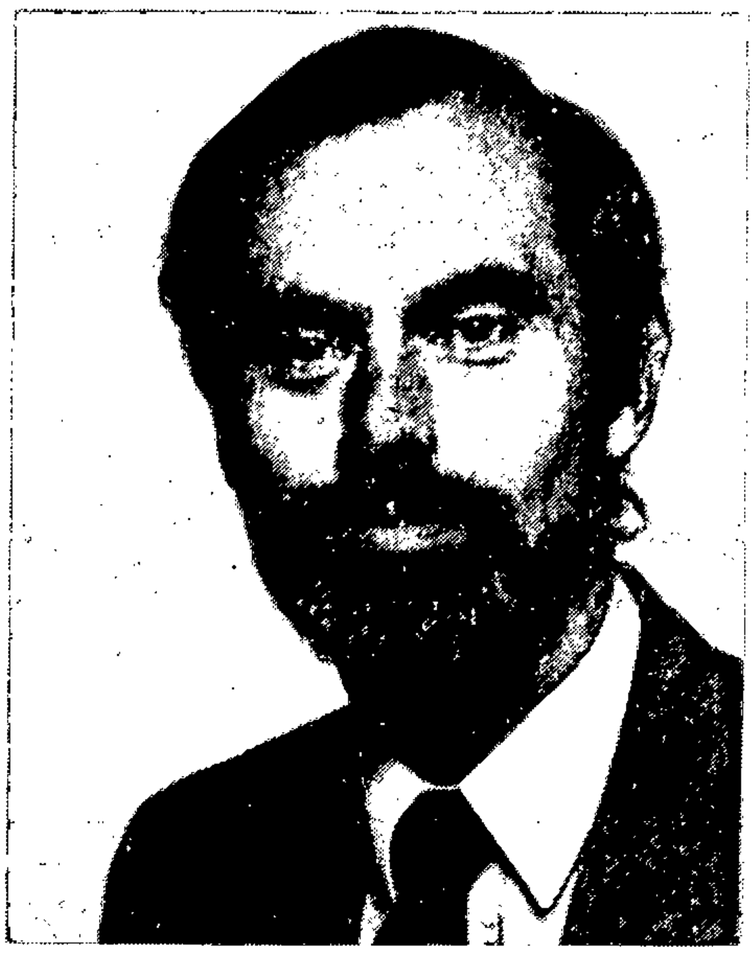

Professor Zwemmer has a degree in civil law and tax law. He earned his LL.D. in 1975. He has been a professor of tax law at the University of Amsterdam since 1980.

INTRODUCTION

No withholding tax is imposed on interest in the Netherlands. Because the Netherlands is a capital-exporting country, no advantages accrue to the economy if a withholding tax on interest is imposed. Many double taxation treaties concluded by the Netherlands provide that no withholding tax will be imposed on interest payable to Dutch residents by a resident of the other Contracting State. If such an agreement cannot be reached with the other State, treaty negotiators will attempt to obtain a reduction in the rate of withholding tax imposed on interest payments to Dutch residents.

Internal factors complicate the answer to the question whether it would be appropriate to introduce a withholding tax on interest in the Netherlands. According to domestic tax legislation, interest received by a Dutch resident constitutes part of his taxable income.[1] In the past, however, there was no means of tracing interest payments made to a taxpayer and no exact record of a taxpayer's capital resources. Given these circumstances, avoidance of tax on interest payments was extensively practiced. In order to ascertain the extent of tax avoidance, in 1983 the Dutch Government decided to conduct a random check on interest payments. This investigation was undertaken with the assistance of banks and savings institutions. The results of the investigation clearly demonstrated that vast amounts of interest payments had not been declared. The purpose of this article is to examine whether a withholding tax on interest offers an acceptable solution to this problem.

INTERNATIONAL ASPECTS OF A WITHHOLDING TAX ON INTEREST

Incoming interest

A foreign withholding tax on interest flowing to the Netherlands, i.e. payable to Dutch residents, only reduces the amount of tax receivable by the Dutch tax authorities because the tax withheld, by virtue of tax treaties, can usually be credited against Dutch tax payable by the recipient. However, where the recipient of the interest is tax-exempt as is, for instance, the case for pension funds, a foreign withholding tax will reduce the return on the investment made abroad. Thus, if it is important for a foreign country to attract Dutch capital but the country imposes a withholding tax on the interest paid to the tax-exempt investor, the latter may no longer be interested in investing in the foreign country.

A complication arises when the Dutch recipient of the interest is part of an international chain set up to take advantage of the Dutch treaty network. If interest payable by one foreign country to another is subject to a withholding tax, it may be more profitable to channel the interest through the Netherlands if the treaty between the Netherlands and the payor country provides an exemption from interest withholding tax.

1. Wet op de inkomstenbelasting, Art. 25.

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Some tax treaties include provisions against this type of treaty-shopping. For example, Art. 11 of the United Kingdom–Netherlands treaty uses the concept of "beneficial ownership". By virtue of this concept, the treaty provisions reducing the withholding tax are only applicable when the Dutch recipient is also the beneficial owner of the interest. For example, if a foreign investor residing in a country with which the United Kingdom has not concluded a tax treaty is entitled to interest payments by a U.K. company, the U.K. withholding tax will not be reduced even if the foreign investor establishes a Dutch company to act as the formal recipient of the interest payments. Because the Dutch company is not the "beneficial owner" of the interest, the withholding tax will not be reduced. Most treaties, however, do not use the "beneficial ownership" test. If the Netherlands introduced a withholding tax on interest it would be less attractive for the treaty shoppers to use the Netherlands as a go-between in their transactions.

Outgoing interest payments

Generally, foreign investors from countries with which the Netherlands has concluded a double taxation treaty receive a full or partial credit in their own country for the foreign tax withheld on the interest payment. In cases where a full credit is available, only a slight decrease in the return on capital will result due to the lapse of time between the withholding of the foreign tax and utilization of the domestic credit. In cases where the foreign investor pays no tax in his own country on the interest he receives, there may be a significant decrease in the return on his capital (e.g. exempt pension funds). A similar decrease in return is experienced by investors from countries with which the Netherlands has no double taxation treaty and which do not impose a tax on interest (e.g. Middle East countries).

Investors naturally look to the return their investment will bring and will choose the country which provides the best return. Foreign investors provide about 50% of the borrowing requirement of the Netherlands. There are, therefore, strong forces within the Ministry of Finance which oppose the introduction of a withholding tax on interest in case this would discourage investment in the Netherlands.

Companies which operate internationally can take advantage of the opportunity to reduce the profits of their subsidiaries by borrowing large amounts from associated companies in low-tax countries. Interest paid by a Dutch company is fully deductible for tax purposes. There is no minimum debt : equity ratio required to prevent the payment of large amounts of interest by thinly-capitalized companies. In order to reduce Dutch corporate tax payments in international structures, Dutch activities can be set up in a company with a minimum of paid-in capital and a maximum of loans. As a result, the return on the investment takes the form of tax-deductible interest on the loans.[2]

A dividend paid by a Dutch company may be lent back to create a deductible interest payment in the Dutch subsidiary. However, the Dutch tax authorities do not encourage these constructions. If a withholding tax on interest was imposed, such schemes would be discouraged but for the reasons mentioned above, this remedy may be worse than the disease itself in the Ministry of Finance's view. The imposition of a minimum debt : equity ratio could be an alternative solution to this problem.

DOMESTIC ASPECTS OF A WITHHOLDING TAX ON INTEREST

Effects of a withholding tax

Residents who do not avoid paying tax on their interest receipts would not be affected by the introduction of a withholding tax. For those taxpayers who currently do not pay any tax on interest, the withholding tax represents a decrease in the return on their capital. They could be expected to invest their money elsewhere if such a tax is introduced.

Prevention of tax avoidance by other means

As mentioned above, it is easy for Dutch residents to avoid tax on interest. The Dutch Parliament has frequently discussed measures to prevent this type of tax avoidance. In April 1981, the Parliament submitted a report relating to bearer savings certificates.[3] The following measures were discussed to prevent using these certificates for tax avoidance purposes:
(1) withholding tax on interest;
(2) registration of the holder of the certificates;
(3) restrictions on dealings in savings certificates.

Measures 2 and 3 have been introduced. The restrictions on dealings in savings certificates require all purchases and sales of such certificates to be made via a recognized stockbroker.

These transactions must be registered. The details to be registered include:[4]
- name and address of the person(s) involved;
- nature of the transaction; and
- the number and type of savings certificates.

Following the announcement that a registration system would be introduced, investment in savings certificates ceased almost completely. Since a withholding tax on interest was expected to give rise to considerable difficulties for investors living in countries with which there is no double taxation convention or where no credit for such tax is given, the Dutch Government preferred the above measures to a withholding tax. Introduction of a registration system resulted in dis-

2. In general, there is no possibility to consider substantial loans as paid-in capital either in whole or in part for tax purposes.
3. Nota Spaarbiljetten aan toonder, Kamerstuk 16,532.
4. However, when these details are registered, no proof of identity is required due to an overwhelming opposition to such a requirement.

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continued investment in savings certificates but it did not stop the avoidance of paying tax on interest as such. Therefore, a new measure was introduced.[5] As from 1987, Dutch banks are required to inform the Dutch tax authorities of all interest paid to their individual clients. This measure has not put an end to tax avoidance but rather (during 1987) caused large amounts of funds to leave the Netherlands in one way or another.

CONCLUSION

From the results of the measures introduced to prevent the avoidance of tax on interest, it can be concluded that the introduction of a withholding tax on interest for residents is too late to be of any effect in the battle against tax avoidance since large amounts of potential investment funds have already been invested abroad by those wishing to avoid tax. Exchange of information between the member countries of the European Community will not solve this problem, i.e. it will only encourage tax avoiders to invest their funds outside the EC. Likewise, introduction of a withholding tax will have a negative effect on the demand which the Netherlands places on the international capital market. The thin capitalization problem can be better solved by introduction of a debt : equity ratio. Based on these reasons, it is safe to conclude that no withholding tax on interest is to be expected in the near future.

5. Letter of 1 July 1987 from the Ministry of Finance to Parliament; see *Vakstudie-Nieuws* of 18 July 1987 at 1447.

INTERNATIONAL FISCAL ASSOCIATION NEWS

SWISS BRANCH

1987 Annual Report

1. Administration

In 1987 the Board met on 5 February in Basle, on 10 June in Zurich and on 26 October in Neuchatel. In addition to administrative matters topical national and international tax problems were discussed.

2. Membership

On 31 December 1987 the Swiss Branch had 340 individual and 77 corporate members (cf. the 1986 Annual Report in *Bulletin* 8-9/1987 at 471).

3. Meetings

– On 6 February 1987 a special (winter) meeting was held dedicated to Swiss measures for retirement and similar pensions. Speakers were Mr. S. Tanner (legal department of the Cantonal Tax Administration of Bern), Dr. M. Steiner (legal department of the Cantonal Tax Office of Zurich), and Mr. A. Schneiter (Winterthur Lebensversicherungs-Gesellschaft). These papers were discussed under the chairmanship of Mr. P. Spori (ATAG, Allgemeine Treuhand AG). In the second part of the meeting a further explanation was given of the Swiss legislation pertaining to this subject by Dr. G. Steinman (main department of the Direct Federal Taxes). Critical remarks were made by Mr. L. von Deschwanden (Prevista Vorsorge AG).

– On 11 June 1987 a meeting took place during which the 1986 Annual Report and the financial records for that year were approved. As before, the Swiss Branch will be presented at Central IFA by Prof. Dr. J.M. Rivier and Dr. A. Buckhardt. Their deputies are Dr. K. Stocker, Dr. H.K. Lüscher, Dr. H. Gunz and J.P. Chapuis.

The main theme of the meeting was a discussion of Switzerland as a financial centre. Dr. G. Streichenberg (Central Board of the Schweizerische Bankverein) read a paper on Switzerland as a financial centre and international competition; Mr. Caflisch (main department for stamp duties and withholding tax of the Federal Tax Administration) discussed the solving of tax problems by changing tax practice and Prof. Dr. Böckli spoke on stamp duty reform.

– On 29 October 1987 a special meeting was held dedicated to a discussion of the proceedings of the 1987 IFA Congress in Brussels and of the reports to be presented at the 1988 Amsterdam Congress.

The proceedings of the Brussels Congress were discussed by Dr. S. Zimmermann (Subject I: The fiscal residence of companies) and by Dr. N. Burki (Subject II: Tax treatment of the liquidation of companies).

Papers on the reports for the Amsterdam Congress were read by Dr. R. Oesch (Cantonal Appeal Commission of Zurich) on Subject I: Recognition of foreign enterprises as taxable entities, and by Mr. Hess on Subject II: Tax treatment of computer software. A paper on incentives for the construction of dwellinghouses was delivered by Mrs. G. Laffely; Dr. F. Bertossa (Swiss-Lex, Schweizerische Juristische Daten-

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bank AG) gave a presentation of the computer programme SWISS-LEX.

– On 21 and 22 May 1988 a joint meeting of the British and Swiss IFA Branches was held (cf. the reports which appeared in *Bulletins* 4/1987 at 180 and 10/1987 at 471).

USA BRANCH

In June 1988 the USA Branch of IFA published a Newsletter which contains information interesting to members of other IFA branches. The Editors of the *Bulletin* have made the following summary.

Membership

The USA Branch is no longer a small organization. It is approaching the 1,000-member mark and is now by far the largest branch in the world-wide IFA organization. Measures to improve its administration are being considered.

International meetings

One of the benefits of IFA is the possibility for each branch to hold meetings jointly with other country branches. In the past the USA Branch has organized joint meetings with branches from Canada, Germany, Mexico, the Netherlands and the U.K. This year the USA Branch has again scheduled a joint meeting with the German Branch. This time in Aachen (Federal Republic of Germany) on 9 and 10 September 1988 (preceding the annual IFA Congress in Amsterdam (the Netherlands) which will start on 12 September 1988. Messrs. Carl Estes and Nick Campbell are co-chairing the U.S. representation.

The USA Branch envisages making these international one-to-one meetings an annual event.

Annual meeting

Because of the increased number of members and their geographical dispersion the USA Branch of IFA must continue to hold its annual meetings in a different place each year. The 1989 meeting will be held in San Francisco (to be organized by Messrs. David Foster, Jay Gonzalez and John Stephan) and the 1990 meeting will be held in Philadelphia (to be organized by Mr. Dave Rachofsky).

Regional groups

For 15 years all the members from the western States were considered as part of the California group. This meant alternating meetings and leadership between Los Angeles and San Francisco. Since this dichotomy is not in the interest of the members, the "West" has been divided into two groups:

– Southern California and Southwest (Los Angeles, headed by Mr. Bill Norman); and
– Northern California and Northwest (San Francisco, headed by Mr. John Nicolai).

In view of the relocation over the past 10 years of a number of large companies from New York City and the accounting firms which serve them, a regional group will be formed which will be based in Stamford (Connecticut). This group will consist of members based in Westchester County, New York and Fairfield County, Connecticut. The group will have approximately 40 members when it commences its activities.

Annual Congress

Complaints have been made about the format and the contents of the technical part of the annual Congress programme. It is understood that Central IFA will study the whole situation in the autumn. The USA Branch will also conduct its own study in order to give the maximum effect to its views. A committee has been appointed for this study chaired by Mr. Bob Patrick, who is assisted by Messrs. Paul Farber, Chet Hilinski, John Huston and Max Stucker.

Publications

The speakers at the Annual Meetings are outstanding technicians in the field of international taxation and this expertise is reflected in their outlines distributed at these meetings. The USA branch is now investigating the possibility of an outside organization publishing these papers. It is hoped that the papers presented at the 1989 Meeting will be the first to be printed. The papers will probably be sold at a nominal charge to members and at much higher price to non-members.

Meetings

Meetings were held in New York City (10 June 1988) and Chicago (8 June 1988).

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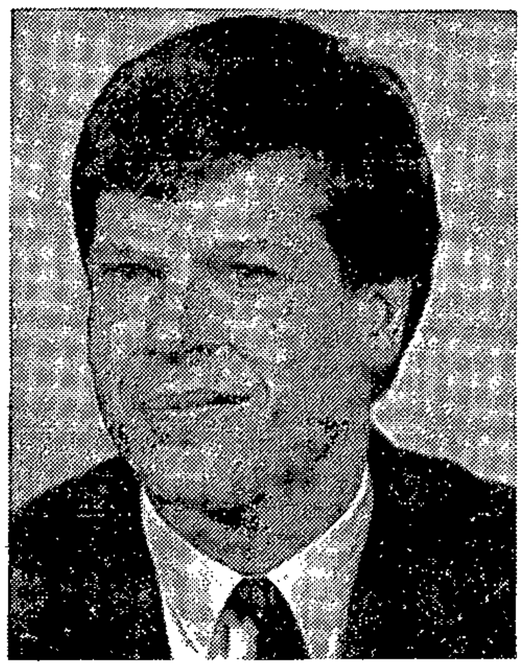
NETHERLANDS:

The Participation Exemption: Present and Future

By E.A. Brood



Edgar A. Brood is an international tax consultant with Begheyn & Sneep Melse in Rotterdam. The firm is a member of Touche Ross International. Mr. Brood studied Dutch company law at the University of Rotterdam and tax law at the University of Tilburg.

I. INTRODUCTION

The Netherlands' participation exemption or affiliation privilege (deelnemingsvrijstelling) ranks as one of the most well-known international tax planning schemes.[1] The affiliation privilege has existed in one form or another in Dutch legislation since 1893.[2] In its present form, companies are exempt from corporate income tax on all benefits (including dividends and capital gains realized upon disposition of shares) deriving from qualifying shareholdings. The basic philosophy underlying the participation exemption is to avoid double taxation of profits, i.e. once a profit is distributed by one company to another company acting as shareholder that income should not be retaxed. Lacking such a privilege corporate income tax would be imposed twice in the Netherlands, i.e. once at the level of the distributing company and once at the level of the recipient corporate shareholder.

One of the basic principles of Dutch fiscal legislation is that each legal entity is deemed a separate entity and therefore (in principle), is subject to tax on its total worldwide income. The ultimate owner of such an entity cannot take the corporate income tax due by the entity into account when determining its own (corporate or individual) tax liability.[3] However, there are 2 important exceptions to these fundamental principles, i.e. the affiliation privilege and the concept of the "fiscal unity" (fiscale eenheid).[4]

Under the aegis of the affiliation privilege, profits which have been subject to corporate income tax once will not be retaxed. The profits received (e.g. dividends) are, in fact, profits of the shareholder but they have already been subject to tax at the level of the participation. This article examines the present status of the affiliation privilege, its various loopholes and some of the recently proposed revisions.

Existing legislation

The affiliation privilege is set forth in Art. 13 of the Corporate Income Tax Act.[5] In general, all corporate taxpayers may avail themselves of the privilege.[6] The affiliation privilege applies to participations in both resident and non-resident companies, although additional requirements must be satisfied for non-resident participations.

1. Resident companies

In order for a corporate taxpayer to benefit from a participation in a resident company several conditions must be fulfilled:

a. *Participation of at least 5%*[7]
The participation must be at least 5% of the shares of the nominal paid-in capital of the company invested in.[8]

b. *"Annual possession"*
The second requirement for application of the affiliation privilege is that the shares be held for an uninterrupted period of time from the beginning of the shareholder's bookyear in which the benefit is received.

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1. Combined with the extensive network of tax treaties concluded by the Netherlands, the beneficial tax arrangement with the Netherlands Antilles and the absence of withholding taxes on interest and royalties the country offers an extremely favorable investment climate.
2. See the Enterprise Tax Law of 1893 (Wet op de Bedrijfsbelasting, 1893); the Income Tax Law of 1914 (Wet op de Dividend en "Tantièmebelasting, 1914); the Profit Tax Ordinance of 1940 (Besluit op de Winstbelasting, 1940); the Corporate Income Tax Ordinance of 1942 (Besluit op de Vennootschapsbelasting, 1942) and the Corporate Income Tax Law of 1969 (Wet op de Vennootschapsbelasting, 1969). For an historic overview of the affiliation privilege, see Hamulyák, A., "Revision of the Participation Exemption", 27 *European Taxation* 10 (1987) at 311.
3. See, Betten, R., "The Fiscal Unity: International Aspects and Recent Developments", 27 *European Taxation* 3 (1987) at 78.
4. Fiscal unities are permitted to file consolidated tax returns in which the profits and losses of the group can be set off and assets can be transferred within the group without regard to capital gains and losses. For a full discussion of the concept and consequences of the "fiscal unity", see footnote 3.
5. Wet op de Vennootschapsbelasting 1969 (hereinafter referred to as CITA).
6. See Art. 2 CITA. Certain other companies, however, are not eligible for the benefits of the participation exemption (see Art. 28 CITA 1969) and text below.
7. A shareholder within the meaning of Art. 13 is any corporate taxpayer which has legal ownership of the shares. Certain exemptions, however, have been granted to economic owners. See also article cited in footnote 2.
8. Certain exceptions apply to this rule as well. For instance, a less than 5% shareholding is approved if the investment serves the public interest or if it is held in the normal course of the taxpayer's business.

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This is commonly known as the "annual possession" (annaal bezit) requirement. If a participation is acquired during the course of the shareholder's bookyear the exemption is unavailable in that year (this also means that losses can be deducted in that year).[9]

c. *Capital divided into shares*[10]

The third requirement is that the company invested in must be a company whose capital is divided into shares.[11] From the Dutch perspective, it is not always clear whether a foreign company can be considered to have capital divided into shares. As a general rule, for example, Liechtenstein Anstalts and trusts are not considered to satisfy this requirement.

2. Non-resident companies

Participations in companies incorporated under foreign law also qualify regardless of whether the company is resident in the Netherlands but, as mentioned above, several additional requirements must be met.

a. *Subject to a profits tax*

Art. 13(3) CITA provides that the participation exemption is only available for participations in non-resident companies if the non-resident company is subject to a profits tax, i.e. the company invested in must be subject to income tax on its profits. Such a requirement is logical in light of the underlying philosophy of the affiliation privilege, i.e. to avoid double taxation of profits.

However, the "subject to" requirement does not necessarily mean that the company actually paid the tax. If the fiscal legislation of the State in which the participation is resident levies tax at the corporate level on companies divided into shares, the requirement is satisfied. So long as an income tax similar to Dutch corporate tax is imposed in the State of residence, the exemption will be available.

The amount of tax levied by the other State is irrelevant. Neither a low tax rate nor a tax holiday (e.g. Ireland and Sri Lanka) will preclude application of the affiliation privilege. However, if a participation is resident in a no-tax country (e.g. the Bahamas), the shareholder cannot avail itself of the exemption.[12]

b. *Country*

The tax to which the participation is subject must be levied by a sovereign power. Doubts have arisen in a few instances whether certain territories could be considered countries (e.g. Hong Kong, the United Arab Emirates). The Under Minister of Finance has issued a statement[13] which confirmed that both Hong Kong and the United Arab Emirates will be deemed countries for the purposes of the affiliation privilege.[14]

c. *Passive investment (belegging)*[15]

Passive or portfolio investments do not qualify for the participation privilege.[16] A passive investment exists, for instance, when shares are held in a foreign portfolio investment company for the mere purpose of receiving a return on an investment. A participation exists when a nexus between the business activities of the 2 companies can be established.[17]

Passive investments have generated a great deal of controversy, particularly with respect to holding companies. Previously, it was of no consequence whether a holding company carried on business activities in order to qualify for the affiliation privilege; so long as the holding company held the requisite amount of shares (and satisfied the other requirements), the affiliation privilege applied. However, based on a 1973 Supreme Court decision[18], Parliamentary discussions and a statement by the Under Minister of Finance, now the shareholder in a qualifying participation must be carrying on a minimum of business activities of its own in order to qualify for the privilege.

The fundamental issue to be decided in such a case is whether the shareholder fulfills an essential function with respect to the group of companies as a whole.[19] A distinction is made between a top holding and an intermediary holding company. A top holding company is the company which controls a group of companies. It may have individual or various corporate shareholders but it is not controlled by other companies. An intermediary holding company, however, is one where the Dutch holding company is itself a subsidiary of (and controlled by) a foreign parent and the Dutch holding company has, in turn, its own foreign subsidiaries.

With respect to a top holding company which is controlled by an individual, the holding company must fulfill some sort of management, policy-making or supervisory function for the group. Lacking such a function, the participation will be considered a passive investment.[20] The situation differs with respect to intermediate holding companies, i.e. the affiliation privilege only applies if a nexus is established between

9. Consequently, if a parent company incorporates a subsidiary during the course of its bookyear and the subsidiary distributes dividends to the parent during that same bookyear, the exemption is not applicable.
10. Art. 13 para. 1.
11. A foundation is not considered to have a capital divided into shares. However, a participation in a cooperative society or in a resident "fund for joint account" may qualify, but these participations are not discussed in this article.
12. This situation can be avoided by incorporating a subsidiary in a low tax country; the subsidiary can then maintain a branch in the no-tax country.
13. Ruling No. 084-2391 of 24 September 1984, as amended by Ruling No. 086-2004 of 8 August 1986.
14. Most Arab countries, however, do not levy any company tax so the condition "subject to" tax will not be fulfilled in these cases.
15. For a discussion of the passive investment issue, see te Spenke, Gerrit, *Taxation in the Netherlands,* Kluwer Law and Taxation Publishers, Deventer, The Netherlands (1985) at 64.
16. See Art. 28 CITA.
17. See also the Official Explanation to the Bill introducing CITA 1969.
18. See decision of the Supreme Court (Hoge Raad) of 7 November 1973, published in Beslissingen in Belastingzaken/Nederlandse Belastingrechtspraak (hereinafter referred to as "BNB") 1974/2. The case is discussed in 13 *European Taxation* 12 (1973) at 433.
19. Ministerial Regulation of 15 October 1974, published in BNB 1975 No. 11.
20. See footnote 18.

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the foreign top holding company and the foreign subsidiaries. Three basic situations are discernable:

(1) The activities of the foreign parent company and the foreign second tier subsidiaries are closely connected (for example, both operate supermarkets or the foreign parent has some other directly-held subsidiaries which operate supermarkets or the 2 entities operate in different lines of vertical production of goods).

(2) The only asset of the foreign parent is the Dutch subsidiary with its own foreign subsidiaries. In such a situation, an advance ruling should be obtained to ascertain applicability of the participation exemption.[21] However, so long as the Dutch intermediary holding company performs an essential function in the group (e.g. financing the subsidiaries), no difficulties should arise in qualifying for the exemption.[22]

(3) There is no foreign parent company, i.e. instead a foreign individual holds this position as shareholder. As a general rule, in such a case, the affiliation privilege does not apply because such a scheme is tantamount to the individual postponing payment of income tax on dividends received by reserving the dividends in the Dutch holding company, unless the holding company has an essential (e.g. managerial) function.

II. EXPENSES

Expenses in this context include interest costs on loans which the parent company has made to finance the purchase price of the participation, capital tax with respect to an increase in share capital in order to finance the purchase price and management and accountancy expenses.[23]

As indicated above, additional requirements exist for application of the participation exemption depending upon whether the participation is in a resident or non-resident company. One of these prerequisites concerns the deduction of expenses related to the participation.[24] Expenses related to a participation are only deductible from the shareholder's taxable profit if these costs can be considered to contribute to profits which are taxable in the Netherlands. Profits distributed by a Dutch subsidiary company are considered to have contributed to such taxable profits so that expenses connected to a qualifying participation in a Dutch company are deductible. However, expenses incurred in connection with a qualifying non-resident participation are not deductible for Dutch income tax purposes because they do not generate profits taxable in the Netherlands since the profits distributed will be exempt under the affiliation privilege.[25]

III. LIQUIDATION

As a matter of logic, it would appear that if qualifying benefits (losses) are to be exempt from company tax, then negative benefits resulting from the same participation should be disregarded when calculating the shareholder's taxable income. The general rule laid down in the law is, indeed, that losses of the participation are not deductible. However, one exception to this rule exists: losses incurred upon a formal liquidation of a subsidiary (if the subsidiary incurred the losses) are deductible from the taxable profit of the parent.[26] Because the liquidated subsidiary cannot carry forward its losses to assessment years in which positive income can be derived, the law permits the parent company a deduction at the time of liquidation.[27]

Generally, the loss is calculated as the difference between the cost price of the participation minus the liquidation distribution to the shareholder. The cost of the participation includes the original amount paid to acquire the subsidiary, increased by any subsequent increases in capital and decreased by any distributions out of the pre-acquisition surplus.[28] The liquidation loss may be deducted in the year in which the liquidation process has been completed.[29]

IV. LOOPHOLES

The statutory language of the participation exemption is fraught with loopholes and recommendations have been submitted to Parliament to check the reins of Art. 13. These recommendations are discussed in V below. Examples of structures which can be created by these loopholes are as follows:

A. Conversion of a branch into a legal entity

If a Dutch company has a branch (permanent establishment) operating in a foreign country which incurs start-up losses, the losses are deductible from the tax-

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21. An advance ruling is a determination by the Dutch tax administration of the fiscal consequences of a particular transaction the taxpayer wishes to engage in. Basically, the tax administration will discuss with the taxpayer the particular tax consequences of a proposed transaction. Such a ruling is particularly useful with respect to applicability of the participation exemption, i.e. the tax authorities can confirm in advance whether foreign shareholdings of a Dutch intermediary holding company are portfolio investments. See Hamulyák, A., "Administration's Policy Concerning Advance Rulings Disclosed", 27 *European Taxation* 7 (1987) at 223.
22. However, the position will also depend on the activities of the foreign parent.
23. Art. 13 para. 4 does not include losses of the participation. These are taken into account upon formal liquidation of the participation. See text below.
24. See Art. 13 para. 4.
25. However, it should be noted that expenses incurred during the period of time when the "annual possession" requirement is not fulfilled can be deducted. See also decision of the Supreme Court of 22 April 1970, published in BNB 1970/51.
26. See Art. 13 para 5.
27. In some foreign jurisdictions, the loss can also be carried over if the subsidiary which is liquidated transfers its operations to another subsidiary of the same group. This may result in a double loss deduction, i.e. in the Netherlands and abroad. See also "Loopholes and Controversies in Dutch Corporate Income Tax Legislation", 26 *European Taxation* 11 (1986) at 359.
28. See note 26.
29. This process can involve several years.

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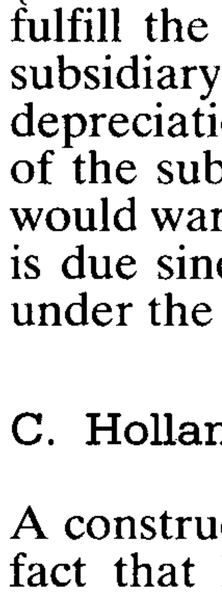
able profits of the Dutch company. The Dutch unilateral provisions for the prevention of double taxation[30] which have been incorporated in most tax treaties, provide, in effect, that under certain time limits, future profits of the branch are taxable up to an amount equal to the sum of the former losses. However, the branch (permanent establishment) can be converted into a foreign participation during the unprofitable period of time. It is preferable that the value of the branch, including goodwill, is more or less nil at the moment of conversion. In that case, the conversion of the branch into a company will not result in taxable income for purposes of Dutch income tax law. Of course, valuation will cause a serious problem. If the company later becomes profitable, any subsequent benefits derived and distributed by the parent company are immediately tax-exempt under the affiliation privilege without affecting the earlier deducted losses.

B. Conversion of loans into share capital

If a parent company finances its foreign subsidiary with a loan and the subsidiary incurs losses to the extent that it cannot be expected to repay the loan, the parent company may amortize, by means of creating a provision, this loan in its books (i.e. a tax-deductible amount) because the funds represented a loan and not an investment of capital.[31] However, the loan must be appreciated if it appears that in later years the foreign subsidiary derives better results, which will lead to the imposition of corporate income tax on the appreciated amount. There is, however, a way to cover this situation. The Dutch Supreme Court has held that the loan (to the amount of its nominal value) can be used to fulfill the obligation to pay for shares issued by the subsidiary to the parent company.[32] Therefore, after depreciation, the loan is converted into share capital of the subsidiary, and if the results of the subsidiary would warrant the appreciation of these shares, no tax is due since the appreciation of shares is tax-exempt under the affiliation privilege.

C. Holland routing

A construction which is used to take advantage of the fact that losses incurred upon the liquidation of a foreign subsidiary may be deducted from the taxable income of the Dutch parent is the so-called "Holland routing". This construction can best be illustrated in the following manner:



Assume foreign parent A has a Dutch subsidiary B. A envisages to create or purchase a subsidiary operating company which will be located outside the Netherlands. Considering that a new company will, in its start-up period, incur losses, A may wish to avail itself of the possibility of the deduction of liquidation losses under Dutch law. For this purpose it is decided to let the Dutch subsidiary create foreign subsidiary C, which in turn creates foreign subsidiary D. D is the operating company in which the contemplated activities are to be performed whereas C acts as a holding company in relation to D. If D indeed suffers a (substantial) loss, B will take the necessary steps to liquidate C. The initial capital cost price contributed by B will exceed the liquidation proceeds, i.e. the value of the shares of D which are distributed by C to B. This excess amount may be deducted as a liquidation loss by B.[33] C will have disappeared after its liquidation and B will directly hold the shares of D. When D's activities become profitable, it may be able to make dividend distributions to B which will be exempt from Dutch corporate income tax in the hands of B.

The main objection the tax authorities have against this type of construction is that the operation is carried out within a group of companies, that the activities are not discontinued, but are only carried out by a third tier company rather than a fourth tier company.

V. DRAFTS TO AMEND THE PARTICIPATION EXEMPTION

The Under Minister for Finance and a member of the Socialist Party, Mr. W. Vermeend[34], have introduced proposals to amend the legislation on the participation exemption. The proposed changes are not designed to alter the basic objective of the affiliation privilege (i.e. profits deriving from qualifying participations remain tax-exempt), but rather to close the above-mentioned loopholes. At this stage it is uncertain which of the drafts will become legislation or whether further amendments will be made to the drafts. Some of the proposed changes in both drafts are set forth in the appendix.

APPENDIX

Vermeend draft

1. The annual possession requirement will be abolished.
2. The affiliation privilege will apply to changes in the value

30. Decree of 4 April 1965 (as amended), Art. 3(3). Note that losses must be carried forward and deducted from the income of the next 8 years.
31. The loss is not deductible, however, if the loan was not made under arm's length terms (e.g. if a bank would not have granted the loan), it will be considered an "informal" capital.
32. Decision of the Supreme Tax Court of 26 April 1978, published in BNB 1978/140.
33. Of course, a taxable profit is "needed" to make the deduction really effective.
34. Press Release Ministry of Finance, No. 86/366 of 1 December 1986.

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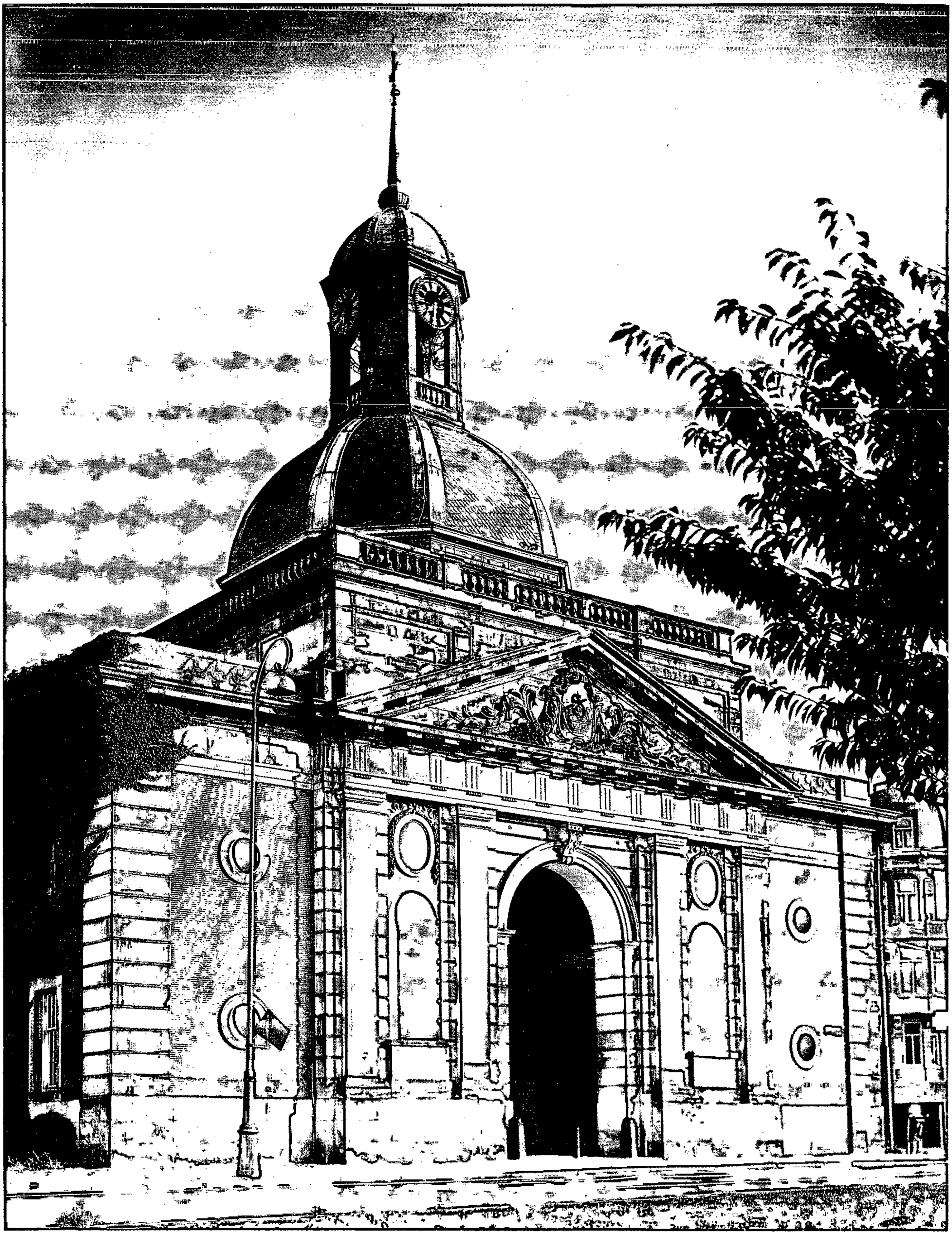
1938 INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION 1988



Built in 1771, on the road from Muiden,
the Muiderpoort is one of the last surviving gateways to the City of Amsterdam

It has been the headquarters of the Bureau since 1963 although
more recently some of the larger departments have been moved to modern premises nearby

THE INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION CELEBRATES ITS 50TH ANNIVERSARY

1988 marks the 50th anniversary of the International Bureau of Fiscal Documentation (IBFD). Various festivities have taken place to celebrate the occasion of the Bureau's golden jubilee which coincides with the golden jubilee of the International Fiscal Association (IFA) to be commemorated during the 1988 IFA Congress in September 1988 in Amsterdam. These festivities, reflecting the best of Dutch maritime tradition, included a trip by barquentine on the former Zuyder Zee offered to the members of IBFD's Board of Trustees and Advisory Council. The celebration will culminate on 13 September 1988 with a grand reception in the Amsterdam Maritime Museum.

50th Anniversary – Boattrip with members of the Board of Trustees and the Advisory Council

Annual Meeting – Chairman Prof. A. Nooteboom

It seems a fitting tribute on the occasion of the 50th anniversary to commemorate the dedication and commitment of all the individuals who have contributed to the prominent position achieved by the IBFD. We are therefore presenting a succinct overview of the IBFD's development over the past 50 years and of its place and function in the world of international and comparative taxation. As a preface to this survey, the editors wish to express the IBFD's gratitude to its staff, to the significant contributions made by IBFD correspondents and for the world-wide support and interest pledged by subscribers and clients alike. In particular, we would like to express our gratitude to the Members of the Board of Trustees and the Advisory Council, without whose invaluable assistance the IBFD would not have been able to function.

As is true with any institution, the Bureau's history has been largely characterized by its leadership. Three phases are discernable – the inception phase (under the management of Professor Adriani), the development and expansion phase (under Professor J. van Hoorn Jr. and D.A. van Waardenburg), and the (further) expansion and computerization phase (under the current directors Hubert Hamaekers and D.A. van Waardenburg).

Shortly after IFA was founded in 1938, its members established the IBFD. Although the IBFD was set up as a "foundation" under Dutch law, its statutes were not officially drawn up until March 1940, i.e. 18 months after the institute came into existence. Professor Adriani was appointed the first director. The statutes have been revised over the years, a major revision taking place in 1956 after the Dutch Foundation Act (Wet op de Stichtingen) was enacted. The statutes were again revised in 1981 to allow the appointment of more than one managing director, and in 1987, the statutes were completely overhauled. This latter revision not only rectified a number of deficiencies and discrepancies which, over the years, had crept into the statutes, but also created an entirely new organ, the Delegated Board of Trustees whose function would be to maintain close contact with the Board of Directors.

Spearheaded by the late Professor Dr. P.J.A.

Professor van Hoorn further steered the course of the IBFD as an independent, self-supporting research institute. In addition to the expanded staff and publications, he initiated contacts with literally hundreds of eminent tax specialists throughout the world. Many of these individuals became regular correspondents for various IBFD publications. Professor van Hoorn and his staff maintained these contacts by extensive traveling, delivering lectures, chairing tax conferences and actively participating in international organizations.

The IBFD also played an instrumental role in the establishment (in 1982) of the *Asian-Pacific Tax and Investment Research Centre* (APTIRC) in Singapore. The centre is patterned after the IBFD, and its objective is to research tax aspects of economic development in the Asian-Pacific region. Harmonious cooperation between the IBFD and APTIRC enhances the services offered by the 2 institutions.

The heads of the type-setting and proof-reading departments discussing the spelling of "Gewinnausschüttung"

14 kilometres of shelves to store all the loose-leaf pages

The expeditious development and expansion within the Bureau necessitated the acquisition of new and larger quarters. In 1963, the Municipality of Amsterdam made available to the IBFD the historic "Muiderpoort" building. Constructed in 1771 under the direction of municipal architect Cornelis Rauws, the Muiderpoort was one of the surviving gateways to the old city. The Muiderpoort originally operated as a levying station where taxes were imposed on all goods and persons passing through the gateway.

The Muiderpoort was restored both functionally and aesthetically by combining its unique interior with the demands of a modern office. The Bureau revived the Muiderpoort's function as a centre of taxation albeit in a different perspective. The building which once served as a levying centre for one city now houses an institute which researches taxation on an international level. The building itself is represented in the Bureau's logo. The Bureau expansion, however, demanded even more office space, and in 1979, a second building located near the Muiderpoort, was also acquired.

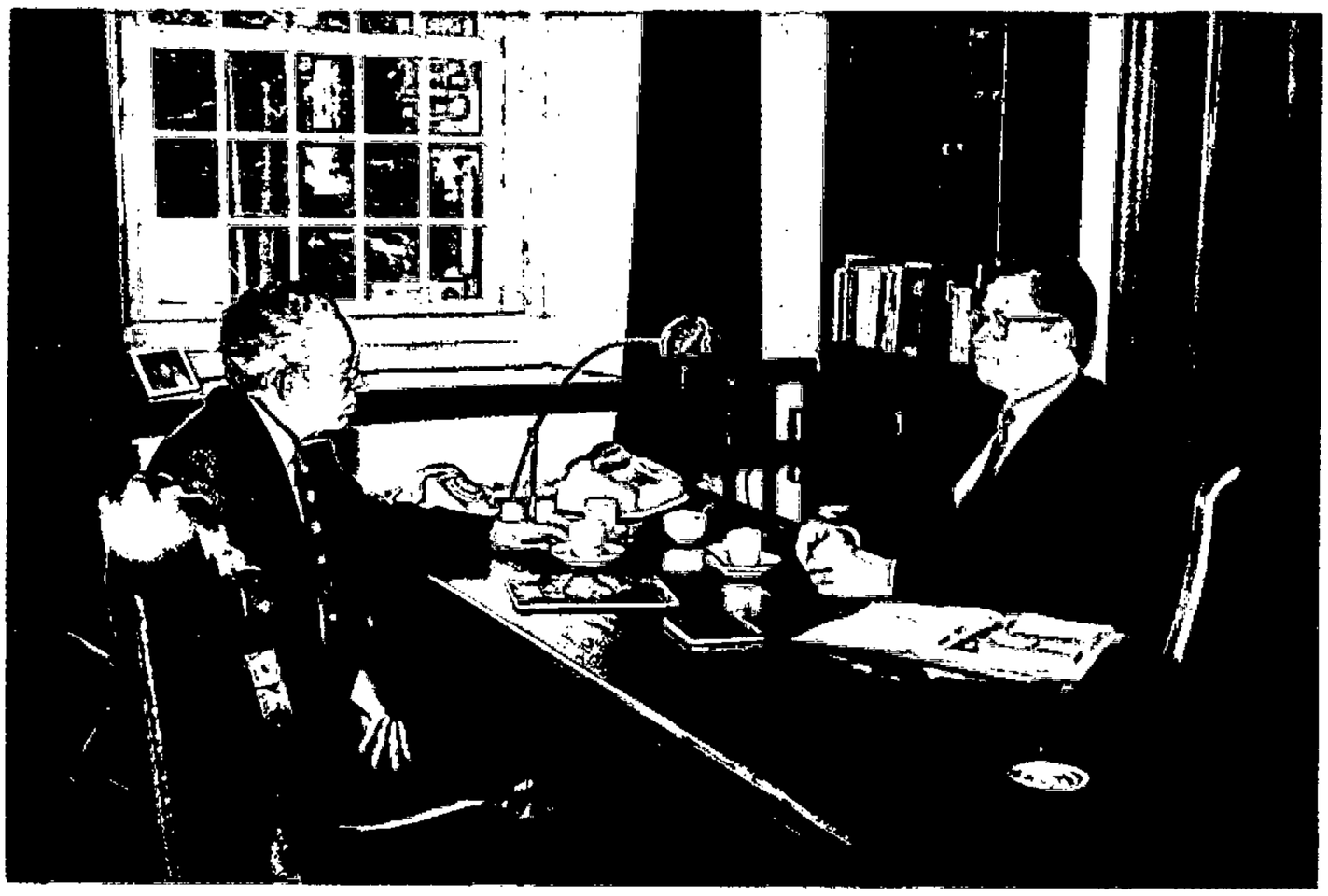
In the conclusion of the IBFD's 1962 Annual Report, Professor van Hoorn expressed the hope that the IBFD's clients would continue to recognize the value of the Bureau's services, and if so, the IBFD could "look forward to the next 25 years with great optimism". That sentiment obviously came to fruition as is evidenced by the position achieved by the IBFD in the past 25 years and it can be aptly applied on this, the 50th anniversary of the IBFD.

Mr. Hubert Hamaekers, a former Director at the Dutch Ministry of Finance, succeeded Professor van Hoorn as Chief Executive of the IBFD in 1985. Mr. Hamaekers was active in the field of international taxation for many years and chaired the Working Group on Taxation of Multinational Enterprises of the OECD as well. Mr. Hamaekers was selected by the IBFD's Board of Trustees on the basis of his knowledge of international taxation and, in particular, because he successfully combined practical experience as a former tax consultant and tax official with modern managerial skills.

One of the first major tasks Mr. Hamaekers set for himself was restructuring the organization of the IBFD. He proposed - in consultation with the IBFD's Chairman of the Board

Mr. Caballero preparing an article on Spain

Astonishing things happen in the computer department



Serious faces: The directors

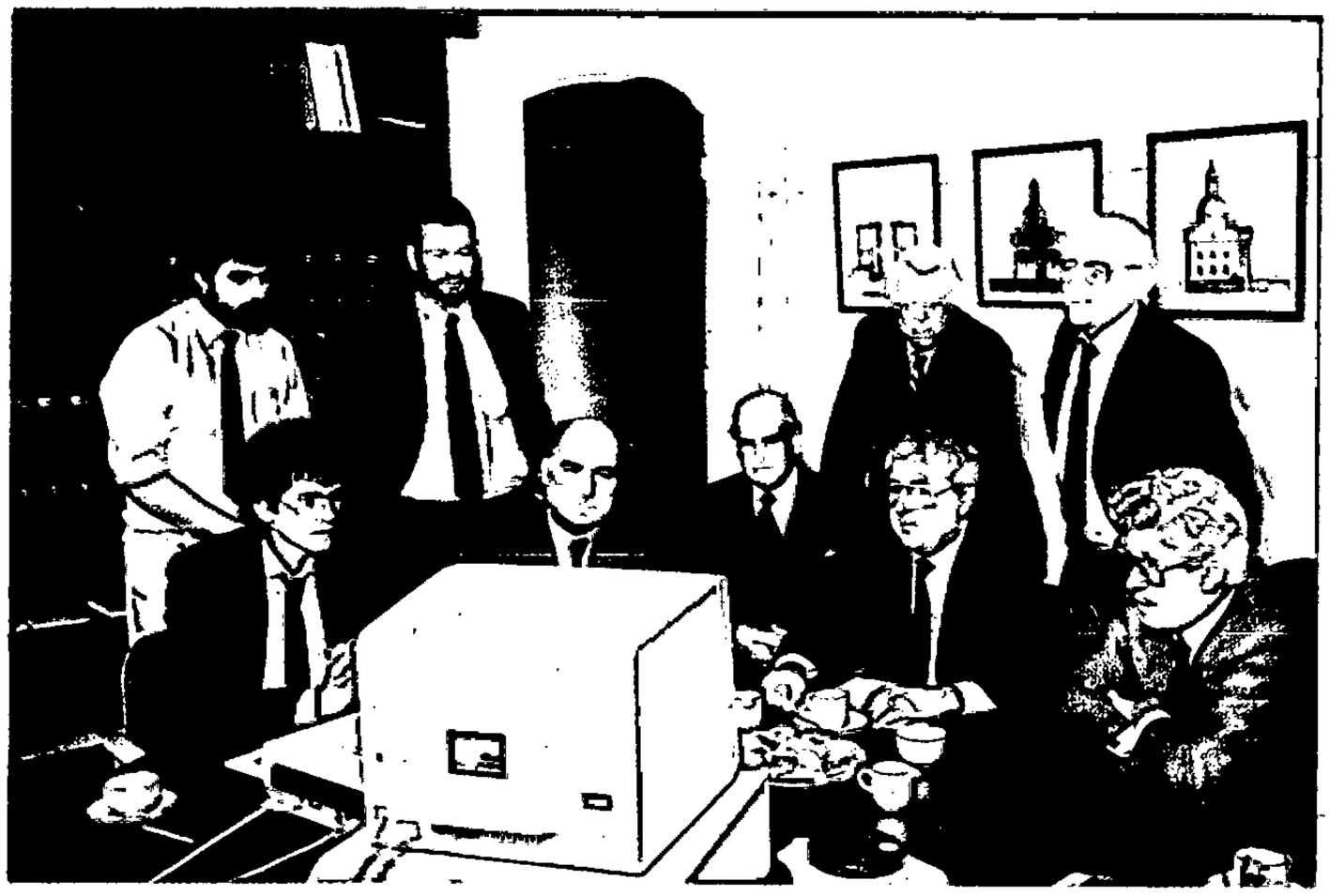
goal almost came to fruition in 1940 but was interrupted by World War II, the occupation of the Netherlands by Nazi Germany and the consequent disruption of communications with other parts of the world. However, in 1946, the first issue of the *Bulletin* finally appeared in print. Today, the *Bulletin* ranks as one of the authoritative sources for the international tax practitioner with its detailed and comprehensive articles on world-wide tax events. The *Bulletin* is the official organ of IFA and occasionally publishes reports of its national branches. A special IFA Congress issue (like this issue) is generally published in honour of the annual IFA Congress and contains articles on topical aspects of the host country. This year the Congress issue focuses entirely on Dutch taxation issues. The articles have been written by eminent tax specialists in the Netherlands.

Professor Adriani resigned as Chief Executive in May 1954 and was replaced by Mr. J. van Hoorn Jr., the then-assistant manager of the IBFD. Mr. van Hoorn was later appointed part-time tax professor for international tax law at the Free University of Brussels. His appointment as Chief Executive ushered in the second phase of the IBFD, i.e. the period characterized by development and expansion.

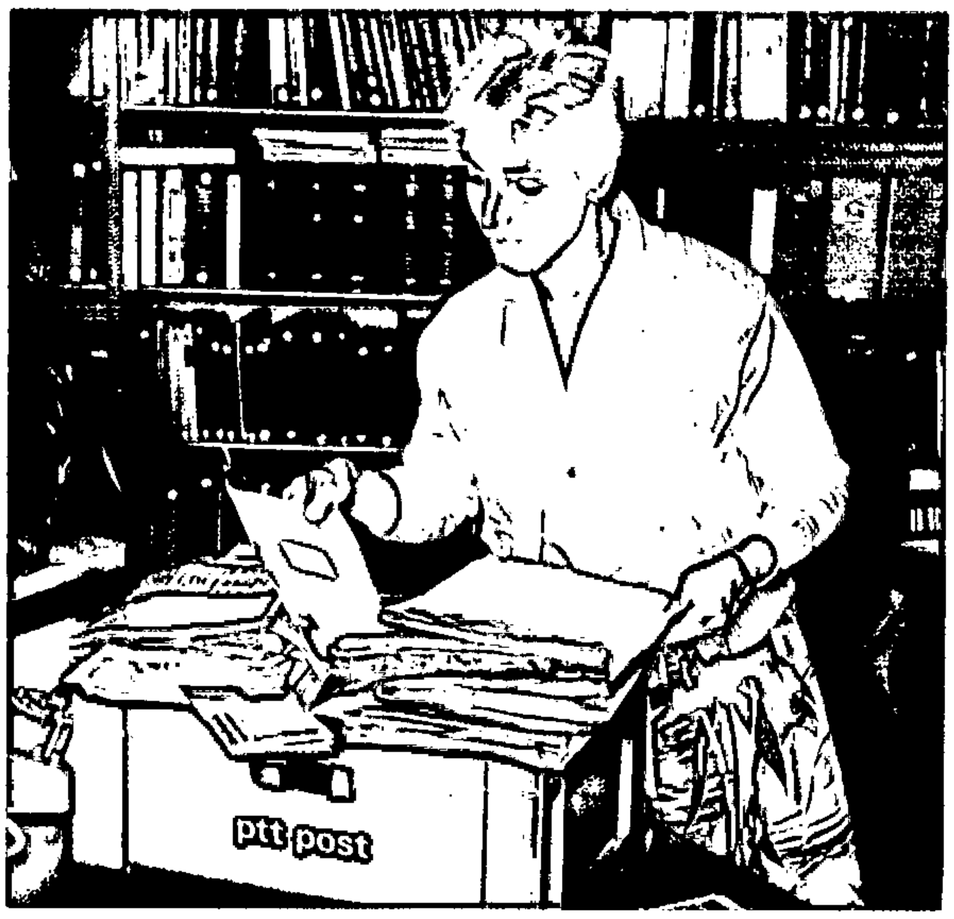
In 1954, the IBFD staff was composed of 5 persons, the *Bulletin* was the sole publication and the IBFD itself was housed in a few rooms throughout the premises of the Amsterdam Municipal Tax Office. By the end of Mr. van Hoorn's tenure in 1985, the staff had expanded to more than 55 persons of about 10 nationalities. The multi-national character of the professional staff guaranteed an ever-improving service to all who availed themselves of the IBFD's facilities.

The efforts of the IBFD were brought to the attention of a larger international tax audience in 1961, the year *European Taxation* commenced publication. Originally published twice-monthly, *European Taxation* later became a monthly journal specializing in taxation of European countries and it achieved a high reputation for its penetrating articles on the tax laws and developments in Europe.

Other IBFD publications followed in rapid succession: *Supplementary Service to European Taxation* and *Guides to European Taxation*, 1963; *Tax News Service* commenced in 1965; The *Handbook on the U.S.-German Tax Convention*, 1966; *Corporate Taxation in Latin America* appeared in 1970; *African Tax Systems* (volumes in English and French), 1971-1972; *Taxes and Investment in the Middle East*, 1977; and *Taxes and Investment in Asia and the Pacific*, 1978.



Demonstration of the tax treaty CD-ROM to guests: Dr. Tanzi, Prof. Valdés Costa, Mr. Becker, Prof. Van Hoorn, Dr. Faist, Mr. Spinosa Cattelà



The IBFD at work: The morning mail

Team meeting – Mrs. Wheeler, Mr. Moore, Mrs. Salomons, Mr. Van Waardenburg, Mrs. Lyons, Mr. Webb, Mr. Kesti

Adriani (the first full professor of tax law in the Netherlands) the goal of the IBFD was to serve IFA and its members within the context of IFA's activities in the field of international and comparative tax law. Specifically, the IBFD was "to organize and maintain an international documentation centre for the purpose of disseminating information concerning tax legislation and application of taxation law, and encourage the study of taxation", namely, it was to act as a depository for books, articles and documents concerning international taxation.

Substantial funds to finance the IBFD were lacking so these functions commenced on an extremely modest scale. The sum available to finance the IBFD's activities during its first year in operation was, in money terms, equal to the amount now spent per hour! Nevertheless, under Professor Adriani's skillful leadership, the IBFD undertook the task of supplying factual data on various taxation systems throughout the world. In 1939, the IBFD was already supplying information on 60 countries.

Professor Adriani correctly anticipated the complex relationships which were to develop between nations with respect to taxation, and that international tax patterns would represent a vital force in determining the form and direction these relationships would assume in the future. He foresaw the necessity for increased cooperation between countries in order to avoid double taxation, the tax relationships between developed and developing countries, harmonization with respect to tax treaties and that cognizance of the international aspects of taxation was an integral part of dynamic socio-economic developments.

Professor Adriani's predictions were verified as businesses and governments throughout the world employed the IBFD to perform services other than mere documentation. Professor Adriani and his small staff committed themselves to the Herculean task of incorporating practical and scientific functions into the operation of an independent international research and documentation bureau.

The Bureau's sphere of activities grew steadily and consequently the IBFD was required to enlarge the ambit of its activities. The IBFD's role as a mere depository of tax data expanded and it evolved into an active disseminator of practical information and scientific data in the areas of comparative and international tax law. The Bureau thus became one of the principal sources of tax information in the world.

One of the original goals of the IBFD was to publish a periodical as a forum for reviewing fiscal legislation, literature and cases. This

of Trustees, Professor A. Nooteboom – a refined delineation of the responsibilities of the Board of Trustees and the Board of Directors as well as the creation of a Delegated Board of Trustees. These proposals were unanimously approved by the Board of Trustees and led to the 1987 amended statutes. Mr. Hamaekers initiated improvements in the IBFD's organizational structure by creating 3 teams within the IBFD's professional staff, each team assigned specific responsibilities. Most staff members have been equipped with personal computers which facilitate their work and have substantially increased output. The IBFD's second office building has also been remodelled to accommodate computerization and increase working space.

Commensurate with the change in management, steps have been taken to further improve the IBFD's publications and its comprehensive research projects. To accomplish its objectives, the IBFD must keep abreast of international tax developments, to disseminate this information and maintain the necessary contacts to ensure up-to-date information. Mr. Hamaekers has pioneered the conversion to advanced computer equipment to fulfill these objectives.

A limited on-line computer data base is anticipated to be in operation in 1988. Initially, the data base will contain texts of approximately 900 tax treaties. The existence of tax treaties is of prime importance for business enterprises which must, of course, take into consideration the effect of treaty provisions where they exist.

The first compact disc was prepared in May 1988; it contains the texts of the tax treaties as well as a retrieval system. Eventually the data base and the compact discs derived therefrom will contain the texts of all IBFD loose-leaf publications which will enable the IBFD to augment its position as an international centre for practical and scientific information as well as provide a departure point for examining new and/or complex issues materializing on the tax horizon.

Since Mr. Hamaekers was appointed Chief Executive, 2 new publications have appeared: *The Tax Treatment of Transfer Pricing* and an analysis of Dutch case law on international tax matters. Both books were published in 1987. The transfer pricing book contains an introduction to the tax issues connected with transfer pricing and multinational enterprises. It currently comprises 11 country chapters which offer detailed descriptions of legislation, regulations, case law and examples. The book was written by eminent tax specialists for the respective countries. The book will be completed with the texts of the OECD reports and other documents on transfer pricing. The Dutch case law publication was prepared by the sub-faculty of tax law of the University of Groningen and edited by the IBFD at the request of the Netherlands Ministry of Finance.

An international *Tax Glossary* is to be published in 1988 and will be presented at the IFA Congress in September. The glossary explains (in English) all terms used in national and international tax theory and practice. The equivalent terms in French, German and Spanish will also be included.

From the inception of the IBFD, the library has been the core of the organization. The library, which hosts hundreds of visitors each year, is the largest in the world in the field of international taxation. It stores almost 20,000 books on taxation and related topics on practically every country in the world. Tax journals, newsletters, official gazettes and other relevant periodicals are also available. This documentation is systematically catalogued and made available to the students, scholars and professionals who visit the library on a daily basis.

A policy was initiated in earlier years to offer facilities to tax experts from third world countries to conduct research in the IBFD's library. Representatives of such countries are found at the IBFD during the entire year.

The task of international research is to examine, without any bias as to political or economic interests, the consequences of the introduction of new tax provisions and to align the research efforts with tax developments throughout the world. The IBFD's mission is to analyze and report, to make all those involved with taxation aware of what is happening and why and to point out new trends in taxation. The Bureau has discharged this task during the past 50 years through its various publications, its international tax service and on the numerous occasions when IBFD representatives have had the opportunity to discuss pressing fiscal issues with various governmental and business groups.

Through the IBFD, these groups have been afforded the opportunity to meet each other on an informal basis, to candidly discuss issues of academic and practical interest and to achieve a mutual understanding of socio-economic problems. One example of this development is reflected in the cordial contacts which exist between the IBFD and tax experts in both "capitalist" and "socialist" states (like the U.S.S.R. and the People's Republic of China). In this way, albeit on a very modest scale, the IBFD may contribute to improved human relationships and ultimately a greater understanding between nations.

of loans insofar as these loans (either directly or indirectly) are used to finance the subsidiary on a long-term basis. This will apply with respect to depreciation (creating a provision) of the loan (not deductible) and revaluation (not taxable).

3. When calculating the non-deductible interest costs with respect to a foreign subsidiary, the so-called mathematics method will be used (i.e. a proportionate method of ascribing the cost of loans to all assets including those of the foreign subsidiary).

4. Deductibility of losses at the moment of liquidation:
- the loss will be decreased by dividend distributions from the last 5 years and the year of liquidation;
- only "liquidation losses" are deductible with respect to resident subsidiaries, and to the extent that these losses have not been incurred (either directly or indirectly) by a foreign or a resident subsidiary not to be liquidated.

5. These regulations are proposed to enter into force as from 25 September 1986.

Government draft

1. The annual possession requirement will be abolished.

2. If a depreciated loan (from a parent company to a subsidiary) is converted into the share capital of the subsidiary, the affiliation privilege will not apply to future dividends/capital gains of the subsidiary up to the amount of the depreciation. The conversion will result in an immediate tax claim equal to the amount of the former depreciation if the subsidiary (or part of it) is transferred to a foreign group subsidiary or to a foreign group company.

If the affiliation privilege does not apply only because the subsidiary is not subject to a profits tax, costs incurred by the subsidiary and losses incurred by it will not result in a tax deduction at the level of the Dutch holding company, i.e. unless the profits are higher than costs/losses, the result remains neutral for Dutch tax purposes. If, and as far as, the profits are higher than the costs/losses, the profits will be taxed.

3. If a permanent establishment is converted into a subsidiary, the affiliation privilege will not be granted with respect to the dividends/capital gains derived from this subsidiary to the extent that there were still losses to be compensated for in the permanent establishment (losses from the 8 years prior to the conversion). An immediate tax claim would arise in a situation comparable with the claim dealt with in "2".

4. In general, liquidation losses remain tax-deductible, taking into account that when calculating the loss, profits received from the subsidiary (dividends/capital gains) over the last 3 years, the year of liquidation and the subsequent years will increase the amount of liquidation proceeds. Liquidation losses will not be accepted if the business activities of the enterprise, in fact, continue within the group. There will be no tax-deductible losses if a foreign subsidiary is liquidated within 3 years after acquisition.

5. The regulations with respect to conversions of loans and permanent establishments and liquidations will apply only after the draft becomes law.

IFA news

BRITISH BRANCH

On 9-10 September 1988 the British and Canadian branches of IFA will hold a joint meeting chaired by Mr. David F.A. Davidson (Arthur Andersen & Co.), Chairman of the British branch. Chairman of the session on 9 September will be Mr. Robert Dart (Price Waterhouse) and on 10 September Mr. John Avery Jones (Speechly Bircham).

The morning of 9 September will be dedicated to problems connected with investment in Canada. Mr. Bob Reid (Thorne, Ernst & Whinney) will speak on Canadian taxation after the tax reform and the impact of provincial taxation in Canada and Messrs. Bill Strain and John Stacey (Deloitte, Haskins & Sells) on planning an investment in Canada, debt/equity ratios, thin capitalization, minimizing taxes and profit repatriation under Canadian law. In the afternoon their British colleagues will submit papers on investment in the United Kingdom. Mr. Malcolm Gammie (Linklater & Paines) will discuss tax aspects of planning a U.K. investment, the use of U.K. holding companies and this capitalization. Mr. Michael Aidin (International Thomson PLC) will speak on the repatriation of income and profits, withholding taxes and tax implications of divestment and Mr. Ian Sommerville (Deloitte, Haskins & Sells) will discuss the international aspects of U.K. VAT. The day will be concluded by a discussion of double tax treaty issues in Canada and the United Kingdom and planning through the Canada–U.K. tax treaty by Messrs. J.S. Wilkie (Stikeman Elliott) and Jonathan Schwartz (Stephenson Harwood).

On the second day, 10 September, the conference will focus on anti-tax avoidance measures. The Canadian approach will be discussed by Messrs. David Ward (Ward & Beck), Howard Kellough (Mawhinney & Kellough) and Brian Arnold (Professor of Law, University of Western Ontario). The U.K. approach will be dealt with by Messrs. Stephen White (Slaughter & May) and Nick Prentice (Arthur Andersen).

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Some Aspects of the International Tax Treaty Strategy of the Netherlands[1]

Unilateral Relief and Tax Treaties

By Susan M.C. Lyons and Dirk A. van Waardenburg

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I. INTRODUCTION

The Netherlands is a small country of slightly over 13,000 square miles. It is densely populated, having approximately 14.5 million inhabitants, which translates into roughly 1,111 per square mile. The country has no substantial natural resources except for natural gas, of which the Netherlands now boasts the largest reserves in Western Europe. The only other resources of any significance are oil and salt. There are large deposits of coal but these are situated so deeply that with the present state of technology a profitable exploitation is unlikely. For a long time the Netherlands was a predominantly agricultural society. However, because of its relatively vast coastline and good harbour facilities, international trade and transport activities flourished during the last centuries and continue to do so today.

After World War II, the Netherlands industrialized rapidly and in the process other branches of activity with strong international affinities became vital to the Dutch economy. Examples of such activity are the electronic and chemical industry, construction, and financial services rendered by banks, insurance companies and retail establishments. However, agricultural produce (vegetables, flowers, meat and dairy products) continue to be important export products. The need for international expansion is, of course, generated by the relatively small Dutch domestic market. In order to benefit from the economies of scale and to compete on an international level, Dutch enterprises must necessarily expand beyond the frontiers of the country.

The internationally-oriented structure of the Dutch economy has resulted in substantial movement of goods and an important flow of money to and from the Netherlands in the form of remittances of profits, dividends, interest and royalties. Cross-border transactions and international payments for goods and services may easily result in more than one country imposing its tax on income derived from such transactions. Double taxation is inevitable if such taxes are levied without taking into account taxation in other countries. This could impair the profitability of the enterprises concerned and would eventually damage the Dutch economy as a whole. The prevention of international double taxation is, therefore, of primary importance to the Netherlands.

1. This article is an expanded and revised version of an article published in 28 *European Taxation* 4 (1988) at 108, under the title "The Netherlands: Tax Treaty Policy". Like its predecessor, the present article is based on a discussion of a letter of 3 December 1987 addressed by the Under Minister for Finance to the Lower House of Dutch Parliament, Document Session 1987-1988 No. 20,355/1-2, entitled "Algemeen Verdragsbeleid" (General tax treaty policy). This document is cited as "GTTP". The authors have attempted to make the contents of the letter accessible to an international readership and have examined the extent to which Dutch tax treaty negotiators have succeeded in translating the wishes of their Government into the tax treaties which have been concluded. For a critical discussion of the letter, see Van Brunschot, F.W.G.M., "Algemeen Fiscaal Verdragsbeleid", *Maandblad voor Belastingbeschouwingen* 3 (1988) at 91 (hereinafter cited as *MBB Belastingbeschouwingen)*.

Ms. Lyons is the Managing Editor of the *Bulletin*. Mr. van Waardenburg is Executive Director of the International Bureau of Fiscal Documentation.

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II. THE DUTCH TAX SYSTEM

The Netherlands ranks as one of the countries with the highest tax burden in the world. If it is admitted that social security contributions are in fact a kind of (income) tax and if its yield is included in total revenue, OECD statistics[2] demonstrate that in 1985 the Netherlands was sixth on the list of OECD Member countries with a total tax revenue of 45% of gross domestic product (GDP) at market prices.[3]

The most important taxes are:
- taxes on income, i.e. the individual and corporate income taxes;
- taxes on capital, i.e. the net wealth tax (also designated as capital tax, in particular in tax treaties), the inheritance and gift taxes; and the
- turnover tax (the value added tax or VAT).

A. Individual income tax[4]

The individual income tax is levied on world-wide income of resident[5] individuals and on Dutch-source income (as specified in the law) of non-resident individuals.[6] The incomes of husband and wife are aggregated, but married persons are taxed separately on earned income (employment income, professional income and business income), income from pension rights, income from social security funds and certain periodic payments.[7]

In computing the taxable base, a fixed 4% deduction (minimum 200 Dfl.; maximum 800 Dfl.) is available for employment income. Actual expenses may be deducted if they exceed 800 Dfl. so long as the expenses can be substantiated.[8] Upon request, non-Dutch residents seconded to the Netherlands within a group of companies may obtain a fixed 35% deduction for a period of 5 years.[9]

Interest received is exempt up to an amount of 1,000 Dfl. (2,000 Dfl. for married persons).[10] Dividends received from domestic companies are also exempt up to an amount of 1,000 Dfl. (2,000 Dfl. for married persons).[11] However, under Dutch law no imputation credit is available as is the case in a large number of other EEC countries.[12]

Capital gains are normally not subject to tax. Some notable exceptions to this rule are:
- capital gains derived through a business or profession[13];
- capital gains realized on the sale of all or part of the shares of a resident or non-resident company provided the shareholding constitutes a "substantial interest".[14] If the gain exceeds 1,000 Dfl. it is subject to a flat 20% rate of income tax; and
- capital gains realized on the redemption of shares. If the shareholder sells shares representing more than 5% of paid-in capital, a special rate (between 20% and 54%) may apply.[15]

In computing the total taxable income, personal deductions are granted which range from 7,392 Dfl. for single persons to 18,185 Dfl. depending on the taxpayer's marital status, the number of dependents, etc.[16] The income tax rates vary from 14% on the first 9,652 Dfl. to 72% on income in excess of 229,625 Dfl.[17]

Employees are also subject to the wages tax[18], which is an advance income tax withheld from taxable wages of employees or persons who are deemed to be employed by individual or corporate employers. The tax has the same function as, for instance, the British pay-as-you-earn system because it permits the Dutch tax authorities to collect tax at the moment it is received. For a large group of taxpayers – those whose income does not exceed 58,500 Dfl. – the wages tax is a final tax, i.e. collection of the wages tax satisfies their income tax liability.[19]

Non-residents are only subject to Dutch income tax on certain Dutch-source income as indicated in the law.[20] They may also be subject to wages tax if their employer is established in the Netherlands or if they are employed by a Dutch permanent establishment of a non-resident employer.[21]

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2. *Revenue Statistics of OECD Member Countries 1985-1986* (hereinafter cited as "Statistics OECD").
3. This figure may be compared with those of Sweden (50.5%), Denmark (49.2%), Norway (47.8%), Belgium (46.9%) and France (45.6%). In 1985 these countries had a higher tax burden. The (unweighted) average for the EEC in that year was 39.8%. But note that the comparable figure for the United States was 29.2% and for Japan 28.0%. Statistics OECD at 82.
4. For a more detailed discussion, see *Supplementary Service to European Taxation* (hereinafter cited as SUPP. SER.), Section B.
5. For a discussion of residency, see van Waardenburg, D.A., "The Concept of Residence Under Netherlands Tax Law", 21 *European Taxation* 5/6 (1981) at 178.
6. Individual Income Tax Law of 1964 (Wet op de inkomstenbelasting, hereinafter cited as "IB"), Arts. 1, 3, 48 and 49.
7. IB, Art. 5.
8. IB, Art. 37.
9. See in this issue Nobel, Nico, "Mandatory Publication of Resolutions and Rulings is Necessary for Fair and Just Taxation". An official translation of the 35% ruling is reproduced in 26 *European Taxation* 6 (1986) at 303.
10. IB, Art. 47a.
11. IB, Art. 47b.
12. Under a tax system granting an imputation credit, the corporate income tax which is levied on income distributed by a company is fully or partially creditable against the income tax due by the shareholders receiving the dividend. An imputation credit is granted under the tax laws of most of the EC Member States, i.e. Belgium, Denmark, France, the Federal Republic of Germany, Ireland, Italy, Spain and the United Kingdom. Greece exempts any corporate distribution from corporate income tax. For more details, see *Guides to European Taxation,* Vol. III, *The Taxation of Private Investment Income* (hereinafter cited as GET- III).
13. IB, Art.7 (implied).
14. IB, Art. 39. A "substantial interest" is deemed to exist if a shareholder, together with his close relatives, owns (or has owned at any time during the past 5 years), either directly or indirectly, at least one-third of a company's share capital whereby the shareholder, alone or with his wife, owned more than 7% of such share capital. The concept of "substantial interest" originated in Germany and has been adopted by many neighbouring countries, i.e. Austria, Belgium, France, Luxembourg and the Netherlands.
15. IB, Arts. 29 and 57.
16. IB, Art. 53.
17. Id.
18. The Wages Tax Law (Wet op de loonbelasting, hereinafter cited as "LB").
19. Similar systems of withholding of tax on employment income exist, for instance, in Belgium and the Federal Republic of Germany.
20. IB, Arts. 48 and 49.
21. LB, Arts. 2-6.

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As a general rule no tax is due on Dutch-source interest or royalties received by non-residents (see below). Dividends and interest from profit-sharing bonds are subject to a flat rate withholding tax of 25% unless a tax treaty provides for an exemption or a lower rate.[22] In nearly all other cases – except for certain taxable capital gains – the normal progressive rates apply, but non- residents are generally not entitled to deduct personal allowances. However, non-residents who derive most of their income from Dutch sources are permitted to deduct certain personal allowances[23] and some tax treaties also contain provisions under which non-residents may benefit from the personal allowance deductions. Examples are the treaties concluded by the Netherlands with Belgium [Art. 25(3)] and the Federal Republic of Germany [Additional Protocol].

B. Corporate income tax[24]

In theory, Dutch corporate income tax is imposed on world-wide income of resident companies, but as a result of the unilateral relief provisions for the prevention of international double taxation[25], the tax is generally only applicable to Dutch-source income. Notable exceptions are foreign-source interest, royalties and portfolio dividends. No legislation extends Dutch tax jurisdiction to foreign subsidiaries as, for instance, is the case in France and the United States.

Double taxation of inter-corporate distributions is to a large extent prevented by the so-called "affiliation privilege", i.e. dividends distributed by a resident or non-resident subsidiary company to its Dutch parent company are exempt from Dutch income tax provided that the shareholding:[26]

- is not a portfolio investment; and
- that the Dutch parent owns at least 5% of the shares of its foreign subsidiary; or
- provided that the Dutch Finance Minister has recognized the shareholding as a "participation" and approved the exemption;
- in addition, where foreign-source dividends are received, the subsidiary company distributing the dividend must have been subject to a foreign income tax.[27]

The Dutch affiliation privilege has a function similar to that of granting a credit for foreign tax, in particular if a credit for "underlying tax"[28]is also granted, i.e. for corporate income tax levied on income from which a distribution is made. However, under the Dutch affiliation privilege capital gains derived from a qualifying participation are exempt as well.

The corporate tax rate is currently 42%.[29] A proposal to reduce this rate to 35% commencing 1 October 1988 was in preparation at the time this article was written. However, a higher 40% rate will apply to the first 250,000 Dfl. of taxable income to prevent tax evasion practices.[30]

Non-resident companies are subject to Dutch corporate income tax on Dutch-source income as indicated in the law, notably on income from real property and business income derived through a permanent establishment situated in the Netherlands.[31] Dutch-source royalties and interest are generally not subject to Dutch corporate income tax, but a 25% flat rate withholding tax (unless this rate is reduced by a tax treaty) is due on Dutch-source dividends and interest from profit-sharing bonds.

C. Net wealth tax[32]

Resident individual taxpayers are subject to the net wealth tax on the value of movable and immovable property whether situated in the Netherlands or abroad.[33] Only net value is taxed so that liabilities may be deducted. Personal deductions include a 56,000 Dfl. deduction for single persons under 27 years of age without minor children; a 89,000 Dfl. deduction for other single persons; and a 113,000 Dfl. deduction for married taxpayers. An additional deduction of 7,000 Dfl. is granted for each dependent child up to the age of 18 years and 35,000 Dfl. for students 18 to 27 years of age.[34]

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22. Under the provisions of the Dividend Tax Law (Wet op de dividendbelasting). For a discussion of the tax treatment of dividends and interest received by resident and non-resident taxpayers, see GET-III (note 12).
23. In order to remove the most glaring inequities, the Dutch tax authorities permit non-resident taxpayers whose income is predominantly composed of Dutch-source income (i.e. at least 90%) to deduct some personal allowances on a pro rata basis, i.e. in the same ratio as Dutch-source income bears to world-wide income). Ruling No. 284-2231 of 28 February 1984 as amended by Ruling 285-3508 of 20 March 1985.
24. Wet op de Vennootschapsbelasting (hereinafter cited as "Vpb"). For a detailed discussion, see *Guides to European Taxation,* Vol. II, *The Taxation of companies in Europe* (hereinafter cited as GET-II) and SUPP.SER, Sec. A. (note 4 above).
25. For a discussion of these provisions, see III below.
26. Vpb, Art. 13.
27. For a more detailed discussion, see GET-II, Chapter The Netherlands, Sec. 9 (note 11). There is no requirement that the rate of foreign corporate income tax be comparable to the Dutch rate of corporate income tax; in certain cases the affiliation privilege may be available if no effective foreign tax is imposed. See also in this issue, Brood, E.A., "The Participation Exemption: Present and Future".
28. This relief is known as an "indirect foreign tax credit" and is available under, inter alia, United Kingdom and United States income tax law.
29. Vpb., Art. 22.
30. See *Tax News Service* (hereafter cited as "TNS") 1988 at 91. The higher rate for low income should prevent the conversion of too many small private enterprises (such as partnerships) into companies for the sole purpose of benefiting from the low rate of corporate income tax. There is, however, a price tag attached to this rate reduction. In the first place the so-called WIR investment premium (see notes 142 and 143 and accompanying text) was virtually abolished as of 29 February 1988 (see TNS-60 (1988)). Secondly, the so-called net worth deduction, i.e. 1% of corporate net worth deductible from taxable income, will be abolished as of 1 October 1988 (see TNS-91 (1980)). Some multinational companies asserted that the Netherlands is effectively increasing the corporate tax burden despite the reduction of the corporate income tax rate. A computation made for the "average" chemical industry indicates (according to these companies) that until now the average burden of Dutch corporate income was 26.7%. See *Financieel Dagblad* of 25 March 1988 at 1.
31. Vpb, Arts. 3, 17 and 18.
32. Vermogensbelasting (hereinafter cited as "VB"). During a meeting on 3 May 1988, the Under-Minister for Finance stated that he was in favour of abolishing the net wealth tax or that at least a drastic reduction would be in order. *Financieel Dagblad* of 4 May 1988 at 1.
33. VB, Art. 3.
34. VB, Art. 14.

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Self-employed taxpayers (e.g. businessmen) whose net business capital does not exceed 119,000 Dfl. are not required to declare this capital. If the business capital exceeds 119,000 Dfl., only 40% is exempt with a minimum of 119,000 Dfl. and a maximum of 530,000 Dfl.[35] The net wealth tax is imposed at a rate of 0.8%.[36]

Non-residents may also be liable to Dutch net wealth tax if they own certain property in the Netherlands such as Dutch-situs real property and business property of a Dutch permanent establishment.[37] Non-resident taxpayers are subject to the same rate of net wealth tax but are generally not entitled to the personal deductions.[38]

D. Inheritance and gift tax

The acquisition of property by inheritance or gift is subject to tax provided that the deceased or donor is or was (or deemed to be) a resident of the Netherlands or, if he is a non-resident, possesses or possessed property in the Netherlands. Three types of taxes may be distinguished:[39]

- a succession tax on the entire value of the property acquired from a person who died resident in the Netherlands;
- a gift tax on the entire value of the property acquired by gift if the donor is a resident of the Netherlands; and
- a transfer tax on the value of certain Dutch-situs property (as indicated in the law) acquired from a person who died resident outside the Netherlands or from a donee resident outside the Netherlands.

A rather complex system of personal deductions is available. For instance, if one spouse dies, the surviving spouse is generally entitled to a deduction of 458,076 Dfl. but this amount is reduced by 50% of the capitalized value of his or her pension. The minimum deduction, however, is 130,878 Dfl.[40] The personal deduction for children who inherit from one of their parents is generally 13,088 Dfl. The personal deductions for purposes of the gift tax are generally much lower.[41]

The rates are a function of the value received and the degree of consanguinity between the deceased/donor and the person who acquires the property. For instance, the rates for acquisitions from a spouse or parent range between 5% and 27%. The maximum rate between brothers and sisters is 53% and if there is no blood relationship the maximum rate may be as high as 68%.[42]

E. Value added tax (VAT)[43]

VAT is imposed on the supply of goods and services in the Netherlands by persons who have the status of "entrepreneur".[44] VAT is also imposed on the importation of goods irrespective of the status of the importer.

Dutch VAT conforms to the model prescribed by the Sixth VAT Directive issued by the Council of the European Communities.[45] VAT's main characteristic is that taxpayers may deduct the tax which has been invoiced to them by their suppliers or which has been paid by them upon importation of the goods from VAT they charge customers.[46] The standard rate of the tax is 20% but a reduced 6% rate applies to basic necessities.[47]

III. UNILATERAL PREVENTION OF DOUBLE TAXATION[48]

The principle of world-wide taxation of residents was introduced in the Netherlands by the end of the 19th century and this principle continues to be one of the cornerstones of Dutch income and net wealth taxation.[49] Obviously, world-wide taxation potentially results in international double taxation so the need to prevent such double taxation arises. Because tax treaties for the prevention of double taxation were not very common in the early 1900s, unilateral measures to prevent double taxation were introduced.[50] Although these measures were originally rather straightforward, they have evolved into a sophisticated system of rules. These rules are currently the subject of the Decree for the Avoidance of Double Taxation of 7 April 1965 (as amended) and are only applicable in the absence of a tax treaty or other provision for the prevention of double taxation.[51]

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35. VB, Art. 7.
36. VB, Art. 14. Note that this tax is not deductible for purposes of the individual income tax. However, the total amount of individual income tax and the net wealth tax may not exceed 80% of taxable income.
37. VB, Arts. 12 and 13.
38. VB, Art. 14.
39. Succession tax law (Successiewet, hereinafter cited as "Succ."), Art. 1.
40. Succ., Art. 32.
41. Succ., Art. 33.
42. Succ., Art. 24.
43. Turnover tax law (Omzetbelasting, hereinafter cited as "OB"). For a detailed discussion, see *Guides to European Taxation,* Vol. IV, *Value Added Taxation in Europe,* Chapter The Netherlands.
44. OB, Art. 1.
45. Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes; Common system of value added tax: uniform basis of assessment. For the full text of the Directive, see SUPP. SER., Sec. D.
46. OB, Art. 15.
47. OB, Art. 9.
48. For a more detailed discussion see GET-II, Chapter The Netherlands, Sec. 8.
49. By virtue of the Law on Wealth Tax 1892.
50. The first comprehensive tax treaty concluded by the Netherlands was the tax treaty of 20 February 1933 with Belgium.
51. The Decree only applies to taxes on income and net wealth. It does not apply to inheritance and gift taxes or to VAT. Currently, new unilateral provisions for the prevention of double taxation have been proposed which will take effect as of 1 January 1988. These new provisions will also apply to the inheritance and gift tax and to the tax on betting and lotteries. See TNS-60 (1988). For articles in Dutch on the proposed legislation, see Vollebrecht, H.A., "Het conceptbesluit voorkoming dubbele belasting 1988", 117 *Weekblad voor Fiscaal Recht* 5820 at 542; Coenen, M.E.P.M. and Vranken, G.G.A., "Besluit voorkoming dubbele belasting 1988: een commentaar", 57 *MBB Belastingbeschouwingen* 5 (1988) at 137; and van Sonsbeek, H.J., "Concept Besluit voorkoming van dubbele belasting 1988 artikelen 11 t/m 16 (betreffende successie- en schenkingsrechten)", 117 *MBB Belastingbeschouwingen* 5 (1988) at 142.

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A. Proportional credit method

The Decree generally uses the so-called "proportional credit method" to prevent double taxation. Under this method, tax relief is granted in the following manner: first, foreign and domestic-source income is aggregated and Dutch tax is computed on this aggregated income; then the tax attributable to foreign-source income is credited against the tax thus computed.

This may be illustrated by the following simplified example.
Assume that Individual A derives an income of 60,000 Dfl. from Dutch sources and a foreign-source income which is eligible for the relief of 15,000 Dfl. Assume that the tax computed on his aggregate income is 40% of 75,000 or 30,000 Dfl. The amount of relief available is:

$$\frac{15{,}000}{75{,}000} \times 30{,}000 = 6{,}000$$

A's ultimate tax liability is (30,000 – 6,000 =) 24,000 Dfl.

Where a flat rate is imposed as is the case for the Dutch corporate income tax (42%), this method is tantamount to an exemption of foreign-source income. In those cases where there is a progressive rate as is the case for the individual income tax, this method gives approximately the same result as the "exemption with progression" method which is generally used in tax treaties.

This tax relief is granted mainly for business income derived through a permanent establishment (branch) or a permanent representative abroad[52], income from certain activities abroad (e.g. employment) and income from foreign-situs real property. The "proportional credit method" assumes additional significance since it is generally referred to in tax treaties concluded by the Netherlands.

B. Permanent establishment

For purposes of the unilateral relief provisions (Decree, Art. 3(4), a permanent establishment is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on, including the place of the enterprise's management, agricultural land, as well as projects lasting more than 12 months". The Decree expressly provides that no permanent representative will be deemed to exist in the following situations:
- if the representative is fully independent;
- if the representative is not authorized to conclude contracts even if he holds a stock of merchandise for the purpose of urgent deliveries.

Similarly, neither a permanent establishment nor a permanent representative will be deemed to be present where merchandise is being held on a commission basis. Note that this definition does not apply in the reverse situation, i.e. where a foreign enterprise is carrying on business activities in the Netherlands.

C. Loss deduction

Since Dutch income tax is levied on world-wide income, foreign-source losses may be deducted from domestic-source income. This may result in a double loss deduction, i.e. for purposes of the Dutch income tax and, assuming the foreign income tax provides for a loss carry-over, for purposes of the foreign income tax as well, in a later year. The Dutch legislature considered this double loss deduction an abuse of the Dutch unilateral relief provisions. Under the current wording of the Decree, any foreign-source loss which has been deducted from domestic-source income must be carried forward to the following 8 years thus reducing the foreign-source income eligible for relief.

On the other hand, if there is a domestic-source loss and foreign-source income, the aggregation of losses and income will result in a reduction of the amount available for unilateral relief. For relief purposes, however, the taxpayer may carry this unused income forward for the following 8 years. Most tax treaties concluded by the Netherlands refer to this provision so that it is incorporated in many tax treaties.

D. Income subject to tax abroad

A prerequisite for the application of the unilateral relief provisions is that the foreign-source income be subject or deemed to be subject to an income tax imposed by the relevant State. No such condition is imposed in a tax treaty situation. Employment income is *deemed* to have been subject to a foreign income tax if the employment is exercised for a continuous period of at least 3 months in a country with which the Netherlands has not concluded a tax treaty. This provision was included, in particular, to grant tax relief to employees based in the Middle East.[53]

E. Overall limitation

The unilateral relief provisions granting the "proportional tax credit" apply to the aggregate foreign-source income even if derived from several foreign countries. There is no per country limitation.

F. Dividends, interest and royalties

In principle, unilateral relief is unavailable with respect to foreign-source dividends, interest and royalties unless they are derived through a permanent establishment situated abroad, in which case they are treated as business income. A major exception applies where such income is derived from a developing country listed in the Ministerial Decree of 28 May 1970. These countries are:

– *in Africa:* Algeria, Angola, Benin, Botswana, Bur-

52. See below.
53. General Law on Taxes, Art. 38(2) (Algemene wet inzake rijksbelastingen). See " 'Cyprus Connection' Terminated", 26 *European Taxation* 4 (1986) at 127.

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kina, Burundi, Cameroun, Cape Verde Islands, Central African Republic, Chad, Comores, Congo, Egypt, Equatorial Guinea, Ethiopia, the Gambia, Ghana, Grenada, Guinea, Guinea-Bissau, Ivory Coast, Kenya, Lesotho, Liberia, Mali, Morocco, Mauritania, Mauritius, Mozambique, Niger, Nigeria, Rwanda, Seychelles, Sierra Leone, Somalia, Sudan, Swaziland, Tanzania, Togo, Tunesia, Uganda and Zaire;

– *in Asia and the Pacific:* Afghanistan, Bangladesh, Bhutan, Burma, China (People's Republic), Cambodia, Djibuti, Fiji, Haiti, India, Iraq, Iran, Jordan, Kiribati, Laos, Lebanon, Madagascar, Malaysia[54], Maldives, Mongolia, Nauru, Nepal, North Yemen, Papua New Guinea, Philippines, Sao Tome and Príncipe, Solomons Islands, Senegal, Syria, Tonga, Tuvalu, Vanuatu, Viet-Nam, Western Samoa and South Yemen[55];

– *in Europe:* Cyprus, Portugal and Turkey;

– *in Latin America and the Caribbean:* Argentina, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Saint Christopher and Nevis, Saint Lucia, Saint Vincent and Uruguay.

In principle, the "proportional credit method" also applies. However, the amount to be credited may not exceed the foreign tax actually imposed, increased by any unused excess credits of the 8 previous years.[56]

G. Affiliation privilege

The Decree does not apply to foreign-source dividends except in the above-described situations. However, an exemption of foreign-source dividends may be available under the so-called affiliation privilege as described in II.B. above.

IV. TAX TREATIES

A. In general

Currently, the most important method for the prevention of double taxation is through application of bilateral tax treaties. Two main groups of treaties may be distinguished, i.e. those which prevent double imposition of taxes on income or capital and treaties whose purpose it is to avoid double taxation of inheritances. The Netherlands has concluded both types of tax treaties although the majority of its treaties fall within the first group. This article focuses on income and capital tax treaties.[57] Bilateral tax treaties are generally better suited for this purpose than unilateral provisions since they can reflect the taxation structures and the special relationships between the Netherlands and its treaty partner.

As may be expected, when negotiating a tax treaty the Netherlands generally strives to obtain the best results, i.e. to lose as little revenue as possible. Other important objectives include:[58]

– non-discriminatory tax treatment of Dutch nationals, in particular Dutch enterprises, so that they receive the same treatment as nationals resident in the treaty country; and
– exchange of information provisions to combat tax evasion and fraud.

During the last few decades, the Dutch tax authorities have generally used the OECD Draft Conventions of 1963 and 1977 as guidelines during treaty negotiations. Attached to the letter of the Under Minister is the Dutch draft model treaty (hereinafter "Dutch Model") which is usually presented to the prospective treaty partner and which serves as a manual during the treaty negotiations. This model treaty is largely based on the revised OECD Model Convention of 1977.[59] A translation of the Dutch Model Convention is appended to this article (Appendix II).

One significant issue concerns the collision of tax treaties and domestic legislation. The extent to which treaty partners are bound by the conventions they conclude is always relevant. As a general rule, tax treaties provide for a procedure under which, after a period of time, the treaty may be renounced. However, this point is not under discussion.

Some countries consider tax treaties as part of their domestic legislation which may be superseded by subsequent domestic law. The United States adheres to this doctrine. The Tax Reform Act of 1986 declared a number of prior tax treaty provisions to be invalid.[60] A considerably different approach is adopted in the Netherlands where the Constitution prescribes that a

54. Note that on 7 March 1988 a tax treaty was concluded between the Netherlands and Malaysia. This treaty is not yet in force.
55. Pakistan and Sri Lanka have not been listed since the Netherlands has concluded tax treaties with these 2 countries so that the Decree is not applicable to income derived from these countries. In February 1988, a tax treaty between India and the Netherlands was initialled so India will eventually be removed from this list.
56. Foreign tax imposed on dividends in excess of 25% is disregarded for purposes of computing the credit.
57. Note, however, that the "non-discrimination" article in such treaties generally applies to all taxes imposed in the Netherlands and the State with which it has concluded a tax treaty. For instance, this is the case in the tax treaties concluded by the Netherlands with Austria [Art. 25]; Belgium [Art. 25]; Canada [Art. 24]; China (PR) [Art. 24]; Czechoslovakia [Art. 26]; Denmark [Art. 26]; Federal Republic of Germany [Art. 24]; Finland [Art. 26]; France [Art. 25]; Greece [Art. 26]; Hungary [Art. 25]; Ireland [Art. 24]; Israel [Art. 27]; Japan [Art. 25]; Korea (South) [Art. 24]; Luxembourg [Art. 24]; Malta [Art. 26]; Morocco [Art. 25]; Norway [Art. 26]; Pakistan [Art. 23]; Poland [Art. 25]; Romania [Art. 26]; Singapore [Art. 25]; Spain [Art. 26]; Sri Lanka [Art. 24]; Surinam [Art. 25]; South Africa [Art. 25]; Sweden [Art. 27]; Switzerland [Art. 10]; Thailand [Art. 24]; U.S.S.R. [Art. 19]; United Kingdom [Art. 23]; Yugoslavia [Art. 24] and Zambia [Art. 23].
58. GTTP at 10.
59. Hereinafter cited as "1977 OECD Model". See *SUPP. SER.*, Sec. D which reproduces this draft convention and the accompanying explanation.
60. See 28 *European Taxation* 7 (1988) for the text of the letter of 18 April 1988 sent by the Ambassador of the Federal Republic of Germany to the Chairman of the U.S. Committee on Foreign Relations expressing his Government's concern about the tax treaty override provisions in the U.S. Technical Corrections Bill and the 1986 Tax Reform Act. This letter was endorsed by 9 other EC Member States, the EC Commission and the Governments of Canada, Japan and Switzerland.

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Court must ignore any domestic legal provisions which conflict with treaty provisions.[61] It has been suggested that the Netherlands should attempt to insert a clause in tax treaties to be negotiated under which the Netherlands would be authorized to sanction its treaty partner should the latter allow domestic law to prevail over the treaty provisions.[62]

B. Business income

1. Income derived through a permanent establishment (Dutch Model, Arts. 5 and 7)[63]

There is a general consensus that a State may tax a foreign enterprise on income derived from activities carried on in that State only if the activities rise to a certain level and if the activities have a degree of permanency, i.e. they are not of a temporary nature.[64] Consequently, tax treaties generally provide that only business income derived by a foreign enterprise from activities carried on through a permanent establishment are taxable in the relevant State.[65] Implementation of this principle may be problematic. Difficulties may be encountered, for instance, in negotiating tax treaties with developing countries, particularly with regard to the right to impose tax on income from the exploitation of natural resources (especially when the resources are located on the Continental Shelf).

a. *Construction*

Developing countries generally wish to subject foreign enterprises to tax liability at an earlier stage than industrial countries, e.g. income from construction activities may be subject to taxation after a period of 3 to 6 months rather than the more commonly applied 12-month period.[66] Examples of a 3-month time limit can be found in the treaties the Netherlands has concluded with Indonesia [Art. 5(2)(h)] and Surinam [Art. 5(2)(h)] although in both cases a 6-month test applies to construction, installation or assembly activities concerning machinery and industrial equipment. A 6-month test applies in the treaties concluded with South Korea [Art. 5(2)(h)], Morocco [Art. 5(2)(h)], Pakistan [Art. 5(3)], Singapore [Art. 5(3)] and Sri Lanka [Art. 5(2)(h)].

Remarkably, "socialist" countries in Eastern Europe often insist on a much longer period of time before a construction project is deemed to be a permanent establishment, e.g. the treaties concluded with Poland: 18 months [Art. 5(3)]; the U.S.S.R.: 12 months but the competent authorities may decide not to consider a construction project to be a permanent establishment [Art. 4(2)]. The treaty with Czechoslovakia expressly provides that a construction project cannot constitute a permanent establishment [Art.5(3)(f)].

b. *Supervision and advice*

The Dutch Model Convention as well as the OECD Model Convention do not list supervisory or advisory activities connected with a construction or assembly project as an example of a permanent establishment if a certain time limit has been exceeded. The Commentary to Art. 5 of the OECD Model indicates that planning and supervision may be included in the construction activities if carried out by the building constructor himself but not if carried out by another enterprise whose activities in connection with the construction work are restricted to such planning and supervision.

In contrast, developing countries often wish to follow the pattern laid down in the United Nations Model Convention which deems a permanent establishment to be present in case of:
1. any supervisory activities in connection with a construction project if these activities last for more than 6 months; and
2. the supply of services (including consultancy services) by employees or other personnel lasting for an aggregate period of more than 6 months during any 12-month period.[67]

In a number of cases the Dutch Government has been prepared to accede to the wishes of the developing country with which it concluded a tax treaty. Examples of treaty provisions under which supervisory activities may constitute a permanent establishment can be found in the tax treaties with Indonesia [Art. 5(2)(h) and (i)], Korea [Art. 5(2)(h)], Malta [Art. 5(2)(g)], Pakistan [Art. 5(3)], Singapore [Art. 5(5)], Sri Lanka [Art. 5(3)(a)], Surinam [Art. 5(2)(h)] and Zambia [Art. 5(4)]. Examples where the supply of services constitutes a permanent establishment may be found

61. Constitution, Art. 94. The Netherlands has also signed the Vienna Convention of 23 May 1969 concerning treaty law which provides in Art. 27 that a Contracting Party may not invoke national law to justify its non-application of treaty provisions.
62. See Ellis, M.J., "Het Nederlandse Standaardverdrag", *MBB Belastingbeschouwingen* 3 (1988) at 100.
63. GTTP at 13-16.
64. See Commentary to the 1977 OECD Draft Convention (hereinafter cited as "COMM") to Art. 5, para. 6.
65. See 1977 OECD Model, Art. 7. The term permanent establishment also covers certain types of representatives. Under Dutch domestic law, foreign enterprises are generally only subject to Dutch tax on business income derived through a permanent establishment or a permanent representative located in the Netherlands (IB, Arts. 48 and 49 and Vpb, Art. 17). However, these laws do not define the terms "permanent establishment" or "permanent representative", thus leaving it to the judiciary to decide when a foreign business has such an establishment or representative in the Netherlands. The definition provided in the Decree for the avoidance of double taxation, Art.2(4), however, may have some interpretative value. In its press release No. 87/205 of 13 July 1987, the Dutch Government announced that it contemplates a change in the law, i.e. the definition of permanent establishment identical to the OECD definition will be introduced.
66. See 1977 OECD Model, Art. 5(3) and COMM, para. 17 in which a 12 month test is recommended. The UN Model Convention provides for a 6 month test (Art. 5(a)) but states in its commentary (at 64) that some members of the Group from developing countries would have preferred to remove the time limit alltogether because (1) as a result of modern technology, construction, assembly and similar activities can be of short duration and still generate substantial profits, and (2) the period during which the foreign personnel involved in the activities remain in the source country is irrelevant for the definition of the developing country's right to tax the corresponding income. Another argument advanced was that enterprises from capital-exporting countries may abuse the time limit and thus evade tax in the source country.
67. Some members from developing countries proposed to include a monetary limitation in the treaty provision, i.e. if the remuneration for the services supplied would exceed a certain amount it would constitute a permanent establishment. To our knowledge no such criterion has been incorporated in any Dutch tax treaty.

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in the treaties with Indonesia [Art. 5(2)(i)], Pakistan [Art. 5(4)], Sri Lanka [Art.(3)(b)] and Surinam [Art. 5(2)(j)].

c. *Business representative*

Developing countries often wish to deem the business representative of a foreign enterprise to be a permanent establishment even though the representative merely maintains a stock of goods or merchandise for delivery to customers of that enterprise. In a number of instances, the Dutch Government has complied with this wish and accepted that such a representative is to be deemed to be a permanent establishment provided he is not an independent agent (e.g. a broker or a general commission agent). Examples can be found in the treaties concluded with Indonesia [Art. 5(4)(b)], Israel [Art. 5(5)(b)], Pakistan [Art. 5(6)(b)], Surinam [Art. 5(4)(b)] and Thailand [Art. 5(5)(b)].

d. *Continental shelf*

A number of coastal States, including some developed countries, may impose tax liability on foreign enterprise activities carried out on the Continental Shelf, after expiration of a short period of time (i.e. if the duration of the activities exceeds 30 days, the enterprise becomes liable to income tax). In this respect, see the treaties concluded by the Netherlands with Canada [Art. 23] and the United Kingdom [Art. I of the Protocol of 12 July 1983 introducing a new Art. 22A]. The Netherlands also contemplates formulating the definition of "permanent establishment" in such a manner that if a foreign enterprise carries on business activities for a continuous period of 30 days on the Dutch part of the Continental Shelf, such activities will constitute a permanent establishment.

e. *Force of attraction*

The Dutch Government adheres to the principle that only income which can be attributed to a permanent establishment is taxable in the State where the permanent establishment is situated. The Government voices forcible objections to application of the "force of attraction" rule under which income which has not been derived through a permanent establishment is nevertheless aggregated with the income derived through the permanent establishment in the country where it is situated.

68. According to the commentary to the U.N. Model (at 82), the countries supporting the "force of attraction" rule generally do not extend this rule to dividends, interest and royalties covered by other treaty articles or to sales effected through independent commission agents and purchase activities. Developed countries argue against introduction of the "force of attraction" rule on the basis that it is undesirable to tax income from activities totally unrelated to the permanent establishment and it creates uncertainty for taxpayers.

69. Note that it is generally the place of management of the *enterprise* which is decisive. In other words, if the place of management and the place of operation are different, the place of management of the enterprise will be determinative. See van Raad, K., *Internationaal Belastingrecht* (in *Cursus Belastingrecht*) (loose-leaf) at IBR 225 (hereinafter cited as "van Raad").

70. Note that ships operated by residents of the Netherlands which are registered in Greece are not exempt from Greek taxation.

This objection also applies to the limited "force of attraction" rule found in Art. 7(1) of the U.N. Model Convention. Under Art. 7(1), income derived from (1) sales of the same or similar goods and merchandise, or (2) income from business activities of the same or similar kind in the country where the permanent establishment is located is also attributed to that permanent establishment. Nevertheless, in the tax treaties with, for example, Indonesia [Art. 7(1)] and Pakistan [Art. 7(1)], the Netherlands has acquiesced to the inclusion of such a clause.[68]

f. *Insurance companies*

In one instance the requirement that a non-resident enterprise may only be taxed in the other country if it carries out its business through a permanent establishment is waived if the pertinent enterprise is an insurance company. In this respect, see the tax treaty with Australia [Protocol, Clause 3, but life insurance companies are excepted].

2. Shipping and air transport (Dutch Model, Art. 8)

a. *Place of effective management*

With respect to income derived from international shipping and air transport, Dutch tax treaty policy aims to obtain exclusive taxing rights in the State where the effective management of the enterprise is situated.[69] Examples are found in the treaties concluded with Austria [Art. 8(1)]; Canada [Art.8 (1)]; China (People's Republic = PR) [Art. 8(1)]; Czechoslovakia [Art. 8(1)]; Ireland [Art. 7(1)]; Luxembourg [Art.8(1)]; the Federal Republic of Germany [Art. 7(1)]; Finland [Art. 8(1)]; Hungary [Art. 8(1)]; Indonesia [Clause II of the Protocol to the treaty in conjunction with the Exchange of Notes published in the Dutch Ruling No. 07-500 050 of 27 October 1975]; Israel [Art.9(1)]; Italy [Art. VI, but ships or aircraft must be registered in the pertinent country; Korea [Art. 8(1)]; Malta [Art. 8(1), however, the Netherlands may tax the income of a Maltese shipping company if it is exempt from Maltese income tax unless the company shows that not more than 25% of its capital is directly or indirectly owned by persons not resident in Malta, Protocol, Clause III]; Morocco [Art. 8(1)]; New Zealand [Art. 8(1)]; Norway [Art. 8(1)]; Pakistan [Art. 8(1)]; Poland [Art. 8(1)]; Romania [Art. 8(1)]; South Africa [Art.8]; Spain [Art. 8(1)]; Surinam [Art. 8(1)]; Sweden [Art.8(1)]; the U.S.S.R. [Art. 6(1)]; the United Kingdom [Art. 8(1)]; Yugoslavia [Art. 8(1)] and Zambia [Art. 8(1)].

In practice other criteria may also be used, such as the country where the ships or aircraft are registered – treaty with the U.S.A. [Art. VI(1)] – or the country where the person (individual or company operating the ships or aircraft) is resident – treaties with Australia [Art. 8(1)]; Belgium [Art. 8(1)] and Greece [Art. 8(1)] in conjunction with the treaty on the prevention of double taxation of shipping and air transport profits of 26 July 1951.[70]

A fourth criterion which may be established in tax

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treaties concluded by the Netherlands is the "shipping or aircraft enterprise of the country concerned" [treaty with Denmark [Art. 8]; Japan [Art. 9(1)]; Korea [Art. 8(1)] and Thailand [Art. 8(1)]. However, since "an enterprise of the country concerned" is generally defined as an "enterprise carried on by a resident of the pertinent country", the last criterion and this one are practically identical.

In some cases the Dutch Government has accepted the sharing of taxing rights, i.e. where the place of residence of the person operating the ships or aircraft is located in one country and the place of effective management is located in the other country. An example may be found in the tax treaty with France [Art. 8(1) and (2)].

In the opinion of the Dutch Government, the fact that the enterprise has a permanent establishment in the other State in the form of an office, agent or otherwise should be immaterial. Two arguments account for this different treatment:

- formulating a satisfactory theory for the allocation of income from shipping and air transport is problematic since this income is mainly derived from activities carried on in the "no man's land" of the high seas or international air space; and
- it is difficult to allocate the income between the countries which have been visited in the course of an international voyage.

Some countries, in particular developing countries, are of the opinion that they are entitled to that part of the income derived from the transport of passengers and cargo which have been taken on board in a sea or air port in the country concerned. In particular, this theory is applied to international shipping and, to a lesser extent, international air transportation. When negotiating a tax treaty, these countries are usually prepared to reduce their tax on international transportation. The Dutch Government, however, considers imposition of such a tax unsatisfactory. For example, Art. 8(2) of the treaty concluded with Sri Lanka provides that if a shipping enterprise established in one of the Contracting States derives profits from the operation of ships in international traffic other than in a casual manner, the enterprise may also be taxed in the other Contracting State. However, the amount of such profits may not exceed 6% of the gross receipts from the carriage of passengers and freight and the tax due in that State must be reduced by 50%. Art. 8(2) of the treaty with Thailand also provides that the tax imposed on profits derived by a shipping enterprise established in the other Contracting State must be reduced by 50% but such shipping profits will only be taxed if derived through a permanent establishment in the State where the profits have been made.

The treaty with Australia contains some peculiar rules, i.e. it generally subjects profits derived from the operation of ships and aircraft by a resident of one of the Contracting States to tax in that State [Art. 8(1)]. The other State may also tax the income if it has been derived from the operation of ships and aircraft confined solely to places in that State, including profits derived from the carriage of passengers, livestock, mail, goods or merchandise shipped in a State for discharge at another place in that State. As a rule, the taxable base may not exceed 5% of the gross receipts (net of rebates) but no rate reduction is available.

b. *Leasing*

The Commentary to Art. 8 of the OECD Model Convention states under Sec. 5 that profits obtained from the leasing of a chartered, fully equipped, manned and supplied ship or aircraft must be treated as profits from the operation of ships or aircraft. This article does not apply to profits derived from leasing a ship or aircraft without a crew, i.e. on a "bare boat" charter basis, unless it is an occasional source of income for an enterprise engaged in the international operation of ships and aircraft.

The Dutch Government directs special attention to income derived from the leasing of ships or aircraft (bare-boat charter) and the leasing of containers. Some countries deem this income to be income from international transportation and wish to apply the pertinent rules. The Dutch maintain that a distinction should be made between enterprises which carry on such activities as part of their transportation business and enterprises whose main purpose is the leasing of ships or aircraft. In the latter case, the Dutch Government embraces the view that no valid reason exists to apply the rules for international shipping and air transport.[71]

Nevertheless, some of the more recently concluded tax treaties contain express provisions with respect to such leasing. For example, Art.8(2) of the 1986 treaty with Canada provides that the term "profits from the operation of ships or aircraft in international traffic" *includes* the rental of ships and aircraft operated in international traffic, the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used in international traffic and incidental rental operations. It should be noted that rentals received for ships or aircraft which are leased on a "bare boat charter" basis are generally covered by the "royalties" article provided the definition of royalties encompasses "consideration for the right to use industrial, commercial or scientific equipment". The result may be that these rentals are subject to withholding tax in the source country.[72] The treaty with Korea, however, excludes rentals of "bare boat charters" from the "royalties" article [Protocol, ad Art. 12].

3. Sale of shares of a subsidiary company[73]

Art. 13 of the CITA exempts dividends received by a Dutch parent corporation from its foreign subsidiary

71. See in this respect Dutch Model, Art. 8(3).
72. In this respect, see *Trends in International Taxation,* the section dealing with "The taxation of income derived from the leasing of industrial, commercial or scientific equipment", in particular sub-sec. 17.
73. See GTTP at 14 and 15.

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from income tax as well as any profit derived from the alienation of the shares in the subsidiary.[74]

Under tax treaty provisions, normal usage prescribes that capital gains derived from the alienation of movable property (including shares) are taxable exclusively in the State where the seller is resident. Recently, however, certain countries, in particular developing countries, have been treating the sale of shares by a parent company in a subsidiary company as if the underlying assets were sold. In this way the State retains its taxing rights with respect to such capital gains.[75] This attitude is difficult for the Netherlands to accept because it dramatically conflicts with the firmly-embedded Dutch corporate income tax principle that income in parent/subsidiary relationships should not be subject to double taxation.[76]

In certain cases, the Netherlands is prepared to alter its policy if a participation is held in a real property company. The Dutch Government is prepared to accept that the State where the company is resident taxes capital gains derived from the sale of its shares. In this respect, see the tax treaties with Canada [Art. 13(4)(a)], France [Protocol Clause II] and Pakistan [Art.13(5)].

4. Special provisions

Some countries interpret tax treaty provisions in a less than customary manner. To protect Dutch taxpayers against unexpectedly burdensome taxation, Dutch tax treaty negotiators attempt to include interpretative provisions which guarantee a treaty application which conforms to Dutch views. Two examples are illustrative:

(a) Contracts for work [Dutch Model, Protocol Clause II]; and
(b) Cost allocation in case of associated companies [Dutch Model, Art. 9(1)].

a. *Contracts for work*

Some countries impose tax on the total consideration received under a contract for work carried out in that country without taking into consideration preparatory work which may have been performed in the taxpayer's home country. Such a policy conflicts with the prevailing opinion that income from business activities should be subject to tax in the country where the activities are actually carried out. For instance, if a Dutch contractor constructs a bridge in another country, the latter should only impose its tax on the income from the construction activities carried on in that country. The income connected with any preparatory work performed in the Netherlands (such as drafting blueprints, purchase of materials and manufacture of spare parts) should fall under the Dutch taxing jurisdiction. To prevent disputes in such cases, the Netherlands generally suggests including a provision under which the consideration is, for tax purposes, split into 2 parts, each relating to the activities performed in the countries concerned. In this respect, see, for instance, the tax treaties concluded by the Netherlands with Canada [Protocol, Clause VI], New Zealand [Protocol, Clause III] and Sri Lanka [Protocol, Clause II].

b. *Cost allocation*

The increasing penetration of Dutch business into international markets has resulted in complex company structures consisting of "top" holding companies in the Netherlands which not only control their domestic and foreign subsidiaries and other associated companies but also often function as service centres for the associated companies. The "top" holding companies perform this function by coordinating activities, conducting research, etc. For this purpose they may enter into arrangements, such as cost-sharing arrangements or general service agreements, for or based on the allocation of executive, general administrative, technical and commercial expenses, research and development expenses and other similar expenses. The costs relating to such services are charged to the associated companies and if the cost is charged on an arm's length basis there is no reason to reject the cost allocation. To better protect Dutch enterprises against arbitrary taxation, Dutch tax treaty negotiators usually propose that this cost allocation rule be expressly included in the tax treaty. In this respect, see the treaty concluded with Canada [Art. 9(1)(b)]. If, however, the other party deems an express provision superfluous (because it is in fact a corollary of the arm's length principle), the Dutch negotiators may agree to omit the express provision.

5. Corresponding adjustments (Dutch Model, Art. 9(2))

If, due to special relationships among associated companies, their accounts fail to reflect the true taxable profits derived in a country, the tax authorities of that country may (under Art. 9) rewrite the accounts of the company or companies concerned. For instance, if a company established in the Netherlands sells merchandise at abnormally low prices to its foreign subsidiary, the Dutch tax authorities (under domestic law as well as under Art. 9) are empowered to increase the sales price to a realistic price level in order to adjust the company's taxable income. The foreign subsidiary will have recorded a small purchase price and an inordinately high profit so that a corresponding adjustment is appropriate. Obviously, the tax authorities of the country where the subsidiary is established will be reluctant to make the adjustment and undoubtedly will voice strenuous objections if the adjustment follows automatically from the action of the Dutch tax authorities because automatic adjustments could make the foreign tax authorities dependent upon the views and policy decisions of the Dutch tax authorities. Dutch policy also mandates inclusion of a provision enabling the contracting partners to make corresponding adjustments but allows the partners to clearly express that no *automatic* adjustment is intended. In such a case, it is expressly provided that the

74. See note 26 and accompanying text.
75. See in this respect the United Nations Model Convention, Art. 13(5) and accompanying text.
76. See III.G above.

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adjustment will only take place when the other State considers such an adjustment to be *justified*. This expression is, inter alia, to be found in the tax treaty concluded by the Netherlands with Turkey [Art. 9(2)]. Other examples of tax treaties which contain provisions under which a profit adjustment has been rendered possible are those concluded with Australia [Art. 9(2)], China (PR) [Art. 9(2)], Pakistan [Art. 9(2)] and Sri Lanka [Art. 9(2)].

C. Withholding taxes[77]

1. Dividends[78]

Dutch fiscal legislation provides for a withholding tax on dividends at the rate of 25%.[79] The tax is withheld by the paying corporation and is essentially an advance levy of income tax. Dividends distributed by a Netherlands company to its foreign shareholder are also subject to the 25% dividend withholding tax although under a majority of the tax treaties concluded by the Netherlands the rate is reduced or eliminated (in particular in the case of a subsidiary paying dividends to its parent).[80]

If a Netherlands company is the recipient of dividends, it is imperative that a distinction be made between a portfolio dividend which is subject to corporate income tax and a dividend distributed by a subsidiary to its parent which is exempt from income tax.[81]

In accordance with Art. 10 of the OECD Model Convention, all tax treaties provide that dividends are taxable in the hands of the recipient; in many cases the treaty also grants the source State the right to levy tax. Under most treaties concluded by the Netherlands dividends paid by a Dutch company to a foreign shareholder are subject to withholding tax rates which are lower than those applicable to Dutch shareholders. Generally, the rate is reduced to 15%. See, for example, the treaties concluded with Australia [Art. 10(2)][82]; Austria [Art. 10(2)]; Belgium [Art. 10(2)]; Canada [Art. 10(2)]; Denmark [Art. 9(2)]; Federal Republic of Germany [Art. 13(3)]; Finland [Art. 10(2)]; France [Art. 10(2)(b)]; Greece [Art. 10(2)(a)(ii)]; Hungary [Art. 10(2)(b)]; Ireland [Art. 8(2)]; Israel [Art. 11(2)(c)]; Japan [Art. 11(2)]; Korea [Art. 10(2)(b)]; Luxembourg [Art. 10(2)(b)]; Malaysia [Art. 11(2)]; Malta [Art. 10(2)(b)]; New Zealand [Art. 10(2)]; Norway [Art. 10(2)]; Poland [Art. 10(2)]; Romania [Art. 10(2)(b)]; Singapore [Art. 10(2)]; South Africa [Art. 10(2)(b)]; Spain [Art. 10(2)]; Sri Lanka [Art. 10(2)(b)]; Sweden [Art. 10(2)]; Switzerland [Art. 9(2)(a)(ii)]; the U.S.S.R. [Art. 7(2)][83]; the United Kingdom [Art. 10(2)(b)]; the United States [Art. VII(1)(a)]; Yugoslavia [Art. 10(2)(b)] and Zambia [Art. 10(2)(b)].[84]

The following treaties contain other rates of Dutch withholding tax: China (PR) [Art. 10(2)] and Czechoslovakia [Art. 10(2)], 10%; Indonesia [Art. 9(2)], Pakistan [Art. 10(2)(b)] and Surinam [Art.10(2)(c)], 20%; and Morocco [Art. 10(2)(b)] and Thailand [Art. 10(2)], 25%. No Dutch withholding tax is imposed under the treaties with Italy [Art. VII(2)] and Malawi [Art. VI].

Under Netherlands tax treaties dividends received by a company holding at least 25% of the capital of the payer company are considered to be substantial participation dividends, and as stated above, these dividends are generally exempt from withholding tax or subject to withholding tax at a much reduced rate.[85] Tax treaties generally provide that a foreign withholding tax imposed on dividends is creditable to the Dutch income tax imposed on that dividend.[86] However, in a parent/subsidiary relationship such a credit or deduction is not possible since there is no Dutch income tax on the dividend received. This results in an additional charge to the Dutch parent company. Consequently, the Dutch Government usually attempts to persuade its contracting partner to eliminate withholding taxes on such dividends.[87] Examples of treaties where the foreign withholding tax has been eliminated are the treaties with Czechoslovakia [Art. 10(3)]; Denmark [Art. 9(3)]; Finland [Art. 10(3)]; Italy, but only if the Dutch company owns at least 75% of the paid-in capital of the Italian company [Art. VII(2)]; Norway [Art. 10(3)]; Poland [Art. 10(3)]; Sweden [Art. 10(3)] and Switzerland [Art. 9(2)(a)].

Only the Dutch withholding taxes are eliminated in parent-subsidiary situations under the treaties with Austria, i.e. Austria may impose its 20% tax on income from movable capital with a 10% refund in case of a substantial participation [Art. 10(3) and Final Protocol] and Indonesia which may levy a 20% withholding tax [Art. 9(3)]. The Singapore treaty does not mention parent-subsidiary relationships with respect to dividend withholding tax imposed by Singapore. Under the terms of that treaty the Netherlands may

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77. GTTP at 16 – 19.
78. Dividend Tax Law (Wet op de dividendbelasting) Art. 5. Dividends include income from shares, profit certificates or any other rights of a corporation whose capital is divided partly or wholly into shares.
79. See note 22 and accompanying text.
80. For a detailed discussion, see GET-II, Chapter The Netherlands.
81. See note 22 and accompanying text.
82. The shareholder, however, must be "beneficially entitled" to the dividend. See D. below.
83. The treaty with the U.S.S.R., however, contains some deviations in wording, i.e. Art. 7 states that taxation may be imposed in the State of which the "person" paying the dividends is resident as opposed to the usual "company" paying the dividends.
84. The treaties with Canada, Greece, Hungary, Malaysia, Malta, New Zealand, Poland, Sri Lanka and the United Kingdom all require the shareholder to be the "beneficial owner" of the dividend. See D. below.
85. Direct ownership of the capital is required in some treaties while in others indirect ownership also qualifies. See, inter alia, the treaties concluded with Austria [Art. 10]; Greece [Art.10]; Malta [Art. 10]; Pakistan [Art. 10]; Singapore [Art. 10] and Sri Lanka [Art. 10]. Other treaties also require that the recipient company be a company divided into shares (or a company other than a partnership), e.g. Indonesia [Art. 9]; Israel [Art. 11]; Korea [Art. 10]; Morocco [Art. 10]; Singapore [Art. 10]; Surinam [Art. 10]; Thailand [Art. 10] and Yugoslavia [Art. 10].
86. If a treaty does not provide for a tax credit, the foreign withholding tax is only deductible for the computation of taxable income.
87. The Dutch view is in conformity with the proposed EC Council Directive concerning the common system of taxation applicable in the case of parent corporations and subsidiaries of different Member States. This draft directive is reproduced in GET-II, Section EEC Directives, II. Tax Law.

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not levy withholding tax in cases of a substantial participation and dividends paid by a company resident in Singapore to a resident of the Netherlands are exempt from tax in Singapore [Art. 10(2) and (3)]. No withholding tax is imposed under the treaty with Malawi [Art. VI(1) and (2)].

If the treaty partner is unwilling to eliminate its withholding tax in the parent/subsidiary situation, the Dutch will be equally unprepared to reduce its withholding tax to zero. In such cases, the Dutch will endeavour to create a "mirror" effect in which the Dutch withholding tax provisions are identical to those of the treaty partner. The rationale underlying this policy is twofold:

- to avoid a situation under which foreign parent companies with Dutch subsidiaries receive more favourable tax treatment than Dutch parents with subsidiaries in the treaty country; and
- in such a case there is no need for the Dutch to sacrifice tax revenue since Dutch enterprises do not receive any benefits in these circumstances.

In the majority of treaties containing "mirror" provisions, the withholding tax is set at a rate not more than 5% of the gross amount of the dividends. See, in this respect, the treaties concluded with Belgium [Art. 10(2)(a)]; France [Art. 10(2)(a)]; Hungary [Art. 10(2)(a)]; Spain (the 5% rate only applies when the Spanish company owns 50% or more of the capital of the Dutch company or if the Spanish company owns 25% or more of the Dutch company and another Spanish company also owns 25% or more of the Dutch company) [Art. 10(3)(a)]; Yugoslavia [Art. 10(2)(a)] and Zambia [Art. 10(2)(a)]. A 10% rate is provided for in the treaties with Canada [Art. 10(2)(a)], Pakistan [Art. 10(2()a)] and Romania [Art. 10(2)(a)]; 15% in the treaties with Australia [Art. 10(2)] and New Zealand [Art. 10(2)]; 7.5% in the treaty concluded with Surinam (but the maximum rate will be 15% if the dividends are not included in the tax base in the country of which the recipient is a resident [Art. 10(2)(a) and (b)]; and 2.5% under the treaty concluded with Luxembourg [Art. 10(2)(a)].

Under the treaty with Greece, the Netherlands may impose a 5% dividend withholding tax but Greece may impose 35% [Art. 10(2)(a) and (b) and Protocol ad Art. 10]. The disparity in rates is due to the fact that in Greece dividends are deductible from the company's profits.[88] The Israel treaty contains provisions which allow the Netherlands to impose dividend withholding tax at a rate not exceeding 5% in the case of a substantial participation but Israel may impose tax at a rate not exceeding 15% [Art. 11(2)(b)]. Under the treaty with Thailand the Dutch withholding tax on participation dividends may not exceed 5% but Thailand may levy 10% [Art. 10(2)(A) and (B)].

In certain treaties the voting power of the shares is the determinative factor for a substantial participation rather than the percentage of share capital held. For instance, in the treaty with Japan [Art. 11(3)(b)], the Dutch tax paid by a company resident of the Netherlands to a company resident in Japan may not exceed 5% of the gross amount of the dividends if the recipient company owns (for a period of 6 months immediately preceding the date the dividend becomes payable) 25% or more of the voting shares.[89] The treaty with the Federal Republic of Germany also uses voting power as the determinative factor, i.e. 10% tax is withheld if the recipient has a substantial participation in the voting stock of the Dutch company [Art. 13(4)]. The Ireland treaty exempts dividends from withholding tax if the recipient holds at least 25% of the voting shares of the payer company [Art. 8(3)]. The United Kingdom treaty provides that 5% dividend tax can be withheld if the U.K. company owns at least 25% of the voting power of the Netherlands company [Art. 10(2)] and the United States treaty also provides for a 5% dividend tax if at least 25% of the voting stock of the Dutch company is owned either alone or in combination with another U.S. company (both companies must own at least 10%) [Art. VII(1)(b)].

2. Branch profit taxation

Some countries, developing as well as industrial countries, take the view that profit remittances made by branches of foreign companies should be subject to withholding tax as if they were dividends distributed by a subsidiary to its foreign parent. In this manner equal tax treatment is accorded to income derived from direct investment through a branch and indirect investment derived through a local subsidiary. Some countries even go a step farther and impose withholding tax on branch profits whether or not they have been remitted abroad. These countries usually attempt to have their branch profits tax recognized in tax treaties. The treaty with Canada contains a provision for a branch profits tax of 10% which is calculated according to treaty provisions [Art. 10(7)]. According to French law, branches of foreign companies are liable to withholding tax on distributable income net of corporate income tax; this tax is based on the fiction that all after-tax income of the branch is distributed to the foreign head office as a deemed dividend.[90] However, no such branch profits tax applies to Dutch companies [Protocol ad Art. 10]. The treaty with Indonesia also contains provisions for a branch profits tax of 10% [Protocol IV ad Art. 7].

The Dutch Government deplores this practice because it conflicts with the Dutch policy of not imposing double tax on business income. Negotiators attempt to persuade the treaty partner to remove branch profit taxation altogether under the pertinent tax treaty – or should that prove infeasible – to reduce the rate as much as possible and to limit the taxable base to the amounts actually remitted to the head office.

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88. Should this circumstance change, however, the 2 Governments will review the applicability of these provisions. See Protocol ad Art. 10.
89. The Japanese tax on dividends paid by a Japanese resident company to a company resident in the Netherlands, however, may not exceed 10% of the gross amount of the dividends (under the same conditions).
90. For a discussion see GET-II, Chapter France.

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3. Interest[91]

The 1977 OECD Model Treaty allocates the right to levy tax on interest to the State of residence of the recipient but the source State retains the right to impose tax if its domestic legislation so provides. Therefore the source State may relinquish its right to tax interest or it may impose tax. As a general rule the right to levy tax is limited by a ceiling, i.e. usually it may not exceed 10%.

Although many countries, both developed and developing, levy withholding tax on interest paid by a resident debtor to a non-resident creditor, Dutch legislation does not impose any withholding tax on interest derived from Dutch sources.[92] The primary goal of Dutch tax treaty negotiators is to persuade the treaty partner to eliminate any withholding tax on interest.[93] In fact the foreign withholding tax has been eliminated in the treaties concluded with Austria [Art. 11(1)]; Belgium (if the interest is paid to an enterprise in the other State) [Art. 11(3)][94]; Czechoslovakia [Art. 11(1)]; Denmark [Art. 10(1)]; Federal Republic of Germany [Art. 14(1)]; Finland [Art. 11(1)]; Hungary [Art. 11(1)]; Ireland [Art. 9(1)]; Luxembourg [Art. 11(1)]; Norway [Art. 11(1)]; Poland [Art. 11(1)]; Sweden [Art. 11(1)]; the United Kingdom [Art. 11(1)]; the United States [Art. VIII]; the U.S.S.R. [Art. 8(1)] and Yugoslavia [Art. 11(1)].

If the treaty partner appears unwilling to remove the withholding tax on interest the Dutch negotiators will endeavour to have the rates reduced. The following treaties contain a 10% limit for source State taxation of interest: Australia [Art. 11(2)]; Belgium [Art. 11(2)]; China (PR) [Art. 11(2)]; France [Art. 11(2)][95]; Greece [Art. 11(2)]; Japan [Art. 12(2)]; Malta [Art. 11(2)]; Morocco (if the interest is paid by a resident of a State to an enterprise of the other State; otherwise the rate is 25%) [Art. 11(2)(a) and (b)]; New Zealand [Art. 11(2)]; Romania [Art. 11(2)]; Singapore [Art. 11(2)]; South Africa [Art. 11(2)]; Spain [Art. 11(2)]; Sri Lanka [Art. 11(2)]; Surinam [Art. 11(2)(b)] and Zambia [Art. 11(2)].

The treaty with Canada, however, provides for a 15% levy [Art. 11(2)]; Indonesia, 20% [Art. 10(2)]; Israel [Art. 12(2)] and Korea, 15% [Art. 11(2)(b)]; Pakistan, 20% [Art. 11(2)(d)]; Switzerland, 5% [Art. 9(2)(b)] and Thailand, a hefty 25% [Art. 11(2)(b)].

Italy may, notwithstanding the existence of a tax treaty, levy its own withholding taxes on interest without any limitations [Arts. VII and VIII].

The withholding tax is usually imposed on the *gross* amount of the interest and since the creditor is usually taxed on *net* income, it often happens that the income tax due from the creditor in his home country on the interest received is lower than the tax withheld. Consequently, any available credit is partially lost and this results in additional taxation to the creditor. Foreign lenders frequently have to increase the interest rate they charge their customers to compensate for this additional taxation. This practice is detrimental to business enterprises in the countries which impose such a withholding tax. As a result, some countries have decided to reduce the rate of withholding tax on outgoing interest if the debtors are established in certain regions under development or if they are active in certain sectors of industry or trade. See, for example, the treaty concluded with Indonesia which provides for a 10% withholding tax if the interest is owed by an enterprise primarily engaged in agriculture, plantation, forestry, fishery, dairy farming, mining, manufacturing industries, transportation, people's housing projects or tourism [Art. 10(3)(a)]. The withholding tax rate in the Pakistan treaty is reduced to 10% with respect to the sale of industrial, commercial or scientific equipment or the construction of industrial, commercial, scientific installations as well as public works [Art. 11(2)(c)].

In certain treaties the foreign withholding tax rates are differentiated in such a manner so that no rate or a low rate of withholding tax applies to interest whose net yield is relatively small. This is often the case with regard to bank interest – see the treaties concluded with France, 0% [Art. 11(3)(b)]; Greece, 8% [Art. 11(2)]; Indonesia, 10% [Art. 10(3)(b)]; Israel, 10% [Art. 12(2)]; Pakistan, 10% [Art. 11(2)(a)]; Sri Lanka, 5% [Protocol III(a)], Surinam, 5% [Art. 11(2)(a)] and Thailand [Art. 11(2)(a)] – and interest charged between associated companies (Pakistan, 15% if interest is paid by a company with a substantial participation in the payer company [Art. 11(2)(b)] and 0% where credit is given by suppliers of merchandise (Canada [Art. 11(3)(a)]). The treaty with Korea provides for a 10% rate of withholding tax if the interest is paid on loans for a period of more than 7 years [Art. 11(2)(a)].

4. Royalties[96]

Most of the treaties concluded with European countries and other developed countries follow the 1963 OECD Draft or the 1977 Model Treaties. The Netherlands supports the view expressed in the 1977 OECD Model that no withholding tax should be levied on royalties paid to a licensor established abroad, i.e. the royalties should be taxed exclusively in the country of the beneficial owner's residence.[97] This approach is consistent with Dutch domestic legislation which does not impose any tax on outgoing royalties (they are

91. Dutch Model, Art. 11.
92. In exceptional cases, however, the Netherlands imposes tax on "outgoing" interest; a withholding tax on interest on profit sharing bonds is levied and normal income tax is levied on interest from loans granted to companies in which the lender has a substantial interest. For a discussion, see in this issue Plante-Failé, M. and Zwemmer, J.W., "Interest: Withholding Tax or No Withholding Tax".
93. Special provisions may exist for interest on mortgage loans and profit-sharing loans.
94. However, a 10% tax may be levied on bonds and interest from loans in parent-subsidiary (and vice versa) situations.
95. However, interest derived from bonds issued prior to 1 January 1965 in France may be taxed in that State at a rate of 12%.
96. Dutch Model, Art. 12.
97. 1977 OECD Model, Art. 12 and COMM. para 1. With respect to para. (1) of the OECD Model, Australia, Austria, Canada, Finland, France, Greece, Japan, Luxembourg, New Zealand, Portugal and Turkey have reserved the right to impose withholding tax on royalties (either in all circumstances or under limited circumstances).

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taxable when derived through a permanent establishment in the Netherlands). If the prospective treaty partner refuses to exempt royalties from any withholding tax, Dutch negotiators will strive for the lowest possible withholding tax rate on industrial royalties (in particular, since the net yield is often very low as a result of high development costs).

Various treaties deviate from the OECD Model and allow the source State to levy tax. Source State taxation is often set at a rate not exceeding 10% of the gross amount of the royalties. See in this respect the treaties concluded with Australia [Art. 12(2)]; Austria (tax may be imposed at a rate not exceeding one-half of the statutory rate of tax but never more than 10% of the gross amount; this taxing right, however, only applies in cases where the recipient owns more than 50% of the capital of the paying company) [Art. 13(2)]; Canada, although copyright royalties and other like payments made with respect to various types of artistic work are exempt [Art. 12(2)][98]; Israel, but the treaty provides for 2 rates of tax which may be withheld at source, i.e. 10% for cinematograph films and films or video tapes for radio or television broadcasting and 5% for all other royalties [Art. 13(2)]; Japan [Art. 13(2)]; Malta, but copyright royalties are exempt [Art. 12(2)] and New Zealand [Art. 12(2)]. The treaty with Spain [Art. 12(2)] allows a 6% tax to be withheld.

The wording of the treaties with the Eastern European countries to a great extent follows the OECD Model Convention although some of the treaties allow source State taxation of royalties. The treaty with Czechoslovakia limits source taxation to 5% [Art. 12(2)]. The treaty with Poland limits source taxation of 10% to industrial royalties [Art. 12(2)]. The Romanian treaty allows the source State to impose tax at a rate not exceeding 10% of the gross amount of the royalties [Art. 12(2)]. The Hungarian treaty, however, does not impose source taxation on royalties [Art. 12]. The U.S.S.R. treaty does not precisely define the term "royalties", so the term "copyrights and licences" is used. Royalty payments are exclusively taxed in the country of the recipient's residence [Art. 9].

Developing countries are less inclined to waive their withholding tax on royalties.[99] An examination of the various double taxation agreements with developing countries reveals a range of withholding tax rates which may be levied by the source State. Several treaties concluded with developing countries grant the right to impose tax at source at a rate not exceeding 10% of the gross amount of the royalties, i.e. China (PR) [Art. 12(2)]; Morocco [Art. 12(2)]; Sri Lanka [Art. 12(2)]; Yugoslavia [Art. 12(2)] and Zambia [Art. 12(2)].

Some treaties, however, provide for 2 or more rates of withholding tax. See, for example, the treaties with Greece, 5% for royalty payments received for artistic, literary or scientific works (including cinematographic films) and a 7% withholding tax for all other royalties [Art. 12(2)]; Indonesia, a tax rate not exceeding 20% but the withholding tax is 10% for royalties deriving from copyrights of scientific works or industrial, commercial or scientific equipment or for information concerning scientific experience and 5% for royalty payments relating to the right to use inventions or discoveries in the field of technology and industry, such as a patent, trade mark, design, etc. for information concerning experience with respect to production and sale, i.e. "know-how" [Art. 11(2) and (3)]; Korea, a rate not exceeding 15% for royalties received for literary, artistic or scientific works, including cinematographic films, and 10% for patents, trade marks, designs or models, plans, secret formulas or processes, industrial, commercial or scientific equipment or information concerning industrial, commercial or scientific experience [Art. 12(2) and (3)]; Pakistan [Art. 12 (2) and (3)] provides for a 15% rate for patents, trade marks, secret formulas or processes, designs or models concerning industrial, commercial or scientific experience and industrial commercial or scientific equipment, and cinematograph films for television and broadcasting, and 5% for literary, artistic or scientific work; the Surinam treaty also imposes 2 rates, i.e. 10% for cinematograph films and films or tapes for radio or television and 5% for all other royalties [Art. 12(2)] and Thailand, where a 5% rate is imposed on literary, artistic or scientific works, and 15% on patents, trade marks, designs or models, plans, secret formulas or processes for information concerning industrial, commercial or scientific experience or cinematograph films or tapes for television or broadcasting [Art. 12(2)].

The Malawi treaty [Art. VII(1)] contains a general provision for taxation of royalties and interest, i.e. the source State may not levy taxes on royalties where the recipient is a resident of the other State if the recipient is subject to tax in that other State. The Singapore treaty, subject to the provision on immovable property, grants the State of residence of the recipient the exclusive right to impose tax [Art.12(1) and (2)].

If it appears that a treaty partner refuses to reduce a high rate of withholding tax, the Dutch negotiators will attempt to define the concept of royalties as narrowly as possible. Fees paid for the use of equipment lacking any technical aspects as well as fees for technical services other than fees for know-how, should be excluded from the royalty definition. These items should be contained in the Articles applicable to business income or income from independent services.

5. Tax-sparing credit relief[100]

As a measure designed to stimulate the economy and encourage foreign investment, some countries – in particular developing countries – have reduced (or waived) the withholding tax on dividends, interest and/

98. This treaty was signed in May 1986 and basically follows the 1977 OECD Model. Under Art. 30(6), certain royalty payments made through 31 December 1988 are treated under the provisions of the 1957 treaty. For a discussion of this treaty, see Sapona, I., "The Canada–Netherlands Tax Treaty", 27 *European Taxation* 5 (1987) at 163.
99. See Art. 12 of the U.N. Model Convention which provides for taxation of royalties in the source State.
100. GTTP at 18.

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or royalties in certain industrial sectors or in underdeveloped regions within the country. The efficacy of these reduced (or waived) rates hinges not only on the treatment accorded the income in the developing country but also how the home country of the recipient of such income treats the income.

Generally, double taxation agreements provide that a tax credit is only available if tax has actually been suffered in the other State. Any tax which is reduced or waived by the developing country cannot be utilized by the foreign investor if he must pay the full amount of tax on the income in his home State. If the home country prevents double taxation by crediting the withholding tax against the income tax in the home country of the recipient, the advantage of the reduced rate may be lost because the recipient will encounter higher taxation in his own country. In other words, the relief granted by the developing country is transformed into increased tax revenue in the developed country.

This result obviously contravenes the purpose of the tax relief granted. To circumvent this occurrence, developing countries frequently request inclusion of a tax-sparing clause in the tax treaty, i.e. that the treaty partner allow a credit for that part of the withholding tax which would have been imposed if the relief had not been applicable.

The Netherlands usually agrees to the inclusion of a tax-sparing credit in tax treaties with developing countries provided the developing country is prepared to sufficiently reduce its withholding tax on the relevant income. In most cases the tax-sparing credit is then limited to the rate of withholding tax agreed upon in the tax treaty and will not be extended to the higher domestic rate of withholding tax. The reason for this restriction is that the Netherlands does not wish to grant (indirectly) development aid which falls under the competence of the Ministry for Development Aid.

The following treaties the Netherlands has negotiated contain tax-sparing provisions: Greece, applicable to interest and royalties [Art. 25(4) and (5)]; Indonesia, applicable to dividends, interest and royalties [Art. 24(3) and (4)]; Israel, applicable to dividends, interest and royalties [Art. 26(4) and (5)]; Korea, applicable to dividends, interest and royalties [Art. 23(4) and (5)]; Malta, applicable to interest and royalties (other than royalties in respect of cinematographic films or tapes for television and broadcasting) [Art. 25(4)]; Pakistan, applicable to interest and royalties [Art. 22(4)]; Singapore, applicable to interest and royalties [Art. 24(4)]; Sri Lanka, applicable to dividends, interest and royalties [Art. 23(4)]; Surinam, applicable to dividends, interest and royalties [Art. 24(4)] and Zambia, but tax sparing credit is limited to dividends [Art. 22(4)].

6. Thin capitalization[101]

The term "thin capitalization" is often used to describe various forms of hidden equity capitalizations.[102] However, we are only concerned here with the situation in which a company relies to a relatively high degree on debt financing rather than equity financing.

Company financing is generally accomplished by the issuance of shares in the company, by borrowing funds or by a combination of the two methods. The advantages which accrue from one form of financing or the other may be influenced by several considerations, e.g. economics, commercial requirements or tax considerations. While shareholders receive a return on their investment in the form of profit distributions, interest payments to a foreign parent (or related) company are treated as deductible expenses of the subsidiary company in the computation of its taxable profits. Debt financing may enable a company to reap a tax advantage by injecting capital in the form of loans. Consequently, the proportion of debt and equity financing sometimes becomes a target of inquiry for the tax authorities, i.e. the authorities will scrutinze the exact nature of a company's financing methods in order to determine whether profits are being transferred under the guise of interest payments.

Although the Netherlands legislation contains no provisions with respect to debt/equity ratios, a number of countries have "thin capitalization" rules. Various approaches have been adopted to tackle the situation where the ratio between debt and equity contributions is excessively high in favour of debt financing. Under some systems the interest is disallowed as a deduction and (sometimes) reclassified as a distribution of profit, i.e. the rules for dividend distributions come into effect.[103]

The majority of OECD member countries oppose using a fixed ratio to determine when excessive debt financing takes place. Under the fixed ratio approach if the debtor company's total debt exceeds a certain proportion of its equity capital the excess of the loan over the allowed proportion is either disallowed or taxable as a dividend.[104] The general consensus is that in international situations such fixed ratios cannot be reconciled with the "arm's length" and fiscal "non-discrimination" provisions which are generally included in tax treaties.

The Dutch Government disapproves of the use of a fixed ratio for several additional reasons as well:

- a fixed ratio approach will deprive the enterprise of a free choice with respect to the debt/equity ratio most conducive to its business;
- if an enterprise's financial structure deteriorates because of substantial losses, thus affecting its debt/equity ratio, the fact that interest payments would become fully or partly non-deductible would further impair the enterprise's chances for recovery; and
- the possibility of international double taxation increases if interest in one treaty country is labelled

101. GTTP at 18. See Juch, D., "Tax advantages and Tax Risks in the Case of Financing Through the Netherlands", 26 *European Taxation* 8 (1986) at 243.

102. For a discussion, see the OECD Report on thin capitalization in *Issues in international taxation* No. 2 (1987).

103. Canada is an example of such a country. The Federal Republic of Germany and the United States contemplated introducing similar legislation but have abandoned the idea.

104. See footnote 102.

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as a dividend and the other treaty country refuses to abide by that decision.[105]

On this basis, the Netherlands rejects inclusion of fixed debt/equity ratios in a tax treaty. It will a fortiori refuse a provision under which the Netherlands would have to adjust its taxation to reflect application of debt/equity provisions in the other treaty country. However, in consultation with the treaty partner, the Dutch Government is willing to determine whether a loan is genuine. The Dutch Government employs Dutch case law as a guideline in making such a determination.

D. The use and abuse of tax treaties[106]

Domestic tax law and tax treaties contain provisions the purpose of which is to promote correct application of the text. These provisions primarily relate to the determination of the beneficiary of income to which the treaty rules apply, the exchange of information between tax authorities and the mutual agreement procedure under which tax authorities attempt to prevent double taxation in cases where there are lacunae in the treaty. If the Netherlands and its treaty partner are of the opinion that such provisions are insufficient to warrant a proper application of the treaty, other special provisions may be also included. The Netherlands will attempt to reach a solution whereby taxpayers who act in good faith receive protection against double taxation which is normally offered by tax treaties.[107]

The issue whether a recipient of income is in fact the beneficiary mainly plays a role with dividends since the creation of a holding company as a conduit for the mere purpose of obtaining the advantage of a tax treaty, i.e. tax treaty shopping, is often frowned upon. Many tax treaties impose the condition that the shareholder be "beneficially entitled" to the dividend received[108] as, e.g., in the treaty with Australia [Art. 10(1)] or that the shareholder be the "beneficial owner" of the income[109] – e.g. treaties with Canada [Art. 10(2)]; China (PR) [Art. 10(2)]; Greece [Art. 10(2)]; Hungary [Art. 10(2)]; Malaysia [Art. 10(2)]; Malta [Art. 10(3)]; New Zealand [Art. 10(2)]; Pakistan [Art. 10(2)]; Poland [Art. 10(2)]; Sri Lanka [Art. 10(2)] and the United Kingdom [Art.10] – to obtain a reduction of the withholding tax rate in the source country or to receive other relief under the treaty provisions. It is not clear whether the term "beneficial owner" will prevent treaty shopping in cases where a foreign company creates a Dutch subsidiary for the sole purpose of benefiting from tax treaty provisions since (to our knowledge) no court decisions have been rendered which deal with the beneficial ownership concept.[110] The "fraus legis" theory could possibly be invoked to attack the abuse (if it is agreed that this is abuse) of tax treaties in the form of tax treaty shopping.[111]

Some treaties expressly provide that a reduction of withholding tax is only available if the dividend is received by a company holding a certain percentage of the capital of the distributing company and provided that the relationship between the 2 companies was not established or not maintained principally for the purpose of benefiting from the reduced rate. This method appears to be a more effective way to prevent treaty shopping. Examples are the treaties concluded with Morocco [Art.10(2)(a)]; Surinam [Art. 10(2)(a)] and Switzerland [Art. 9(1)(a)]. The tax treaty with the United Kingdom contains detailed provisions directed at tax treaty shopping [Art. 10(3)].[112]

Generally, the tax treaties which use the beneficial ownership concept for dividends also employ this concept to determine whether the treaty benefits are available to recipients of interest and royalties. The same issues arise in these cases.

E. Frontier workers[113]

The general rule in tax treaties is that income from employment is taxable in the country where the work is performed except in certain cases where the activities are only exercised for a limited period of time, usually not exceeding 183 days. The country where the employee is resident (residence State) must generally grant relief for taxation suffered in the country where the employee works (work State).

Specific problems frequently materialize with respect

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105. This could occur, for instance, if the country where the debtor resides imposes a withholding tax on dividends but not on interest. If this country deems the interest to be a dividend, withholding tax is suddenly levied. The creditor's country may then refuse to allow a credit for the withholding tax arguing that the tax was incorrectly imposed.
106. GTTP at 19-20.
107. This part of the Under Minister's letter clearly deals with treaty shopping although the term is not used. No approval or disapproval of treaty shopping is expressed. However, because of the lengthy discussion with respect to the importance of international trade and finance, the reader may receive the impression that a modest opportunity to engage in some treaty shopping would not be unfavourable to the Dutch economy and would not be unwelcome at all times.
108. In Dutch: "waartoe een inwoner van de andere Staat uiteindelijk gerechtigd is".
109. In Dutch: "de uiteindelijk gerechtigde".
110. The Commentary to the OECD Model Convention 1977 states that the rate reduction will be refused when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the intermediary and the beneficiary are resident in the same country. It does not expressly state that term "beneficial owner" will prevent the creation of a holding company to be used as a conduit in a treaty country. For a discussion, see the article prepared by the staff of the International Bureau of Fiscal Documentation, "Further Attacks on Treaty Shopping", 21 *European Taxation* 5-6 (1981) at 141. In particular, see pages 143 and 150 where the beneficial ownership concept is discussed. In this respect, see also in this issue, Plante-Failé, M. and Zwemmer, J.W., "Interest: Withholding tax or No Withholding Tax". These authors conclude that "beneficial ownership" may indeed prevent tax treaty shopping.
111. For an article on the "fraus legis" doctrine, see van Brunschot, F., "Fraus legis and Multinational Companies" in this issue.
112. See Staff of the International Bureau of Fiscal Documentation, "The U.K.–U.S. and U.K.–Netherlands Double Taxation Conventions, 21 *European Taxation* 5/6 (1981) at 141; van Gorkum, R.A., "The Controversial New sub-paragraph (d) to Article 10(3) of the Netherlands–U.K. (income) Tax Treaty", 21 *European Taxation* 5/6 (1981) at 157; Spierdijk, J.F., "Netherlands–U.K. Income Tax Convention: the New Article 10(3) subpara. (d) – Warnings of an Overkill", 21 *European Taxation* 5/6 (1981) at 159.
113. GTTP at 19 – 20.

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to frontier workers. The work State generally does not take the personal circumstances of non-resident employees into account on the assumption that personal relief will be granted by the residence State which generally subjects the employees' world-wide income to tax. If the salary is the only source of income (which is often the case), the residence State can do little or nothing to mitigate this situation with the result that frontier workers are taxed less favourably than their colleagues who live and work in one of the treaty countries.

To remedy this situation, the Netherlands has concluded special agreements with its immediate neighbours, i.e. the Federal Republic of Germany and Belgium. The Protocol of 13 March 1980 to the Dutch-German tax treaty provides that the work State may, under certain conditions, grant personal relief to frontier workers as if they were residents. Under Art. 15(3) of the Belgian-Dutch tax treaty, frontier workers are exclusively subject to tax in the residence State.

The Netherlands prefers that the income of frontier workers be taxed exclusively in the residence State. If this proves unacceptable to the treaty partner, a limited right of taxation in the work State may be granted. This tax should then be credited against the tax on the frontier worker's world-wide income imposed in his residence State. If the tax in the work State exceeds the tax in the residence State, the latter would refund the excess to the employee but this excess credit will then be charged to the work State.[114]

F. Other types of earned income[115]

Tax treaties usually contain special provisions for certain types of income, thus deviating from the general rule that the income should be taxable in the country where the work is performed. The Netherlands usually conforms to the guidelines set forth in the OECD Model.

1. Directors' fees[116]

The right to tax directors' fees and other remuneration received by persons in their capacity as members of the Board of Directors of a company is usually granted to the country where the company is established. In principle, the Netherlands prefers to apply this rule to all kinds of remuneration received by such directors, including fixed salaries, shares in the profit of the company, etc.

Sometimes an additional provision is included under which directors' fees paid for work performed for a permanent establishment located in the other treaty country are taxable in the latter country under certain conditions. These conditions generally require that the activities performed are of a regular and substantial nature and that the remuneration is deducted from the income of the permanent establishment. Examples can be found in the treaties concluded by the Netherlands with Australia [Art. 16(3)]; Belgium [Art. 16(3)]; Canada [Art. 16(2)]; France [Art. 16(3)]; Morocco [Art. 17(3)]; New Zealand [Art. 16(3)]; Pakistan [Art. 16(2)]; Romania [Art. 17(3)]; Sri Lanka [Art. 16(2)]; the United Kingdom [Art. 16(2)] and Zambia [Art. 16(3)].

2. Artistes and athletes[117]

Foreign artistes and athletes who perform in the Netherlands are deemed to be employees and are thus subject to wages tax to be withheld by the person who hired them.[118] In principle, artistes and athletes are also subject to individual income tax (the wages tax is credited against the individual income tax).[119] However, special rules apply to artistes who perform for a short period of time in the Netherlands, i.e. they are not subject to the normal progressive rates of wages tax but rather to a fixed 25% rate.[120] This tax is a final tax so no further individual income tax is due.[121]

Under tax treaty law the right to tax income from artistes and athletes is usually accorded to the country where these individuals perform their work. No exception is made for individuals who remain for a limited period of time in the other country.

Certain countries wish to include an exception where artistes or athletes perform their activities within the framework of a cultural or sports exchange programme in which case the Netherlands will consent to taxation by the State of residence. Examples are the treaties concluded with China (PR) [Art. 17(3)]; Hungary [Art. 17(3)]; Malaysia [Art. 17(2)]; Poland [Art. 17(3)]; Romania [Art. 18(2)]; Singapore [Art. 17(2)]; Turkey [Art. 17(3)] and Yugoslavia [Art. 17(3)].

Artistes and athletes sometimes attempt to evade income tax by entering into the service of a company of which they and/or their spouse and other close relatives hold the shares. They then contend that it is the *company* which carries on activities in the country where they perform and, lacking a permanent establishment, no tax should be due on the fee charged by the company. A number of tax treaties contain express provisions to counteract such practices.[122] Examples

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114. The problems connected with the taxation of frontier workers is currently the subject of discussion within the European Communities. The points of view of the Member States differ to such an extent that the Dutch Government does not expect an early solution to the problem. GTTP at 21.
115. GTTP at 21 – 22.
116. Dutch Model, Art. 16.
117. Dutch Model, Art. 17.
118. LB, Art. 4 in conjunction with Regulations to the LB, Art. 2.
119. IB, Art. 49(2).
120. LB, Art. 34b.
121. Any non-resident taxpayer who is subject to the wages tax is, in principle, also subject to the individual income tax unless his income does not exceed a certain amount. See II.A. above. However, IB, Art. 49(1)(b)(1°) expressly provides that non-resident artistes performing for a short period of time in the Netherlands are exempt from individual income tax. This exemption was granted because it is extremely difficult in practice to assess these individuals.
122. In the case of the Netherlands, such a provision is probably not necessary. In a decision dated 23 November 1983 (cited as BNB 1984/33), the Supreme Court held that for purposes of Dutch Wages Tax Law, 5 musicians employed by a Swiss company but hired by a Dutch impresario were deemed to be employed by the Dutch impresario and that he was responsible for the withholding of the wages tax.

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are the tax treaties concluded with Australia [Art. 17(2)]; Canada [Art. 17(2) and (3)]; China (PR) [Art. 17(2)]; France [Art. 17(2)]; Greece [Art. 18(2)]; Hungary [Art. 17(2)]; Israel [Art. 19]; Japan [Art. 18(2)]; Korea [Art. 18(1)]; Malta [Art. 18(2)]; Malaysia [Art. 17(2)]; New Zealand [Art. 17(2)]; Pakistan [Art. 17(2)]; Sri Lanka [Art. 17(2)]; Surinam [Art. 18]; Thailand [Art. 17]; Turkey [Art. 17(2)]; the United Kingdom [Art. 17(2)]; Yugoslavia [Art. 17(2)] and Zambia [Art. 17].

3. Government officials[123]

Government officials are generally taxable in the source State, i.e. the state which pays their salary, insofar as they receive a salary for the discharge of functions of a governmental nature. If the salary is paid by a Government (or a sub-division thereof) for services rendered in connection with a business carried on by such Government, the salary is usually taxable in conformity with the provisions which apply to private employment, i.e. in the country where the work is performed.[124] Various versions of these rules can be found; for instance, in the tax treaties concluded by the Netherlands with Australia [Art. 19]; Austria [Art. 20(1) and (3)]; Belgium [Art. 19]; Canada [Art. 19]; China (PR) [Art. 19(1)(a) and (3)]; Czechoslovakia [Art. 20]; Denmark [Art. 15(1) and (2)]; Federal Republic of Germany [Art. 11]; Finland [Art. 20]; France [Art. 19]; Greece [Art. 20(1)(a) and (3)]; Hungary [Art. 19(1)(a) and (3)]; Indonesia [Art. 19(1) and (2)]; Ireland [Art.18]; Italy [Art. XIV(1)]; Japan [Art. 20(1) and (3)]; Korea [Art. 20(1) and (2)]; Luxembourg [Art. 20(1) and (2)]; Malta [Art. 20(1)(a) and (3)]; Morocco [Art. 20]; New Zealand [Art. 19(1)(a) and (3)]; Pakistan [Art. 19(1)(a) and (3)]; Poland [Art. 19(1)(a) and (3)]; Romania [Art. 20(1) and (2)]; Singapore [Art. 19(1) and (2)]; South Africa [Art. 20]; Spain [Art. 20]; Sri Lanka [Art. 19(1)(a) and (3)]; Surinam [Art.20(1) and (2)]; Sweden [Art. 21(1) and (3)]; Thailand [Art. 19]; U.S.S.R. [Art. 13]; the United Kingdom [Art.19(1)(a) and (3)]; Yugoslavia [Art. 15(4)(a) and 5] and Zambia [Art. 19].

An exception may be made for local personnel working for a foreign Government in their State of residence; for instance a Dutch secretary working in a foreign embassy or consulate. This is usually expressed by stating that these individuals are only taxable in the residence State if the recipient of the income is a national of the residence State or (in the more recently concluded treaties) a (permanent) resident of that State provided he or she did not become a resident of that State solely for the purpose of rendering the services. See for instance the tax treaties concluded with Australia [Art. 19(1)]; Belgium [Art. 19(1)]; Canada [Art. 19(1)]; China (PR) [Art 19(1)(b)]; Federal Republic of Germany [Art. 11(1)]; Greece [Art. 20(1)(b)]; Hungary [Art. 19(1)(b)]; Indonesia [Art. 19(3)]; Israel [Art. 21(3)]; Malta [Art. 20(1)(b)]; Morocco [Art. 20(1)]; New Zealand [Art. 19(1)(b)]; Pakistan [Art. 19(1)(b)]; Poland [Art. 19(1)(b)]; Romania [Art. 20(3)]; Singapore [Art. 19(3)]; Sri Lanka [Art. 19(1)(b)]; Surinam [Art. 20(3)]; Yugoslavia [Art. 15(4)(b)] and the United Kingdom [Art. 19 (2)(6)].

Although Government *pensions* are often treated as any other pension (see below), they may in a number of cases be treated as Government salaries or be subject to provisions which closely resemble those for Government salaries. Examples are to be found in the treaties concluded with Australia [Art. 19(1)]; China (PR) [Art. 19(2)]; Czechoslovakia [Art. 20(1)]; Greece [Art. 20(2)]; Hungary [Art. 19(2)]; Israel [Art. 21(1)]; Italy [Art. XIV(1)]; Japan [Art. 20(1) and (2)]; Korea [Art. 20(1)]; Luxembourg [Art 20(1)]; Malta [Art. 20(2)]; New Zealand [Art. 19(2)]; Pakistan [Art.19(2)]; Poland [Art. 19(2)]; Romania [Art. 20(1)]; Singapore [Art. 19(1)]; South Africa [Art. 20(1); Spain [Art 20(1)]; Sri Lanka [Art. 19(2)]; Surinam [Art. 20(1)]; Sweden [Art. 21(1)]; Thailand [Art. 19(1)]; the United Kingdom [Art. 19(2); the U.S.S.R. [Art. 13(1)] and Zambia [Art. 19(1)].

4. Professors and teachers[125]

The general policy is that professors and teachers (sometimes researchers as well) who remain abroad for a limited period of time (usually 2 years or less) for teaching or research purposes, will be exempt from income tax in the country they visit with respect to the salary received for such activities. The following treaties concluded by the Netherlands provide for the 2-year or less exemption: Australia [Art. 20]; Belgium [Art. 20]; Czechoslovakia [Art. 21]; Denmark [Art. 18]; Federal Republic of Germany [Art. 17]; Finland [Art. 21(1)]; France [Art. 20(1)]; Greece [Art. 21]; Hungary [Art. 20]; Indonesia [Art. 20]; Ireland [Art. 27]; Israel [Art. 22(1)]; Italy [Art. XVI]; Japan [Art. 21]; Korea [Art. 21(1)]; Malta [Art. 21(1)]; New Zealand [Art.20(1)]; Norway [Art. 21(1)]; Pakistan [Art. 20(1)]; Poland [Art. 20(1)]; Romania [Art. 21(1)]; South Africa [Art. 21]; Spain [Art. 21]; Sri Lanka [Art. 20(1)]; Sweden [Art. 22(1)]; Turkey [Art. 20(1)]; U.S.S.R. [Art. 14(1)] and Yugoslavia [Art. 19]. China (PR) provides for a 3-year or less exemption [Art. 20(1)].

Not all tax treaties deal with this subject, however. Express provisions concerning professors, teachers etc. are lacking in the treaties concluded with Austria, Canada, Luxembourg, Morocco, Singapore, Surinam, Switzerland, the United Kingdom and Zambia.

5. Students[126]

Students (and sometimes business apprentices) will generally be exempt from taxation with respect to income received under a scholarship from persons resident in the other country. The Netherlands is, in principle, not prepared to extend this exemption to income derived from other activities in the country

123. Dutch Model, Art. 19.
124. There may be exceptions to this rule if the employee is employed in the relevant State for a period not exceeding 183 days and if some other conditions are fulfilled.
125. Dutch Model, Art. 20.
126. Dutch Model, Art. 21.

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where the individual is studying. Exceptions to this rule under which such persons may (to a limited extent) exercise salaried activities may, inter alia, be found in the treaties concluded by the Netherlands with Austria [Art. 21(2)]; Finland [Art. 22(2)]; France [Art. 21(2)]; Indonesia [Art. 21]; Ireland [Art. 28]; Israel [Art. 23]; Korea [Art. 22]; Malta [Art. 22]; Morocco [Art. 21]; Norway [Art. 22]; Pakistan [Art. 21]; Poland [Art. 21(2)]; Romania [Art. 22(2)]; Singapore [Art. 20]; Sri Lanka [Art. 21]; Surinam [Art. 21]; Thailand [Art. 21(2)]; Turkey [Art. 21(2)]; Yugoslavia [Art. 20(2)] and Zambia [Art. 20(2)].

G. Pensions and other payments[127]

1. In general

A distinction is made between private pensions and pensions paid by the Government for past governmental services. Private pensions are generally only subject to tax in the country where the beneficiary resides. A few exceptions to this rule are as follows:

(i) some treaties provide that pensions paid for a past employment exercised in the source State are under certain conditions taxable in that State (e.g. the treaty concluded with Zambia [Art. 18(a)]);
(ii) other treaties provide that a pension payment may be taxed in the source State if the pension is charged against profits derived in the source State by an enterprise of that State; e.g. the treaties concluded by the Netherlands with Indonesia [Art. 18(a)]; Korea [Art. 19(2)] and Thailand [Art. 18(2)]. In contrast, Government pensions are also taxable in the country from which the pension is paid.

A problem which is not urgent at present but which may become so when the pertinent Dutch legislation has been adopted, concerns the situation in which a Government official accepts employment with a private firm or where a person employed in the private sector becomes a Government official and the individual uses his current pension rights to secure a pension from the new employer. In such a case it will be well nigh impossible to determine which part of the pension is connected with private employment and which part pertains to Government service. This will result in a change of approach by the Dutch Government. Under such circumstances, it only seems fair if both types of pensions receive similar treatment, i.e. both the source State and the residence State will receive the right to tax the income but the latter should give relief for tax imposed in the source State.[128]

2. Lump-sum payments[129]

Under the provisions of Dutch Income Tax Law premiums paid for approved pension schemes are deductible from taxable income and the pensions paid from these schemes are fully taxable.[130] If pension rights are redeemed against payment of a lump sum, the latter will be fully taxable at a special rate which is computed according to a distinct formula but which must be at least 20%.[131]

Under many tax treaties concluded by the Netherlands, these lump-sum payments are deemed to be pensions and consequently they are exempt from Dutch tax and only taxable in the country where the beneficiary resides. Such countries often refrain from taxing such lump-sum payments, or if they do impose tax, the rate is very low. In practice, taxpayers sometimes move to a tax treaty country for the sole purpose of redeeming the pension right, cashing the lump sum and then returning to the Netherlands. Several attempts by the Dutch tax authorities to halt this practice by refusing to apply the pension article of the treaty have proved unsuccessful because in most cases the Dutch Supreme Court has ruled that the lump-sum payments should be considered pensions and thus be exempt from Dutch income tax.[132] The Dutch Government envisages including a special provision in tax treaties by which it reserves the right to tax these lump sums. Such a provision is already included in the treaties concluded with Greece [Art. 19(2)]; Hungary [Art. 18(2)]; New Zealand [Protocol ad Art. 18 and 19]; Pakistan [Art. 18(2)]; Sri Lanka [Art. 18(2)]; Turkey [Art.18(3)] and the United Kingdom [Art. 18(2)].

3. Deduction of pension premiums

Normally, tax treaties only contain provisions allocating the right to tax income between the treaty partners paying little or no attention to deductions from taxable income. This is also the case with regard to pension premiums. If, however, the treaty partner's domestic legislation provides that pension premiums are *only* deductible if paid to a local pension fund or insurance company, the Dutch Government attempts to persuade its treaty partner to make these premiums deductible if paid to a Dutch pension fund or insurance company in cases where employees are temporarily seconded to the treaty country. The Dutch have succeeded in this respect in the treaty concluded with Canada [Art. 27(4)].

4. Social security payments

If not dealt with elsewhere in the treaty, social security payments are covered by the treaty article applicable to "other income" (see below) which means they will be taxable in the country where the beneficiary resides. The Netherlands, however, prefers to have these payments also taxed in the source State, since to a certain extent they are comparable to Government pensions. A number of treaties are illustrative of this policy by providing that social security benefits in the nature of a pension are taxable in the source State, e.g. the treaties concluded with Austria [Art. 20(2)]; China

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127. GTTP at 22 – 23.
128. The Dutch tax authorities will urge the OECD Tax Committee to study this issue.
129. For a detailed discussion, see the article in this issue by Kooi, J., "Pensions: A Survey of Recent Developments in the Netherlands".
130. IB, Art. 22 in conjunction with LB, Arts. 10 and 11.
131. IB, Art. 57.
132. See Dik, B.P., "Tax Liability of Non-Residents for Lump Sums Paid in Lieu of Pensions", 27 *European Taxation* 9 (1987) at 295.

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(PR) [Art. 18(2)]; Hungary [Art. 18(3)]; Korea [Art.19(3)] and Yugoslavia [Art.18(4)].[133]

Under Art. 18(3) of the treaty concluded with Turkey, social security payments paid to a person resident in one of the countries in consideration of past employment in the other country is generally taxable in the source Country. However, an exception is made if the person is a national of the country where he resides. The treaty with Romania, however, expressly provides that social security payments are exclusively taxable in the residence State [Art. 19].

H. Other income[134]

The "other income" article applies to income which has not been dealt with in the other treaty articles. The general rule is that such income is taxed exclusively in the State where the beneficiary resides irrespective of whether the income has been derived from sources in the other treaty country or from sources in a third country. However, some treaties contain an additional formula which provides that the "other income" article does not apply (with the exception of income from real property) if the recipient carries on activities in the other State through a permanent establishment or a fixed base and the right or property in respect of which the income is paid is effectively connected with that permanent establishment or fixed base. This formula may be found in the treaties concluded with Greece [Art. 23(2)]; Poland [Art. 22(2)]; Turkey [Art. 22(2)]; the United Kingdom [Art. 21(2)] and Yugoslavia [Art. 21(2)].

The United Nations Model Convention includes a paragraph which allows the source State to tax the income if it arises in that State. The State of residence must then grant relief for the tax imposed by the source State. Whether the Netherlands is prepared to adopt this formula depends on the wording of the preceding articles on income. The more detailed the treaty the less significant the "other income" article; if its significance is slight, the Dutch Government may be willing to adopt the United Nations formula although at the time of writing this article no examples of this type of provision exist. A number of treaties lack an "other income" article, e.g. the treaties concluded with Australia, Korea, New Zealand and Pakistan.

I. Prevention of double taxation[135]

In general

The article which regulates the method for the prevention of double taxation usually states which method will be used when giving relief for tax imposed on income derived by a resident of one of the countries from sources in the other country.[136] The Netherlands usually applies 2 methods, i.e. the credit method and the "proportional credit method".[137] The credit method, under which the foreign tax is credited against the Dutch tax, usually only applies to dividends, interest and royalties. The Dutch Government also wishes to use this method with respect to foreign-source income derived by artistes and athletes, lump-sum payments in lieu of pension rights and capital gains derived from the sale of shares.

The credit is usually limited to a certain maximum which may be:
(i) the formula which is often found in the "older" tax treaties concluded by the Netherlands under which the maximum reduction equals the average Dutch income tax attributable to that income. See, for instance, the treaties concluded with Australia [Art. 23(1)]; Austria [Art. 24(2)]; Belgium [Art. 24(1)(c)]; Czechoslovakia [Art.25(3)]; Denmark [Art. 22(2)]; Finland [Art. 25(3)]; France [Art. 24(A)(2)]; Indonesia [Art. 24(3)]; Ireland [Art. 22(2)]; Japan [Art. 24(2)(c)]; Korea [Art. 23(3)]; Luxembourg [Art. 23(2)]; Malta [Art. 25(3)]; Morocco [Art. 24(A)(3)]; Poland [Art. 24(3)]; Romania [Art. 25(3)]; South Africa [Art.24(2)]; Spain [Art. 25(2)]; Surinam [Art. 24(3)]; Sweden [Art. 26(2)]; Thailand [Art. 23(3)] and Zambia [Art. 22(3)]; or (ii) the more recently concluded treaties which limit the amount of reduction of Dutch income tax to the amount which would have been granted if the "proportional credit method" had been applied. See, for instance, the treaties concluded with Canada [Art. 22(3)]; China (PR) [Art. 23(1)(c)]; Greece [Art. 25(A)(3)]; Hungary [Art. 24(3)]; New Zealand [Art. 22(3)]; Pakistan [Art. (22(3)]; Sri Lanka [Art. 23(3)]; Turkey [Art. 23(2)(c)] and Yugoslavia [Art. 23(3)].

Currently, 3 major issues exist which the Dutch Government endeavours to resolve under tax treaty provisions:

1. *Prevention of the double imposition of net wealth tax*

The Netherlands imposes a tax on the net wealth of individual persons as a supplement to the individual income tax.[138] The taxable basis is the value of property situated in the Netherlands and abroad minus liability. The Dutch unilateral measures for the prevention of double taxation and most tax treaties contain a provision under which tax relief is available for certain qualifying property situated abroad. This relief is granted using the "proportional credit method," also applicable to income tax.[139]

In a number of cases the Dutch Supreme Court has held that when computing treaty relief the gross value of the foreign-situs property must be used whereas any

133. The provision in the treaty with Yugoslavia only applies to Dutch social security payments.
134. GTTP at 23 – 24.
135. GTTP at 24 – 25.
136. See Dutch Model, Art. 24.
137. For a discussion, see text at III above.
138. The underlying philosophy is that persons who own property have a greater taxable capacity than persons who do not own property. Under the provisions of the IB, no differentiation is made between earned income and income from investment in that the latter is more heavily taxed. The differentiation is made through imposition of the annual net wealth tax at the rate of 0.8%. Corporate taxpayers are not subject to net wealth tax. See text at II.C. above.
139. See note 36. Since net wealth tax is levied at a flat rate this method results in an exemption of qualifying property situated abroad.

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liabilities connected with such property can only reduce the value of total property.[140] Although this manner of computation is consistent with the system of Dutch net wealth tax, the Dutch Government feels it offers an undue advantage to taxpayers especially when foreign-situs property is financed through mortgage loans.[141] The Dutch Government, therefore, attempts to include a clause in tax treaties under which mortgage loans will be deductible from the value of foreign-situs property for purposes of computing the foreign net wealth relief. A provision to this effect can be found in the treaty concluded with Hungary [Protocol ad Art. 24].

2. *The "WIR" premium*[142]

Dutch law contains no general tax incentives which reduce taxable income, such as accelerated depreciation or investment allowances. Prior to 29 February 1988, however, an investment *subsidy* was granted in the form of a premium ("WIR"-premium) increased by a number of special bonuses.[143] The "WIR" premium was abolished on 29 February 1988 and only the "small-scale investment" bonus has been maintained.

The subsidy was a function of the cost of investment in qualifying assets and was only available if, within one year, qualifying investments exceeded 2,900 Dfl.[144] The premium and bonuses were granted in the form of tax credits. However, if in any given year subsidized assets were alienated for a value exceeding 2,900 Dfl., a "disinvestment payment" had to be made equal to the percentage of investment credit which had been granted for those assets applied to the sales price. This disinvestment payment was generally only imposed if the alienation occurred within 8 years after the beginning of the year in which the assets were acquired.

The balance of the tax credit and disinvestment payments reduced or increased the taxpayer's income tax liability. If the credit exceeded the income tax liability, a carry-back of 3 years and a carry-forward of 8 years was accorded.

Generally speaking, the Dutch system of granting investment incentives was a well-designed and highly sophisticated system. It had, however, a disadvantage in international relationships where another country granted tax relief in the form of a credit for income tax imposed in the Netherlands on Dutch-source income. In such a case the advantage offered by the Netherlands in the form of a tax reduction would be absorbed by the corresponding lower credit in the other country. Thus, when negotiating a tax treaty with a country which used the credit method to grant tax relief the Netherlands generally attempted to persuade the treaty partner to ignore the effect of the "WIR" premium on Dutch tax liability. In at least one instance, the Netherlands has succeeded; see Art. 23(1)(c) of the treaty concluded with Turkey.[145]

Although abolition of the "WIR" premium (except the small-scale investment bonus) apparently removes the above problems to a large extent it is somewhat premature to indicate the effects on future Dutch tax treaty negotiations.

3. *The profit share of oil and gas companies*

Companies deriving income from the extraction of oil or natural gas on the Dutch portion of the Continental Shelf are subject to a "production profit tax" at the rate of 70% or 50%, as the case may be. This tax is levied in addition to corporate income tax but the latter may be credited against the corporate income tax.

The Dutch Government wishes any treaty partner to recognize the "production profit tax" as an income tax for which relief should be available in the treaty country. Examples are the treaties concluded with Canada [Art. 2(3)], China (PR) [Art. 2(3)], Malaysia [Art. 2(1)] and Turkey [Art. 2(3)].

J. Exchange of information[146]

Tax treaties generally serve not only as a means to prevent international double taxation but also to afford the tax authorities of the contracting countries the possibility of detecting tax evasion and tax fraud through mutual consultation and the exchange of information. The provisions of the 1977 OECD Model Convention offer a useful guideline to the Dutch Government.

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140. The Supreme Court rendered 3 decisions all dated 20 April 1983 in which it held that under the treaties with the Federal Republic of Germany, Switzerland and the United States, the gross value of foreign-situs property must be taken for purposes of the computation of net wealth tax relief. For a discussion of these cases, see "Relief for the Avoidance of Double Taxation", 23 *European Taxation* 12 (1983) at 400.

141. This may be illustrated by the following simplified example. Assume taxpayer A owns real property in the Netherlands with a value of 5,000,000 Dfl. Assume also that A purchased real property situated in a treaty country with a value of 2,000,000 Dfl. To partially finance the purchase of the foreign-situs real property, A took a mortgage loan of 1,000,000 Dfl. using the foreign-situs real property as collateral. Net wealth tax on his total property (disregarding any deductions available to the taxpayer) would be (5,000,000 + 2,000,000 – 1,000,000) × 0.8% = 48,000 Dfl. Under the theory developed by the Supreme Court the relief for foreign-situs real property is:

$$\frac{2{,}000{,}000}{7{,}000{,}000 - 1{,}000{,}000} \times 48{,}000 = 16{,}000 \text{ Dfl.}$$

In other words A's total tax liability is 48,000 – 16,000 = 32,000 Dfl.
In the opinion of the Dutch Government a more equitable result would be reached if the relief were computed in the following manner:

$$\frac{2{,}000{,}000 - 1{,}000{,}000}{7{,}000{,}000 - 1{,}000{,}000} \times 48{,}000 = 8{,}000 \text{ Dfl.}$$

Total tax liability would be 48,000 – 8,000 = 40,000 Dfl.

142. For a discussion, see GET-II, Chapter Netherlands, Sec. 2.3.5.

143. The rate for the basic premium was 12.5%. In addition, a degressive "small scale investment" bonus was available increasing the basic premium by a number of percentage points. This bonus ran from 6 percentage points for investments between 2,900 Dfl. and 49,000 Dfl., to 0.25 percentage points for investments between 1,106,000 Dfl. and 1,154,000 Dfl. No bonus was available for investments exceeding 1,154,000 Dfl.

144. Most assets qualify; non-qualifying assets include land, dwelling-houses, private motorcars and securities (shares and bonds).

145. In fact the Netherlands is requesting that a tax-sparing provision be included in the tax treaty. See IV.C.5 above.

146. GTTP at 25. See Van Raad, K. and Milders, E., "Uitwisseling van inlichtingen in de Nederlandse belastingverdragen en de verhouding daarvan tot andere regelingen", *MBB Belastingbeschouwingen* 3 (1988) at 58.

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A law was enacted in 1986[147] which provided the legal basis for the international exchange of information in the field of taxation thereby closing a gap in Dutch legislation which had prevented the Netherlands from properly fulfilling its obligations under the EC Directive on Mutual Assistance and tax treaties.[148] This law aims to furnish administrative assistance by supplying information to the tax authorities of EC or tax treaty countries to ensure a correct assessment of taxes due. The information may be provided automatically or spontaneously upon request of the foreign tax authorities. The law also provides for a procedure to protect the rights of the taxpayer. Generally, the tax authorities must notify the taxpayer that information will be supplied to foreign tax authorities and allow him 30 days in which to lodge his objections. The taxpayer may also go to Court to attempt to reverse the decision of the tax authorities.[149] The law indicates on which grounds the exchange of information may be refused, i.e. the information requested does not fall within the scope of the Dutch international obligations under the EEC Directive or under tax treaties; it is contrary to Dutch public policy; the information is neither available nor obtainable under the Dutch law or administrative practice with respect to the tax involved; the foreign tax authorities have not exhausted their methods of obtaining the requested information; the foreign tax authorities are unable to reciprocate and supply similar information to the Dutch tax authorities; the information would reveal commercial, industrial or professional secrets; or official secrecy is not safeguarded.

In March 1988, the Council of Europe and the OECD approved the Multi-National Convention on Mutual Administrative Assistance in Tax Matters and it seems at least possible that the Netherlands will ratify this treaty in the future. If a sufficient number of countries also ratify the treaty, a powerful tool will have been created to combat tax evasion.

The Dutch Government is also of the opinion that the exchange of information provisions should not be applied if a criminal investigation procedure has been started. Such a procedure falls under the competence of the Minister for Justice and has been regulated in treaties for mutual assistance in criminal cases. The tax treaty provisions concerning mutual consultation (the mutual agreement procedure) contain a number of clauses which indicate under which conditions the tax authorities of the treaty partners may initiate a consultation procedure but these clauses do not provide for a certain period of time in which the consultation should be completed nor do they guarantee taxpayers that the tax authorities of the 2 countries will reach a compromise.[150] Consultation procedures may, therefore, take a considerable period of time. For practical reasons, the Dutch Government advocates invoking arbitration in such cases.

147. Law of 24 April 1986, concerning the international assistance with regard to the collection of taxes. See Salomons, C., "Exchange of information", 26 *European Taxation* 8 (1986) at 262. See also Wisselink, M.A.; "Informatieplicht ingevolge artikel 47 AWR in internationale verhoudingen: Heroverweging nodig? En informatieuitwisseling op grond van de WIB", *MBB Belastingbeschouwingen* 3 (1988) at 72, 79.
148. Directive of the Council of the European Communities of 19 December 1977 No. 77/799/EEC, *Official Journal of the European Communities* 1977, L 336.
149. However, if compelling reasons exist, the Dutch tax authorities may supply the information within the 30-day period and may postpone notification to the taxpayer until 120 days after the decision has been made.
150. 1977 OECD Model, Art. 25.

APPENDIX I

LIST OF TAX TREATIES

1. Comprehensive income tax treaties which are in force

The Netherlands has concluded comprehensive income tax treaties with the following countries: Australia; Austria; Belgium; Canada; China (PR); Czechoslovakia; Denmark; Finland; France; Germany (Federal Republic of); Greece; Hungary; Ireland; Indonesia; Israel; Italy; Japan; Korea (South); Luxembourg; Malta, Morocco; Malawi; New Zealand; Norway; Pakistan; Poland; Romania; Singapore; South Africa; Spain; Sri Lanka; Surinam; Sweden; Switzerland; Thailand; U.S.S.R.; United Kingdom; United States; Yugoslavia and Zambia. Special provisions which take the form of a tax treaty apply to the Netherlands Antilles and Aruba.

2. Existing treaties regarding international shipping and/or air transport

The Netherlands has concluded tax treaties with respect to income derived from international shipping and air transport with Argentina; from international air transport with Egypt; and from international shipping with Mexico.

3. New treaties which have been concluded but which are not yet effective

The Netherlands has concluded tax treaties with Malaysia and Turkey but both treaties still require ratification. Similarly, a protocol amending the tax treaty with the United Kingdom awaits ratification.

4. New treaties whose text has been initialled

In a number of cases new tax treaties have been prepared by treaty negotiators and have reached a stage in which the delegates of the contracting parties have reached agreement and have initialled the treaty. However, these treaties still require approval from the Dutch Parliament. These treaties are new revised treaties with Italy and Norway, new treaties with the Philippines and Zimbabwe, and amending protocols to the treaties with Indonesia and the United Kingdom.

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APPENDIX II

DUTCH MODEL DOUBLE INCOME TAX CONVENTION

CONVENTION BETWEEN THE KINGDOM OF THE NETHERLANDS AND . . . FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

The Government of the Kingdom of the Netherlands

and

the Government of . . .,

Desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital,

Have agreed as follows:

CHAPTER I
Scope of the Convention

Article 1
Personal scope

This Convention shall apply to persons who are residents of one or both of the States.

Article 2
Taxes covered

1. This Convention shall apply to taxes on income imposed on behalf of one of the States or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are, in particular:
(a) in the case of the Netherlands:
- income tax (de inkomstenbelasting);
- wages tax (de loonbelasting);
- company tax (de vennootschapsbelasting); including the Government share in the net profits of the exploitation of natural resources levied pursuant to the Mining Act of 1810 (Mijnwet 1810) with respect to concessions issued from 1967, or pursuant to the Netherlands Continental Shelf Mining Act of 1965 (Mijnwet Continental Plat 1965);
- dividend tax (de dividendbelasting);
- capital tax (de vermogensbelasting);

(hereinafter referred to as "Netherlands tax").

(b) in the case of . . .:
(hereinafter referred to as ". . . ."

4. The Convention shall also apply to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the States shall notify each other of any substantial changes which have been made in their respective taxation laws.

CHAPTER II
Definitions

Article 3
General Definitions

1. For the purposes of this Convention unless the context otherwise requires:
(a) the term "State" means the Netherlands or ..., as the context requires: the term "States" means the Netherlands and ...;
(b) the term "the Netherlands" means the part of the Kingdom of the Netherlands that is situated in Europe, including the part of the sea bed and its sub-soil under the North Sea, to the extent that area in accordance with international law has been or may hereafter be designated under Netherlands laws as an area within which the Netherlands may exercise certain rights with respect to the exploration and exploitation of the natural resources of the sea bed or its sub-soil;
(c) the term ... means ...;
(d) the term "person" includes an individual, a body corporate and any other body of persons;
(e) the term "company" means any legal entity or any entity which is treated as a legal entity for tax purposes;
(f) the terms "enterprise of one of the States" and "enterprise of the other State" mean respectively an enterprise carried on by a resident of one of the States and an enterprise carried on by a resident of the other State;
(g) the term "international traffic" means any transport by a ship or an aircraft operated by an enterprise which has its place of effective management in one of the States, except when the ship or aircraft is operated solely between places in the other State;
(h) the term "nationals" means:
1. any individual possessing the nationality of one of the States;
2. any legal entity, partnership and association deriving its status as such from the laws in force in one of the States;
(i) the term "competent authority" means:
(i) in the Netherlands, the Minister of Finance or his duly authorized representative;
(ii) in ....

2. As regards the application of this Convention by one of the States any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Article 4
Residence

1. For the purposes of this Convention, the term "resident of one of the States" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both States, then his status shall be determined as follows:
(a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
(b) if the State in which he has his centre of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
(d) if he is a national of both States or of neither of them, the competent authorities of the States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

Article 5
Permanent establishment

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

2. The term "permanent establishment" includes especially:
(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;
(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site, or a construction or assembly project constitutes a permanent establishment only if it lasts more than ... months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

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(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

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

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

CHAPTER III
Taxation of income

Article 6
Income from immovable property

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

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

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

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

Article 7
Business profits

1. The profits of an enterprise of one of the States shall be taxable only 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 that permanent establishment.

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

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment – including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. In so far as it has been customary in a Contracting State to determine the profit to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

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

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

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

Article 8
Shipping and air transport

1. Profits of an enterprise of one of the States from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. If the place of effective management of a shipping enterprise is aboard a ship, then it shall be deemed to be situated in the State in which the home harbour of the ship is situated, or, if there is no such home harbour, in the State of which the operator of the ship is resident.

3. For the purposes of this article, profits derived from the operation of ships or aircraft in international traffic include profits from the rental of ships and aircraft without crew if these ships and aircraft are operated in international traffic and in so far as these profits ensue from profits defined in paragraph 1.

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

Article 9
Associated enterprises

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

It is understood, however, that the fact that associated enterprises have concluded arrangements, such as cost sharing arrangements or general service agreements, for or based on the allocation of executive, general administrative, technical and commercial expenses, expenses for research and development and other similar expenses is not in itself a condition as meant in the preceding sentence.

2. Where one of the States includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the States shall if necessary consult each other.

Article 10
Dividends

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

2. However, such dividends may also be taxed in the State of which the company paying the dividends is a resident and according to the laws of that State, but if the recipient is the beneficial owner of the dividends, the tax so charged shall not exceed ...% of the gross amount of the dividend.

3. The State of which the company is resident may – notwithstanding the provisions of paragraph 2 – not charge any tax on dividends distributed by that company to a company the capital of which is divided into shares and which is a resident of the other State and which directly or indirectly holds at least 25 % of the capital of the company paying the dividend.

4. The competent authorities of the States shall by mutual agreement settle the mode of application of paragraph 2 and 3.

5. The provisions of the paragraphs 2 and 3 shall not affect the taxation of the companies in respect of the profit from which the dividend was paid.

6. The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights participating in profits, as well as income from debt claims participating in profits as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

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7. The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the dividend being a resident of one of the States, carries on business in the other State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

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

Article 11
Interest

1. Interest arising in one of the States and paid to a resident of the other State may only be taxed in that other State if the recipient is the beneficial owner of the interest.

2. The competent authorities of the States shall by mutual agreement settle the mode of application for the waiver of the tax.

3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage but excluding those which carry a right to participate in the debtors' profits, and in particular, income from Government loans and income from bonds or debentures, including premiums attaching to such loans, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for purposes of this Article.

4. The provisions of paragraphs 1 shall not apply if the beneficial owner of the interest, being a resident of one of the States, carries on business in the other State in which the interest arises, through a permanent establishment situated therein, or performs in the other State independent personal services from a fixed base situated in that State, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

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

Article 12
Royalties

1. Royalties arising in one of the States and paid to a resident of the other State shall be taxable only in that other State if such resident is the beneficial owner of the royalties.

2. The competent authorities of the States shall by mutual agreement settle the mode of application for the waiver of the tax.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use of, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

4. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of one of the States, carries on business in the other State in which the royalties arise, through a permanent establishment situated therein, or performs in the other State independent personal services from a fixed base situated in that State, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

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

Article 13
Capital gains

1. Gains derived by a resident of one of the States from the alienation of immovable property referred to in Article 6 and situated in the other State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of one of the States has in the other State or of movable property pertaining to a fixed base available to a resident of one of the States in the other State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains derived by an enterprise of one of the States from the alienation of ships or aircraft operated in international traffic, or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the State where the place of effective management of the enterprise is situated. The provisions of paragraph 2 of Article 8 shall be applicable.

4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the State of which the alienator is a resident.

5. The provisions of paragraph 4 shall not affect the right of each of the States to levy according to its own law a tax on gains from the alienation of shares or "jouissance" rights in a company, the capital of which is wholly or partly divided into shares and which under the laws of that State is a resident of that State, derived by an individual who is a resident of the other State and has been a resident of the first-mentioned State in the course of the last five years preceding the alienation of the shares or "jouissance" rights.

Article 14
Independent personal services

1. Income derived by a resident of one of the States in respect of professional services or other activities of an independent character shall be taxable only in that State unless he has a fixed base regularly available to him in the other State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other State but only so much as is attributable to that fixed base.

2. The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15
Dependent personal services

1. Subject to the provisions of Articles 16, 18, 19 and 20, salaries, wages and other similar remuneration derived by a resident of one of the States in respect of an employment shall be taxable only in that State unless the employment is exercised in the other State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of one of the States in respect of an employment exercised in the other State shall be taxable only in the first-mentioned State if:
(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the tax year of that State, and
(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of one of the States in respect of an employment exercised aboard a ship or aircraft operated in international traffic, may only be taxed in that State.

Article 16
Directors' fees

Directors' fees or other remuneration derived by a resident of one of the States in his capacity as a member of the board of directors, a "bestuurder" or a "commissaris" of a company which is a resident of the other State may be taxed in that other State.

Article 17
Artistes and athletes

1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of one of the States as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the State in which the activities of the entertainer or athlete are exercised.

Article 18
Pensions and social security pensions

1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remunera-

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tion paid in consideration of past employment paid to a resident of one of the States shall be taxable only in that State.

2. However, where such remuneration is not of a periodic nature and is paid in consideration of past employment in the other State, it may be taxed in that other State.

3. Pensions and other payments paid out under the provisions of a social security system of one of the States to a resident of the other State may be taxed in the first-mentioned State.

Article 19
Government service

1. (a) Remuneration, not including pensions, paid by one of the States or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or authority thereof may be taxed in that State.

(b) However, such remuneration shall be taxable only in the other State if the services are rendered in that State and the individual is a resident of that State who:
   1. is a national of that State; or
   2. did not become a resident of that State solely for the purpose of rendering the services.

2. (a) Any pension paid by, or out of funds created by a State or political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or local authority shall be taxable in that State.

(b) However, such pension shall be taxable only in the other State if the individual is a resident of and a national of that State.

(c) The provisions of Articles 15, 16 and 18 shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a State or a political subdivision or a local authority thereof.

Article 20
Professors and teachers

1. Payments which a professor or teacher who is a resident of one of the States and who is present in the other State for the purpose of teaching or scientific research for a maximum period of two years in a university, college or other establishment for teaching or scientific research in that other State, receives for such teaching or research, shall be taxable only in the first-mentioned State.

2. This Article shall not apply to income from research if such research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

Article 21
Students

Payments which a student or a business apprentice who is or was immediately before visiting one of the States a resident of the other State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Article 22
Other income

1. Items of income of a resident of one of the States, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of one of the States, carries on business in the other State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

CHAPTER IV
Taxation of capital

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 by movable property pertaining to the operation of such ships and aircraft, shall be taxable only in the State in which the place of effective management of the enterprise is situated. The provisions of paragraph 2 of Article 8 shall be applicable.

4. All other elements of capital of a resident of a State shall be taxable only in that State.

CHAPTER V
Elimination of double taxation

Article 24
Elimination of double taxation

1. The Netherlands, when imposing tax on its residents, may include in the basis upon which such taxes are imposed the items of income or capital which, according to the provisions of this Convention, may be taxed in ....

2. However, where a resident of the Netherlands derives items of income or owns items of capital which according to Article 6, Article 7, paragraph 7 of Article 10, paragraph 4 of Article 11, paragraph 4 of Article 12, paragraphs 1 and 2 of Article 13, Article 14, paragraph 1 of Article 15, Article 16, paragraph 3 of Article 18, paragraph 1 subparagraph a and paragraph 2 subparagraph a of Article 19, paragraph 2 of Article 22 and paragraphs 1 and 2 of Article 23 of this Convention may be taxed in ... and are included in the basis referred to in paragraph 1, the Netherlands shall exempt such items of income or capital by allowing a reduction of its tax. This reduction shall be computed in conformity with the provisions of Netherlands law for the avoidance of double taxation. For that purpose the said items of income shall be deemed to be included in the total amount of the items of income which are exempt from Netherlands tax under those provisions.

3. Further, the Netherlands shall allow a deduction from the Netherlands tax so computed for the items of income which according to paragraph 2 of Article 10, paragraph 5 of Article 13, Article 17 and paragraph 2 of Article 18 of this Convention may be taxed in ... to the extent that these items are included in the basis referred to in paragraph 1. The amount of this deduction shall be equal to the tax paid in ... on these items of income, but shall not exceed the amount of the reduction which would be allowed if the items of income so included were the sole items of income which are exempt from Netherlands tax under the provisions of Netherlands law for the avoidance of double taxation.

4. (Elimination of double taxation by ...). For the purposes of this paragraph in determining the taxes on income paid to the Netherlands, the investment premiums and bonuses and disinvestment payments as meant in the Netherlands Investment Account Law (Wet Investeringsrekening) shall not be taken into account. For the purposes of this paragraph, the taxes referred to in subparagraph a of paragraph 3 and paragraph 4 of Article 2, with the exception of the capital tax, shall be considered taxes on income.

CHAPTER VI
Special provisions

Article 25
Non-discrimination

1. Nationals of one of the States shall not be subjected in the other State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the States.

2. The taxation of a permanent establishment which an enterprise of one of the States has in the other State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging one of the States to grant to residents of the other State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Except where the provisions of paragraph 1 of Article 9, paragraph 5 of Article 11, or paragraph 5 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of one of the States to a resident of the other 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 one of the States to a resident of the other State shall for the purpose of determining the taxable capital of such enterprise be deductible as if they had been contracted to a resident of the first-mentioned State.

4. Enterprises of one of the States, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind or description.

Article 26
Mutual agreement procedure

1. Where a person of one of the States considers that the actions of one or both of the States

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result or will result for him in taxation not in accordance with this Convention, he may, irrespective of the remedies provided by the national law of those States, present his case to the competent authority of the State of which he is a resident or, if his case comes under paragraph 1 of Article 25, to that of the State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of this Convention.

2. The competent authority shall endeavour, if the objection appears to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other State, with a view to the avoidance of taxation not in accordance with the Convention. Notwithstanding any time limits in the domestic law of the States, any agreement reached shall be implemented.

3. The competent authorities of the States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

Article 27
Exchange of information

1. The competent authorities of the States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1. Any information received by one of the States shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the States the obligation:

(a) to carry out administrative measures at variance with the laws and the administrative practice of that or of the other State;
(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other State;
(c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

Article 28
Diplomatic agents and consular officers

1. Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

2. For the purposes of the Convention an individual, who is a member of a diplomatic or consular mission of one of the States in the other State or in a third State and who is a national of the sending State, shall be deemed to be a resident of the sending State if he is subjected therein to the same obligations in respect of taxes on income and capital as are residents of that State.

3. The Convention shall not apply to international organizations, organs and officials thereof and members of a diplomatic or consular mission of a third State, being present in one of the States, if they are not subjected therein to the same obligations in respect of taxes on income and capital as are residents of that State.

Article 29
Territorial extension

1. This Convention may be extended, either in its entirety or with any necessary modifications, to Aruba and/or the Netherlands Antilles provided that the territory concerned imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed in notes to be exchanged through diplomatic channels.

2. Unless otherwise agreed the termination of the Convention shall not terminate the extension of the Convention to any territory to which it has been extended under this Article.

CHAPTER VII
Final provisions

Article 30
Entry into force

This Convention shall enter into force on the thirtieth day after the latter of the dates on which the respective Governments have notified each other in writing that the formalities constitutionally required in their respective States have been complied with, and its provisions shall have effect for taxable years and periods beginning on or after the first day of January in the calendar year following that in which the latter of the notifications has been received.

Article 31
Termination

This Agreement shall remain in force until terminated by one of the Contracting Parties. Either Party may terminate the Agreement, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the expiration of a period of five years from the date of its entry into force. In such event the Convention shall cease to have effect for taxable years and periods beginning after the end of the calendar year in which the notice of termination has been given.

IN WITNESS WHEREOF the undersigned, duly authorized thereto, have signed this Convention.

DONE at ... this day of ... 19.. in the Dutch, the ... and the English language, which are equally authentic. In case there is any divergence of interpretation between the Dutch and the ... text, the English text shall prevail.

For the Government of the Kingdom of the Netherlands:

For the Government of ...

PROTOCOL

At the moment of signing the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, this day concluded between the Kingdom of the Netherlands and ... the undersigned have agreed that the following provisions shall form an integral part of the Convention.

I. Ad Article 4

An individual living aboard a ship without any real domicile in either of the States shall be deemed to be a resident of the State in which the ship has its home harbour.

II. Ad Article 7

In respect of paragraphs 1 and 2 of Article 7, where an enterprise of one of the States sells goods or merchandise or carries on business in the other State through a permanent establishment situated therein, the profits of that permanent establishment shall not be determined on the basis of the total amount received by the enterprise, but shall be determined only on the basis of the remuneration which is attributable to the actual activity of the permanent establishment for such sales or business. Especially, in the case of contracts for the survey, supply, installation or construction of industrial, commercial or scientific equipment or premises, or of public works, when the enterprise has a permanent establishment, the profits of such permanent establishment shall not be determined on the basis of the total amount of the contract, but shall be determined only on the basis of that part of the contract which is effectively carried out by the permanent establishment in the State where the permanent establishment is situated. The profits related to that part of the contract which is carried out by the head office of the enterprise shall be taxable only in the State of which the enterprise is a resident.

III. Ad Articles 10, 11 and 12

Where tax has been levied at source in excess of the amount of tax chargeable under the provisions of Articles 10, 11 and 12, applications for the refund of the excess amount of tax have to be lodged with the competent authority of the State having levied the tax, within three years after the expiration of the calendar year in which the tax was levied.

IV. Ad Article 24

It is understood that for the computation of the reduction mentioned in paragraph 2 of Article 24, the items of capital referred to in Article 23 shall be taken into account for the value thereof reduced by the value of the debts secured by mortgage on that capital and the items of capital referred to in paragraph 2 of Article 23 shall be taken into account for the value thereof reduced by the value of the debts pertaining to the permanent establishment or fixed base.

IN WITNESS WHEREOF the undersigned, duly authorized thereto, have signed this Protocol.

DONE at ... this day of ... 19.. in the Dutch, the ... and the English language, which are equally authentic. In case there is any divergence of interpretation between the Dutch and the ... text, the English text shall prevail.

For the Government of the Kingdom of the Netherlands:

For the Government of ...

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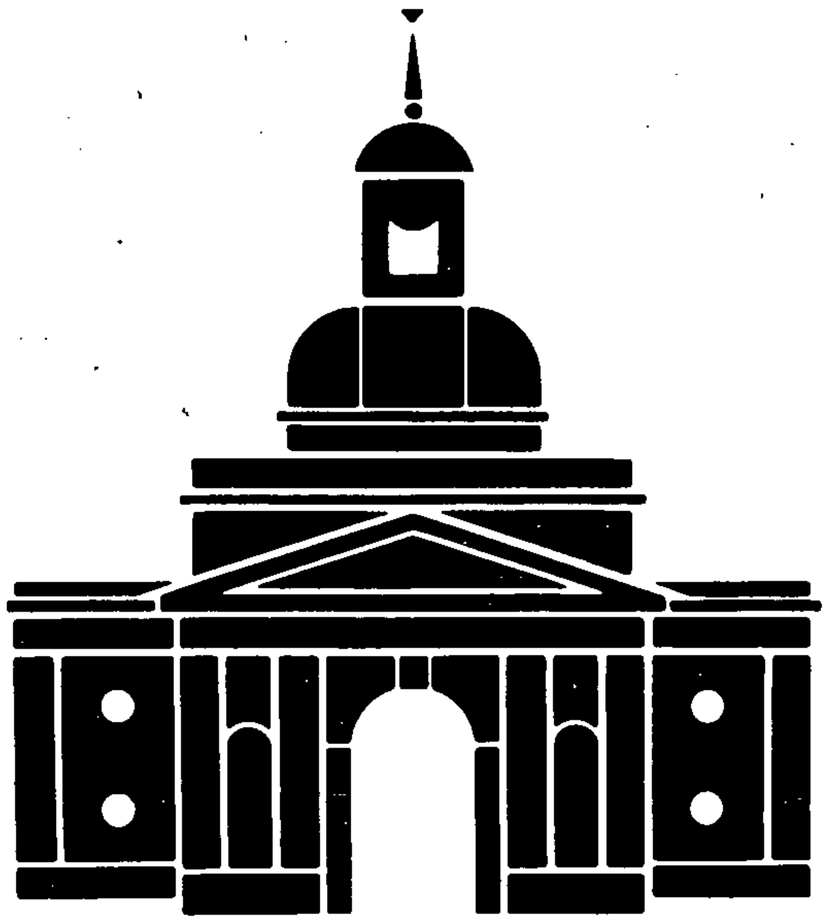

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PEOPLE'S REPUBLIC OF CHINA: TAXATION OF PRIVATE BUSINESS AND PRIVATE INVESTORS 415
In July 1988 the first national legislation governing private enterprises and income taxation on private enterprises became effective. This article surveys the permissible forms of private business activities in China and the various laws regulating such activities. In addition, the author has provided an English translation of the new legislation.

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A. Lapidoth:

ISRAEL: "ADMINISTRATIVE OFFENCES" IN AID OF TAX ENFORCEMENT 421
A controversial new measure was introduced into the Israeli tax system in 1987, i.e. the imposition of administrative fines for offences referred to as "administrative offences". Professor Lapidoth examines the main features of the Administrative Offences Law and evaluates its effectiveness as a measure to check non-compliance.

M.M. Sury:

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Customs, excise duties and sales tax comprise the core of the Indian tax system. In this article, the author highlights the salient features of these 3 taxes, including the revenue significance, commodity coverage, rate structure and exemptions and concessions.

Maximo Bomchil, Jr. and Marcelo E. Bombau:

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The author briefly describes the procedure for debt-equity swaps in Ecuador.

NEW ZEALAND: FINAL REPORT OF THE CONSULTATIVE COMMITTEE ON FULL IMPUTATION AND INTERNATIONAL TAX REFORM 441
On 28 July 1988 the second and final report of the Consultative Committee on Full Imputation and International Tax Reform was released together with draft legislation. The text of the report and an introductory statement by the Minister of Finance and the Minister of Revenue is reproduced below.

J.S. Uppal:

INDONESIA: CENTRAL TRANSFERS AND LOCAL FINANCES 448
Indonesian fiscal structure is characterized by a high degree of centralization. An analysis of central government outlays and grants to the provincial and local governments demonstrates that the outlays have a negative correlation with the level of per capita GRDP and extent of poverty in various provinces, thus helping to reduce regional disparities; central grants do not reward provinces with higher tax effort; and central transfers are negatively correlated with provincial expenditures on essential services, thus equalizing provision of these services in the country.

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Le rapport annuel du Professeur Dr. Jan H. Christiaanse est brièvement présenté ici. Il faut noter parmi les sujets de ce rapport, le 50ème anniversaire de l'IFA, le Livre du Jubilé, le Livre des Résolutions, la Première Conférence Régionale en Asie du Sud-est et les événements du 41ème Congrès de l'IFA qui s'était tenu à Bruxelles en septembre 1987.

Li Jinyan:

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La première législation nationale régissant les entreprises privées et leur imposition sur le revenu est entrée en vigueur en juillet 1988. Cet

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IFA Mitteilungen:

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Kurze Zusammenfassung des letzten Jahresberichtes, der dem IFA-Kongress durch Prof. Dr. J. Christiaanse angeboten wird. Die Themen, welche behandelt werden, sind der 50. Geburtstag der IFA, das Jubileumbuch, das Resolutionenbuch, die Erste Regionale Steuer-Konferenz in Südostasien und die Ereignisse des 41. IFA-Kongresses in Brüssel im September 1987.

Li Jinyan:

Volksrepublik China: Die Besteuerung der Privatunternehmen und Privatinvestoren 415
Im Juli 1988 trat die erste nationale Gesetzgebung mit Bezug auf Privatunternehmen und die Besteuerung ihrer Einkommen in Kraft.

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article résume les formes autorisées d'activités commerciales privées en Chine ainsi que les différentes lois régissant de telles activités. L'auteur a traduit en anglais cette nouvelle législation.

Carnet des Congrès *420*

A. Lapidoth:

Israël: Fautes administratives et imposition *421*
Une nouvelle disposition discutable a été introduite en 1987 dans le système fiscal israëlien, à savoir, l'imposition des amendes administratives pour fautes qualifiées de "fautes administratives". Monsieur le Professeur Lapidoth analyse les principaux points de la Loi sur les Fautes Administratives et évalue son efficacité en tant que mesure destinée à freiner la non-obéissance.

M.M. Sury:

Inde: Structure et réforme des impôts indirects *424*
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Maximo Bomchil, Jr. et Marcelo E. Bombau:

Le programme de conversion de la dette extérieure argentine en actions *434*
Le programme de conversion argentine de dettes en actions est prévu afin d'assurer que, dans les 5 années qui viennent, 1900 millions de $ US de dette argentine extérieure publique et privée soient convertis en investissements productifs. Cet article analyse les points particuliers du programme de conversion de dettes en actions, à savoir: les investissements possibles, les conditions de participation aux ventes publiques, les conversions des fonds et les aspects fiscaux des conversions.

Edgar L. Naranjo:

Equateur: Conversion de la dette extérieure *440*
L'auteur décrit brièvement la procédure de conversion des dettes en actions en Equateur.

Nouvelle Zélande: Rapport définitif du Comité Consultatif sur l'Imputation Totale et la Réforme Fiscale Internationale *441*
Le deuxième rapport (et version définitive) du Comité Consultatif sur l'Imputation Totale et la Réforme Fiscale Internationale a été publié le 28 juillet 1988 en même temps que le projet de loi. Le texte du rapport ainsi que l'introduction du Ministre des Finances et du Ministre des Contributions est reproduit ci-dessous.

J.S. Uppal:

Indonésie: Transferts exécutés par le gouvernement central et les finances locales *448*
La structure fiscale indonésienne se caractérise par une importante centralisation. Une analyse des dépenses et allocations du gouvernement central en faveur des gouvernements provinciaux et locaux montre que les dépenses sont dans un rapport négatif avec le niveau du produit social brut par personne et le degré de pauvreté des différentes provinces, et ne réduisent pas les disparités régionales. Les subventions du gouvernement central ne récompensent pas les provinces fournissant les plus hauts revenus fiscaux. Il existe également un rapport négatif entre le niveau des transferts financiers du gouvernement central et les dépenses provinciales correspondant aux services de première nécessité, nivelant ainsi ces dépenses dans le pays.

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Dieser Artikel gibt eine Übersicht der zugelassenen Formen von privaten Geschäftsaktivitäten in China und der verschiedenen Gesetze, die solche Aktivitäten regulieren. Der Autor gibt zusätzlich eine englische Übersetzung des neuen Gesetzes.

Veranstaltungskalender *420*

A. Lapidoth:

Israel: „Administrative Vergehen" als Hilfsmittel zur Steuererhebung *421*
Im Jahre 1987 wurde im israelischen Steuersystem eine kontroversielle Massnahme eingeführt, mit deren Hilfe administrative Geldstrafen für sogenannte „administrative Vergehen" auferlegt werden können. Herr Professor Lapidoth untersucht die wichtigsten Merkmale des Administrativen Vergehensgesetzes und evaluiert, in wie weit dieses Gesetz effektiv ist, Steuerzahler dazu zu veranlassen, ihren Steuerverpflichtungen nachzukommen.

M.M. Sury:

Indien: Struktur und Reform der indirekten Steuern *424*
Zölle und Akzisen sowie die Verkaufssteuer bilden den Kern des indischen Steuersystems. Der Autor fasst die wichtigsten Merkmale dieser drei Steuern zusammen und beschreibt dabei ihre Bedeutung für das föderale Budget, die Güter, welche den Steuern unterliegen, die Satzstruktur und die Befreiungen und Ermässigungen, die gewährt werden.

Maximo Bomchil Jr. und Marcelo E. Bombau:

Argentinien: Das Programm für die Konversion von Schulden in Kapitalbeteiligungen *434*
Das argentinische Programm für die Konversion von Schulden in Kapitalbeteiligungen hat zum Ziel, innerhalb der nächsten fünf Jahre eine argentinische ausländische Staats- und Privatschuld von US$ 1,900 Millionen in produktiven Investierungen zu verwandeln. Dieser Artikel analysiert die besonderen Merkmale dieses Programmes, die zugelassenen Investierungen, die Bedingungen, welche für die Teilnahme in Auktionen gelten, die Konversion der Gelder und die Besteuerung solcher Konversionen.

Edgar L. Naranjo:

Ecuador: Die Konversion von Schulden in Kapitalbeteiligungen *440*
Der Verfasser gibt eine kurze Beschreibung des Verfahrens für die Konversion von Schulden in Kapitalbeteiligungen in Ecuador.

Neuseeland: Abschlussbericht des Beratungsausschusses bezüglich der Völligen Steuerverrechnung und der Internationalen Steuerreform *441*
Der zweite und letzte Bericht des *Beratungsausschusses bezüglich der Völligen Steuerverrechnung und der Internationalen Steuerreform* wurden mit dem entsprechenden Gesetzesentwurf am 28. Juli 1988 veröffentlicht. Der Text des Berichts und die einleitenden Bemerkungen des Finanzministers und des Ministers für Staatseinnahmen sind in diesem Heft abgedruckt.

J.S. Uppal:

Indonesien: Transfers der Zentralregierung und lokale Finanzen *448*
Die Struktur der indonesischen Staatsfinanzen wird in hohem Masse von Zentralisierung gekennzeichnet. Wenn man die Regierungsausgaben und Subventionen in Bezug auf die provinzialen und lokalen Verwaltungen analysiert, zeigt sich, dass in den Provinzen eine negative Korrelation zwischen diesen Ausgaben und dem Bruttosozialprodukt pro Kopf der Bevölkerung und dem Stand der Armut besteht. Dadurch werden die regionalen Wohlstandsunterschiede verringert. Die Subventionen der Zentralregierung belohnen jedoch nicht die Provinzen, die die höchste Steuerleistung bieten. Auch gibt es eine negative Korrelation zwischen den Geldmitteltransfers der Zentralregierung und den provinzialen Ausgaben für notwendige Dienstleistungen mit dem Erfolg, dass das Angebot solcher Dienstleistungen im Lande nivelliert wird.

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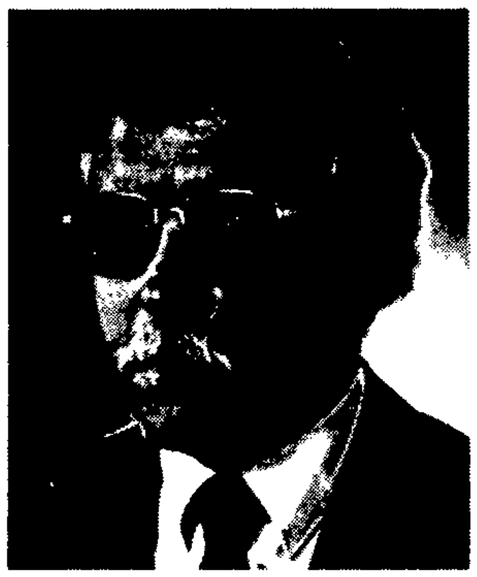
INTERNATIONAL FISCAL ASSOCIATION NEWS

Some Highlights from the Secretary General's 1987/88 Annual Report

Presented at the Amsterdam Congress 1988



PROFESSOR CHRISTIAANSE ANNOUNCES HIS RESIGNATION

At the end of January 1988, Prof. Dr. Christiaanse sent a letter to the President of IFA and its Executive Committee requesting, for health reasons, to be relieved from his functions as Secretary General as of the close of the General Assembly of the Amsterdam Congress (16 September 1988). Prof. Christiaanse served IFA as an Assistant Secretary General in 1968 and as of 1969 as its Secretary General. As an officer of Central IFA, he has always striven to emphasize the international character of the Association. IFA is a unique forum where academicians, top civil servants, independent advisers and fiscal specialists of multinationals can meet. This requires continuous guidance so that these various groups can feel they are represented in IFA.

During IFA's Executive Committee meeting on 13 February 1988 Mr. Pieter den Boer was appointed as Prof. Christiaanse's temporary replacement. Mr. den Boer was awarded the title of Acting Secretary General of IFA and he assumed Prof. Christiaanse's responsibilities during the second half of 1987/88. One of his tasks was to coordinate the efforts to locate a candidate as a successor to Prof. Christiaanse. A Search Committee was formed and a suitable candidate will be presented at the meeting of the General Assembly in Amsterdam.

FIFTIETH ANNIVERSARY OF IFA

The year 1987/88 is marked by the commemoration of the 50th Anniversary of IFA which was founded on 12 February 1938 in The Hague. Prof. Christiaanse organized a jubilee ceremony on 12 February 1988 in the Peace Palace in The Hague which was followed by an official banquet in the "Hall of Knights" (Ridderzaal). Mr. J.W.B. Westerburgen replaced Prof. Christiaanse at the jubilee ceremony.

JUBILEE BOOK

On the occasion of IFA's 50th anniversary, IFA commissioned Mr. Willem Dirksen to write a jubilee book entitled: "IFA 1938-1988". The book describes the goals, procedures and development of IFA and comments on IFA's history. The book was published through IFA's in-house publishers, Kluwer of the Netherlands.

RESOLUTIONS BOOK

In cooperation with its sister organization, the International Bureau of Fiscal Documentation (IBFD), IFA also published a Resolutions Book containing the resolutions adopted by IFA during the past 50 years. This book was initiated by Dr. Raoul Lenz, Chairman of the Permanent Scientific Committee and its compilation and translation (where necessary) were supervised by the IBFD.

REGIONAL CONFERENCE OF IFA

On 18-20 February 1988 IFA held its First Regional Conference in South East Asia. The Conference was organized by the Chairman of the Indian Branch of IFA, Mr. O.P. Vaish. The Permanent Scientific Committee discussed the scientific set-up of this Conference and the proposal to hold such regional conferences was approved by IFA's Executive Committee and its General Council. Approximately 350 persons attended the Conference, deriving from the host country India and its neighbouring countries Bangladesh, Bhutan, Nepal, Pakistan and Sri Lanka. There were also delegates from Australia, France, the Federal Republic of Germany, Hong Kong, Japan, the Netherlands, Sweden and Switzerland. Mr. Richard M. Hammer (Chairman of IFA, U.S.A.) was discussion leader of one of the main subjects: "Direct tax structures with

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particular reference to provisions relating to foreign entities doing business in/with the host country". Dr. Raoul Lenz (Chairman of IFA's Permanent Scientific Committee, Switzerland) was discussion leader on the subject: "Situation vis-à-vis double taxation avoidance treaties". Dr. Leif Muten (Sweden) delivered a key-note address on: "Tax sparing and its practical results".

BLUEPRINT COMMITTEE

An extensive analysis was carried out with respect to the Questionnaire which was sent out to ascertain the wishes of IFA members regarding IFA Congresses. A small Committee was established (the Blueprint Committee) under the Chairmanship of Mr. Raoul Lenz. It appears that delegates wish to have more variety in the choice of seminars and this is already having an impact on the number of seminars to be offered in the future.

BRUSSELS CONGRESS

The Brussels Congress (6-11 September 1987) – IFA's 41st Congress – was attended by 1,184 delegates and 511 accompanying persons. This highly interesting Congress under the Presidency of Prof. Dr. I. Claeys Bouuaert dealt with the following important subjects:

Subject I: *The fiscal residence of companies.* The General Reporter on this subject was Prof. J.M. Rivier (Switzerland). The Chairman of the Working Session was Prof. Dr. P. Sibille (Belgium) and the Discussion Leader Prof. H. Ault (U.S.A.). Ms. A-M. Colaert (Belgium) acted as Secretary to the subject and panelists were Mr. G. Cohen (Australia), Dr. K. van der Heeden (Netherlands), Mr. B.M. Jeffcote (U.K.), Dr. M. Lehner (Fed. Rep. of Germany) and Mr. F.A.M. Muessnich (Brazil). The Chairman of the Resolutions Committee was Prof. Avv. P. Adonnino (Italy) assisted by its members, Mr. R.O. Asorey (Argentina), Mr. N. Boidman (Canada), Dr. W. Seitz (Austria), Mr. J. Malherbe (Belgium) and Mrs. N. Sen (India).

Subject II: *Tax problems of liquidation of corporations.* The General Reporter was Prof. G. van Frayenhoven (Belgium). The Chairman of the Working Session was Mr. J. Olinger (Luxembourg), the Discussion Leader was Prof. N. Mattson (Sweden) and the Secretary of the Subject was Ms. Ch. Cloquet (Belgium). Panelists were Mr. P. de Freminet (France), Dr. H.U. Freimueller (Switzerland), Dr. L. Hernandez Berenguel (Peru) and Mr. R.F. Hudson (U.S.A.).

Resolutions Committee: its Chairman was Mr. A. Gauthier (Canada) and the other members Mr. P. Ehman (Luxembourg), Ms. M. Erskine (U.K.), Mr. H. Matsumura (Japan), Dr. M. Pires (Portugal) and Mr. Sellerier (Mexico).

Seminar A: *Taxation of human rights* was chaired by Prof. M. Baltus (Belgium). Panelists were: Mr. R. Baconnier (France), Mrs. Buquicchio-de Boer (European Commission of Human Rights), Prof. Dr. J.M. Moessner (Fed. Rep. of Germany), Prof. McDaniel (U.S.A.), and Mr. P. Olavarrieta (Mexico). Seminar Secretary was Mr. J.A. Monsma (Netherlands).

Seminar B: *Effectiveness of current competent authority procedures for relief of international double taxation: future developments* was chaired by Prof. L. Hinnekens (Belgium). Panelists were Dr. B. Gangemi (Italy), Prof. G. Lindencrona (Sweden), Mr. S.H. Goldberg (U.S.A.), Dr. T. Menck (Fed. Rep. of Germany), and Dr. F. Sass (European Communities).

Seminar C: *Belgium and Luxembourg --developments in taxation* was chaired by Mr. A. Elvinger (Luxembourg). Subjects discussed were: Belgian coordination centers, investment funds and the EEC Directives on UCITS in Luxembourg, and reinsurance. Panelists were: Mr. J.P. Lagae (Belgium), Mr. E. de Baenst (Belgium), Mr. A. Cookson (U.K.), Mr. P. Kelley (U.S.A.), Mr. J.P. Winandy (Luxembourg), Mr. C. Hall (U.K.), Mr. M. Thomas (Fed. Rep. of Germany), Mr. G. Delorme (France), Mr. G. Haug-Adrion (European Communities), Mr. G.V. Rod (Luxembourg), Mr. G. Bernard (Luxembourg), Dr. M. Pankow (Fed. Rep. of Germany), Mr. J.D. Delannoy (U.S.A.), and Mr. D.W. Welles (U.S.A.).

PERMANENT SCIENTIFIC COMMITTEE

The PSC met in February 1988 in The Hague. The following subjects were discussed:

- *The proceedings of the Brussels Congress:* Prof. Ault (U.S.A.) interrupted panelists and floor speakers on points of issue in order to stimulate a livelier discussion. He and his colleague Prof. Mattson found that panelists sometimes were holding up the panel proceedings by late submission of their papers. Deadlines were therefore imposed.
- *The increasing size of the Cahiers:* it was decided to shorten the length of the General Reports and the directives issued by the General Reporters.
- *Simultaneous interpretation.* This is expensive but the Blueprint Committee concluded that for the time being this should not result in a change of the scientific structure of the Congress programme.
- *The adoption of a precis rather than resolutions.* A precis frequently reflects the view of the Congress participants more accurately.
- *The Amsterdam Congress and future Congresses.* (See below.)

EXECUTIVE COMMITTEE

Mr. R. Koch-Nielsen (Denmark), 1st Vice-President, Mr. M. Marin Arias (Spain), 2nd Vice-President, and Mr. A. Willemsen (Fed. Rep. of Germany) retired

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from the Executive Committee. Three new members were elected, viz. Mr. P. Sundgren (Sweden), Mr. F. Fernandez Ordonez (Spain) and Dr. K. Beusch (Fed. Rep. of Germany).

The resignation of Prof. Christiaanse as Secretary General of IFA will require moving the headquarters of Central IFA to another location. Since 1969, the Erasmus University has provided free office space to IFA but this will terminate with Prof. Christiaanse's retirement resulting in an increased financial burden for IFA.

Membership fees

The extreme fluctuations of the U.S. dollar vis-à-vis international exchange rates are causing problems which will be aggravated by the increased cost for housing (see above). Fortunately, a contingency reserve has built up in the past years. However, a problem of prime importance is that IFA's revenue is in U.S. dollars while most of its expenditure is in Dutch guilders (Dfl.). The decision has been taken to change the currency of IFA's primary income from U.S. dollars to Dfl. A special rule has been implemented for those IFA Branches which are unable to obtain Dfl. in their countries. The conversion from U.S. dollars to Dfl. will relieve IFA from having to act as a currency exchange hedger.

The proposed membership fees for 1989 are:
95 Dfl. for individual members of national IFA Branches;
105 Dfl. for direct individual members of IFA; and
225 Dfl. for corporate members, both direct and national IFA Branches.

National branches and membership

During the Brussels Congress, the Pakistan Branch of IFA was recognized. A new Branch was formed in Bermuda; this Branch has applied for recognition and this will probably take place during the Amsterdam Congress.

Prof. Christiaanse thanks those IFA Branches which are active and who submit news of their activities to Central IFA. The latter passes this information on to its sister organization, the IBFD, Amsterdam, which publishes articles of interest under the IFA News Column in the *Bulletin*. He reiterates his request that all National Branches follow this practice and encourages other Branches to maintain an active practice of Branch meetings, workshops, joint seminars and bilateral meetings. Access to information on the various Branches enables IFA to provide less developed Branches with relevant information.

International Bureau of Fiscal Documentation

Prof. Christiaanse participated in the jubilee festivities of the IBFD which also celebrates its 50th anniversary in 1988. The ties between IFA and IBFD continue to be strong and Prof. Christiaanse complimented Mr. Hamaekers, Chief Executive of IBFD, on the manner in which he manages the IBFD.

AMSTERDAM CONGRESS 1988

At the time this report was written, preparations for the Amsterdam Congress were being finalized. Amsterdam was chosen as the location for IFA's 42nd Congress in view of the fact that IFA was founded in the Netherlands 50 years ago. This is the fifth time an IFA Congress has been held in the Netherlands.

The International Bureau of Fiscal Documentation will be IFA's host during one of the evenings. The Dutch tax administration will arrange an exhibition on the automation of processing of tax returns.

The subjects for the Congress will be:

Subject I: *Recognition of foreign enterprises as taxable entities*. General Reporter: Prof. Dr. C. van Raad (Netherlands); Discussion Leader: Prof. Dr. K. Vogel; and Chairman of the Resolutions Committee: Dr. W. Ryser (Switzerland).

Subject II: *Tax treatment of computer software*. General Reporters: Mr. J.B. Jones, Jr. and R.N. Mattson (U.S.A.); Discussion Leader: Mr. D.G.H. Bowman (Canada); and Chairman of the Resolutions Committee: Dr. H.A. Kogels (Netherlands).

Seminar A: *Data processing in taxation*. Chairman: Dr. A. Sebiger (Fed. Rep. of Germany).

Seminar B: *Tax consequences of pension provisions for the internationally transferred employee*. Chairman: Mr. P. den Boer (Netherlands).

Seminar C: *Recent issues in tax conventions*. Chairman: Mr. M.J. Ellis (Netherlands).

Seminar D: *Draft EC Directives on parent-subsidiary, mergers and arbitration*. Chairman: Mr. R. Baconnier (France).

RIO DE JANEIRO CONGRESS 1989

The subjects of the Rio de Janeiro Congress will be:

Subject I: *Disregarding a legal entity for tax purposes*. General Reporter: Mr. Condorcet Rezende (Brazil).

Subject II: *Administrative and compliance costs of taxation*. General Reporter: Prof. C. Sandford (United Kingdom).

Seminar A: *Taxation of services as rendered internationally as opposed to technical assistance or industrial licence agreements*. Chairman: Prof. Dr. R. Valdes Costa (Uruguay).

Seminar B: *Tax treaties and domestic legislation*. Chairman: Mr. Justice F. Rezek (Brazil).

Seminar C: *Turnkey jobs*.

Seminar D: *Taxation systems of the South American Common Market*.

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Seminar E: *Structure of the Brazilian tax system.*

MITCHELL B. CARROLL PRIZE

The Mitchell B. Carroll Prize is presented to persons under 35 years of age who have submitted a paper devoted to international fiscal law, comparative tax law or national law relating to fiscal law in foreign countries. The 1987 prize was awarded to Mr. Harry A. Shannon for his work entitled "The Double Taxation Convention in the United States – Policy and Law". An honourable mention was made to Mr. Fischer-Zernin for his paper entitled "GATT versus Tax Treaties".

Seminar on Taxation Organized by the International Fiscal Association – Sri Lanka Branch

A seminar on taxation was held under the auspices of the International Fiscal Association – Sri Lanka Branch on 9 August 1988 at Hotel Galadari Meridien in Colombo.

Mr. Samy M. Pasupati, Chartered Accountant and Chairman of the IFA (Sri Lanka Branch) spoke on the need for an Imputation System for Corporate Taxation while Mr. T. Ratnasunderam, Commissioner of Inland Revenue (Corporate Taxes) explained in detail the provisions in the proposed law in regard to the imputation system.

Mr. C.G. Perera, Commissioner of Inland Revenue (Metropolitan Region) discussed some of the recent changes in tax laws, particularly the changes in taxation of capital gains and tax exemptions for housing.

Mr. R.G.L. de Silva, Attorney-at-Law and Secretary of the IFA (Sri Lanka Branch) analyzed the impact of some of the recent changes in tax laws on taxpayers. He said that the new Sub-sec. 2A of Sec. 92 of the Inland Revenue Act which states:

> Every person who furnishes a return of income and wealth which is not in such form and does not contain such particulars as are specified by the Commissioner-General for purposes of the foregoing sub sections shall be deemed, for the purposes of this Act, not to have furnished a return of his income and wealth

will have far-reaching effects, particularly in regard to the "Time-bar" of an assessment, which generally operates after 3 years from the end of the year of that assessment. He also stressed the need for granting depreciation allowance on motor vehicles used for travelling by professionals and businessmen in computing their respective incomes.

Mr. A.M. Jayasekera, Commissioner of Inland Revenue (Turnover Taxes) and Mr. M.S.M.T. Samaratunge, Tax Consultant spoke on the changes in the turnover tax laws.

Lectures were followed by a topical and lively panel discussion. Nearly 200 persons comprising Corporate Directors and Executives, Tax Officials, Accountants, Financial Advisors and Tax Lawyers participated in the Seminar.

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PEOPLE'S REPUBLIC OF CHINA:

Taxation of Private Business and Private Investors

By Li Jinyan

Li Jinyan: University of International Business and Economics, Beijing – B. Econ., 1980-84; graduate student in law, 1984-85; Queen's University, Kingston, Ontario, Canada – LL.M., 1985-86; Osgoode Hall Law School, Toronto, Ontario, Canada – D. Jur., 1987. Li Jinyan is presently a consultant at the legal firm of Stitt, Baker & McKenzie, the Toronto office of the international firm of Baker & McKenzie.

INTRODUCTION

In the course of the past 10 years, private business has mushroomed in China and become a necessary part of the socialist economy. By the end of 1987, there were over 13 million households conducting private industrial and commercial activities and employing some 20 million people. In addition, over 220,000 private enterprises had been established, with a total registered capital of more than 55 billion yuan.[1] Nonetheless, the first national laws governing private enterprises and income taxation on private enterprises were only adopted in June and became effective in July 1988[2], although several interim provisions had been previously adopted to regulate household businesses.[3]

FORMS OF PRIVATE BUSINESS

Under Chinese law and regulations, individuals may, within the limits of the law, engage in private business activities in industry, construction, transportation, commerce, catering, services, repairing, technological consultancy, etc. They are prohibited from operating in military and financial industries and from producing products which are prohibited by the State, such as goods for superstitious purposes, obsolete medicines and illegal publications. At present, private businesses are operated either by way of individual industrial and commercial households or in the form of private enterprises. A "private enterprise" is defined as an individually owned business with 8 or more employees.[4] Private enterprises include exclusively individually-funded enterprises, partnerships and corporations with limited liability.

A. Individual industrial and commercial households (geti gongshang hu)

An individual industrial and commercial household is generally owned and managed by one member of a family or by the entire family. One or more "assistants", but not more than 7, can be hired if hands are needed.[5] Such a household business may engage in small-scale industrial and commercial activities and services (in particular retailing, repairing, catering and consultancy).

1. *Renmin Ribao* (Haiwai Ban) of 12 March 1988 at 1; 30 December 1987 at 3; and 2 July 1988 at 3 (in Chinese). See also *Beijing Review*, 17-24 July 1988 at 10.
2. The Provisional Regulations on Private Enterprises of the People's Republic of China, adopted by the State Council on 3 June 1988, promulgated on 25 June and effective as of 1 July 1988 (hereafter the Private Enterprise Law); and the Provisional Regulations of the People's Republic of China on Private Enterprises Income Tax, adopted by the State Council on 3 June and promulgated on 25 June 1988 (hereafter the PEIT Law). The texts of the Private Enterprise Law and the PEIT Law were reproduced in *Renmin Ribao* (Haiwai Ban) on 30 June 1988 (in Chinese). The author's translation of the PEIT Law is appended hereto in Appendix I.
3. For instance, the Interim Regulations on Income Tax of Urban and Rural Individually-Operated Industrial and Commercial Households, promulgated by the State Council on 7 January 1986 (hereafter the Household Income Tax Law); Several Regulations on Individually-Operated Industrial and Commercial Households in Rural Areas, promulgated by the State Council on 27 February 1984; Regulations on Book-Keeping of the Individually-Operated Industrial and Commercial Enterprises, promulgated by the Ministry of Finance on 15 February 1986; the recent Provisional Regulations on the Management of Individual Industrial and Commercial Households in Urban and Rural Areas, promulgated by the State Council on 5 August 1987 (hereafter the Household Regulations); and the Detailed Rules for the Implementation of the Provisional Regulations on the Management of Individual Industrial and Commercial Households in Urban and Rural Areas, promulgated by the State Administration Bureau of Industry and Commerce on 5 September 1987.
4. Private Enterprise Law, Art. 2.
5. Household Regulations, Art. 4.

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In the case of individual operations, any debts incurred by an industrial and commercial household must be borne by the proprietor's personal property and, in the case of a family operation, by the family property.[6] The profits of the household are taxed under the Household Income Tax Law.

B. Private enterprises (siying qiye)

(1) Exclusively individually-funded enterprises (duzi qiye)

An exclusively individually-funded enterprise is an enterprise whose capital is contributed exclusively by one individual, and the individual has unlimited liability for all the debts of the enterprise.[7] This form of business has been mostly used by private investors, and comprises about 45% of the entire private sector.[8]

(2) Partnership enterprises (hehuo qiye)

A partnership enterprise is an enterprise which is jointly invested and managed by 2 or more persons in accordance with a partnership agreement.[9] A partnership agreement generally includes terms regarding the amount of funds to be contributed, profit sharing, undertaking of debts, joining and withdrawing from the partnership and the termination of the partnership.[10] Partners are required to undertake a joint unlimited liability for the debts of the partnership.[11]

(3) Limited liability corporations (youxian zeren gongsi)

Although a corporation law has not yet been promulgated, both the Civil Code[12] and the Private Enterprise Law contain rules concerning the legal status of corporations. Under Art. 9 of the Private Enterprise Law, a limited liability corporation is an enterprise whose investors' liability is limited to their equity in the corporation and the corporation is liable for its debts with all of its assets. Such a corporation must satisfy all of the following conditions:

(a) the name of the corporation must include the word "limited";
(b) there must be articles of association of a company;[13]
(c) the number of investors shall not be fewer than 2 and more than 30;[14]
(d) the registered capital must be supported by a certificate indicating that the capital conforms with the legal requirements;
(e) where an investor wishes to transfer his capital, the permission of the other investors must be obtained, or in the case where more than 3 persons have invested in the corporation, the consent of the majority must be obtained;
(f) the registered capital must not be reduced; and
(g) no stock shall be issued to the public.[15]

A limited liability corporation may obtain the status of a legal person.[16] A corporation must also register with the appropriate government agency when it commences, changes or terminates its business.[17]

TAXATION OF PRIVATE BUSINESSES

At present, private businesses are subject to 2 income taxes: the *household income tax* and the *private enterprise income tax.*

A. Household income tax

Prior to 1985, individual industrial and commercial households were taxed under the Industrial and Commercial Income Tax Law.[18] In 1985, when the Collec-

6. Art. 29 of the General Provisions of the Civil Code of the People's Republic of China, adopted by the 4th Session of the 6th National People's Congress on 12 April 1986 (hereafter the Civil Code). See also Household Regulations, Art. 4 supra note 3.
7. Private Enterprise Law, Art. 7.
8. An example cited by a Chinese writer is Liu Xigui, a millionaire engaged in transportation business. He started his business with an old truck in 1985, prospered, and bought another 20 trucks later on and hired 100 drivers and loaders. He also engaged some retired cadres as advisors. At the beginning of 1988, he invested and built a chemical factory, a fluorescent light factory and an automobile repair shop. See Zhang Zeyu, *Private Businesses Produce Millionaires, Beijing Review,* 21-27 March 1988 at 14.
9. Private Enterprise Law, Art. 8.
10. Civil Code, Art. 31.
11. Art. 8 of the Private Enterprise Law, supra note 2, and Art. 35 of the Civil Code. For a discussion of partnerships between individuals in China, see Ni Hongzhi, "A Brief Discussion of Our Country's Partnerships between Citizens", *Zhongguo Fazhi Bao* (Chinese Legal News), 25 July 1986 at 3 (in Chinese).
12. Arts. 41-49 of the Civil Code.
13. The articles of association of the company must include the following:
- name and address of the corporation;
- business objects and scope;
- registered capital and each investor's equity;
- name, address and rights and liabilities of the investors;
- organization of the corporation;
- conditions of dissolution;
- terms on the transfer of equity capital by investors;
- terms on profit distribution and undertaking of liability;
- procedures on amending the by-laws of the corporation; and
- other matters needed to be included.

See Art. 14 of the Private Enterprise Law, supra note 2.
14. If the number of investors exceeds 30, a specific report must be filed with the Industrial and Commercial Administration Agency and permission must be received before the corporation is registered; Art. 9 of the Private Enterprise Law, supra note 2.
15. One of the reasons given for this is that so far there have not been many enterprises issuing shares to the public and stock exchanges have not been established. The Government lacks experience in dealing with stocks. See *Renmin Ribao* (Haiwai Ban) of 30 June 1988 at 3.
16. Art. 10 of the Private Enterprise Law, supra note 2. A legal person is defined as "an organization with a capacity for private rights and a capacity for civil acts which according to law independently enjoys private rights and bears civil obligations". A legal person must possess the following: "(a) it has been established according to law; (b) it possesses the necessary property or funds; (c) it has its own name, organizational structure and residence; and (d) it is able to undertake independent civil liability". See Arts. 36 and 37 of the Civil Code.
17. Art. 19 of the Private Enterprise Law, supra note 2, and Art. 2(5) of the Regulations of the People's Republic of China on the Registration of Enterprise Legal Persons, adopted by the State Council on 13 May 1988, promulgated on 3 June 1988 and effective as of 1 July 1988.
18. The Industrial and Commercial Income Tax (ICIT) was part of the Provisional Regulations for the Industrial and Commercial Tax, passed by the Government Administration Council on 27 January 1950 (hereafter the ICT Law). In 1958, when the other components of the ICT Law were incorporated into the Consolidated Industrial and Commercial Tax, ICIT became an independent tax. Until 1980, this was the only tax on business profits. It was imposed on the income of all industrial and commercial enterprises operated for profit. Since 1980, new legislation has been adopted to tax enterprises with foreign investment and various types of domestic enterprises. ICIT, although never formally repealed, became non-existent in reality.

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tive Income Tax Law was introduced[19], they were taxed in accordance with that law;[20] however, from 1986 a separate income tax – the household income tax – has been levied on the profits of these households.

The household income tax is charged on profits after deducting costs, expenses, salaries and losses.[21] The amount of salary which is deductible is required to be in line with the amount payable to workers in collective enterprises in the same industry and region.[22] The net profits are taxed according to a 10-grade progressive scale which rises from 7% to 60%.[23] In addition, a surtax of from 10% to 40% is imposed on taxable income in excess of 50,000 yuan a year, the exact amount of which is determined by local governments.[24] Since most households operate on a fairly small scale, with the number of workers being limited to 7, the surtax is only applicable to a few enterprises and is used to adjust the profit levels of those enterprises.

Special reductions in the tax are accorded to the childless elderly, handicapped and those providing badly needed services requiring high labour intensity.[25] Doctors, dentists and veterinarians opening their own clinics are exempted from the tax on income earned through private practice if the fees charged are reasonable.[26] Households engaged in farming activities or water transportation are also exempted from the tax.[27]

B. Private enterprise income tax

Private enterprises established under the Private Enterprise Law are currently taxed under the Private Enterprise Income Tax Law on their profits derived from engaging in industry, construction, transportation, commerce, catering or other service industries. The tax is imposed on profits after deducting costs, expenses, turnover taxes and non-business expenses allowed by the State.[28] Unlike the household income tax, a flat rate of tax of 35% is charged on the taxable amount[29] and no surtax is levied. Moreover, business losses incurred by a private enterprise can be carried forward for 3 years.[30]

Exemptions and reductions are granted if a private enterprise manufactures goods by using waste water, gas or materials, or where the taxpayer is in financial difficulty due to storm, fire, flood, earthquake or other natural disaster. Special exemptions may also be allowed in other situations.[31]

TAXATION OF PRIVATE INVESTORS

The first individual income tax to exist, since the establishment of the People's Republic, was promulgated in 1980 – the Individual Income Tax Law (hereafter IIT Law).[32] When the IIT was introduced, it was intended primarily to satisfy the needs of the "open" policy and was designed mainly to tax foreigners living and working in China. Within a few years of the economic reform, it became apparent that an appreciable number of Chinese citizens were receiving substantial incomes without paying tax. The basic exemption limit (800 yuan per month) provided under the IIT Law, which appeared to be quite reasonable for foreign executives having to live in scarce and expensive apartments or in hotels, was nevertheless many times higher than the average Chinese wage or salary. The large difference between average incomes and the incomes of this newly emerging wealthy class necessitated regulation, and a new personal tax was thus introduced in 1986 – the *individual income regulatory tax* (hereafter IIRT).[33] As a result, Chinese citizens who have a residence in China[34] are liable to the IIRT on their wages and salaries, income from contractual and sub-contractual fees, income from remuneration for personal services, rental income, royalties, interest, dividends and other income specified by the

19. The Provisional Regulations of the People's Republic of China on Collective Enterprise Income Tax, promulgated by the State Council on 11 April 1985; and the Detailed Rules for the Provisional Regulations of the People's Republic of China on Collective Enterprise Income Tax, adopted by the Ministry of Finance on 22 July 1985. For a brief discussion of the tax, see A.J. Easson and Li Jinyan, "The Evolution of the Tax System in the People's Republic of China", 23 *Stanford Journal of International Law* (1987) at 399.
20. See Ding Wen, et al., *Shuishou yu caiwu shouce* (Taxation and financial affairs handbook), Beijing (1987) at 50.
21. Household Income Tax Law, Art. 3.
22. Art. 4 of Certain Policy Regulations concerning the Urban and Rural Individual Industrial and Commercial Household Income Tax, issued by the Ministry of Finance on 18 April 1986: (86) *Cai Shui Zi,* No. 091 (hereafter the Household Income Tax Policies).
23. The schedule is as follows:

annual income (yuan)	*rate (%)*	*deduction (yuan)*
below 1,000	7	0
between 1,000 and 2,000	15	80
2,000 and 4,000	25	280
4,000 and 6,000	30	480
6,000 and 8,000	35	780
8,000 and 12,000	40	1180
12,000 and 18,000	45	1780
18,000 and 24,000	50	2680
24,000 and 30,000	55	3880
above 30,000	60	5380

Formula for calculation of tax payable at progressive rates: (income × rate) – deduction sum = tax sum.
24. Household Income Tax Law, Art. 4.
25. Household Income Tax Law, Art. 5.
26. Arts. 6 and 9 of the Household Income Tax Policies.
27. Household Income Tax Policies, Arts. 7 and 8.
28. PEIT Law, Art. 2.
29. PEIT Law, Art. 3.
30. PEIT Law, Art. 6.
31. PEIT Law, Art. 4.
32. The Individual Income Tax Law of the People's Republic of China, adopted by the 3rd Session of the 5th National People's Congress and effective on 10 September 1980 (hereafter the IIT Law); the Detailed Rules for the Implementation of the Individual Income Tax Law of the People's Republic of China, approved by the State Council on 12 December 1980 and promulgated by the Ministry of Finance on 14 December 1980.
33. The Provisional Regulations concerning Individual Income Regulatory Tax of the People's Republic of China, promulgated by the State Council on 25 September 1986 and effective as of 1 January 1987 and the Detailed Rules for the Provisional Regulations concerning Individual Income Regulatory Tax of the People's Republic of China, issued by the Ministry of Finance on 10 December 1986 (hereafter the IIRT Rules). For a brief discussion of the IIRT, see Li Jinyan, "People's Republic of China: The New Regulatory Tax on Individual Income", 41 *Bulletin for International Fiscal Documentation* 4 (1987) at 167.
34. "Residence in China" is interpreted as a Chinese citizen who has Chinese nationality, a household registration and actually stays in China. See Art. 2 of the IIRT Rules.

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Ministry of Finance.[35] The tax is charged at progressive rates, with the top marginal rate being 60%.[36]

An obvious omission from the categories of taxable individual income is income from business, since such income earned by an individual will be taxed under the Household Income Tax Law rather than under the IIRT. This is beneficial in that, although both taxes impose a maximum 60% rate, the top rate is reached much sooner under the IIRT (on a monthly income of 800 yuan) than under the household income tax (annual income of 30,000 yuan). However, under the latter tax there is no basic monthly deduction.

By contrast, if an entrepreneur runs his business in the form of a private enterprise, any salary income earned by him for participating in the enterprise management is subject to IIRT, and is presumably deductible in computing the profits of the enterprise. Normally an enterprise manager, who will usually be the entrepreneur himself, may receive a salary not exceeding 10 times the average amount payable to his employees.[37] There would consequently seem to be some advantage in withdrawing one's share of profits partly in the form of salary and partly as dividend.

Income distributed by a private enterprise to its investors from retained earnings is taxable again in the hands of the investors under a new regulatory tax – the *private investors individual income regulatory tax.*[38] The investor is exempted if he puts the retained earnings in the "production development fund" as reinvestment, the amount of which shall not be less than 50% of the total after-tax income.[39] If the investor withdraws the earnings for personal consumption, a 40% regulatory tax is levied on the amount withdrawn.[40] Where the investor takes money out of the production development fund, or from disposing of business assets for personal consumption purposes, he will also be liable to pay the regulatory tax at 40%.[41]

TURNOVER TAXES

In addition to income taxes, individual industrial and commercial households and private enterprises are also subject to turnover taxes which include *product tax, value added tax* (VAT) and *business tax*. The product tax is payable if taxable products are manufactured, purchased or imported by private businesses. Under the product tax law[42], there are 270 taxable items, of which 260 are industrial products and 10 agricultural, taxable at 26 different rates ranging from 3% to 66%.

VAT is levied on 24 categories of industrial products including, inter alia, some textile products, machines and machinery, electronic products and steel products.[43] The tax rates vary from 8% on steel billet to 45% on cosmetics.[44]

The business tax is payable by a private business on gross revenue when it receives income from its business activities.[45] The tax is levied at 3% on income derived from retailing, transportation and construction, and 10% on catering services.

Private businesses are also required to pay an *urban maintenance and construction tax* at a rate of 7% in cities, 5% in county towns and 1% in other areas of the amount of tax payable under product tax, or VAT and the business tax.[46] As from 1 July 1986, there is an education surcharge of 1% levied on the product tax, VAT and the business tax.[47]

CONCLUSION

As the government policy towards private businesses becomes more flexible, more private enterprises will emerge and develop, creating employment opportunities, generating wealth and thus constituting an important component of the national economy. The current tax policy with regard to the private sector is not only to motivate individuals to operate private businesses by allowing them to keep a reasonable amount of profit but also to control the income level of those individuals to a certain extent and to limit excessive increases in consumer consumption.[48] Compared to the income taxes levied on large and medium-sized State enterprises at a 55% flat rate[49], and on small-scale State enterprises and collective enterprises at an 8-grade progressive rate, ranging from 7% to

35. IIRT Law, Art. 3.
36. See Li, supra note 33 at 171.
37. Private Enterprise Law, Art. 36.
38. The State Council Regulations concerning the Levy of Individual Income Regulatory Tax on Private Investors' Income from Private Enterprises, adopted by the State Council on 3 June 1988 and effective as of 1 January 1988 (hereafter the Private Investors IIRT Law). The author's translation of the law is appended hereto in Appendix II.
39. Private Enterprise Law, Art. 38.
40. Private Investors IIRT Law, Art. 3.
41. Private Investors IIRT Law, Art. 3.
42. Regulations of the People's Republic of China on Product Tax (Draft), promulgated on 18 September 1984 by the State Council; and the detailed rules for the implementation of the law were issued by the Ministry of Finance on 28 September 1984.
43. See the Regulations of the People's Republic of China on Value Added Tax (Draft), promulgated by the State Council on 18 September 1984; detailed rules for the implementation of the law were issued by the Ministry of Finance on 24 September 1984. See also the Notification of the Ministry of Finance No. 042 (87) of 20 March 1987. For an English translation of the Notification, see Li Jinyan, "People's Republic of China: Value Added Tax", 42 *Bulletin for International Fiscal Documentation* 1 (1988) at 17.
44. Ministry of Finance circular: (87) *Cai Shui Zi,* No. 242 of 13 October 1987.
45. See Regulations of the People's Republic of China on Business Tax (Draft), promulgated on 18 September 1984 by the State Council.
46. See Provisional Regulations of the People's Republic of China on Urban Maintenance and Construction Tax, promulgated on 8 February 1985 by the State Council.
47. See Provisional Regulations on the Collection of Education Surcharge, issued by the State Council on 28 April 1986.
48. *Renmin Ribao* (Haiwai Ban) of 30 June 1988 at 3.
49. Under the Regulations of the People's Republic of China on State Enterprise Income Tax, promulgated by the State Council on 18 September 1984; and the detailed regulations for the law were issued by the Ministry of Finance on 18 October 1984.

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55%[50], the 35% flat rate applicable to private enterprises is relatively favourable to private investors. If one takes account of the individual income regulatory tax, which must be paid by investors when they receive income from enterprises, the combined tax rate reaches only 48%.[51]

50. The schedule is as follows:

annual income (yuan)	*rate (%)*	*deduction (yuan)*
below 1,000	10	0
between 1,000 and 3,500	20	100
3,500 and 10,000	28	380
10,000 and 25,000	35	1080
25,000 and 50,000	42	2830
50,000 and 100,000	48	5830
100,000 and 200,000	53	10830
above 200,000	55	14830

Formula for calculation of tax payable at progressive rates: (income × rate) – deduction sum = tax sum. See schedules attached to the State Enterprise Income Tax Law; and Collective Enterprise Income Tax Law.

51. This rate is calculated as follows:
35% + (40% × ½ of 65) = 48%.
If, however, the investor decides not to put any money into the production development fund, his income will be taxed at 61%, which is calculated as follows: 35% + (40% × 65) = 61%.

APPENDIX I

Provisional Regulations of the People's Republic of China on Private Enterprise Income Tax
(Adopted by the State Council on 3 June 1988 and promulgated on 25 June 1988)

Article 1

All private enterprises in urban and rural areas engaged in industry, construction, transportation, commerce, catering and other industries are taxpayers of the private enterprise income tax (hereinafter referred to as "taxpayers") and shall pay income tax in accordance with these regulations.

Article 2

The taxable income of a private enterprise shall be the net income in a tax year after deduction of costs, expenses, taxes and non-business expenses which are allowed by the State to be deducted from computing taxable income.

The deductible items from and standards for calculating taxable income of a taxpayer shall be specified by the tax authorities.

Article 3

The private enterprise income tax shall be levied at a 35% flat rate.

Article 4

Where a taxpayer encounters one of the following situations, the government of each province, autonomous region, or municipality directly under the control of the Central Government may grant reductions in or exemptions from the income tax for a limited period of time:

(a) the taxpayer manufactures products by utilizing waste liquid, waste gas or materials and other waste residue;
(b) the taxpayer has difficulty in paying the tax due to suffering storm, fire, flood, earthquake or other natural disaster; or
(c) there are special situations and the tax needs to be reduced or exempted.

Article 5

Reductions in and exemptions from the tax for reasons other than those listed in Art. 4 of the regulations shall be approved by the Ministry of Finance.

Article 6

Losses incurred by a taxpayer in a tax year may, upon approval by the tax authorities, be carried over to the next tax year and made up with a matching amount drawn from that year's income. Should the income in the subsequent tax year be insufficient to make up for the said losses, the balance may be made up with further deductions against income year by year over a period not exceeding 3 years.

Article 7

The private enterprise income tax shall be paid to the local tax authorities by the taxpayer.

Article 8

The private enterprise income tax shall be levied on an annual basis and be paid monthly or quarterly. The final settlement shall be made at the end of the year. Excess payments shall be refunded by the tax authorities or deficiencies made good by the taxpayer. The exact period of payment of the tax shall be determined by the local tax authorities at county or city level.

Article 9

A taxpayer shall, in accordance with the regulations made by the tax authorities, establish a book-keeping system and keep vouchers, and file a financial report and tax return to the local tax authorities. In the case of violation of the above, the tax authorities may impose a penalty of 5,000 yuan or less on the taxpayer. In the case of gross violation, upon approval by the tax authorities of the province, autonomous region, or municipality directly under the control of the Central Government, a penalty of 30,000 yuan or less may be imposed.

Article 10

The collection of the private enterprise income tax shall be conducted in accordance with the Provisional Regulations of the People's Republic of China on the Administration and Collection of Taxes.

Article 11

It is the responsibility of the Ministry of Finance to interpret these regulations, and detailed rules and regulations for the implementation of these regulations shall be formulated by the Ministry of Finance.

Article 12

These regulations shall become effective from the 1988 tax year.

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APPENDIX II

The State Council Regulations concerning the Levy of Individual Income Regulatory Tax on Private Investors' Income from Private Enterprises

(Adopted by the State Council on 3 June 1988 and promulgated on 25 June 1988)

Article 1

These regulations are promulgated to regulate the income of private investors in private enterprises and to encourage private investors in private enterprises to develop production.

Article 2

Salary income earned by a private investor in a private enterprise for participating in the enterprise management shall be subject to individual income regulatory tax in accordance with the Provisional Regulations concerning individual income regulatory tax of the People's Republic of China.

Article 3

Investment income received by a private investor in a private enterprise from the enterprise's after-tax profits shall be levied or exempted from individual income regulatory tax in accordance with the following rules:

(a) the individual income regulatory tax shall be exempted on the amount of investment income received by the investor from the enterprise's after-tax profits and used as production development fund;
(b) the amount of investment income received from the enterprise's after-tax profits and used by the investor for personal consumption purposes shall be subject to individual income regulatory tax at a 40% rate; and
(c) where a private investor in a private enterprise withdraws, in any manner, the production development fund or disposes of business assets of the enterprise and uses the money for personal consumption purposes, the individual income regulatory tax shall be levied in accordance with Art. 3(2) of these regulations.

Article 4

These regulations shall be interpreted by the Ministry of Finance.

Article 5

These regulations shall come into force from the 1988 tax year.

CONFERENCE DIARY

SEPTEMBER 1988

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

Inhoud en Consequenties Commissie Oort. Rotterdam, 21 September (Dutch):
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The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

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Kluwer Studiecentrum, Antwoordnummer 2345, 3600 WB Maarssen, the Netherlands.

OCTOBER 1988

Disclosure to the Tax Authorities Home and Abroad – United States, United Kingdom, France, Germany, Switzerland. Geneva, 3-4 October (English):
Conference Organiser, Business Research International, 57-61 Mortimer Street, London W1N 7 TD, United Kingdom.

Fachkongress der Steuerberater, Cologne 3-5 October 1988 (German):
Fachinstitut der Steuerberater e.V., Stresemannstrasse 15, 4000 Düsseldorf 1, Federal Republic of Germany.

Praktiker-Seminar zur Steuerreform. Kiel, 7 October, or Würzburg, 8 October (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln, Federal Republic of Germany.

Congres Belastinghervorming – Noodzaak en gevolgen van het Rapport Oort. Utrecht, 10 October (Dutch):
Vermande studiedagen, Antwoordnummer 234, 8200 VB Lelystad, the Netherlands.

Tax Strategies for Cross Border Acquisitions. Munich, 12-13 October (English and German):
Frau Gabriela Reiss, Ernst & Whinney GmbH, Thomas-Wimmer-Ring 17, D-8000 Munich 22, Federal Republic of Germany.

International Tax Planning. Amsterdam, 13-14 October (English):
Seminar Services SA, Blvd de Pérolles 7a, CH-1700 Fribourg, Switzerland.

International Trusts – Non-resident trusts, immigrant and emigrant trusts, dual resident trusts and mixed resident trusts. London, 17 October (English):
Key Haven Productions Ltd., 61 Harrington Gardens, London SW7 4DZ, United Kingdom.

Lugano International Banking Symposium. Lugano, 17-19 October (Italian, English, German and French):
Interconvention LTD "Lugano", c/o Swissair P.O. Box, CH-8058 Zürich Airport, Switzerland.

The Use of Trusts for Europeans, Geneva, 19-20 October 1988 (English):
European Study Conferences Ltd., Douglas House, Queen's Square, Corby, Northants NN17 1PL, United Kingdom.

Takeovers & Acquisitions; Law, Tax and Practice – Preparing for 1992. Stockholm, 14 October; Frankfurt, 20 October (English):
Legal Studies & Services Limited, Bath House, 56 Holborn Viaduct, London EC1A 2EX, United Kingdom.

How to Set up and Operate Holding and Finance Companies – Switzerland, Liechtenstein, Luxembourg, Anglo-Saxon jurisdictions, the Netherlands, the Netherlands Antilles. Zurich, 20-21 October (English):
Seminar Services SA, Blvd de Pérolles 7a, CH-1700 Fribourg, Switzerland.

Gaining Benefit of Tax Treaties in Europe and the U.S.A., Amsterdam, 24-25 October 1988 (English):
Legal Studies & Services Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom.

Treasury Management 1988. Amsterdam, 25-26 October (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, the Netherlands.

NOVEMBER 1988

Taxovers & Acquisitions; Law, Tax and Practice – Preparing for 1992. Paris, 2 November; Madrid, 25 November (English):
Legal Studies & Services Limited, Bath House, 56 Holborn Viaduct, London EC1A 2EX, United Kingdom.

European Trends in Taxation facing 1992. Antwerp, 2-3 November (English, French, Dutch, Spanish, Italian and German):
Europea – Photon Services S.A., Avenue Jules César 14, 1150 Brussels, Belgium.

Belasting-Controle – Spelregels in praktijksituaties. Noordwijk, 3, 10 and 17 November 1988 (3-day course) (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

Doing Business between the European Community and the Comecon (CMEA) Countries, Budapest, 10-11 November (English):
Seminar Services SA, Blvd de Pérolles 7a, CH-1700 Fribourg, Switzerland.

Planning and Executing Successful International Acquisitions and Divestitures – An insight into the techniques. Brussels, 28-30 November (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, the Netherlands.

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ISRAEL:

"Administrative Offences" in Aid of Tax Enforcement

By Arye Lapidoth*

In July 1987, a controversial measure was introduced into the Israeli tax system to aid in the enforcement of tax legislation: the imposition of administrative fines in respect of offences referred to as "administrative offences". This note examines the main features of the "administrative offences" legislation and evaluates its effectiveness as a measure to check on non-compliance.

MAIN FEATURES OF THE ADMINISTRATIVE OFFENCES LAW

The legal basis for the use of the new measure is the general Administrative Offences Law, 5746-1985 (hereinafter referred to as the Law)[1], effective as of 1 December 1985. The Law empowers the Minister of Justice to make rules specifying the type of offences which shall be regarded as "administrative offences", i.e. offences in respect of which a fine may be imposed by the administration rather than by a court of law.

The Law is not a fiscal law but rather a general law introducing a new method of dealing with offences other than traditional crimes (such as theft and murder), which normally involve moral turpitude and a guilty mind (mens rea) or social stigma.[2] Administrative offences are generally "malum prohibitum" offences, such as failure to comply with certain statutory requirements or violation of statutory prohibitions; mens rea is not a component of the offence so the act need not have been committed with any malicious intent, negligence or recklessness.[3]

The Law is directed to minor violations of relatively new legislation characteristic of the modern "welfare state" (or "administrative state").[4] Because the Law aims at minor offences, it limits the "administrative offences" to those other than a felony.[5] The Law further limits the "administrative offences" by specifically listing the statutes covered. Thirty-two statutes are listed in the appendix to the Law but only 6 of the statutes relate to fiscal legislation.[6] The Minister of Justice has authority to amend the appendix by adding new statutes or deleting old ones via a relatively uncomplicated legislative process.

Two types of fines may be imposed under the Law: (1) a "fixed fine", i.e. either a fixed amount or an amount to be computed on the basis of certain rates arrived at by a set method; and (2) "non-fixed fines", which are left to the discretion of the authorities to be imposed (within a range of minimum and maximum rates) according to the circumstances of each case. Thus far, the Law has been carried out only in respect of "fixed fines".

The administration may impose a fixed fine if it has reason to believe that an administrative offence has been committed. A notice to that effect must be delivered to the person concerned. If the person fails to respond to the notice he must pay the fine.[7] He may, however, elect to be tried in a court of law[8] and be prosecuted accordingly.[9] The fine for which the taxpayer will be liable in court will not be less than the administrative fine.

To ensure enforcement of the administrative fine, the Law contains severe sanctions.[10] The unpaid amount is increased by 1½% for each week of deferment. If the fine is not paid within 6 months, a court of law may impose imprisonment of up to one year in lieu of the fine.

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* The subject of this note was discussed by a panel (chaired by Professor Y. Zamir, who also delivered the main lecture on the new legislation) on 3 May 1988, under the auspices of the Institute for Continuing Education for Lawyers in Tel Aviv. The author, who attended the discussion, is solely responsible for the views expressed in this article.

1. *Sefer Ha-Chukkim,* No. 1160 of 24 October 1985 at 31.
2. Traditional crimes continue to be punishable under the regular criminal law process.
3. A typical example of "malum prohibitum" offences are traffic offences which, in Israel (before implementation of the Administrative Offences Law) had been disposed of by a widely-used method of "optional fine". For example, a driver who received an "optional fine" ticket could elect to pay the fine instead of being prosecuted in a court of law. Certain features of the Law were introduced as a result of the experience gained by administering the "optional fine" to enforce traffic laws.
4. For example: legislation relating to the control the Government assumes over economic activities and/or employment matters, as well as matters like the prohibition of smoking in public places, the regulation of traffic, etc.
5. A felony is defined as a crime punishable by death or imprisonment for more than 3 years.
6. For instance, legislation relating to matters such as the prohibition of smoking in public places, the prohibition of night baking and the right of employees to annual leave, etc. is included in the list.
7. Under the old system of "optional fine" traffic offences (which has also been changed), drivers could either pay the fine or, if they failed to respond, they were liable to prosecution. Apparently many persons did not pay the fine and the police were too busy to prosecute all offenders.
8. However, he must notify the tax administration of this option.
9. Where a person opts for a regular trial in a court of law, he will normally be prosecuted accordingly unless special grounds exist for not prosecuting him (in which case the person will neither be prosecuted nor obliged to pay the administrative fine).
10. The amount of the unpaid fine is linked (e.g. to the cost of living index) to avoid its erosion as a result of inflation.

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The Law is characterized by 2 other notable features. The prosecution is not precluded from indicting an individual in a court of law in respect of an offence which has been classified as an "administrative offence" if an indictment is justified by the circumstances of the case. A law suit may be initiated only so long as the administrative fine has not been paid. Once the fine is paid, the offence is forgiven, i.e. the offender is not regarded as having been convicted.

The need for a new method of dealing with administrative offences stems from the shortcomings of the regular criminal law process which is notoriously long, costly and cumbersome because every effort is made to protect the civil rights of the defendant. Conviction generally carries a social stigma so only selected cases are brought to trial. This process is unsuitable for administrative offences which are numerous and which do not (as a rule) carry any stigma. Prior to the new Law, administrative offences were disposed of via the regular criminal process and enforcement was very poor. This new method of dealing with administrative offences is also considered preferable to the power to compound an offence, a practice which was formerly an alternative to the regular criminal procedure. This power is considered below.[11]

THE USE OF "ADMINISTRATIVE OFFENCES" IN THE TAX AREA

The Revenue Administration has been selected as the first sector to carry out the Administrative Offences Law. The selection was not made because non-compliance is more prevalent in the tax area but rather because the tax administration is already highly computerized and therefore in a better position to impose administrative fines on non-compliant taxpayers.

An alternative to the regular criminal process (already well-established in fiscal law) is the power vested in the tax authorities to compound an offence committed by the taxpayer. In such a case, the taxpayer will pay a sum of money in exchange for the administration's agreement not to prosecute him. The power to compound an offence has been exercised in Israeli fiscal law for many years in areas such as excise duty, income tax, value added tax and currency regulations. The disadvantages to this power are that it invites pressure on the administration to compound the offence rather than prosecute and it may result in discriminatory practices. The authority to compound offences is more suitable for selected cases as opposed to the numerous minor offences. Consequently, the new Law provides that the power to compound offences has no effect with respect to administrative offences.[12]

The tax administration has been issuing notices of administrative fines since July 1987. Thus far, a considerable number of recipients of such notices have neither paid the fine nor responded to them. It is apparently too early to reach any definite conclusion as to the success of the new measure. However, apart from the question of the *efficacy* of the administrative fine in the tax area, one may reflect on its *desirability*.

EVALUATION OF THE ADMINISTRATIVE FINE

The main criticism of the manner in which taxpayers have been informed of the administrative fine is that the notices are not accompanied by adequate documentation to alert taxpayers to the measure and its nature and consequences. No doubt many notices have been disregarded because the recipients failed to realize the significance of the notice and that the new notice differed from the "regular" one, i.e. a notice in which it is "never too late" to respond.

The way in which the tax administration may exercise its discretion with regard to a determination that sufficient grounds exist to assume an administrative offence has been committed is also troublesome. Taxpayers are concerned that the circumstances of particular cases are not scrutinized closely enough and that, as a result, administrative fines are improperly imposed on bona fide taxpayers. The administration assures the public that each case is carefully examined before the notification is mailed.

Admittedly, a taxpayer who feels aggrieved may elect to go to court in lieu of paying the fine. However, many taxpayers accede to the temptation to pay the fine to rid themselves of a nuisance although the taxpayers feel begrudged. The temptation to pay the fine increases because the offence is entirely forgiven once the fine is paid. Not only is the taxpayer's sense of justice offended but the resentment may impair morale and lead to rationalization of future non-compliance.

The use of administrative fines in the tax area involves problems specifically relating to the role of deterrence measures in combatting tax evasion. Clearly, imposition of fines should not be an end in itself; the ultimate goal is to minimize tax evasion and promote voluntary compliance. The following question arises, however: should all taxpayers who violate the laws be prosecuted or is tax law a sui generis law, the violation of which should not necessarily lead to criminal prosecution? There are 3 prevailing attitudes concerning criminal prosecution of tax evaders: tax systems (e.g. the United Kingdom) which appear reluctant to use criminal prosecutions; others (e.g. the United States) which pursue a vigorous but selective prosecution policy; and a third which adheres to a comprehensive non-selective prosecution policy (e.g. the one advocated by A. Witkon).[13]

Selective prosecution does not necessarily derive from difficulties in obtaining conviction in a court of law. It may be deliberately adopted because such an approach is considered more suitable for enforcement of tax

11. The power to compound has been retained with respect to offences which have not been classified as administrative offences.
12. See Sec. 25.
13. Witkon, A., *Introduction to the Law of Taxation,* Schoken Publishing Company (1956) at 171 (in Hebrew). A similar view is expressed in later editions. See also Witkon, A., *Law and Society,* Dvir (1955) at 116 (in Hebrew). Shortly after retiring from the bench, Justice Witkon appears to have mitigated that view in an article entitled "Endurance Limit of Paying Tax", published in *Davar,* a Hebrew daily newspaper, of 11 July 1980 at

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laws. In Israel, where tax evasion has been vigorously fought by the Revenue Administration, selective prosecution policy has been adopted advisedly, following the guidance of a special Adviser on Tax Law and Administration.[14]

Given that widespread use of administrative fines is preferable to regular prosecution (inter alia because the latter is necessarily selective), it is doubtful whether administrative fines are suitable for tax offences where violators have always been selectively prosecuted. Admittedly, the use of administrative fines in respect of minor offences does not preclude the Revenue Administration from pursuing its selective prosecution policy in respect of grave violations such as wilful tax evasion. It is, however, questionable whether a selective prosecution policy should not continue to be adhered to for minor offences, a policy which could be realized through the regular criminal process.

To enable the Revenue Administration to enforce tax laws, the Israeli Legislature has been generous in providing requisite statutory assistance. For example, the Revenue has broad authority to conduct audits, inquiries, searches, seizures, etc.; bookkeeping has been made compulsory; new offences have been added; penalties made more severe; the burden of proof has been shifted to the defendant in certain cases; and presumptions added to ease the prosecution's burden of establishing a prima facie case. If widespread non-compliance persists, it is not due to a lack of adequate legal measures.

When considering the use of deterrence measures to enforce tax laws, one should also bear in mind the special nature of enforcement of tax legislation. A close study of the Israeli Income Tax Ordinance, for example, will reveal that "the Legislature, striving for an efficient and speedy collection of taxes, which is the main object of the law, wanted the amount of income tax payable by the citizen to be fixed not by a superior order, but as a result of friendly negotiations between the assessor and the assessee, which eventually settle the differences between them and lead them to an agreement".[15]

The idea that the tax should be collected on a voluntary and confidential basis (so far as possible) is characteristic of the legislation in the tax area. It is also reflected in the special duty of secrecy. For example, a taxpayer who discloses that he committed a criminal offence (other than a tax law violation) can rest assured that the Revenue will normally not turn him over to the police because a strict statutory secrecy provision precludes such an action. Another example is found in the power to compound an offence; amnesty is also a frequent occurrence in the tax area.

The role of deterrence measures promoting compliance should not be over-emphasized. As noted, neither the lack of legal measures nor the paucity of criminal prosecutions contributed to continuing tax evasion practices. It is doubtful whether the new "administrative fines" will prove effective in checking non-compliance. Nevertheless, the new measure is worth a cautious experiment accompanied by a close follow-up of the results, and not neglecting other measures which promote compliance.[16] Although the effectiveness of the new measure cannot be scientifically estimated, it may be of interest to wait and see if any improvement in tax compliance is achieved, which, broadly speaking, can be attributed to the imposition of the new "administrative fines".

14, 20. Justice Witkon's views are considered by Neeman, Y., "The Citizen and the Revenue Authorities in the Opinions of the Late Justice Witkon", published in Witkon, A., *Justice and the Judiciary, a Collection of Articles and Notes,* Schoken Publishing House (1988) Part One, in Memoriam at 19 (in Hebrew).

14. See Wilkenfeld, H.C., *Taxes and People in Israel,* Harvard University Press (1973) at 231. See also Amir, G., *Income Tax Handbook, Offences and Penalties,* Sadan Publishing House (1981) at 58 et seq.

15. A free translation from the Hebrew. Per Justice Silberg in Civil Appeal 125/53, *Assessing Officer v. Topper and Zuckerman,* 7 Piskei Din 786 at 788.

16. For other measures against tax evasion, see, for example, Lapidoth, A., *Evasion and Avoidance of Income Tax,* Museum of Taxes (1966) at 47.

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INDIA:

Structure and Reform of Indirect Taxes

By M.M. Sury

ABSTRACT

Indirect taxes form the backbone of the Indian tax system. Customs, excise duties and sales tax make up the basic structure of indirect taxes. In December 1985, the Government announced its Long Term Fiscal Policy which, inter alia, *set forth a broad course and strategy for reform of indirect taxes. As a result, some major changes, aimed to rationalise and simplify the tax system, have been introduced. This article highlights and examines various aspects of indirect taxes in India, including the recent reforms. The main areas covered are: legal framework, revenue significance, commodity coverage, rate structure and exemptions/concessions.*

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I. INTRODUCTION

The federal constitution of India[1] (adopted in 1950) explicitly defines the taxing powers of the Union and the States. It reserves to the Union Government the power to levy customs and excise duties while the right to impose sales tax is vested in State Governments. In essence, these 3 taxes constitute the nucleus of the Indian tax system. The dominant role of indirect taxes is a post-Independence phenomenon, reflecting a structural change in the country's tax system. This development has reduced the role of direct taxes, making the tax structure lopsided and generally iniquitous.[2]

Table I highlights the revenue significance of indirect taxes, which accounted for 86% of total tax revenue in 1986-87. Combined, the various indirect taxes, i.e. customs, excise duties and sales tax, generated 72.5% of the total tax revenue.[3] These 3 taxes exert far-reaching influence on investment decisions, choice of technology, costs and prices and consumption patterns. A comparative analysis of these taxes elucidates inter-governmental taxing powers and the issues associated with an overlap of authority.

II. UNION EXCISE DUTIES

Excise duties comprise the single largest source of tax revenue for the Central Government. In 1986-87, they accounted for 44.1% of the Centre's total tax collections (Table II). In 1947, excise taxation in India was highly selective in terms of commodity coverage. The few commodities on which excises were imposed included motor spirit, kerosene, tobacco, sugar and salt. In 1950-51, Union excises accounted for only 16% of the Centre's tax yield.

However, when the Five-Year Plans were launched in the early 1950s, the need for massive resource mobilisation led to a widening of the excise base. Moreover, prospects of extension of excise coverage improved considerably as development efforts were intensified for production of industrial goods which enjoyed a relatively large and stable domestic market. The history of excise taxation in India after 1954 is one of increasing commodity coverage, culminating in the introduction of a generalised system of excise taxation in 1975.

1. India achieved Independence from Britain in 1947 and presently forms a federation of 25 States and 7 Union Territories. The Central Government is composed of a Parliament and a Cabinet, a structure also followed by the States. The unit of currency is the Indian rupee. At present (April 1988), the rate of exchange is 1 pound sterling = 24 Rs., and US$ 1 = approximately 13 Rs.
2. For a detailed explanation of the diminishing role of direct taxes, see M.M. Sury, "India: Decline of Direct Taxes" 41 *Bulletin for International Fiscal Documentation,* 6 (1987) at 279.
3. Other notable indirect taxes include the foreign travel tax, State excises on liquor, entertainment levy, taxes on motor vehicles and octroi.

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Table I

Relative shares of direct and indirect taxes in India 1986-87*

	(billion Rs.)	
1. Total (Centre and States) taxes	495.2	(100.0)
2. Direct taxes	69.1	(14.0)
3. Indirect taxes	426.1	(86.0)
of which		
(a) Customs duties	115.0	(23.2)
(b) Union excise duties	143.5	(29.0)
(c) Sales tax	100.4	(20.3)

* Revised estimates.
Figures in parentheses are corresponding percentages of total tax revenue.
Source: Government of India, *Economic Survey*, 1987-88, Tables 6.1 and S-36.

Table II

Structure of Central tax revenue in India 1986-87

	(billion Rs.)	
A + B Total Central taxes	327.9	(100.0)
A. Direct taxes	62.8	(19.1)
of which		
1. Corporation tax	31.6	(9.6)
2. Personal income tax	28.8	(8.8)
B. Indirect taxes	265.1	(80.9)
of which		
1. Customs duties	114.7	(35.0)
2. Union excise duties	144.7	(44.1)

Figures in parentheses are corresponding percentages of the total Central taxes.
Source: Government of India, Ministry of Finance, *Receipts Budget* 1988-89, Annexure 11 (excerpted).

A. Constitutional provisions

By virtue of the taxation powers set forth in Entry No. 84 of List I of the Seventh Schedule to the Constitution, the Central Government is authorised to impose excise duties on goods manufactured or produced in India, except alcoholic liquors and narcotics.[4] In accordance with Constitutional provisions, various types of excise duties are imposed by the Union Government under different Acts of Parliament. However, the Central Excises and Salt Act, 1944 is the primary Law under which duties are levied on different goods. The duty levied under Sec. 3 of this Act is commonly known as the basic excise duty.[5] It may be fixed with reference to the value, weight, volume, unit, length or area of the excisable goods.

Although the Central Government has authority to levy duties on agricultural products, it has refrained from doing so in view of the attendant administrative difficulties. Therefore, the excise system remains confined to products of the industrial sector (with the notable exceptions of tea and coffee).

The description and rate of excise duty on goods is provided in the Schedule to the Central Excise Tariff Act, 1985. This Act, effective as from 28 February 1986, was a landmark in the history of excise taxation. The excise tariff is elaborate and based broadly on the pattern of classification derived from the International Convention on the Harmonised Commodity Description and Coding System.[6]

This new tariff, in line with internationally-accepted nomenclature, is spread over 91 chapters and covers approximately 700 4-digit and 1400 6-digit headings. Goods of the same class have been grouped together to enable parity in treatment. The comprehensive nature of the system will help reduce disputes concerning tariff classification and it has ensured considerable alignment between the customs and excise tariffs, the former already being governed by Harmonised System Nomenclature.

B. Assessment procedures

Central excise duties are assessed and collected by a vast network of offices scattered throughout the country. At the apex of this network is the Central Board of Excise and Customs, working under the Department of Revenue of the Ministry of Finance. Various procedures to assess and collect Central excises are prescribed but the main procedure is the Self-Removal Procedure (SRP), a record-keeping system which relies on mutual trust between the manufacturer and the Government. The SRP was introduced in 1968 to replace the physical control system[7] and it applies to most excisable commodities of the organised sector. Under SRP, an assessee may remove goods from a warehouse without having them physically inspected by the excise officers. However, before effecting any removal, the assessee must have his classification list approved by the excise authorities. The assessee must provide a detailed description of the goods manufactured in order to categorise the goods for the applicable rates of duty. In case of ad valorem duties, the assessee must also submit a price list disclosing the prices charged along with any discounts and deduction.

Significant revenue items

The budget papers of the Indian Government classify excise revenue under 139 commodity heads. Out of

4. Excise duties on liquor and narcotics (like opium) are imposed by the State Governments under provisions of Entry No. 51 of List II of the Seventh Schedule to the Constitution. These duties, however, are not part of this article.
5. In 1986-87, basic excise duty accounted for 82.5% of revenue from all types of excise duties.
6. The tariff had previously been governed by the First Schedule to the Central Excises and Salt Act, 1944. This Act contained considerable definitional problems and overlapping provisions, which often led to confusion and litigation.
7. Prior to the introduction of SRP, the physical control system was the main procedure to collect Central excises. Under this method, excise control was exercised by officers of the excise department who were posted in factories to observe operations in the various departments in order to prevent illegal disposal of manufactured goods. The few commodities still subject to physical control are: palmyra sugar, matches, snuff and chewing tobacco.

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these, the top 10 revenue items listed in Table III accounted for 60.3 billion Rs. (50.5%) of the total excise yield from basic duties of 119.6 billion Rs. in 1986-87. Manifestly, in spite of a generalised system of excise taxation, a substantial part of revenue is derived from a limited number of commodities which form (in a sense) the core of the system. Many commodities on the tariff list, however, yield a negligible or meagre amount of revenue.

Table III

Ten top items of excise revenue
1986-87

S.No.	Excisable commodity	Revenue in billion Rs. (in descending order)
1.	Cigarettes and cigarillos	8.7
2.	Synthetic filament yarn	8.7
3.	Cement all sorts	8.3
4.	Motor spirit	8.1
5.	Refined diesel oil	6.0
6.	Tyres, tubes, and flaps	5.2
7.	General machinery	4.9
8.	Iron and steel	4.3
9.	Electrical machinery	3.4
10.	Transport equipment	2.7
A.	Total from S.Nos. 1 to 10	60.3
B.	Total excise revenue from basic duty	119.6
C.	A as percent of B	50.5

Source: Government of India, Ministry of Finance, *Receipts Budget*, 1988-89, Annexure 2 (excerpted).

C. Rate structure

Rates of excise duty approved by the Indian Parliament are termed as statutory or tariff rates. However, the Government enjoys the power to exempt, by notification, any excisable goods from the whole or any part of duty leviable on such goods. In exercise of this power, the executive periodically determines and announces the effective rates of duty. The rationale for granting such powers to the executive is that during the period between 2 consecutive budgets necessary adjustments might be implemented to regulate exports, consumption and prices of various commodities.

Nature of tariff

In the early days of the excise system, the emphasis on specific duties was due to administrative reasons. However, the emphasis shifted to ad valorem rates during inflationary periods (particularly in the 1970s). Consequently, the Government converted the then-existing specific rates into ad valorem rates on cement, vegetable products, electric fans, lighting tubes and bulbs, soaps, soda and sodium silicate, paints, varnishes, radios and tape recorders.

In the 1980s, however, the trend toward ad valorem rates not only has halted but has also reversed as a result of the unprecedented spurt in litigation concerning disputes over classification and valuation of goods for purposes of excise levies. To combat tax avoidance and evasion, the basis of duty has been changed from ad valorem to specific on a number of commodities. The important commodities affected by this shift (with year of change given in brackets) are flat glass, aluminium metal (1982-83), paper, aerated waters, motor cars, sugar (1983-84), paper boards, tyres for buses and trucks (1984-85), gases, tubes and flaps of tyres, and colour television sets (1985-86), and cigarettes (1987-88).

The future policy of the Government as regards the nature of excise tariff was set forth in the Long Term Fiscal Policy Statement:[8]

> Economic analysis generally favours *ad valorem* rates of duty. But in recent years, problems of evasion and related administrative exigencies have led to the replacement of some *ad valorem* rates by specific ones. An important handicap of specific rates is that their revenue yields do not keep pace with inflation. In this way the existence or proliferation of specific rates of duty tends to weaken the built-in revenue raising capacity of the tax structure. Recognising that administrative considerations will call for continued levy of specific duties in many instances, it is proposed to institute a system whereby all specific rates are periodically revised upwards keeping in view the price increase.

Presently, excise duties are mainly specific or ad valorem in nature although there are a number of variants of these 2 forms. Important commodities which bear specific rates of duty are cigarettes, coffee, tea, sugar, beverages, mineral fuels, mineral oils, silk, man-made staple fibres, iron and steel. Ad valorem rates dominate in the case of organic chemicals, pharmaceutical products, leather, footwear, ceramic products, tools and implements, machinery and mechanical appliances, electrical machinery and equipment, and miscellaneous manufactured articles. A few commodities, i.e. cotton fabrics, paper and paper boards, are subject to ad valorem-cum-specific rates of duty.

It is discernible from Table IV that specific duties account for a much larger share of excise revenue. The share of specific duties (including the specific component of ad valorem-cum-specific duties) was computed at 82.3 billion Rs. (66.7% of the total estimated excise revenue of 123.6 billion Rs. for the year 1985-86. The remainder of the revenue was attributable to ad valorem duties. Broadly speaking, specific duties account for two-thirds of the revenue and the ad valorem duties for the remaining one-third.

Complexity of rates

Excise taxation in India exemplifies an interesting illustration of the multitude of rates which are subject to frequent revisions. The rate structure is found in the Schedule to the Central Excise Tariff Act, 1985 which includes goods ranging from toys to nuclear reactors. The Schedule is divided into 20 sections covering 96 chapters. Goods falling under each chapter are divided and sub-divided into numerous headings and sub-

8. Government of India, Ministry of Finance, *Long Term Fiscal Policy* (December 1985), para. 6.23.

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Table IV

Relative significance of specific and ad valorem duties in excise revenue

S.No.	Nature of duty	Estimated revenue in 1985-86 (billion Rs.)	Percentage share in total excise revenue
1.	Specific rate	60.9	49.3
2.	Ad valorem rate	34.6	27.9
3.	Specific-cum-ad valorem rate	28.1	22.8
	(i) Specific component	21.4	17.4
	(ii) Ad valorem component	6.7	5.4
Total		123.6	100.0

Source: Government of India, Ministry of Finance, *The Report of the Technical Study Group on Central Excise Tariff,* Part I 1985, Table 6.

headings. The statutory rate of duty applicable to each item is presented against the appropriate heading/subheading under which it falls. These statutory rates are modified (in most cases) by Government announcements.

Although found in the tariff list, commodities such as sewing machines, utensils, pressure cookers, hurricane lanterns, unprocessed fabrics, water coolers and bicycles are completely exempt from payment of duty. However, a host of other commodities bear a wide amplitude of excise rates. The rate of duty[9] on food products like cheese is 15%, and on butter and vegetable oils it remains low at 10%. Excise duty on pharmaceutical products ranges from 12 to 15% ad valorem.

Essential household goods are taxed moderately with ad valorem rates of duty ranging from 10% on footwear, 15% on clocks and watches to 30% on washing machines. Ad valorem rates of excise duty on semi-luxuries range from 25% on tape recorders and refrigerators to 40% on colour televisions. Luxury items bear a high rate of duty, with cosmetics and air-conditioners subject to 105% and 110% ad valorem duty, respectively.

Most capital goods are presently classified under chapter 84 of excise tariff and are subject to 15% ad valorem rate of duty. Some important items in this category are machine tools, cranes, textile machinery and printing machinery. However, calculators, automatic data processing machines and other office machines are subject to 20% ad valorem duty.

Tobacco items are conspicuous for very high rates of duty. The ad valorem rate of duty on fine varieties of cigars is 75%, and on smoking blends 225%. Cigarettes bear a specific rate of duty based on the length of the cigarette. In value terms, the rate of duty in certain cases reaches 400%. Petroleum products are also conspicuous for bearing specific rates of duty, i.e. the rates on motor spirit is high, on diesel oil moderate, and on kerosene, used by the poor as fuel and for lighting, very low.

In the 1988-89 budget, a surcharge by way of a special excise duty was levied at the rate of 1/20 of the basic duty of excise. The purpose of this surcharge is to procure additional resources to meet the after-effects of the unprecedented drought of 1987. Certain commodities of mass consumption, i.e. sugar, matches, cotton fabrics, refined vegetable oil, tea, coffee and kerosene are exempt from this surcharge.

The above-described version exemplifies the philosophy behind the rate-setting procedure. Broadly speaking, necessities of life are either exempt or taxed at a low rate, comforts and semi-luxuries are moderately taxed while luxuries, tobacco and certain petroleum products stand out distinctly as high-rated tariff items. Capital goods bear a relatively low rate of duty.

D. Treatment of inputs

Before the mid-1950s, excise coverage in India was limited to consumer goods (with the notable exception of steel ingots). However, the need for additional resources compelled extension of the excise net to capital goods and raw materials. An examination of the present list of tariff items discloses that various products like internal combustion engines, aluminium, cotton yarn, woollen yarn, fertilisers, chemicals etc., fall within the excise ambit.

It is well-known that excise duties on inputs lead to cost and profit escalations and also help promote vertical integration in industries to the disadvantage of the small-scale sector. Still, levies on inputs form an integral part of the excise system in India owing mainly to administrative and revenue considerations. However, the excise law contains provisions to deal with the cascading effect of excise duties. A recently-introduced provision is the modified value added tax (MODVAT).

VAT and MODVAT

Theoretically, value added tax (VAT), prevalent in most West European countries, is the most desirable way to combat the adverse effects of input taxation. However, adoption of a full-fledged VAT is neither feasible nor practical in India. The existing excise system is characterised by a broad scope of excise rates of varying nature. Any major deviations from the present scheme of excise tariff may seriously disturb the existing balance among different sectors of production. Moreover, the excise system also contains a complicated network of exemptions/preferences which serve diverse goals of economic policy. To retain these features in a comprehensive VAT would not only be difficult but would also negate VAT's essential character.

VAT is expedient only if it replaces all kinds of commodity taxes. In India, excise duty is levied by the

9. This and the following rates of basic excise duty, compiled from recent budget speeches of the Finance Minister, are intended to give a broad pattern of tariff structure. They are liable to variations in view of various exemptions/concessions announced from time to time.

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Centre while sales tax is imposed by the States on almost the same set of commodities (including inputs). The nature and rates of sales tax differ from State to State and it is extremely difficult to integrate them with excise duties to yield to a full-fledged VAT. Therefore, when the Central Government introduced a scheme to grant excise relief to inputs, it was called modified value added tax (MODVAT). This scheme, effective as from 1 March 1986, relieves inputs from excise duty but not from sales tax.

Main features of MODVAT

The MODVAT scheme provides for immediate and complete reimbursement of the excise duty paid on components and raw materials which are used in the manufacture of finished goods. Articles which are not used as inputs in the manufacturing process are not eligible for the credit under the scheme.

Initially, the MODVAT scheme covered 38 chapters of the Central excise tariff. These chapters pertained to the products of chemical and allied industries, paints and packaging materials, plastics, glass and glassware, rubber products, base metals and articles of base metals, machinery and mechanical appliances including electrical equipment, motor vehicles and certain miscellaneous manufactured products. The scheme was extended to all the remaining chapters (except those relating to textiles, tobacco and the petroleum sector) in the 1987-88 budget. The extension covered food products, mineral products, leather and travel goods, footwear, paper and paper-board, wood and cork products, asbestos cement products and precious metals.

The credit under MODVAT is available to a manufacturer of a final product only if the final product is subject to central excise duties. Credit is allowed once evidence of payment of duty has been received by the excise department. If the same input is used for different finished products, some of which are not dutiable, the credit is allowed only for that part attributable to inputs used for the manufacture of finished goods subject to central excise duty.

Under the MODVAT scheme, inputs may be either procured from outside or manufactured in the factory. In either case, the duty credit is available to the extent of duty actually paid. It is noteworthy that machines, plant, equipments, apparatus, tools or appliances used in the manufacture of the final products are not covered by the term "inputs" for the purpose of MODVAT benefits.

The underlying philosophy of MODVAT seeks to avoid the cascading effects associated with a traditional turnover tax. It is designed to operate as a cost-saving device by allowing the manufacture immediate credit for duty paid on the inputs and the consequent reduction of the interest costs. It is claimed that MODVAT will check excise evasion because credit of input duty cannot be claimed unless actual production is declared to excise authorities. The introduction of MODVAT scheme is a positive measure in the reform of indirect taxation in India.

E. Exemptions/concessions

The excise law provides for a variety of exemptions and preferences to promote a host of socio-economic objectives (e.g. employment, export promotion and promotion of small industries). Excise exemptions and concessions are usually granted through Government announcements. The purpose a particular exemption/preference purports to serve is generally stated in the announcement itself or is manifest from the conditions to which the exemption/preference is made subject.

To ensure equity and promote employment, the excise law grants general exemptions to certain sectors of society which manufacture goods primarily used by low income groups. Some important sectors under this category using labour-intensive technology are non-power operated units, cottage and village industries, handicrafts and leather.

Excise relief to small industries

In alignment with the Government's policy of encouraging small industries, a wide range of concessions and exemptions from excise duty is available to small producers to enable them to compete with large-scale manufacturers. In 1986-87, the Government introduced a new scheme of excise concessions for small-scale units producing excisable goods. Excise concessions under this scheme are given in the following manner:

(1) Eligibility criteria

The basis for identifying small-scale units for purposes of excise concessions is the value of clearances (i.e. production). Any manufacturer whose value of clearances of excisable goods did not exceed 15 million Rs. in the preceding financial year is eligible to take advantage of the exemption. If a manufacturer has more than one factory, the clearances from all his factories are combined to determine eligibility for the exemption. The clearances of goods which are fully exempted from the excise duty are excluded. It is noteworthy that a small-scale independent manufacturer of excisable goods is allowed to clear his goods with the brand name of another manufacturer and is entitled to exemption for such clearances.

(2) Extent of exemption

(a) *Full exemption*

A small-scale unit is allowed complete exemption from excise duty on the first clearances made in any financial year (beginning 1 April) up to a value of 1.5 million Rs. for goods classifiable under any one heading of the Central excise tariff. If a small-scale unit manufactures excisable goods falling under more than one tariff heading, it is allowed full exemption up to 3 million Rs., subject to the condition that the value of clear-

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ances under full exemption shall not exceed 1.5 million Rs. in respect of any one heading.

(b) *Partial exemption*

For clearances of goods in excess of the full exemption limit, the small manufacturer must pay a concessional rate of duty, i.e. normal duty reduced by 10 percentage points, subject to a minimum duty of 5%.[10] This concessional rate of duty is allowed on clearances up to a total value of 7.5 million Rs. For clearances in excess of 7.5 million Rs., the normal rate of duty applicable for the commodity is charged. The small unit can retain the concessions enjoyed by it for the clearances up to 7.5 million Rs.[11] In tabular form, the scheme is as follows:

Value of clearances (million Rs.)	*Extent of duty exemption*
Up to 15	Eligible for the scheme
Up to 1.5	Full duty exemption
between 1.5 and 7.5	10 percentage points less than the normal duty subject to a minimum duty of 5%

Since the scheme allows a small-scale manufacturer to clear his goods with the brand name of another manufacturer, it is common for established concerns to purchase certain products from the exempted sector and market the goods under their own brand names. Products most favoured for this practice include footwear, domestic electrical appliances, electronic goods, wires and cables.

III. CUSTOMS DUTIES

With respect to revenue, customs duties are next in importance to excise levies. Just as "domestic production flows" provide the base for excise taxation so "international trade flows" are the basis for customs duties. Entry No. 83 of List 1 of the Seventh Schedule to the Indian Constitution empowers the Union Government to impose "duties of customs including export duties".

A. Trends in revenue significance

Historically, Central tax revenues during pre-Independence days and even during early post-Independence period were dominated by customs duties because domestic requirements for manufactured goods were generally fulfilled by imports (chiefly from the United Kingdom). The import duties were levied on almost all items of imports whereas major items for export duties were jute and tea, items in which India enjoyed a near-monopoly in the world market. The relative share of customs duties began dwindling from the early 1950s due to import restrictions and substitutions. The share of customs revenue in the Centre's tax collections dropped from 38.9% in 1950-51 to as low as 16.3% in 1970-71. Since that time, customs revenue has maintained an upward swing, accounting for 35% of the Centre's total tax collections in 1986-87. The trend may continue in the same direction in view of the changed emphasis from physical to fiscal controls to regulate imports. This is borne out by the following assertion in the Long Term Fiscal Policy Statement.[12]

> The basic thrust of customs tariff reform will be to place increasing reliance on tariffs to regulate imports and progressively reduce the role of quantitative restrictions in this regard. The move in this direction should increase revenues, encourage less import-intensive forms of production, moderate the unjustifiably high protection granted by quantitative restrictions to certain industries and reduce the delays and uncertainties associated with the administration of import licensing.

In India, customs revenue is mainly composed of import duties[13], levied on a wide range of commodities. In 1986-87, import duties formed 97.3% of total customs revenue. Apart from revenue function, import duties function as policy instrument to protect domestic industry, conserve and ration scarce foreign exchange and frame general international trade policy.

Like excise levies, the revenue from import duties is also concentrated in a select few commodities, including machinery and transport equipment, petroleum oils, chemicals, plastics, iron and steel. These items form the bulk of India's imports and hence customs revenue. In 1986-87, capital goods and petroleum oils accounted for 27.2% and 13.3% of India's imports, respectively.

The revenue from import duties is classified under 52 specific commodity heads. Table V lists the top 10 items of import duty revenue. Combined, these items accounted for 69.1 billion Rs. (61.5%) of the total import duties of 112.1 billion Rs. from 52 commodities in 1986-87.

B. Tariff pattern

Import duties in India are mostly ad valorem in nature.[14] Essential consumer goods like foodgrains, edible oils, life-saving drugs and life-saving medical equipment bear nil or low rates of import duty. Government-controlled hospitals may import duty-free

10. For example, if the normal rate of duty is 15% ad valorem, the concessional rate beyond the full exemption limit will be 5%. If the normal duty for a commodity is 10%, the concessional rate will be 5%. For goods chargeable to specific duty, the concessional rate of duty is arrived at by reducing the specific duty by an amount equal to 10% of the value of the goods. If concessional rate so arrived at is less than 5%, then the minimum duty of 5% is payable.
11. Concessions on the clearances up to 7.5 million Rs. in any financial year (say 1987-88) may be retained even if a small unit exceeds the eligibility limit of 15 million Rs. in that financial year. However, such a unit will not be entitled to concessions during the next financial year, i.e. 1988-89.
12. Government of India, Ministry of Finance, *Long Term Fiscal Policy* (December 1985), para. 6.24.
13. Export duties are levied on a few commodities, such as coffee, mica, black pepper, hides, skins and leather. The revenue from export duties is negligible in view of export promotion efforts aimed at bridging the ever-widening deficit in the balance of payments. Export duty on an item is levied after considering such factors as domestic production and likely exportable surpluses, demand for the item in the foreign markets, changes in exchange rates and the prices prevailing in the international market.
14. Some notable items bearing specific rates of duty are: caustic soda (3,500 Rs. per metric tonne), and PVC resin (7,500 Rs. per metric tonne).

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hospital equipment, apparatus and appliances. Conversely, import of non-essential consumer goods is either banned or subjected to a very high rate of duty ranging from 200% to 300% ad valorem.

Table V

Top 10 items of revenue from import duties 1986-87

S.No.	Description of the commodity	Revenue in billion Rs. (in descending order)
1.	Project imports	13.1
2.	Machinery	11.6
3.	Petroleum oils	8.6
4.	Organic chemicals	7.6
5.	Electrical machinery	6.7
6.	Iron and non-alloy steel	6.5
7.	Plastics and articles thereof	6.0
8.	Baggage	3.8
9.	Animal or vegetable fats	2.7
10.	Motor vehicles and parts thereof	2.5
A.	Total from S.Nos. 1 to 10	69.1
B.	Total import duties	112.1
C.	A as per cent of B	61.5

Source: Government of India, Ministry of Finance, *Receipts Budget* 1988-89, Annexure 1 (excerpted).

Consequent upon the rationalisation of import tariff on capital goods in the 1987-88 budget, the rate of import duty on general machinery is 85% ad valorem. Import duty on components for machinery is 15% below the applicable rate on finished machines. This differential (in line with the recommendations of the Long Term Fiscal Policy) is designed to encourage domestic production of capital machines in place of importing such machines.

Imports of capital goods for certain preferred sectors bear relatively low rates of duty. For example, duty on equipment for fertiliser plants is 15% ad valorem and on machines, equipment and tools for gems and jewellery 25% ad valorem. Another preferred sector for fiscal incentives is the electronics industry which has made rapid strides in recent years. The 1988-89 budget establishes a uniform concessional import duty of 60% ad valorem in respect of 280 items of machinery for the electronics sector. The budget also reduces the duty on moulds, tools and dies required by the electronics industry from 60% to 30% ad valorem with the underlying purpose of promoting domestic development and production of electronics and computers.

High rate of import duty in some cases aims to protect domestic industry. For example, in the 1986-87 budget, import duty in respect of certain machine tools frequently used for domestic production was fixed at 110%; the duty for machine tools and instruments not often used for domestic production was fixed at 35% ad valorem. Similarly, various other considerations influence the pattern of import tariff on different items. In an effort to encourage the production of fuel-efficient motor vehicles, import of components for such vehicles bear a moderate duty of 55% ad valorem. Other items subject to moderate duty are flax and ramie fibres 40%, solar cells 45% and engineering plastics 60% ad valorem.

Items bearing higher rates of import tariff include synthetic organic dye stuffs 150%, specified data communication equipment 100%, and 235 specified drug intermediates 90% ad valorem.

C. Future policy

The need for import tariff rationalisation was emphasised in the Long Term Fiscal Policy Statement of the Government. A distinction was made between the following categories of imports: capital goods, raw materials, other intermediate goods including components, essential consumer goods (i.e. foodgrains, edible oils and life-saving drugs) and non-essential consumer goods. Understandably, essential goods will either remain exempt or bear low rates of import duties while non-essential items will either remain banned or subjected to high import tariff. With respect to the first 3 categories of goods the Statement observed:[15]

> Ideally, in the long run, there is a strong case for subjecting all capital goods, raw materials, components and other intermediate products to the same rate of nominal tariff. This system, if it could be implemented, would have several important advantages. First, the substitution of the present multiplicity of nominal tariff rates by a single rate would constitute an enormous simplification for both trade and industry as well as for the customs administration. Second, this would vastly reduce incentives for misclassification of imports to evade taxes. Third, a single nominal rate of import duty would assure a uniform rate of effective protection (that is, protection of value added) at different stages of production of intermediate and capital goods. This would encourage the economy to specialise in those activities in which it has competitive strength.

However, the Policy Statement cautioned that a major deviation from the present pattern of import tariff is not immediately feasible. Domestic industries have developed under diverse levels of protection and are in varying stages of maturity. The rationalisation of import tariff must be phased over a long period of time, providing some differentials in import tariff short of a uniform system of duties.

IV. SALES TAX

Sales tax is the most controversial and intricate aspect of the Indian tax system. Under the Constitution, the right to levy sales tax is allocated to the State Governments.[16] Each State is, therefore, empowered to collect tax on the sale of goods within its territory according to its own rules. Different State Governments impose sales tax on a wide range of commodities at different rates with different procedures and rules for its collection. The Central Government also enters the

15. Government of India, *Long Term Fiscal Policy* (December 1985), para. 6.26.
16. Vide entry No. 54 of List II (State List) of the Seventh Schedule to the Constitution of India.

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picture insofar as it prescribes the ceiling for sales tax on goods in inter-State commerce. In the case of 3 important commodities, i.e. textiles, sugar and tobacco, additional duties of excise are imposed in lieu of sales tax, the proceeds of which are distributed among the States.

Sales tax, in its modern form, was first imposed by the Province of Bombay in 1938. Since then it has grown considerably in depth and coverage, and forms the backbone of States' tax revenues. Table VI highlights the relative significance of sales tax in the tax structure of the States. In 1985-86, the relative share of sales tax stood at 57.9%: 84.3 billion Rs. out of a total collection of 145.5 billion Rs. from States' taxes.

Table VI

Structure of States' taxes in India
1985-86

	(billion Rs.)	
A + B Total States taxes	145.5	(100.0)
A. Direct taxes	14.8	(10.2)
of which		
(i) Stamps and registration fees	8.5	(5.8)
(ii) Land revenue	3.5	(2.4)
B. Indirect taxes	130.7	(89.8)
of which		
(i) Sales tax	84.3	(57.9)
(ii) State excise on liquor	20.5	(14.1)

Figures in parentheses indicate corresponding percentages of total revenue from States' taxes.
Source: Reserve Bank of India, *Report on Currency and Finance*, 1986-87, Vol. II, Statement 85A. (excerpted).

D. Nature of the levy

Different States have adopted variants of the sales tax for a number of reasons, including administrative convenience, ad hoc measures to increase tax revenues and to attract enterprises.

Sales tax may be a single-point, double-point and/or multi-point levy. Multi-point sales tax, a kind of general turnover tax, is imposed on some commodities in a few States, i.e. Kerala, Karnataka, Andhra Pradesh and Tamil Nadu. A few commodities are subject to double-point sales tax in Maharashtra and Gujrat. However, single-point is the main type of sales tax imposed on most commodities in all States. Single-point tax may either be levied at the first stage of sale, i.e. at the manufacturer's level, or at the final stage of sale, i.e. at registered retailer's level. In most States, a significant part of sales tax revenue comes from first-point levy. Certain States also levy surcharges on sales tax as ad hoc measures to augment their resources.

The rate structure of sales tax is highly complicated in view of different lists of exemptions, a large number of nominal rate categories in different States and a diversity of concessions and administrative procedures in the States. These variations have caused disparities in the effective rate of sales tax on similar commodities in different States. Nevertheless, some broad features of this heterogenous levy are discernible.

Agricultural commodities, like cereals and pulse, are exempt or bear low rates of taxation ranging from 2 to 3%. For most commodities, the rate of single-point levy varies between 4 and 8%. However, in the case of luxury items like automobiles, refrigerators and VCRs the rate may reach 15% in some States.[17] The rate of multi-point levy in some States on some commodities hovers around 4%.

Differential rates of sales tax on the same set of commodities in different States often leads to distorted diversion of trade and production centres. It is not uncommon for individuals of one State to make purchases in other States to avoid or reduce sales tax liability. Apparently, purchases from lower tax States are beneficial so long as the cost of transporting goods is lower than the tax differential. Purchase of truck chassis in Daman (a Union Territory levying a low rate of 3%) by the residents of the distant States of Jammu and Kashmir is a popular case in point. Similarly, rate differentials may cause a transfer of capital and enterprises from high to low tax rate States. This may distort natural selection of production centres based on geographical advantages, leading to unnecessary transportation of raw materials and finished goods and hence cost escalation. Such a misallocation of resources undermines economic efficiency and retards developmental efforts.

As already noted, single-stage levy at the manufacturing level is the predominant form of sales tax in most States and the preference for it continues. If sales tax is levied at the manufacturing level, no functional difference between sales tax and the excise duty exists, except in nomenclature. The implications, or rather ill-effects, of first-point levy are well-known. If the middlemen apply fixed percentage mark-ups to purchase prices as their profit and if the purchase prices include the sales tax, the mark-ups will be applicable to the tax component of the purchase price as well. In other words, an increase in the price of manufacturing as a result of the tax is more than the amount of tax. Therefore, sales tax at the retail stage is the most satisfactory method because it avoids the cascading or pyramiding effects of taxation. A given revenue can be realised by applying a lower tax rate because of the enlargement of the tax base at the retail stage. Again, the desired change in the ratio of tax to consumer expenditure can be achieved more effectively in case of retail stage sales tax. Furthermore, sales tax at the retail stage can be evidenced separately from the price of the goods and thus made known to the final consumer, increasing tax consciousness among the taxpayers. Lastly, expected changes in the rates of retail sales tax do not lead to changes in the inventory posi-

17. For a detailed comparative view of sales tax rates on various commodities in different States as well as the schemes of exemptions and concessions, see M. Govinda Rao and V.B. Tulasidhar, "Economic Analysis of Sales Taxation in India", 40 *Bulletin for International Fiscal Documentation*, 7 (1986) at 288.

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tion of the firms. Anticipated changes in the rates of sales tax at "other stages" may influence inventory decisions of the firms, causing dislocation in trade circles.

However, retail-stage sales tax has its own problems, the main one being the large number of taxpayers operating as small shopkeepers in scattered retail outlets. In developing countries, the problem is still grave because of widespread illiteracy, lack of use of money and poor accounting practices. From the administrative viewpoint, this form of taxation is more expensive and cumbersome as it offers ample scope for tax evasion and corruption.

Therefore, from an administrative viewpoint, sales tax at the wholesale stage or manufacturing level is preferable because the number of taxpayers is small and readily identifiable. The problem of cascading, however, which becomes more critical as we move farther from the retail stage, reappears. Basically, the issue boils down to a trade-off between economic efficiency and administrative convenience. The relative weight to be accorded to these competing objectives depends on political judgement and the economic circumstances under which the tax system must operate.

A closely related problem is the taxation of inputs and capital goods by the Central Government (through excise duties) and the State Governments (through sales tax). To tackle the problem of cascading effect associated with taxation of intermediate goods, recent reforms at the Central level[18] provide immediate credit of excise duty paid on inputs but these facilities are rare at the State level. This lacuna in the sales tax system should be a priority item in the agenda for indirect tax reforms.

B. Central sales tax (CST)

A notable aspect of the Indian sales tax system is the taxation of inter-State trade. Tracing the development of sales tax in India, Walter Mahler remarked:[19]

> Perhaps, the most important problem relating to sales taxation in the pre-Constitution period was the taxation of inter-State sales. All the Provinces, with the exception of West Bengal, were collecting sales tax on goods being sent to other Provinces and were, in effect, indulging in beggar-my-neighbour' policies.

However, the present Constitution contains provisions for regulating taxation of inter-State sales. These regulations find expression in the Central Sales Tax Act, 1956, and provide, inter alia, for a degree of uniformity by prescribing a maximum rate of sales tax on certain goods considered important to the country. Sec. 14 of the Act declares certain goods to be of special importance in inter-State trade.[20] Sec. 15 of the Act lays down the rate structure. The rates vary depending on the class of goods and the status of the person to whom the goods are sold.

Thus, goods are either "declared goods" (goods of special importance) or "non-declared goods", a person may be a registered or a non-registered dealer. Based on these classifications, the rates of sales tax are prescribed by the Central Government. However, the tax is collected and appropriated by the State Governments.

The maximum prescribed rate of sales tax on "declared goods" in a State is 4% of the sale price and is not leviable at more than one stage.[21] In the case of inter-State sales of such goods to registered dealers, the rate of tax is the same as applicable to the sale of such goods inside the exporting State. In respect of sales of "declared goods" to non-registered dealers (including consumers), the CST is chargeable at twice the rate applicable to the same goods inside the State, i.e. 8%. If "non-declared" goods are sold to a registered dealer in the course of inter-State trade, the ceiling rate is 4% or the rate applicable to internal sales of the concerned goods, whichever is lower.[22] However, on inter-State sales of "non-declared" goods to non-registered dealers, the rate of CST is 10% or the rate applicable to the sale of such goods inside the exporting State, whichever is higher.[23]

Basically, CST authorises a State to tax residents of other States. Lest this power be misused to cause undue tax burdens to other States, the original scheme devised in 1956 maintained the low rate of CST (1%), ensuring some reasonable revenue for the exporting States. However, over the years, the rate of CST has been increased by stages to 4%. This trend has benefited industrially-advanced States (like Maharashtra, Gujrat, Tamil Nadu and West Bengal) at the cost of industrially backward States. Since manufactured goods are the main items of inter-State trade, the developed States are able to export a part of their taxation to other States. In effect, it amounts to transfer of financial resources from poorer States to wealthier States, much against the declared objective of regional balanced development. Moreover, the high rate of CST hinders the free flow of trade and commerce within the country.

C. Tax rental agreement

The varying rates of sales tax and assessment procedures in different States have caused difficulties for traders, particularly small ones. Expressing their re-

18. See above, discussion of MODVAT.
19. Walter R. Mahler, *Sales and Excise Taxation in India* (New Delhi: Orient Longman Ltd., 1970) at 151.
20. These goods are coal, cereals, cotton, cotton yarn, cotton fabrics, crude oil, hides and skins, iron and steel, jute, oilseeds, pulses, rayon and artificial silk fabrics, sugar, tobacco and woollen fabrics.
21. In 1956, when the Central Sales Tax Act was passed, the rate was fixed at 1%. Subsequently, it was raised to 2%, 3% and 4% in 1958, 1966 and 1975, respectively.
22. Thus, the States are free to fix rate of sales tax on the internal sales of "non-declared" goods but there is a ceiling rate of 4% on the sale of such goods in inter-State trade. For example, if the rate of sales tax on internal sales is 6%, it will be 4% for inter-State trade, being lower of the 2 rates.
23. In other words, the rate of CST is a minimum of 10%. For example, if general sales tax is charged at the rate of 5% on the sale of colour televisions in a State, the rate of CST on the same will be 10%, being the higher of the 2 rates.

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sentment against the vexatious levy, the business community has often suggested that in place of sales tax, corresponding hikes should be made in Central excises, the proceeds of which could be earmarked for distribution among the States. Such an arrangement, it is argued, will (a) help maintain uniformity in all-India prices of widely-consumed goods; (b) facilitate rationalisation and co-ordination of commodity taxation; (c) contribute to the development of an integrated market by facilitating movement of goods across State borders; (d) reduce the costs of collection; and (e) eliminate obstacles for both large and small dealers.

Interestingly, some arrangements already exist in this regard. Following a 1956 voluntary agreement between the Centre and the States, the sales tax on textiles, tobacco and sugar were replaced with additional duties of excise and the income derived therefrom is distributed among the States. The net proceeds from additional excise duties are distributed among the States in accordance with recommendations and principles of distribution periodically formulated by the Finance Commissions.[24]

This scheme, called *tax rental agreements* by Finance Commissions, has operated quite successfully for over 3 decades and demands are raised time and again for its extension to other commodities. In January 1983, an expert committee[25] recommended the extension of this scheme to cover vanaspati (vegetable oils), drugs and medicines, cement, paper and paper board, and petroleum products. Unfortunately, some of the States opposed the Centre's initiative to implement the recommendations and the matter has been hanging fire since, stalling the process of tax reforms.

V. CONCLUDING REMARKS

The heavy reliance on indirect taxes in the Indian economy has serious equity and efficiency implications. The distribution of the indirect tax burden is often, though not always, regressive and even the poorest of the poor are made to contribute to public exchequer. Although many items of mass consumption are exempt from excise duty and sales tax, a number of essential items do bear these levies, though at moderate rates. Some notable items in this category are sugar, kerosene, vegetable products, soap, matches, patent and proprietary medicines, footwear, toothpaste, etc. Some of these items yield fairly high revenue and it is necessary to review the desirability of retaining these essential items on the tariff list.

Central excise duty and States sales tax fall, in most cases, on the same set of commodities without co-ordination among the competing authorities. This intermingling and overlapping of taxes has hindered rationalisation of the commodity tax structure to judiciously determine the impact of different levies on investment, production and the burden on the consumer. Recent reforms at the Central level (like introduction of MODVAT) are incomplete in the absence of similar measures by the State Governments. The varying tax practices in different States have restricted free flow of trade and impeded industrialisation. Quite often, revenue-raising objective is paramount, relegating equity and efficiency to the background.

Rationalisation of indirect tax structure needs understanding and co-ordination not only between the Centre and the States but also among the States themselves. A national approach is required for an integrated system of indirect taxation.

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24. Art. 280 of the Constitution provides for the appointment of a Finance Commission every quinquennium, or earlier if necessary. The primary objective of a Finance Commission is to develop a scheme of transfer of financial resources from the Centre to the States with due regard to the revenues and needs of the 2 tiers of the Government. This is a unique feature of the Indian Constitution which has no parallel in the existing federal constitutions of the world.

25. Government of India, Ministry of Finance, *Report of the Expert Committee on Replacement of Sales Tax by Additional Excise Duty* (Chairman Kamlapati Tripathi), January 1983.

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Argentine Foreign Debt to Equity Conversion Programme

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I. INTRODUCTION

The Argentine Foreign Debt to Equity Conversion Programme (hereinafter referred to as "the Conversion Programme") is regulated by Ministry of Economy (ME) Resolution 992 of 18 October 1987, as amended by ME Resolution 65 of 22 January 1988 and its complementary provisions: Undersecretariate of Economic Policy (UEP) Resolution 20 of 5 November 1987, and Argentine Central Bank (BCRA) Communication "A" 1109 of 27 October 1987, as amended. The Conversion Programme's primary objective is to ensure that within the next 5 years US$ 1,900 million of public and private external Argentine debt is converted into productive investments.

The Conversion Programme is similar in its purpose and effects to benefits derived from an industrial promotion regime, and in this respect, the programme resembles a subsidy. The national government, through its financial agent (the BCRA), purchases certain securities of the external debt which national and foreign investors offer for sale. The securities are acquired at their face value less a discount or commission which must be offered by the investor. The investor must have assumed the obligation of investing the converted funds as well as additional funds (matching funds) in specific projects previously approved by the UEP. The "subsidy" is the difference between the price the investor paid for the securities (currently quoted in the international market at approximately 30% of their face value) and the sale price to the BCRA, which will be equal to the face value of the securities less the discount or commission offered by the investors during the bidding process.

II. INVESTORS

The Conversion Programme is available to both local and foreign investors. Local investors are defined as individuals or companies which have their effective domicile within the Argentine Republic.[1] Foreign investors are individuals or corporations domiciled abroad. Foreign investors include local companies with foreign capital which hold investments in other local companies.[2] Local firms with foreign capital are companies domiciled in the Argentine Republic in which foreign persons directly or indirectly own more than 49% of the capital or control a quantity of votes sufficient to predominate at shareholders' meetings.[3] Both types of investors are subject to the same regulations in connection with the Conversion Programme. However, foreign investors must also comply with regulations established by the FIL, and consequently obtain any required authorizations.[4]

Capital investment participations obtained from the conversion of public external debt securities cannot be sold or assigned to other investors for 3 years as from the date of their integration.[5] A foreign investor may only repatriate his capital investment in foreign currency after 10 years from the date of his investment. If the foreign investor assigns his participation after the 3-year period has elapsed but prior to the 10-year repatriation restriction, he is entitled to purchase freely-available foreign currency provided that the foreign investor simultaneously establishes a fixed-term foreign currency deposit at the National Development Bank. The deposit must cover the remaining period of the 3-year period restriction.[6]

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1. Art. 2 para. 5 of the Foreign Investment Law (FIL).
2. Art. 2 para. 2 FIL.
3. Art. 2 para 3 FIL.
4. See Arts. 4 and 6 FIL.
5. Art. 7 of Resolution ME 992. This author is of the opinion that the 3-year period commences from the date on which the funds were paid to the recipient firm. Although legal provisions do not specifically refer to the date the 3-year period commences, a reasonable interpretation of Art. 6 of UEP Resolution 20 supports this opinion.
6. Art. 7 of ME Resolution 992, as amended by ME Resolution 65.

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III. PUBLIC FOREIGN DEBT CONVERSION PROCEDURE

The conversion regime of the public external debt is governed by BCRA Communication "A" 1109, as amended.

A. Convertible public debt

In accordance with Communication "A" 1109, the following public debt can be applied to the Conversion Programme:

(1) nominative bonds in dollars;
(2) obligations of the national government in dollars, and interim obligations of the national government in dollars;
(3) external bonds of the Argentine Republic;
(4) other foreign loans to the national government;
(5) credit and deposit facilities for current deposits at the BCRA;
(6) BCRA obligations in dollars and BCRA interim obligations in dollars;
(7) medium-term loans granted to the BCRA;
(8) other foreign debts of the BCRA;
(9) guaranteed public sector refinanced contracts; and
(10) other foreign obligations of the public sector, except short-term commercial obligations and debts which have been granted or guaranteed by foreign official agencies.

Locally-domiciled persons cannot be holders of certain public debt securities (BONODS and Promissory Notes) by virtue of limitations established when these securities were issued. In such cases, Communication 1109 provides that the creditors of the securities may present them to the BCRA and instruct the latter to deposit the conversion funds to the account of an investor who holds an approved project (i.e. one which has been favoured in the conversion bidding). The investor's conformity must be proven.

From a practical point of view, the nominative bonds in dollars (BONODS) are the preferred securities to use for the Conversion Programme. BONODS are substantially less expensive than the external bonds of the Argentine Republic (BONEX) and, contrary to other foreign debt, are readily available on the market and easy to transfer.

B. Eligible investments

The only investments which are eligible to participate in the Conversion Programme are those investments approved by the UEP. According to Art. 4 of ME Resolution 992, eligible investments are those which purport to accomplish any of the following goals:

(1) purchasing of new equipment;
(2) construction of industrial plants or other facilities which tend to increase productive capacity in order to increase the quantity of goods offered; and
(3) other investments which tend to increase the efficiency, productivity and supply of services. In accordance with Art. 4 of UEP Resolution 20, the investment's contribution in affecting the country's balance of payments will be taken into consideration when making the determination whether projects designed to increase efficiency, productivity and supply of services are eligible for the programme. If no exports are anticipated, a portion of the investment may still be declared eligible if it is deemed beneficial to the national economy. In such a case, the authorities will determine the percentage of the total investment which can be covered by conversion proceeds.[7]

Specific projects, however, are not eligible for the conversion programme, i.e. those investments whose purpose is:

(1) acquisition of real estate or working capital;[8]
(2) acquisition of quotas, shares and other corporate participations or rights to the same and subscription of coupons;
(3) financial investments; and
(4) acquisition of used movable goods or goods previously installed in other plants (including machinery).

The UEP must determine the eligibility of an investment project within 45 days from the date it receives the requisite information.[9] Within the same term (and if the ME is granted exclusive competency), the FIL authorizations are granted.[10] In most cases, the ME has exclusive authority to approve foreign investment projects.

UEP Resolution 20 sets forth the information necessary for the project to be considered for the Conversion Programme. The Resolution indicates (under Annexes I and II) the general rules for presentation of projects and instructions for completion of the presentation. Instructions are also provided for those cases in which prior approval (under FIL) is required (Annex II module II) and the necessary information to obtain the exemption of duties for importation of capital goods under Decree 515/87 (Annex II module III).

Among the investment projects which have been deemed ineligible are: manufacturing of pharmaceutical products, processing of citrus plants and vegetables, domestically manufactured automobile components (as opposed to import of these components as has been done in the past), compressed natural gas plants, clearing land for purposes such as cattle breeding, milk production and agriculture, construction of

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7. ME Resolution 1192 of 7 December 1987.
8. If a prohibited investment is made to enable execution of an eligible project, a maximum of 10% of the total cost of the project (excluding foreign equipment) may be authorized.
9. Art. 5 of ME Resolution 992. The 45-day term means 45 working days (since there is no regulation to the contrary). See Art. 1 para. e) 2 of the Administrative Procedure Law 19,549.
10. If the ME does not have exclusive competency for purposes of FIL authorization, consent must be obtained from other corresponding ministries. In such cases, there is no maximum term for the UEP to approve the project.

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5 star hotels, installation of breweries, increasing the production capacity of a slaughter house and textiles.

C. Convertible amounts and matching funds

Proceeds deriving from the conversion of securities of public foreign debt can cover up to a maximum of 70% of the total cost of the approved project (excluding foreign equipment). Henceforth, the investor must provide matching funds equal to 30% of the total cost of the project, either in foreign currency or in australs (Argentine currency).[11] The additional matching funds can either be capital investments or financing provided by third parties. However, "on-lending" funds do not qualify as matching funds.[12]

In order to invest the conversion funds, the investor must prove that the proportional matching funds to the amounts he is willing to dispose of, have previously been contributed. The following procedure must be followed to determine the 70% limit:

1. The cost of foreign equipment is deducted from the total cost of the project. This includes the value of equipment, machinery, component parts, spare parts and accessories as well as costs for engineering, setting up, transportation, insurance and taxation (taxes, customs duties and other levies) even if the beneficiary was granted an exemption of import duties under Decree 515/87.[13]

2. After these deductions are made, the proportional amounts representing real estate and working capital must be made.

3. If the result of "2" is lower than or equal to 10% of "1", that amount is the maximum amount which can be invested through debt conversion. However, if the result of "2" exceeds 10% of "1", the surplus will be deducted from the amount in "1" and 70% of this figure represents the maximum amount which may be capitalized by way of debt conversion.

In addition to the eligibility determination, the UEP must also determine the maximum convertible amount, using this same formula.[14]

The total face value amount of convertible securities is obtained by taking into account the maximum amount which can be capitalized through the Conversion Programme and the discount or commission over the face value of the securities which will be sold to the BCRA. For that purpose, the maximum amount subject to capitalization is divided by the amount which results from subtracting the approved percentage of discount or commission from "1".

The following example is illustrative. Assuming foreign equipment valued at US$ 600, an offered conversion discount or commission of 25% and real estate and working capital of 350:

(a) total cost of the project	1,600
(b) value of the foreign investment	(600)
(c) local investment	1,000
(d) deduct: surplus of real estate and working capital over 10% of "c"	250
	750
(e) maximum amount subject to capitalization, i.e. 70% of "d"	525
(f) total face value amount of securities subject to conversion $\frac{525}{1-0.25}$	700

D. Bidding procedure at the BCRA

An investor with a qualified project must participate in the 2 monthly auctions held by the BCRA. The annual quotas and the 2 monthly limits for the debt conversion will be fixed by previous agreement between the UEP and the BCRA (Art. 2 para. 6 of ME Resolution 992). The BCRA has authority to increase the 2 monthly limits. A higher limit can be established to cover an investment project, if during the auction procedure, the last approved project could only be partially covered by the current limit (Art. 3 of ME Resolution 992).

On the basis of UEP declarations and the compromise which the national government has agreed to with its foreign creditors, it is estimated that the annual quotas will amount to approximately US$ 300 million during the first year and US$ 400 million during the following 4 years, reaching a total of US$ 1,900 million. The 2 monthly limits of convertible amounts during the first year amount to US$ 50 million each (meaning that 6 auctions will be held during the year).

To date, 2 auctions have taken place, the first on 20 January 1988 in which 15 projects submitted bids. Six of these bids were granted. The second auction was held on 29 March 1988 and 20 projects competed. Fifteen of these bids were granted. In both cases, the limits for conversion were fixed at US$ 50 million, and conversion was granted for approximately US$ 54 million in each auction.

1. Requirements for participation in the BCRA bidding

(a) The investor must have an investment project qualified under the Conversion Programme regulations and must have obtained authorizations required by the FIL.

(b) The investor must make a debt conversion offer which covers the face value of the convertible securities and the conversion discount or commission which he offers.

(c) The investor must execute a conversion guarantee in favour of the BCRA. The guarantee may consist of either a bank guarantee or a deposit to the order of the BCRA through a bank authorized to execute exchange operations. The amount of the guarantee must be equivalent to 1% of the face value of the convertible securities. In the case of a deposit, the interest rate will be the same rate as the financial index fixed by the

11. The form of the currency is at the option of the investor.
12. UEP Resolution 24.
13. Arts. 9 and 10 of UEP Resolution 20.
14. Art. 8 of UEP Resolution 20.

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BCRA. The conversion guarantee will be released at the time the converted funds are invested and will be made proportionally to the percentage the converted funds represent with regard to the total face value of the debt subject to conversion.

2. Procedure for evaluation and selection of the requested conversion

(a) *Evaluation of the offers*

All proposals are scored. The score is based on the importance of the conversion discount or commission which is offered. The higher the value of the offered discount or commission, the higher the score. If 2 or more proposals offer a similar discount or commission, the project offering to cover the lowest percentage of its total cost with funds proceeding from the conversion will be given preference.

It is interesting to analyze the events of the 2 recent auctions. When the first auction was called (i.e. 20 January 1988), UEP Resolution 25 established that the minimum discount which could be offered by investors was 25%. During this auction, investors offered discounts ranging from 28% to 40.2% of the face value of the securities. The minimum discount accepted by the BCRA was 35.25%.

During the 29 March 1988 auction, investors offered discounts ranging from 38.1% to 57.10%, with an average of 53.87%. The minimum discount accepted by the BCRA was 51.1%. This clearly demonstrates the interest the Conversion Programme has kindled and that investors are, in fact, willing to accept large discounts in order to convert their debt into investments.

(b) *Number of conversions*

Projects whose face value are worth up to US$ 2.5 million must be converted at one time. However, projects with face values exceeding US$ 2.5 million may be converted up to 3 times; of these projects, the first conversion must be equivalent to at least US$ 2.5 million. No more than 12 months can elapse between each conversion.

(c) *Participation in the bidding process*

Investors wishing to participate in the bidding process must file certain documents with the BCRA. The documents are filed through a local bank authorized to carry out exchange operations.[15] The following documentation is required:

(1) qualification certificate issued by the UEP;
(2) formula containing the proposed conversion proceeding;
(3) conversion guarantee certificate;
(4) statement of acceptance of the Conversion Programme's regulations; and
(5) an option for an alternative payment of the converted funds (see below).

(d) *Conditional and definite awards*

The BCRA will announce the outcome of the bidding process (i.e. either conditional acceptance or rejection of the proposals) within 4 working days of the auction. Within the next 15 working days, the investor must file the securities to be converted.

This file will be submitted for BCRA analysis for a 6-day term. Thereafter, the BCRA will notify the investor of the definite award of the conversion.

3. Conversion and application of the funds

(a) *Conversion of the funds*

On the third working day after the definite award is announced, the BCRA will proceed to convert the securities less the commissions or discounts which were accepted. The average of the free market exchange rate's "buyer" quotation of the Banco de la Nación Argentina (at closing time 10 days before the conversion is carried out) will be considered to establish the amount in australs. The australs obtained from the conversion process will be deposited in the local intervening bank to the order of the investor. The investor may not dispose of the funds until he has met his obligations. The investor can assign his rights to the deposit in favour of the recipient firm. At the investor's option, this deposit will be subject to a service charge which is fixed according to the variation of the financial index established by the BCRA or that of the exchange rate in the free exchange market, plus Libor (London Interbank Offering Rate).

(b) *Release of the funds*

The capitalization process concludes when the funds are released. Funds proceeding from a conversion, and which are subject to the above-mentioned deposit, can only be released (in part or in full) by prior application of the agreed matching funds to the investment project.

The intervening bank must verify that an additional investment of at least 0.43 austral cents was made in relation to each converted austral to be released (Art. 13 of UEP Resolution 20).[16] In addition, the local bank must always verify that the preceding stage of the investment plan has been completed before progressing to the next stage. UEP Resolution 4 establishes which documents the investor must use to prove the investment plan is advancing (i.e. invoices, certificates of work, instruments issued by public notaries, etc.). This evidence need not be produced for the first release of funds which may not exceed 5% of the total amount of the project.

5. Industrial promotion regimes

Investment projects carried out through the Conversion Programme prevent the recipient company from reaping any promotional benefit granted by the na-

15. The investor's participation in all stages of this procedure is carried out through one local bank. Another bank may be used if the investor can show justifiable cause and obtain authorization from the BCRA.
16. Because 43% is the proportion that 30 represents in 70, the verification ensures that the matching funds represent at least 30% of the total cost of the investment at all times.

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tional government with the exception of those benefits contemplated in Decree No. 515/87 for the import of capital goods free of customs duties if the necessary approval is obtained.

IV. PRIVATE FOREIGN DEBT CONVERSION PROCEDURE

Private foreign debt conversion is governed by BCRA Communication "A" 1056 of 30 July 1987. The capitalization of private sector external debt is subject to different treatment depending upon the possibility of payment abroad, i.e. it depends on whether the debt is subject to compulsory refinancing of the country's external debt, if the debt is not subject to refinancing because it was assumed after 10 December 1983, if a foreign exchange contract has been entered or if it is a swap. These differences have resulted in separate regulation under Communication "A" 1056. Although the scheme is established to favour capitalization of the debt with the same debtor, under certain circumstances and conditions, a change of debtor and creditor may be authorized.

A. Debts without foreign exchange insurance contracts

These debts are divided into 2 groups depending on whether payment is subject to refinancing the Argentine external debt.

1. Group 1

Group 1 includes the external debts which are *not* subject to refinancing the Argentine foreign debt. Anticipated cancellation of these debts, with the aim of capitalization in the same debtor, is not subject to the regulations of the Conversion Programme. Henceforth, they need not qualify for eligibility nor is any authorization necessary from the UEP or the BCRA.

Debts arising from the following operations fall within this group:

(i) imports carried out at any time with payment originally assumed up to a one-year term;
(ii) imports carried out as from 10 December 1983, in which a term longer than one year was originally agreed upon;
(iii) financial loans entered into in accordance with BCRA Communication "A" 558 of 28 November 1984; and
(iv) other liabilities entered into as from 10 December 1983 except those assumed on the basis of "on-lending" operations.

The amounts which are capitalized cannot be repatriated before maturation of the original term of the respective foreign debt. However, this is without prejudice to the 3-year limitation established by the FIL so that foreign investors who have registered their investments can repatriate them (Art. 13 para. 1 (a) FIL).

For FIL purposes, the capitalizations are considered an investment of freely available foreign currency rather than a capitalization of credit (Art. 1 of UEP Resolution 8 of 30 July 1987).[17]

2. Group 2

Group 2 encompasses the liabilities which have been refinanced under Argentine external debt rescheduling plans. Their anticipated cancellation for capitalization purposes does not require authorization from the UEP or the BCRA. However, repatriation is prohibited prior to maturation of the original term projected in the loan or before 10 years from the date of capitalization, whichever is later. Dividends cannot be paid out during the first 4 years, but these unpaid dividends can be remitted in 8 semi-annual installments commencing 4 and a half years after capitalization, subject to regulations in force at the time each payment is made.

Debts arising from the following operations are included in this group:

(i) imports carried out prior to 10 December 1983 whose terms were originally longer than one year;
(ii) financial loans which were not agreed to under BCRA Communication "A" 558, regardless of their date of origin; and
(iii) other liabilities assumed up until 9 December 1983.

B. Debts with foreign exchange insurance contracts

External debts which have entered into unmatured foreign exchange insurance contracts can also be capitalized. All regulations of the Conversion Programme apply to these debts (see above).[18]

C. Swaps

Unmatured debts introduced under swap regulations can be capitalized under one of the following alternatives:

1. Capitalization under the Conversion Programme

The swap is paid off in australs at its counter value. The creditor must comply with the Conversion Programme regulations and obtain authorization of the BCRA prior to the bidding process.

2. Capitalization not under the Conversion Programme

The debtor must waive his rights to any undisposable deposit[19] which may exist at the time the swap is cancelled. The debt will then be considered an obligation

17. This is logical considering the mechanism applied by the BCRA for the conversion: the foreign currency is sold which cancels the external debt to the investor; the investor simultaneously repurchases the same in local currency.
18. Previous authorization of the BCRA is required and interested parties must submit a consultation before the auction. Therefore, the investor must ensure that the project qualifies, obtain any authorizations required by the FIL and obtain the approval of the BCRA before the auction.
19. The term "undisposable" is used here because the deposited funds will only be freed once the matching funds are paid.

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without an exchange insurance contract for the sole purpose of capitalization. The investor will be subject to the limitations discussed above for conversion of obligations without exchange insurance contracts. This mechanism also requires authorization of the BCRA.

V. FOREIGN INVESTORS

As previously stated, foreign investors are subject to all FIL regulations, and henceforth must request the authorizations established in Arts. 4 and 6 FIL if applicable.

In addition, the following rules apply to foreign investors:

1. The amounts resulting from the debt conversion will be considered an investment in foreign currency for FIL purposes, i.e. the conversion mechanism implies an effective sale of foreign currency by the BCRA to the foreign investor and its simultaneous repurchase.[20]

2. The converted amounts may be registered as a foreign investment so long as registration is accomplished according to the terms and conditions established by FIL Decree 103/81. With respect to the amounts corresponding to the converted debt, registration must be requested within 120 days from the date of conversion, without prejudice to the fact that the effects of the conversion commence on the date of the effective capitalization for purposes of calculating the limitation terms for remittance of capital and/or dividends (Arts. 2 and 4 of UEP Resolution 8).

3. According to Art. 7 of ME Resolution 922, the recipient firms cannot remit dividends corresponding to the converted capital to their foreign investors until after the fourth accounting year of the recipient firm. If the recipient firms distribute dividends before that term, the foreign investor may purchase foreign currency so long as he simultaneously executed a fixed deposit in foreign currency for the pending period with the Banco Nacional de Desarrollo.

The 4-year period will be deemed completed once 4 complete accounting years have elapsed as from the date of the first capitalization (made with amounts resulting from the conversion of securities).[21] The UEP issues a certificate which proves that the term has expired (Art. 7 of UEP Resolution 20).

VI. TAX ASPECTS

The difference between the price for which the investor purchases the securities or foreign debt and its sale price to the BCRA is taxable income in Argentina, regardless of whether the investor is domiciled in Argentina. When the Conversion Programme was first established, it was thought that this circumstance could jeopardize the success of the entire Programme. The authorities expressed the intention of enacting exemption legislation. A draft was prepared but it was never sent to Congress. The experience derived from the 2 recent auctions demonstrates that such fears were unfounded. With the success of the Conversion Programme in sight, a law exempting this income from tax must be rejected.

If an investor is a person domiciled in Argentina (i.e. a company or a physical person), the profit derived from the conversion must be included in its taxable income and it will be taxed according to the general rules (33% for companies, 45% for branches and progressive rates ranging from 7% to 45% for physical persons).

If the investor is a foreign beneficiary (i.e. a person who does not have a permanent residence in Argentina), the taxable income will be calculated according to the provisions contained in Arts. 91, 92 and 93 of the Income Tax Law. The tax rate is 45% of the net profit, calculated under one of 2 methods at the taxpayer's option:

(a) 50% of the total price paid to the foreign beneficiary for the converted debt; or
(b) deducting all expenses incurred to obtain the profit (including the acquisition price which must be approved by the Tax Department) from the sale price.

The 45% income tax rate applies to the net profit so calculated.

If the converted debt is represented by nominative bonds in dollars (BONODS) or external bonds of the Argentine Republic (BONEX), the transfer of securities tax at the rate of 0.75% of the purchase price paid by the Central Bank will be applicable (Transfer of Securities Tax, 1986 text, Arts. 1 and 5). The amounts paid may be computed on account of the income tax payable up to the limit of 33% of the profit generated in the conversion transaction if the taxpayer is a corporation and 15% in all other cases (Income Tax Law, 1986 text, Art. 101).

VII. CODEX REGISTRY

In accordance with Art. 9 of ME Resolution 992, UEP Resolution 20 creates the "Registry of Investment Proceedings from the Conversion of Public External Debt". This registry is known as the "Codex Registry". It is independent from the Registry of Foreign Investments and all investments carried out by local or foreign investors with funds resulting from debt conversions must be registered with the "Codex Registry". The Registry also takes note of the variations of capital, distribution of dividends, assignments, modifications in shareholders' participations and, in general, any other information the UEP may deem necessary.

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20. See also the rules set out in UEP Resolution 8/87.
21. Art. 6 UEP Resolution 20.

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VIII. CONCLUSION

This author is of the opinion that the Conversion Programme develops an important mechanism to stimulate the flow of productive investments. Practical experience derived from operation of the programme will undoubtedly bring to light the necessity of implementing complementary regulations (for instance, the taxing regime applicable to benefits arising from the sale of the securities to the BCRA at a price which is higher than the acquisition price). The annual quotas and twice-monthly units of funds must also be handled with certain flexibility to prevent them from interposing formidable obstacles to important investments required by Argentina's economy and infrastructure.

Finally, the administrative offices must adhere to the timetables established for approval of the projects. Persistence in these respects will surely aid in the Conversion Programme's success. The experience gained in the 2 recent auctions verifies that the Programme is a success not only for the government (which is repurchasing its debt with a significant discount) but for investors as well.

ECUADOR: Foreign debt swaps

By Edgar L. Naranjo

At the end of 1984, Ecuador's foreign debt amounted to US$ 6.9 billion and it is estimated that the foreign debt will reach US$ 10.450 billion by the end of 1988, i.e. a 50% increase. During this period the debt structure changed; private banks limited new credit while international lending institutions provided most of the new loans. As a rule the new loans contain softer and longer terms.

The suspension of debt servicing during 1987 complicates the balance of payments for the future. The burden of debt servicing interposes an obstacle to economic growth because it engenders a vicious circle. As a result, the Monetary Board established that the 1 November 1982 - 31 December 1989 maturities of the private sector (i.e. those registered with the Central Bank up to 21 April 1983) could apply for refinancing benefits called "sucretización". "Sucretización" is an agreement under which the Central Bank becomes the debtor of the foreign creditor. The Central Bank accepts the substitution of an Ecuadorian Bank or "Financiera" as its debtor; the original obligation will be denominated in sucres. The Bank or "Financiera" becomes the only creditor of the original private borrower and the debt is denominated in sucres.

The Ecuadorian Government's concern over the foreign debt resulted in the issuance of Regulations 408 and 431 (8 February 1987 and 2 July 1987, respectively) which permit creditors of Ecuadorian private foreign debt which has been "sucretized" to lend (or cede) their paper for operations which will ultimately result in capitalization of companies domiciled or established in Ecuador. The purpose of this procedure is to reduce the size of the outstanding debt, thus reducing the service burden on it and motivate the return of flight capital, as well as strengthen the balance sheets of strategic companies. The foreign creditor is given a market for his paper, the Ecuadorian Government's international liabilities and its future dollar service commitments are reduced and the balance sheet and/or the shareholder roster of the concerned company is bolstered.

The mechanism for debt-equity swaps is as follows: (1) the owner (original or new) of an Ecuadorian obligation which has been "sucretized" can present it to the Central Bank and obtain the equivalent of its nominal value in a sucre credit (at the official rate of exchange) which can only be used for eventual capitalization of an approved company; and (2) the Ministry of Industries will specify the eligible sectors of the economy where such companies exist.

An active market for Latin American foreign debt paper has developed since the international debt crisis started in 1982. However, few of these transactions have been converted into swaps in Ecuador. The authorities explained that the swaps were causing excessive pressure on the free market rate of exchange. In August 1987, the Ecuadorian Government suspended capitalization of its debt. While this procedure was primarily directed to the financial and commercial sectors of the economy, it has not had a significant impact since only 15% of the companies were capitalized with US$ 44 million and another US$ 24 million is pending. The Ecuadorian debt is currently discounted by 67-70% of its face value.[1]

1. A new administration was inaugurated on 10 August 1988 and the authorities may introduce new policies regarding foreign debt swaps.

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NEW ZEALAND:

Final Report of the Consultative Committee on Full Imputation and International Tax Reform*

INTRODUCTORY NOTE

On 17 December 1987 the New Zealand Government released an economic statement proposing major reforms to the country's tax system. A detailed discussion of the proposals contained in this statement was published in the April 1988 issue of the *Bulletin*.

Two of the most significant features of the December economic package were Consultative Documents on Full Imputation and International Tax Reform. Submissions were invited from the public on the measures proposed in both documents and a committee set up under the chairmanship of Mr. Arthur Valabh, a tax partner and partner in charge of Messrs. Deloitte, Haskins and Sells, Auckland. The committee's terms of reference were to receive public submissions, to report to the Minister of Finance on the matters covered by the documents and raised in submissions, to make recommendations should any amendments be considered necessary and to prepare draft legislation to give effect to the proposed measures.

The final report of the Consultative Committee on Full Imputation and International Tax Reform is reproduced below. There follows first a brief summary of the steps leading up to this final report and an outline of the changes made in the process to the proposals set out in the original Consultative Documents. The summary deals first with the measures relating to international tax reform and secondly with those relating to full imputation.

1. International tax reform

The first part of the Valabh Committee's report on international tax reform was presented to the Minister of Finance on 23 March 1988. Whilst the report endorsed the December Consultative Document in broad terms, a number of alterations to the original proposals, some of them radical, were recommended. (For details of the original proposals readers are referred to the April 1988 issue of the *Bulletin* at 180-186.)

The major change advocated in the report was that the application of the branch-equivalent regime should be restricted to circumstances where New Zealand residents control a foreign company provided that certain criteria concerning the company's overseas residence are also met. Under the branch-equivalent regime the income of an overseas company is calculated according to New Zealand principles; the resident shareholder's percentage interest in this income is then included in his return and taxed in the normal manner. In the Consultative Document it was proposed that the branch-equivalent method of taxation would apply to all interests of New Zealand resident shareholders in the undistributed income of foreign companies where certain income limits were exceeded. The recommendation of the Committee was that the regime should only apply to New Zealand residents holding interests of not less than 10% in companies, 50% of which are owned by 5 or fewer New Zealand residents. Furthermore, taxpayers with interests in such controlled foreign companies (CFCs) in certain "white-list" countries which themselves have CFC legislation would be exempt from branch-equivalent taxation. There would also be a "grey list" of countries with high tax rates but offering tax preferences (such as exemptions or concessionary rates for foreign income) which may result in a low effective tax rate. If such tax preferences were utilized, then the branch-equivalent regime would be applied.

A second significant change recommended in the Committee's report was the introduction of a foreign investment fund (FIF) regime to operate in conjunction with the branch-equivalent regime. FIFs would basically be overseas entities which derive income largely from holding or trading portfolio investments and which, because of their country of residence and their distribution policy, pay less tax on such income than would have been paid had the income been derived in New Zealand. The income of investors in FIFs would be calculated by comparing the market value of their investments at the beginning of the income year with that at the end of the income year (the comparative value method). Should interests in overseas entities be caught under both the branch-equivalent and FIF regimes, the branch-equivalent regime would apply.

The third important new proposal put forward in the Committee's report was that a "settlor" regime be introduced for overseas trusts. Under such a regime overseas trusts would be treated as a New Zealand resident where the settlor was a New Zealand resident, thus enabling non-resident trustees to be taxed as if

* The introductory note was written by Nick C. Webb of the International Bureau of Fiscal Documentation.

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they were New Zealand residents. Should the non-resident trustees fail to comply with the regime liability would fall on the New Zealand resident settlor.

On 25 March 1988 the first part of the Consultative Committee's report on international tax reform was made public and a joint statement issued by the Minister of Finance and the Minister of Revenue which generally endorsed the Committee's conclusions. Three reservations about the Committee's recommendations were articulated. Most importantly the exclusion of all non-controlling shareholders of active tax haven entities from the FIF regime was seen to be a cause for concern. It was felt that the definition of investments and income under the fund provisions would need to be carefully considered to ensure that no obvious avoidance opportunities remained. The Government was of the opinion that this area would have to be closely monitored and that if problems emerged, the regime might have to be strengthened accordingly. Doubts were also expressed about the Committee's recommendation that capital profits earned by trusts subject to the "settlor" regime and by testamentary trusts after 31 March 1989 should be allowed to pass through to beneficiaries tax-free. The Government's view was that this recommendation should be considered further in the context of imputation and super-annuation reforms. The Government's third reservation was of less significance and concerned transitional measures relating to the taxation of trusts settled on or before 17 December 1987.

2. Full imputation

The Valabh Committee's initial report on full imputation was released by the Minister of Finance and the Minister of Revenue on 15 April 1988. The report largely upholds the proposals made in the December Consultative Document (see the April 1988 issue of the *Bulletin* at 186-190) and also examines the relationship between imputation and the withholding payments and international tax regimes. A number of alterations to the original proposals contained in the Consultative Document are suggested in the report and these are now summarized.

In order to ensure that tax credits were distributed on a pro rata basis, the Consultative Document proposed certain criteria to restrict the differential allocation of tax credits to holders of the same class of shares. The Committee's report envisages problems in defining share classes and therefore advocates a system which would require companies to maintain the same ratio of tax credit to net distribution for all distributions made during the income year. Thus the first distribution made in any income year would fix the ratio for all subsequent distributions made up to the following 31 March.

The second major change suggested was the creation of an option concerning bonus share issues. Under the system originally proposed in the Consultative Document companies would be allowed to attach imputation credits to bonus issues of shares as well as to dividends. The report of the Consultative Committee recommends that companies be allowed to make 2 kinds of bonus issues – taxable bonus issues which would carry imputation credits and which would form part of the paid-up share capital, and non-taxable bonus issues which would not carry imputation credits and which, for tax purposes only, would not form part of the paid-up capital.

Another major departure from the original proposals was the rejection by the Committee of the suggestion that the distributions of co-operatives to members should be treated in the same way as the distributions of other companies. Instead, the report advocates that distributions made by co-operatives to their members in the way of business transactions should continue to be deductible. The Committee did, however, accept that distributions to members made purely because of their membership should be subject to imputation.

The final significant change recommended in the initial report is the treatment of distributions made by companies during the course of a winding-up. The report proposes that distributions of retained profits and other taxable reserves made by companies in these circumstances prior to 1 April 1989 would be subject to a winding-up distribution tax at a rate of 10%. The tax would not apply to distributions out of dividends received by companies after 15 April 1988, the date on which the measure was announced.

On 28 July 1988 the second and final report of the Consultative Committee on Full Imputation and International Tax Reform was released together with draft legislation. The text of the report together with an introductory statement by the Minister of Finance and the Minister of Revenue is reproduced below.

Changes to the regimes developed and presented in the 2 earlier reports are relatively small and the emphasis of the report is rather on the detailed implementation of the 2 systems. With a few minor reservations, which are referred to in the text, the Committee's conclusions have been accepted by the Government.

Statement by

Minister of Finance, Hon RO Douglas
Minister of Revenue, Hon TA de Cleene

INTRODUCTION

This document is the final report of the Consultative Committee on Full Imputation and International Tax Reform. It contains the recommendations of the Committee on the further detailed measures required for the operation of the imputation and international tax regimes. The draft legislation for these regimes is set out in a separate annex to the Committee's report.

As noted by Mr. Valabh in his covering letter, the report involves a number of changes to the regimes

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developed by the Committee and presented in its first reports but nothing which could be described as fundamental. These changes reflect the detail required to implement the regimes in accordance with the structure and principles already approved.

The Government supports the Committee's recommendations subject to some minor changes and reservations on definitional matters as highlighted further below. An enormous amount of detail has had to be developed in a relatively short space of time. We concur with the Committee that the overall regime is now at a sufficiently advanced stage for the legislation to be circulated. After being introduced to the House, the Bill will be referred to a Select Committee. There will then be a final opportunity for submissions.

IMPUTATION

The Government endorsed the Committee's recommendations on imputation set out in its earlier report. There were relatively few issues that required further work. The Committee now makes additional recommendations on the rules governing the allocation of imputation credits, the inclusion of co-operative companies and producer boards within the imputation regime, the treatment of returns of capital, the carry forward of unutilised imputation credits, the operation of the dividend withholding payment system, and on consequential changes to the definition of a dividend and to the excess retention tax and deemed dividend provisions. All these recommendations are supported subject to the following changes.

First, the Committee recommends that distributions subject to the winding-up distribution tax of 10% should not also be subject to non-resident withholding tax. It had been envisaged that the winding-up distribution tax would be enacted along with the imputation and international tax reforms later in the year. The Government considers that it would instead be preferable to enact this measure as soon as possible to facilitate the winding-up process. Accordingly, the Government has decided that the measure will be enacted through the Taxation Reform (No. 4) Bill.

Secondly, the Committee has recommended that fringe benefits received by a major shareholder/employee be subject to the FBT regime rather than the current deemed dividend provisions, in respect of fringe benefits other than loans with effect from 1 April 1988, and in respect of loans with effect from 1 October 1988. The Government agrees with the extension of the FBT regime but has decided that the change apply to fringe benefits including loans with effect from 1 April 1988. It will give further consideration to the details of the change to take account of anti-avoidance rules which are being developed to strengthen the provisional tax regime. Consideration also needs to be given to the implications for companies which wind up before the legislation extending the FBT is passed.

In its earlier report the Committee recommended that the date for the first withholding payment by companies, in respect of foreign-source dividends received after 1 April 1988, be the 20th of the month following the month in which the necessary legislation is passed. Given the scheduled enactment of the legislation later this year, the Government has decided that, in order to provide greater certainty for taxpayers, the date for the first withholding payment will be 20 January 1989.

INTERNATIONAL TAX

The international tax regime recommended by the Committee in its first report comprises a branch-equivalent (BE) regime, a foreign investment fund (FIF) regime, and a revised trust regime. The regimes are designed to reduce the myriad opportunities for residents to avoid or defer New Zealand tax where they interpose foreign entities between themselves and income-producing assets.

The legislation has been drafted to ensure that the 3 regimes support one another and other recent tax reform. The provisions are necessarily detailed and are supported by a number of anti-avoidance provisions. These should not be read down given the clear objective of the reforms. The purpose of the BE regime is to tax on a current basis New Zealand residents having economic or financial interests, including contingent interests, in the income of any foreign company where 5 or fewer residents in any manner whatsoever have a 50% or more interest in the company. The purpose of the FIF regime is also to tax residents on a current basis where they have interests in, but do not control, foreign entities in which they are able to accumulate income and obtain taxation advantages. Such interests include policies with foreign life offices and superannuation funds. The revised trust regime supports the BE and FIF regimes by generally taxing on a current basis the foreign-source trustee income of trusts having a New Zealand settlor, and taxing to New Zealand resident beneficiaries distributions from non-resident trustees.

We highlight the following features:

Aspects of BE regime

Two important aspects here include the measurement of interests and an additional transitional measure. The Committee originally considered that a resident's control and income interests be measured on each day of the foreign company's accounting year. After further consideration, in light of the high compliance costs of daily measurement, the Committee now recommends that a resident's control and income interests be measured at the end of each quarter in a year and that anti-avoidance measures be adopted. In our view, this line strikes the right balance between minimising compliance costs and countering avoidance.

The Committee recommends that in respect of existing investments taxpayers should have the option of apply-

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ing the BE regime before the end of the transitional period so that losses during that period may be accounted for in determining future BE income. In exercising this option, however, taxpayers cannot bring in losses and not profits. Accordingly, taxpayers will be entitled to elect, in respect of all of their income interests held on 17 December 1987 in all CFCs resident in countries not on the transitional list, to apply the BE regime for the accounting years of such CFCs falling in whole or in part during the period 1 April 1988 to 31 March 1990.

The Government has also decided the composition of, and the nature of the qualifications to, the permanent and transitional country lists as discussed below.

Grey list

The costs of complying with the BE regime should not exceed the revenue to be gained. For this reason, taxpayers with interests in CFCs resident in certain listed countries will not be subject to the regime. However, if stated preferences are utilised the BE regime will apply and income will be computed on a simplified basis. This list of countries is called a grey list.

Australia, Canada, France, Japan, the Federal Republic of Germany, the United Kingdom, and the United States of America will be on the grey list (see Attachment A). The relevant considerations in deciding the list included: the definition of taxable income, the extent of any tax preferences, the level of income tax rates, the efficiency of tax administration and the extent of protection of the domestic tax base (including a comprehensive international tax regime) in each country.

It might be argued in certain circumstances that a taxpayer with an interest in a CFC in a grey-list country will be treated more favourably than a taxpayer with a similar interest in a non-listed country. However, favourable treatment in this context means only that some taxpayers are freed from additional income calculations; it does not necessarily mean that there is any anomaly in terms of tax liability. Rather than make all taxpayers calculate their BE income, it is preferable to relieve at least some from compliance costs where there is little risk to revenue.

Qualification of grey list

The general qualification to the grey list relates to business income derived by a CFC from outside the listed country in which it is resident which is not subject to tax in that country. Other forms of income such as interest and dividends are also being considered for qualification. A general qualification rather than a qualification by country is favoured at this stage. Should it be necessary to introduce country qualifications they will have prospective effect.

Transitional list of low tax countries

Under the transition recommended by the Committee, residents with interests acquired on or before 17 December 1987 in companies resident in countries other than low tax jurisdictions will be exempt from the BE regime until 31 March 1990. The list of low tax jurisdictions for this purpose is contained in Attachment B. The list is an updated and more detailed version of the illustrative list set out in the Committee's earlier report.

Trusts

The Committee has recommended changes to these trust regime set out in Part 1 of its report but these are of detail rather than of principle. The Committee continues to hold to the following principles:

- the taxation of foreign-source trustee income (ie income which is not taxed as beneficiary income) should be determined by the residence of the settlor, rather than by the residence of a trustee as is currently the case;
- where there is a resident settlor of a trust in the year in which the trustee of the trust derives foreign-source trustee income, the liability for New Zealand tax on that income should rest in the first instance with the trustee (whether that trustee is a resident or a non-resident) and if the trustee does not meet the liability and is not resident in New Zealand, the liability should fall to the resident settlor.

Transitional provisions apply where a resident settled a trust on or before 17 December 1987.

In addition, the Government has decided that testamentary or inter vivos trusts settled by a person who dies a resident of New Zealand, should also be subject to New Zealand tax on their foreign-source income where such trusts have a resident trustee. Although in these cases there is no resident settlor in the year trustee income is derived, the resident trustee provides a sufficient basis for taxation.

With respect to the recommended taxation of distributions from trusts, effective from 1 April 1988, the Government has decided to modify the treatment recommended by the Committee for foreign trusts (trusts which at no time since 17 December 1987 have had a settlor who is a New Zealand resident). As recommended, distributions from the trustee income of such trusts derived in income years commencing after 1 April 1987, other than of corpus and capital profits, would be assessable to a beneficiary at his of her marginal tax rate but other distributions from such trusts would be non-assessable. The Government has decided that distributions of trustee income of such trusts derived in income years commencing on or before 1 April 1987 should also be assessable to a beneficiary but at a flat rate of 10%. This treatment is consistent with the transitional provisions recommended by the Committee in respect of trusts settled before 17 December 1987 which are either wound up by 31 March 1989 or brought within the new settlor regime for the 1989 income year.

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Under the new trust regime recommended by the Committee, the existing distinction between specified and non-specified trusts will be removed with effect from the income year commencing 1 April 1988 (the distinction was originally made to limit the scope for income splitting). Along with this change, the Committee has recommended a widened definition of beneficiary income to include income of a trust which vests in a beneficiary, as well as income paid to or applied for the benefit of a beneficiary within 6 months of the end of a trustee's income year. The Government wishes to consider further the definition of beneficiary income.

Residence rules

The definitions of residence under the Income Tax Act will be amended in order to reduce the scope for individuals and companies to manipulate their affairs to obtain taxation advantages. The new definitions, building on existing concepts, make it easier for a person to become a resident of New Zealand and harder to become a non-resident, and they more precisely define residence for companies.

In brief, if a person has a permanent place of abode in New Zealand or is present here for at least 183 days in any year he or she is resident, only ceasing to be so if absent for at least 325 days in any year having during that time no permanent place of abode here. A company will be resident in New Zealand if it is incorporated here or has its head office or its centre of director control or executive management here. There will be no special rule for banking companies.

Other legislative changes

To support the regime recommended by the Committee, 2 other legislative changes are required. These will be made through the Taxation Reform (No. 4) Bill.

The first change is to the low income earner rebate. Despite the substantial reduction in the incentives for income splitting as a result of the flattening of the income tax scale, the Government is concerned to reduce them even further. Accordingly, it has decided to include beneficiary income in income which does not qualify for the low income earner rebate.

The second change relates to the rate of taxation of trustee income. The Committee has recommended a complete upgrading of the taxation of trusts including the removal of the distinction between specified and non-specified trusts from 1 April 1988. The uniform treatment of trustee income is an integral part of the trust regime and hence of the overall international regime since the BE, trust, and FIF regimes are mutually interlocking.

Accordingly, the trustee income of all trusts will be taxed at a rate of 35% or at the marginal composite rate scale for individuals (whichever is the higher) in the current year. From the 1989 income year, trustee income will be taxed at the top marginal rate for individuals (33% in that year).

This change will mean that some trustee income will be subject to a higher rate of tax than it would otherwise have been in the current year. This move towards a more uniform taxation of trustee income has been foreshadowed both in terms of the rates as originally set out in the No. 4 Bill and the Government's acceptance of the Committee's earlier recommendations on the reform of the taxation of trusts.

Earlier reservations

There were 3 issues on which Government expressed reservations in response to the Committee's first report on international tax reform:

(a) the exclusion from the fund regime of the interests of residents in active businesses in low tax countries;
(b) the treatment of capital profits from certain trusts; and
(c) the transitional provisions in respect of trusts settled by residents before 17 December 1987.

The Government maintains its reservation in (a) and will be closely monitoring the FIF regime and strengthening it if necessary. As mentioned below, the reservations in (b) and (c) are removed in the light of changes to the Committee's recommendations on trusts.

The Committee recommends that where a trust settled on or before 17 December 1987 does not wind up before 1 April 1988 or the settlor, trustee or a beneficiary does not pay a tax of 10% on the net assets of the trust at 31 March 1988, distributions from the trust would be treated as non-qualifying distributions. This means that all such distributions (other than of corpus) would be taxable to beneficiaries at a tax rate of 45%. The Government considers that this measure provides a sufficient incentive for settlors in a position to do so to wind up such trusts or subject their foreign-source trustee income to tax in New Zealand.

Under the non-qualifying distribution provisions, distributions of capital profits would be taxed to a beneficiary. Distributions of capital profits which are not non-qualifying distributions would be non-assessable. Capital profits would of course, in some cases, continue to be taxable as trustee or beneficiary income. Capital profits of trusts that are foreign investment funds would also be taxable to residents. The recommended taxation of distributions of capital profits from trusts is broadly in line with existing treatment. However, it will need to be reviewed in considering the introduction of a capital gains tax.

CONCLUSION

The Government supports the recommendations of the Consultative Committee subject to some relatively

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minor changes and reservations. The changes, as discussed, relate to:

- the timing of the implementation of the winding up tax on distributions;
- the timing of the extension of the fringe benefit regime to major shareholders/employees for concessionary loans;
- the taxation of the foreign-source trustee income of certain trusts which have a resident trustee but no resident settlor; and
- the taxation of certain distributions from foreign trusts.

As discussed, the only points on which the Government reserves its position at this stage concern:

- the definition of a foreign investment fund. The Government maintains its earlier reservation and will strengthen the fund regime if necessary;
- the need for anti-avoidance rules to support the extension of the fringe benefit tax; and
- the definition of beneficiary income under the new trust regime.

The Goverment has also decided that in order to provide greater certainty for taxpayers the date for the first withholding payment by companies, in respect of foreign-source dividends received after 1 April 1988, will be 20 January 1989.

In addition to the legislation to implement the measures recommended by the Committee, 2 other consequential legislative changes are required. One is the addition of beneficiary income to the list of income which does not qualify for the low income earner rebate. This is designed to counter income splitting. The other change required is the rationalisation of the rate of taxation of trustee income. This is necessary given the removal of the distinction between specified and non-specified trusts under the new trust regime. These changes together with the distribution winding up tax will be implemented through the Taxation Reform (No. 4) Bill.

The Government has decided the composition of, and the nature of the qualifications to, the permanent and transitional country lists for the purposes of the BE regime. The lists are set out in Attachments A and B to this statement.

Once again we record our thanks to the Committee. It is to be commended for its report and for its professional commitment to seeing through an extremely difficult job. Chaired by Mr. Arthur Valabh, the Committee comprises Dr. Robin Congreve, Mr. Stuart Hutchinson, Dr. Susan Lojkine, Professor John Prebble and Mr. Tim Robinson.

After being introduced to the House, the Bill giving effect to the imputation and international tax reforms will be referred to a Select Committee. There will then be a final opportunity for submissions. We commend a close examination of the Committee's report and the draft legislation to all interested parties.

ATTACHMENT A

PERMANENT LIST OF EXCLUDED COUNTRIES

Australia, excluding the Territory of Norfolk Island;

Canada;

Federal Republic of Germany;

French Republic, including the European and Overseas Departments, but excluding the Overseas Territories;

Japan;

United Kingdom of Great Britain and Northern Ireland;

United States of America, but excluding its possessions and territories.

Notes:

1. The Government has considered the Consultative Committee's recommendations concerning the listing of preferences and has decided that initially it would be more appropriate to list general features of tax systems which might be used to avoid the BE regime rather than listing specific preferences in relation to individual countries listed above. However, the Government intends to monitor developments in the seven listed countries. Once it is decided to list a particular preference or feature, or amend a listing, the change will apply prospectively.
2. The legislation presented to Parliament will include one general qualification which will apply to all of the above listed countries. Interests in a CFC resident in a listed country will be subject to the BE regime where a CFC derives certain forms of foreign-source income which are not subject to income tax in the listed country of residence. At this stage, it has been decided that the general qualification will apply to foreign-source "business" income. Other forms of foreign-source income, such as interest and dividends, are being considered for inclusion in this general qualification too.

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ATTACHMENT B
TRANSITIONAL LIST OF LOW TAX JURISDICTIONS OR TERRITORIES

Andorra
Angola
Anguilla
Antigua and Barbuda
Bahamas
Bahrain
Barbados
Bermuda
British Channel Islands
British Virgin Islands
Campione
Cayman Islands
Cook Islands
Costa Rica
Cyprus
Djibouti
Dominica
Ecuador
French Polynesia
Greece
Grenada
Gibraltar
Guatemala
Hong Kong
Isle of Man
Jamaica
Jordan
Kuwait
Lebanon
Liberia
Liechtenstein
Luxembourg
Macau
Madeira
Maldives
Marshall Islands
Monaco
Montserrat
Nauru
Netherlands Antilles and/or Aruba
Nevis
New Caledonia
Norfolk Island
Oman
Panama
Palau
Puerto Rico
Saint Helena
Saint Kitts
Saint Lucia
Saint Vincent
San Marino
Seychelles
Solomon Islands
Sri Lanka
Switzerland
Turks and Caicos Islands
United Arab Emirates
Uruguay
Vanuatu
Venezuela

Belgium
- companies which are regarded as Foreign Sales Corporations by the United States of America and which therefore qualify for reduced Belgian taxation
- companies approved under Royal Decree No 187 of 30 December 1982 as Coordination Centres (as defined by the original Royal Decree or by subsequent amending laws)

Brunei
- companies deriving income from sources outside Brunei

Ireland
- companies obtaining relief or exemption from tax under Part V of the Corporation Tax Act 1976 or Sec. 43 of the Finance Act 1980 (profits from trading within Shannon Airport)
- companies obtaining relief or exemption from tax under Part IV of the Corporation Tax Act 1976 or Sec. 42 of the Finance Act 1980 (profits from exporting certain goods)
- companies certified by the Minister of Finance to provide international financial services or to carry on any other activities in the Customs Dock area

Kenya
- companies having income granted exemption from tax under para. 11 Schedule 1 of the Income Tax Act 1973

Malaysia
- companies exempt from tax in relation to shipping
- companies subject to tax at 5% in relation to inward reinsurance
- companies deriving income from sources outside Malaysia

Netherlands
- companies exempt from tax under the Decree for the Avoidance of Double Taxation 1985 for foreign source business profits
- companies which have obtained a participation exemption under Art. 13 of the Corporate Income Tax Act 1969 or under Art. 18 of the Corporate Income Tax Act 1969
- companies which are regarded as Foreign Sales Corporations by the United States of America and which therefore qualify for reduced Netherlands taxation
- companies which have obtained an advance ruling from the Ministry of Finance in relation to income earned with respect to intercompany loans

Philippines
- companies which are regional headquarters companies
- companies which operate as an Offshore Banking Unit or a Foreign Currency Deposit Unit
- companies which receive interest on deposits with a Foreign Currency Deposit Unit, or other interest subject to reduced rates of tax under the National Internal Revenue Code

Singapore
- companies subject to the concessionary rate of tax for insurance and reinsurance of risks outside Singapore
- companies which operate Asian Currency Units which have income –
  - taxed at a concessionary rate by virtue of Sec. 43A of the Income Tax Act
  - exempted from tax under the Income Tax (Income Arising from Syndicated Offshore Loans) Regulations 1984
- companies which are exempt from tax on the income of a shipping enterprise
- companies which derive any income to which Sec. 43E of the Income Tax Act applies (headquarters companies)
- companies which are incorporated in Singapore but not managed and controlled from Singapore and which derive any income from sources outside Singapore

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INDONESIA:

Central Transfers and Local Finances

By J.S. Uppal

Dr. J.S. Uppal, Professor of Economics, State University of New York at Albany. He completed this paper while he was a visiting professor of Economics, Gadjah Mada University, Yogyakarta, Indonesia.

A study of the fiscal structures of countries at varying stages of development shows that, in general, the degree of fiscal centralization as indicated by central government revenues and expenditures as a proportion of total revenues and outlays (see Tables I and II) tend to be higher in developing than in developed countries. Several reasons account for the high degree of fiscal centralization in developing countries, i.e. lack of administrative skills at the local level, the high level of regional disparities and strong political pressures for balanced development and the need for a strong central authority to keep separatist tendencies (including secession movements) under strict control. In addition, developing countries are engaged in centralized planning for overall socio-economic development, including provision of vital infrastructure such as communication, transport and irrigation projects.

Indonesia appears to be in a state of development in which a high degree of fiscal centralization may be an economic and political necessity; however, with decreasing oil revenues and the falling related tax receipts, the central government is likely to expect the sub-national (provincial and local) governments to raise more revenue to finance their increasing expenditures. This is likely to enhance the role of provincial and local governments in the Indonesian fiscal structure. This paper discusses the magnitude of central transfers to provincial and local governments in Indonesia and estimates the impact of these transfers on the fiscal structure of provincial and local governments as well as on the balanced regional development of the country.

CENTRAL TRANSFERS

The share of provincial and local governments in central revenues falls into 2 categories in Indonesia: assigned revenues and grants. Assigned revenues include cesses, taxes and royalties initially levied by the central government but assigned wholly or in part to the sub-national governments. Included in these revenues are property tax (*Pajak Bumi Dan Bangunan*), the tax on property-land and urban buildings, the share of royalties on timber extracted from provincial and local territories, and cess on cloves (*Sumbangan Rehabilitasi Cengkt*) and copra (*Dana Rehabilitasi*). Grants paid by the central government to provincial and local governments for general and specific projects include subside *Derah Otonom* to cover salaries and

Table I

The degree of fiscal centralization in selected developing countries

Country	Central government revenues as percent of total government revenues[a]	Intergovernmental fiscal transfers as percent of subnational revenues[b]	Subnational revenues from own sources as percent of total government revenues
Syria, 1970	96.3	40.5	2.2
Panama, 1968	95.8	4.8	4.0
Ceylon, 1968	94.7	20.8	4.2
Peru, 1967	94.2	10.3	5.2
Paraguay, 1971	93.6	0.0	6.4
Viet-Nam, 1967	92.9	60.6	2.8
Zambia, 1967	91.7	18.1	6.8
Malawi, 1966	91.5	56.5	3.7
Costa Rica, 1968	90.2	44.9	5.4
Turkey, 1964	87.7	46.3	5.7
Dominican Republic, 1964	87.7	65.9	4.2
Israel, 1968	86.0	18.6	11.4
Indonesia, 1970	83.8	90.1	1.6
Philippines, 1963	80.6	42.3	11.2
Kenya, 1968	80.5	16.9	16.2
Venezuela, 1969	80.5	71.8	5.5
Tanzania, 1965	71.3	24.3	21.7
Uganda, 1965	67.8	37.9	20.0
Columbia, 1967	58.7	12.6	36.1
Korea, 1970	58.5	60.5	16.4
Taiwan, 1969	55.5	18.2	36.4
Nigeria, 1965	44.6	52.2	26.5
Brazil, 1968	39.6	21.0	47.7

a. Includes transfers from higher-level governments.
b. In some cases includes taxes collected by central government for subnational governments.

Source: World Bank, *Inter Governmental Fiscal Relations in Developing Countries*, Working Paper 304, Washington, DC (October 1978), at 8.

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Table II

Proportion of central government revenues in total government revenues in selected developed countries, 1976-81

France	84%
United Kingdom	71%
Sweden	57%
Germany (West)	57%
United States	55%
Australia	51%
Switzerland	47%
Canada	41%

Source: Harvey S. Rosen, *Public Finance*, Richard Irwin, Homewood, Illinois (1985) at 506.

responsibility allowances, plus two-thirds of the food allowances of "organic" civil services employed by or attached to provincial, Kabupatan and Katamadya governments; *Bantuan Pembanguan Dati I* (Provincial Development Grant) often known as *Inpress Provinsi* or *Inpress Dati I,* for development projects undertaken by provincial governments; *Bantuan Kabupaton* (District Development Grant) paid to all Kotamadya and Kabupatan governments for expenditure on development projects within the guidelines prescribed by the central government; *Bantuan Pembanguan Sekolah Dasar* (elementary education grant); *Bantuan Sarana Kesehatan* (public health grant); *Subsidi Pembiayana Penyelengg-Araan Sekolah Dasar* (school operation and maintenance grant). In addition to assigned revenues and grants, substantial amounts of the central budget are spent on projects falling within the domain of the regional governments.

CENTRAL TRANSFERS TO SUB-NATIONAL GOVERNMENTS

The magnitude of the central transfers to provincial and local governments is estimated in Table III. The relative position of inter-governmental transfers in the budgetary receipts of provinces and municipalities (Kotamadya) and Kabupatan is indicated in Tables IV and V.

It may be noted that the provincial and Kotamadya/ Kabupatan governments have high degrees of fiscal dependence; 76.41% and 86.96% of their total revenues, respectively, come from transfers from higher levels of government. The revenues of provincial and local governments derived from their own sources constitute only 23.59% and 13.04% of their total receipts, respectively. Additionally, most of their sources are minor (note the small amount of revenue raised) and their taxes inelastic and uneconomic. The above figures, however, do not include the massive outlays spent by various ministries of the central government on projects, both from the routine and development budgets of the central government. Bappenas (Planning Commission) also spends substantial amounts on various development programmes under Repelita (5-

Table III

Central government transfers to provinces 1977-78 (in billions of rupiahs)

	1977-78		*1980-81*		*1982-83*	
	Amount	% total *Budget*	*Amount*	% total *Budget*	*Amount*	% total *Budget*
Current receipts	471.7	76.3	963.6	74.6	1282.2	74.7
Development receipts	83.3	58.1	218.3	60.0	294.7	65.5
Total	555.0	72.8	1181.9	71.4	1576.9	72.8

Source: Calculated from: *Statistic Keuangan Premerintah Daerah*, 1986.

Year Plans). If this direct expenditure from the central government is taken into account, the already high ratios of fiscal dependence will increase considerably.

In addition to the high degree of fiscal dependence on the central government, the strict system of budgetary controls practiced in the Indonesian fiscal structure should also be noted. As mentioned above, the central government must approve the budgets of provincial governments, which in turn approve the budgets of local governments. Every project funded under the various grants must be approved by some higher level of government. The budgets of all levels of government must be balanced and this requirement limits budgetary options of the respective governments.

CENTRAL TRANSFERS AND REGIONAL BALANCED DEVELOPMENT

Central government transfers to provincial and local governments are of high magnitude. Thus, the central government transfers and expenditures can play a dominant role in achieving balanced regional development by removing regional disparities in income. The central government also directs expenditures and investments under Repelita in different provinces and transfers to provincial governments can help to eliminate poverty, thus promoting the economic development of the provinces. The extent to which the central outlays and transfers have achieved these goals is examined in this section.

In Table IV the Indonesian provinces are arranged in descending order of their per capita non-mining Gross Regional Domestic Product (GRDP).[1] Figures are provided on central government expenditure and transfers as a proportion of the non-mining GDP of the provinces. Figures are also given on the percentage of total investment made under Repelita I-III in various provinces. The incidence of poverty, i.e. the percentage of the population below the poverty line in various provinces, is set forth in Table VI. Since we are interested in the impact of central outlays on the

1. The provincial income from mining and oil is excluded from the GRDP since the inclusion of income from these sources for few provinces overstates their GRDP. In addition, income from oil and mining accrues to the central government for spending in the country as a whole rather than to the provinces.

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Table IV

Sources of revenue for provincial governments (first stage regions) in Indonesia 1980-81 and 1982-83
(percent of total revenue)

Revenue sources		1980-81		1983-84	
A.	*Revenue from own sources*		24.60		23.59
	(a) Taxes		11.90		12.00
	Household tax	0.10		0.24	
	Transfer duties on motor cars	6.50		6.81	
	Tax on motorized vehicles	3.40		3.80	
	Surcharge on wealth tax	0.10		0.00	
	Tax on forestry products	0.00		0.00	
	Tax on fuel	0.01		0.01	
	Tax on fish catch	0.01		0.01	
	Other taxes	1.78		1.13	
	(b) Income from local government enterprises		0.20		0.30
	(c) Receipt from services		1.20		1.50
	(d) Rental receipts (land, housing and buildings, vehicles)		0.01		0.02
	(e) Receipts from official services agencies		0.80		0.90
	(f) Miscellaneous (including loans)		10.49		8.87
B.	*Inter-governmental revenues*		75.40		76.41
	(a) Assigned revenues[1]	6.1		3.57	
	(b) Grants[2]	69.3		72.84	

Sources: Calculated from Biro Pusat Statistik, *Statistik Keuangan Pemerintah Daerah, Daerah Tingkat II*, and *PRISMA* 12 (1985) at 38-39. J.S. Uppal, *Taxation in Indonesia*, Gadjah Mada University Press Yogyakarta (1987) at 70-71.

1. Assigned revenues are composed of Ipeda and royalties and cesses 5.4. and 2.6%, respectively during 1980-81. Ipeda (tax on land and buildings) has been replaced by a new property tax (Pajak Bumi dan Bangunan) since 1 January 1986.
2. Grants are composed of Subsidi Daerah Otonam and Inpress Programmes (other grants) 46.0 and 23.3%, respectively during 1980-81.

Table V

Sources of revenue for municipalities (Kotamadya) and Kabupatan in Indonesia, 1980-81
(percent of total revenue)

Revenue sources		1980-81	
A.	*Revenue from own sources*		13.04
	(a) Taxes		2.84
	1. Entertainment taxes	1.10	
	2. Restaurants and hotel taxes	0.68	
	3. Radio tax	0.04	
	4. Foreigners tax	0.15	
	5. Slaugther tax	0.08	
	6. Tax on non-motorized vehicles	0.05	
	7. Advertisement tax	0.08	
	8. Dog licences	0.13	
	9. Liquor tax	0.01	
	10. Toll road	0.15	
	11. Enterprise registration tax	0.14	
	12. Other taxes	0.23	
	(b) Tax on local services		4.93
	(c) Receipt from official services		0.93
	(d) Rental receipts (land, houses and buildings and vehicles) and others		1.00
	(e) Income from local government enterprises		0.26
	(f) Miscellaneous receipts		3.08
B.	*Inter-governmental revenues*		86.96
	(a) Assigned revenues	7.30	
	(b) Grants	79.66	

Sources: Calculated from Biro Pusat Statistik, *Statistik Keuangan Pemerintah Daerah, Daerah Tingkat II*, and *PRISMA* 12 (1985) at 38-39. J.S. Uppal, *Taxation in Indonesia*, Gadjah Mada University Press, Yogyakarta (1987).

relative position of various provinces in regard to their per capita GDP, the coefficients of rank correlation between the per capita non-mining GRDP and central outlays mentioned above have been computed. Table VII provides the coefficients of rank correlation.

The negative and significant rank correlation between the provincial per capita GRDP and central transfers suggests that the allocation of central transfers is greater in provinces with lower per capita GRDP and vice versa. Similarly, the central government investments under Repelita I-III have been greater in provinces with lower per capita income. All of these relationships suggest that various central outlays tend to contribute to the elimination of regional disparities in income and, indirectly, reduce the incidence of poverty, which, as the negative correlation coefficient suggests, tends to be less in provinces with higher per capita non-mining GRDP. In other words, the central outlays including transfers, direct expenditures and investments under Repelita I-III tend to assist in reducing regional disparities and thus achieve balanced regional development.

CENTRAL TRANSFERS, "TAX EFFORT" AND "FISCAL NEED"

What factors should guide the determination of central transfers to sub-national governments? The literature on inter-governmental finance suggest several formulae, incorporating factors such as tax effort, i.e. the tax actually collected by a jurisdiction as opposed to tax capacity or tax potential. In other words, tax effort is the amount of tax the jurisdiction is capable of collecting on the basis of some tax base, generally per capita income. The ratio between tax effort and tax capacity is referred to in literature as tax performance. Realizing that all citizens of a country have a right to certain basic minimum public services, the total outlays required to provide those services in that jurisdiction constitute its "fiscal need". Fiscal need is also referred to as the cost of maintaining socio-economic infrastructure such as transport and communications, educational institutions and public health centres. It is argued that fiscal transfers and government outlays should have the "equalization effect" of achieving reasonable equality in the provision of basic public services. The extent to which central transfers and outlays in Indonesia conform to the various fiscal criteria will be examined in this section.

Table VIII provides estimates on tax effort in various provinces during 1982-83. Tax effort is defined to include revenues raised from own sources (including local taxes, receipt from general services and receipt from official services) as a proportion of per capita GRDP. Assuming the national average tax rate (total revenues from own sources in all provinces in Indonesia as a proportion of the Indonesian per capita GRDP) as the standard tax rate (akin to tax capacity),

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Table VI

Gross domestic product, central government expenditure and incidence of poverty in provinces, 1980

Province (according to decreasing order of per capita/GRDP)	Per capita GRDP (R_p)	Central government expenditure % of non-mining GDR	Central government transfers as % GRDP/PC	Percent of total investment under Repelita I-III	Incidence of poverty – % population below poverty line[a]
East Kalimantan	301.470	16	2	3.9	13.4
DKI Jakarta	264.620	23	18	17.8	16.9
South Sumatra	145.320	13	7	3.0	13.6
Central Kalimantan	140.080	17	15	0.7	12.3
North Sumatra	130.470	12	8	3.3	20.4
North Sulawesi	119.330	19	15	0.8	32.7
Maluku	118.920	15	12	0.9	39.0
Irian Jaya	112.880	34	11	7.1	7.8
Bali	112.170	18	14	4.0	38.3
Riau	109.300	16	2	1.5	13.3
West Kalimantan	105.770	17	14	3.6	9.4
Aceh	99.720	22	5	9.6	8.8
East Java	95.530	9	7	29.6	54.9
West Java	95.200	13	8	0.4	32.7
Jambi	93.730	30	21	1.0	7.9
South Sulawesi	92.210	14	11	1.3	42.3
South Kalimantan	85.360	23	19	1.6	12.5
West Sumatra	82.160	20	17	0.8	14.0
Lampung	82.110	13	11	0.4	45.5
Bengkulu	80.670	38	28	0.1	21.0
Southeast Sulawesi	79.140	72	35	0.6	28.8
Central Sulawesi	75.470	27	24	6.6	49.1
Central Java	69.090	11	9	0.3	57.9
DI Yogyakarta	67.860	22	17	0.3	56.9
East Nusa Tenggara	53.630	27	24	0.3	56.6
West Nusa Tenggara	53.330	23	21	0.1	50.0

Source: Biro Pusat Statistik, *Statistic Indonesia*, 1984, *Perdapatan Regional Provinsi – Propinsi Di Indonesia*, 1976-80 and *State and Local Finances* (First Stage Governments), 1982.

a. The definition of poverty is based on minimum food expenditure requirement of 17.6 kg of rice per month per capita which is required to provide 2,150 calories and 30 grammes of protein per day. In addition, an allowance is made for non-food basic items such as shelter and clothing, related to the consumption expenditures of households subsisting at the minimum food expenditure level.

the Tax Performance Index (tax effort/standard tax rate × 100) is computed in Column 2 of Table VIII.

Table IX provides estimates on the "Index of Fiscal Need", defined as the ratio between per capita actual expenditure on social services (education, youth welfare, religion, manpower, social welfare, health and family planning, family welfare, housing and sanitation) in each province (Column 3) and per capita expenditure on these services in the country as a whole. The lower the ratio, the greater the fiscal need of the province. Although these estimates on fiscal need are limited in that they do not include expenditure on infrastructure, etc., the index does take into account the essential social services for the population in general.

In order to estimate the extent to which the central transfers to sub-national governments and central outlays in various provinces are affected by tax effort and fiscal need in the provinces, the coefficients of correlation between these variables are computed and the results provided in Table X.

The negative and significant coefficient of correlation between central transfers and tax effort suggest a disquieting aspect of inter-governmental fiscal relations in Indonesia. In literature on the subject, there is a general consensus that central transfers should encourage tax efforts by sub-national governments, i.e. a larger amount of transfers for jurisdictions with greater tax effort. Unfortunately, in Indonesia, the reverse seems to be the case; the negative coefficient of correlation suggests that the central transfers tend to reward lower tax effort and vice versa. The earlier studies suggested either no such relationship or a very weak one. In a study conducted in the 1970s, G.K. Shaw (Shaw, 1980 at 284) found, ". . . absence of any linkage between grant allocations and provincial tax effort". On the basis of data for 1973-74, Anne Booth (Booth, 1977 at 80-81) found a very weak relationship (coefficient of correlation: 0.0478) between tax effort and per capita development grants. However, correlating tax effort with the real growth rate of GRDP during 1968-72, she found a significant and negative coefficient of correlation (– 0.4770), which is consistent with the estimates here. What seems to have happened is that since the 1970s, with large increases in oil revenues and foreign development assistance, the magnitude of central transfers registered a significant increase and it was allocated to provinces without any regard to tax efforts on the part of the sub-national jurisdictions. It is important that the central grants be restructured to ensure that tax efforts are promoted by higher allocations among sub-national governments

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Table VII

Rank correlation between per capita non-oil GRDP and central outlays (1980)

Variables	*Coefficients of Rank Correlation*
Central Transfers to Provinces	–0.5068
Central Government Expenditure in Provinces	–0.3882
Central Government Investment Under Repelita I-III	–0.5332
Proportion of Population Below Poverty	–0.3851

making greater tax efforts. It becomes more important since, as stated earlier, provincial and local governments would need to increase their tax efforts to finance expenditures in light of the declining central revenue from the fall in oil prices, etc. However, it may be noted that the central expenditure as a percentage of provincial GRDP and tax effort are positively related.[2]

The negative and significant coefficient of correlation (– 0.5367) between central transfers and per capita provincial expenditure on social services or fiscal need indexes suggests that central transfers assist in equalizing the provision of essential social services among the provinces. A similar, albeit weaker, relationship exists between the central government expenditure as a proportion of GRDP and per capita provincial expenditure on social services. On this account the central transfers are meeting their objective of "equalization" of basic social services.

Although weak (0.1071), the estimates on the coefficient of correlation between central assistance and proportion of total population in various provinces suggests that, contrary to popular belief, population is not the dominant factor in allocation of central grants and direct central government expenditure in provinces. In fact, a negative coefficient of correlation (– 0.3366) is found between the central government expenditure and provincial population.

SUMMARY AND CONCLUSIONS

On the basis of an international comparison of the degree of fiscal centralization in developed and developing countries, Indonesia is at a stage of development when it has a high degree of fiscal centralization. The provincial and Kabupatan and Kotamadya governments are highly dependent on grants from the central government for their routine and development budgets. The central government expenditures on projects which are in the domain of sub-national governments also constitute a high proportion of the budgets of provincial and local governments. After listing components of assigned revenues and grants from the central government to sub-national governments, their impact on the provincial per capita GRDP and proportion below the poverty line have been estimated. The central government outlays have negative coefficient or correlation with both the level of per capita GRDP and magnitude of poverty in various provinces. In other words, central outlays, including grants, direct

Table VIII

Tax effort & tax performance in provinces in Indonesia – 1982-83

	Tax effort revenue from own resources as % of non-oil GRDP (1)	Index of tax performance (2)
1. Aceh	0.24	48
2. North Sumatra	0.53	106
3. West Sumatra	0.50	100
4. Riau	0.08	16
5. Jambi	0.45	90
6. South Sumatra	0.26	52
7. Bengkulu	0.68	136
8. Lampung	0.47	94
9. DKI Jakarta	1.80	360
10. West Java	0.40	80
11. Central Java	0.50	100
12. DI Yogyakarta	0.83	166
13. East Java	0.45	90
14. Bali	0.60	120
15. West Nusa Tenggara	0.37	74
16. East Nusa Tenggara	0.27	54
17. West Kalimantan	0.35	70
18. Central Kalimantan	0.20	40
19. South Kalimantan	0.64	128
20. East Kalimantan	0.17	34
21. North Sulawesi	0.44	88
22. Central Sulawesi	0.47	94
23. South Sulawesi	0.54	108
24. South East Sulawesi	0.22	44
25. Maluku	0.16	32
26. Irian Jaya	0.17	34
INDONESIA	0.50	100

Source: Biro Pusat Statistik, Statistik Keuangan Pemerintah Daerah, (Propinse), 1977/78-1982/83, Jakarta (1986).

central government expenditures in provinces and investments under Repelita tend to narrow regional disparities in income, thus promoting balanced regional development. Estimating the relationship between central transfers to provinces and their "tax effort" in 1982-83, it is estimated that the central grants do not reward provinces with higher tax effort. The results are the other way around, a finding which is inconsistent with the generally accepted fiscal transfer norm that central government grants should be greater for provinces with higher tax effort. In view of the shrinking central revenues from falling oil prices and related tax sources, an urgent need exists to restructure the central grants system in Indonesia to promote greater tax effort among provinces. An index of fiscal need has been constructed on the basis of per capita expenditure by various provinces on essential social services. By correlating the central transfers with provincial fiscal need, it is found that the central transfers are negatively correlated with provincial expenditures in the social sector. Thus the central outlays: grants and direct expenditure tend to equalize provision of social services by giving greater assistance to provinces which have lower per capita expenditure on these services. Contrary to popular belief, provincial population is not a dominant factor in allocation of central grants to sub- national governments.

2. The relationship, however, is somewhat weak.

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Table IX

Central transfers and outlays and expenditure on social services in various provinces in Indonesia – 1982-83

	Central transfers as % of total provincial receipts	Central outlays in provinces as % per capita GRDP (1982)	Expenditure on social services per capita rupiahs	Index of fiscal need	% of total population
1. Aceh	79.26	5	1041.5	147.2	1.7
2. North Sumatra	72.81	8	419.9	59.3	5.6
3. West Sumatra	80.55	17	551.3	77.9	2.3
4. Riau	72.30	2	8606.6	1216.4	1.5
5. Jambi	76.36	21	1332.3	188.2	1.0
6. South Sumatra	75.17	13	105.7	14.9	3.1
7. Bengkulu	78.71	28	1718.8	242.9	0.52
8. Lampung	70.37	11	370.0	52.2	3.1
9. DKI Jakarta	33.80	18	6364.1	899.5	0.04
10. West Java	72.28	8	216.4	30.6	18.6
11. Central Java	82.51	9	186.6	26.4	17.2
12. DI Yogyakarta	74.93	17	545.1	77.0	1.8
13. East Java	77.99	7	336.6	47.6	19.8
14. Bali	76.74	14	1341.2	189.6	1.6
15. West Nusa Tenggara	81.64	21	492.9	69.7	1.8
16. East Nusa Tenggara	78.82	24	273.9	38.7	1.8
17. West Kalimantan	76.19	14	1115.8	157.7	1.6
18. Central Kalimantan	82.00	15	2214.8	313.0	0.6
19. South Kalimantan	73.28	19	1373.4	194.1	1.3
20. East Kalimantan	60.05	2	4465.4	631.1	0.8
21. North Sulawesi	83.70	15	na	na	1.4
22. Central Sulawesi	60.05	24	982.0	126.1	0.9
23. South Sulawesi	79.92	11	379.0	53.6	4.1
24. South East Sulawesi	79.36	35	1410.2	199.3	0.6
25. Maluku	82.22	12	na	na	0.9
26. Irian Jaya	90.32	11	1959.7	276.9	0.8
INDONESIA	72.82		707.5	100	100

Source: Biro Pusat Statistik, Statistik Keuangan Pemerintah Daerah, (Propinse), 1977/78-1982/83, Jakarta (1986).

Table X

Coefficients of correlation between central transfers and outlays in provinces & tax effort and expenditure on social services in Indonesia

Variables	Central transfers to provinces	Central government expenditure as percent provincial GRDP
(i) Tax effort: Revenues from own sources as percent of non-mining GRDP	−0.6888	0.2198
(ii) Per capita expenditure on social services in provinces	−0.5367	−0.2332
(iii) Percent of total population in provinces	0.1071	−0.3366

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PEOPLE'S REPUBLIC OF CHINA: TAX INCENTIVES FOR FOREIGN INVESTORS **467**
During the past few years the Chinese Government has taken several steps to encourage foreign investment, i.e. a number of new regions have been opened to foreign investors and measures have been adopted to ease foreign exchange difficulties and promote export-oriented and technologically advanced investment. Professor Easson provides an overview of the "regular" tax regime for foreign investment and then explains the various special tax incentives available to potential investors.

Leif Mutén:

INTERNATIONAL: A NEW INTERNATIONAL TAX ORDER? **471**
The July issue of the Bulletin *contains an article by Professor Richard Bird in which he advocates abolition of tax deferral and a move toward unitary apportionment. This month we are featuring a reply to the article.*

Har Govind:

INTERNATIONAL: PROMISSORY ESTOPPEL IN TAX ASSESSMENTS **473**
The doctrine of promissory estoppel is a well-recognized legal principle which applies when one party induces another to alter his position and the latter party reasonably changes his position in reliance on the promise. The doctrine is now being applied to tax authorities although the extent to which promissory estoppel may be invoked in tax proceedings varies considerably from country to country. This article discusses the concept of promissory estoppel in several countries and compares the benefits and protection available to taxpayers through its application.

Joseph S.H. Tang:

HONG KONG: THE DRAFT BASIC LAW OF HONG KONG AND THE CONSTITUTIONAL CONSTRAINTS ON BUDGETARY EXPENDITURE AND REVENUES **479**
After 1997, the Basic Law of the Hong Kong Special Administrative Region (HKSAR) will be promulgated and enacted in accordance with the constitution of the People's Republic of China. Arts. 105 and 107 of the draft Basic Law, the so-called balanced budget and low tax articles, are the most controversial among the 38 articles contained in the Chapter on Economy. The purpose of these 2 articles is to constrain the spending and taxing power of the Government in order to prohibit elected members of the Legislative Council from turning Hong Kong into a welfare state. This article reviews the historical development of the balanced budget and low tax policy in Hong Kong and discusses the technical difficulties and constitutional inappropriateness of including Arts. 105 and 107 in the Basic Law. The article concludes with an amended version of the articles.

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Richard Vincent:

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Since July 1987 a foreign tax credit system has applied to foreign-source income derived by Australian residents. According to the Economic Statement issued by the Treasurer this year, significant changes are to be made in the taxing of this income. This article discusses the proposed system for taxing foreign-source income.

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République Populaire de Chine: Avantages fiscaux accordés aux investisseurs étrangers *467*
Le Gouvernement chinois a pris un certain nombre de mesures au cours de ces dernières années afin d'encourager les investissements étrangers, à savoir: de nouvelles régions ont été ouvertes aux investisseurs étrangers, des dispositions ont été adoptées pour atténuer les difficultés de contrôle des changes et promouvoir des investissements orientés vers l'exportation ainsi que ceux de haute qualité technologique. Le Professeur Easson donne un aperçu du régime fiscal "ordinaire" applicable aux investissements étrangers et analyse les différents avantages fiscaux particuliers prévus en faveur d'investisseurs potentiels.

Leif Mutén:

International: Un nouvel ordre fiscal international? *471*
Le numéro de juillet du *Bulletin* présentait un article du Professeur

INHALTSVERZEICHNIS

A.J. Easson:

Volksrepublik China: Steuerliche Anreize für ausländische Investoren *467*
Während der letzten paar Jahre hat die chinesische Regierung mehrere Massnahmen zur Förderung von ausländischen Investitionen genommen, d.h. eine Anzahl von neuen Regionen wurde für ausländische Investoren eröffnet und Massnahmen genommen, um Probleme mit ausländischen Währungen zu lösen und Export-gerichtete und technologisch fortgeschrittene Investitionen zu fördern. Professor Easson gibt eine Übersicht über das „normale" Steuer-System für ausländische Investitionen und erklärt dann die verschiedenen steuerlichen Anreize für mögliche Investoren.

Leif Mutén:

International: Eine neue internationale Steuerordnung? *471*
Das Juli-Heft des Bulletins enthält einen Artikel von Professor Richard Bird, in dem er die Abschaffung der Steuerstundung und eine Auf-

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Richard Bird dans lequel il plaidait en faveur de la suppression du report fiscal et souhaitait aller dans le sens d'une répartition unitaire. Nous publions ici une réponse à cet article.

Har Govind:
International: Force obligatoire d'une promesse en matière fiscale *473*
La force obligatoire d'une promesse est un principe de droit bien connu qui s'applique lorsqu'une des parties persuade l'autre de modifier sa position et que cette dernière s'exécute en se fiant à la promesse qui lui a été faite. Ce principe s'applique maintenant aux autorités fiscales bien que le domaine dans lequel on puisse invoquer la force obligatoire d'une promesse varie considérablement selon les pays. Cet article analyse le principe de la force obligatoire d'une promesse dans plusieurs pays et compare les avantages et la protection accordés aux contribuables de par son application.

Joseph S.H. Tang:

Hong Kong: Le projet de Loi Fondamentale de Hong Kong et les contraintes constitutionnelles sur les dépenses et revenus budgétaires *479*
La Loi Fondamentale de la Région Administrative Particulère de Hong Kong (HKSAR = Hong Kong Special Administrative Region) sera promulguée après 1997 en application de la constitution de la République Populaire de Chine. Les articles 105 et 107 du projet de Loi Fondamentale, articles portant sur l'équilibre du Budget et la faible imposition, sont les plus controversés des 38 articles contenus dans le Chapitre sur l'Economie. Ces deux articles ont pour but de limiter le pouvoir d'achat et d'imposition du gouvernement afin d'empêcher les membres élus du Conseil Législatif de transformer Hong Kong en un état providence. Cet article résume le développement historique de la politique de l'équilibre du budget et de la faible imposition à Hong Kong et commente les difficultés techniques et l'anticonstitutionnalité de l'introduction des articles 105 et 107 dans la Loi Fondamentale. L'article se termine par une version modifiée des articles.

Nouvelles de l'IFA *488*

Arthur Young International, Australie

Imposition en Australie pour les expatriés *489*
A partir de ce numéro, le *Bulletin* se propose de publier une série d'articles sur l'imposition des expatriés. Cet article analyse les points les plus importants du système australien d'impôt sur le revenu des personnes physiques qui sont applicables aux étrangers résidant en Australie.

Richard Vincent:

Australie: Imposition des revenus de source étrangère *493*
Un système de crédit fiscal étranger est applicable depuis juillet 1987 aux revenus de source étrangère reçus par des résidents australiens. Le Communiqué Economique du Ministre des Finances de cette année mentionne que des modifications importantes devraient être introduites quant à l'imposition de cette catégorie de revenus. Cet article commente le système proposé pour l'imposition des revenus de source étrangère.

Carnet des Congrès *496*

22ème Assemblée Générale du CIAT:

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Ce rapport résume les politiques brésiliennes suivies dans les conventions fiscales internationales et mentionne également les contextes économique et politique dans lesquels les traités sont signés.

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International: Der versprochene Klageausschluss bei Steuerveranlagungen *473*
Die Doktrin des versprochenen Klageausschlusses (Estoppel) ist ein weitbekanntes Rechtsprinzip, das angewendet wird, wenn eine Partei eine andere dazu veranlasst, ihre Position zu ändern und die letztgenannte Partei ihre Position im Vertrauen auf das Versprechen entsprechend ändert. Diese Doktrin wird jetzt auch auf die Steuerbehörden angewendet, obwohl das Mass, in dem der versprochene Klageausschluss in steuerlichen Verfahren angerufen werden kann, sich von Land zu Land unterscheidet. Dieser Artikel behandelt den Begriff des „versprochenen Klageausschlusses" in mehreren Ländern und er vergleicht die Vorteile und den Schutz, die Steuerpflichtigen durch dessen Anwendung zur Verfügung stehen.

Joseph S.H. Tang:

Hong Kong: Der Entwurf des Grundgesetzes von Hong Kong und die verfassungsrechtlichen Beschränkungen auf Haushaltsausgaben und -Einnahmen *479*
Nach 1997 wird das Grundgesetz des speziellen Verwaltungsgebietes Hong Kong (HKSAR) gemäss der Verfassung der Volksrepublik China verkündet und erlassen. Die Artikel 105 und 107 des Entwurfs des Grundgesetzes, die sogenannten Artikel über das abgewogene Budget und die niedrige Besteuerung, sind die meist umstrittenen Bestimmungen der 38 Artikel, die das Kapitel über die Wirtschaft enthält. Der Zweck dieser 2 Artikel ist, die Verausgabungs- und Besteuerungsmacht der Regierung zu beschränken, um so zu verhindern, dass die gewählten Mitglieder des Gesetzgebenden Rates Hong Kong in einen Wohlfahrtsstaat verwandeln. Dieser Artikel überprüft die geschichtliche Entwicklung des abgewogenen Budgets und der niedrigen Besteuerungspolitik in Hong Kong und bespricht die technischen Schwierigkeiten und verfassungsrechtliche Unangemessenheit, um die Artikel 105 und 107 aufzunehmen. Der Artikel schliesst mit einem Änderungsvorschlag der Bestimmungen.

IFA Mitteilungen *488*

Arthur Young International, Australien:

Steuern in Australien für ausländische Arbeitnehmer *489*
In diesem Heft des *Bulletin* wird mit einer Serie von Artikeln begonnen, die sich mit der Besteuerung von ausländischen Arbeitnehmern befassen werden. Dieser Artikel analysiert die wichtigsten Merkmale des australischen Steuersystems, welche für ausländische, in Australien wohnhafte Arbeitnehmer von Bedeutung sind.

Richard Vincent:

Australien: Besteuerung von Auslandseinkünften *493*
Seit Juli 1987 gilt eine Anrechnung von ausländischen Steuern auf ausländische Einkünfte, die von australischen Ansässigen erhalten werden. Dem „Economic Statement", das dieses Jahr vom Finanzminister erteilt wurde, entspechend werden bedeutende Änderungen bei der Besteuerung dieser Einkünfte gemacht. Dieser Aufsatz behandelt die Vorschläge für die Besteuerung von Auslandseinkünften.

Veranstaltungskalender *496*

Die 22. allgemeine CIAT Versammlung:

Brasilien: Die brasilianischen Erfahrungen mit internationalen Doppelbesteuerungsabkommen *497*
Dieser Bericht fasst die brasilianische Politik in Bezug auf internationale Doppelbesteuerungsabkommen, einschliesslich des wirtschaftlichen und politischen Zusammenhanges, in der die Abkommen sich entwickeln, kurz zusammen.

International: Schlussfolgerungen während der dritten Versammlung über Besteuerung genehmigt: Internationaler Schutz der Rechte von Steuerpflichtigen *500*
Eine inoffizielle Übersetzung der Schlussfolgerungen des Teams I während der dritten Versammlung über Besteuerung im Monat Mai 1988 in La Plata, Argentinien.

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PEOPLE'S REPUBLIC OF CHINA:

Tax Incentives for Foreign Investors

By A.J. Easson

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Since the door was opened in 1979, foreign investment in China has tended to come in waves. The initial excitement at the prospect of access to a market of a billion people was followed by a period of greater caution as it became clear that establishing an operation in China was not such a simple task. As the experiences of the pioneers demonstrated, these difficulties could be overcome with patience and, although the domestic market could not be penetrated as easily as had been hoped, there nevertheless were rewards for carefully planned operations. A second wave of investment occurred from 1983 to 1985, but this was followed by a dramatic slump in the latter part of 1985, largely precipitated by the tightening of China's foreign exchange controls.

In response, the Chinese authorities acted swiftly, opening a number of new regions to foreign investment and adopting measures to ease foreign exchange difficulties and to promote export-oriented and technologically-advanced investment.[1] In consequence, an almost bewildering array of new incentives, and especially of tax incentives, has been presented to potential investors. The response seems to have met the expectations of the Chinese authorities. The pace of foreign investment speeded up towards the end of 1986 and by the end of 1987 the number of enterprises with foreign investment in China had exceeded 10,000, with a total contract value in excess of US$ 22 billion.[2]

I. CHINA'S FOREIGN INVESTMENT TAX REGIME

Before attempting to examine and classify the various special tax incentives, it first seems appropriate to review briefly what might be described as the "regular" tax regime for foreign investment.[3] After all, the attractiveness or otherwise of a special incentive to invest can only be judged in comparison with the treatment which would be accorded to the same investment under ordinary circumstances. As with most countries, a distinction has to be drawn between direct and "passive" investment and, further, in the case of direct investment, according to the business medium which is adopted.

A. Direct investment

A distinction is commonly made between the so-called "equity joint venture" and other forms. Recently, however, the position has become somewhat more complex.

1. Equity joint ventures

An equity joint venture is a Sino-foreign joint venture established under the *Joint Venture Law* of 1979. As such, it is a legal person incorporated and resident in China, with its own articles of incorporation, registered capital, board of directors and other features which characterize a corporation in most countries. Equity joint ventures are taxed under the *Joint Venture Income Tax Law* of 1980[4] upon their world income. Taxable income is taxed at a flat rate of 30%, in addition to which a local surcharge may be imposed at a rate of 10% of the central tax. Thus, the effective rate of tax, unless some special reduction applies, is 33%. Dividends remitted to investors outside China are subject to a special withholding tax at a rate of 10%.

Accounting principles and rules for the calculation of taxable income, including depreciation, amortization and loss carry-over rules, follow normal international practice. In addition, however, there are 2 provisions of general application which might properly be styled "investment incentives":

(a) newly established equity joint ventures scheduled to operate for a period of 10 years or more may be exempted from tax in the first 2 profit-making years and allowed a 50% reduction in the following 3 years. Additionally, joint ventures engaged in low-profit operations such as farming and forestry, and those located in remote, economically under-developed regions, may be allowed a further 15 to 30% reduction for up to an additional 10 years;

(b) only those profits which are remitted outside China are subject to the special withholding tax of 10%. Additionally, where the foreign participant in an equity joint venture reinvests any part of its share of the profits of the venture in China, for a period of 5 years or more, it is entitled to a refund of 40% of the tax paid in respect of those profits.

2. Cooperative joint ventures and wholly foreign-owned enterprises

In contrast to equity joint ventures, those investments which have been styled "contractual" or "cooperative"

1. See Charles Toy, "New Regulations on Foreign Exchange Balancing in Joint Ventures" 40 *Bulletin for International Fiscal Documentation*, April/May (1986) at 154.
2. *China Daily*, 23 January 1988 at 1.
3. For a comprehensive analysis, see A.J. Easson and Li Jinyan, *Taxation of foreign investment in the People's Republic of China* (Kluwer, Deventer, 1988). A concise summary is provided by E. Jehle, "Taxation in the People's Republic of China", 39 *Bulletin for International Fiscal Documentation*, 9 (1985) at 405.
4. Income Tax Law of the People's Republic of China concerning Chinese-Foreign Joint Ventures, adopted by the 3rd session of the Fifth National People's Congress and promulgated on 10 September 1980 (hereafter JVIT Law).

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joint ventures have been taxed under the *Foreign Enterprise Income Tax Law* of 1981.[5] So too have wholly foreign-owned enterprises established under the *Foreign Enterprise Law* of 1986, and it is this tax which is also imposed on the income of representative offices of foreign enterprises in China.

In the great majority of cases, a foreign enterprise engaged in a cooperative joint venture has been regarded as a non-resident carrying on business in China through an establishment there, and consequently taxable on the income attributable to that establishment. In effect, the pre-tax profits of the venture are divided between the parties; the Chinese party pays tax under the relevant domestic law and the foreign party pays tax under the FEIT Law. However, there seem to have been some cases where a cooperative joint venture has been regarded as a distinct legal person and has been taxed as such under the JVIT Law, the participants sharing after-tax profits.

The new *Cooperative Joint Venture Law,*[6] does little to clarify the situation. A joint venture may elect whether or not it is to have legal personality and, it seems, whether the parties should share pre-tax or after-tax profits. The situation appears to be that a venture which has the status of a Chinese legal person, and which agrees to share after-tax profits, will be taxed under the JVIT Law. In other instances, the FEIT Law will continue to apply.[7]

Under the FEIT Law, profits are taxed according to a progressive scale, rising from 20%, on annual profits not exceeding 250,000 yuan, to 40%, on profits exceeding 1 million yuan annually. An additional local income tax, of 10% of taxable income, brings the effective tax rate to 30-50% of profits. There is, however, no additional tax on profits remitted to the foreign participant in a cooperative joint venture or wholly foreign-owned enterprise.

Unlike the JVIT Law, there is no general tax holiday for newly-established cooperative joint ventures or wholly foreign-owned enterprises, though enterprises scheduled to operate for 10 years or more in farming, forestry or other low-profit activities may be exempted for the first profit-making year and be allowed a 50% reduction for the following 2 years, with the possibility of further reductions for a period of up to 10 years. Again, the FEIT Law contains no provision for a tax refund in respect of profits reinvested in China, though the *Foreign Enterprise Law,* governing wholly foreign-owned enterprises, does so provide and, in practice, investors in cooperative joint ventures also enjoy this privilege.[8]

3. Other taxes

In addition to the JVIT or FEIT, foreign enterprises carrying on business in China are subject to the *consolidated industrial and commercial tax* (CICT), which is a form of turnover tax applying to the sale or importation of goods and the provision of services, to *customs duties* on imports and on a few exports, and to some local taxes, of which only the *urban real estate tax* and *vehicle and vessel tax* are of much concern. Also of importance are *land use fees* which the local authorities are empowered to levy.

B. Passive investment

A non-resident individual, or a foreign enterprise which has no establishment in China, is subject to a withholding tax under the FEIT Law at a flat rate of 20% on the gross amount of any dividend (other than those dividends taxed at 10% under the JVIT Law), interest, rent or royalty received from a source within China. A variety of payments, however, are taxed at reduced rates or are exempted; these include interest on loans to Chinese State banks and to certain other bodies at preferred rates, rental income from leasing fees under contracts entered into between 1983 and 1990, and most fees for the use of proprietary technology.

Table I

The regular tax treatment of foreign investment

	JVIT	FEIT
Enterprise income tax	30%	20-40%
Local income tax	3%	10%
Dividends remitted abroad	10%	
Reinvested profits	40% refund	40% refund
Tax holidays:	(new EJVs)	(some)
exemption	2 years	1 year
half-rate	3 years	2 years
Withholding tax		20%

II. INVESTMENT IN PREFERRED REGIONS

China's policy towards regional investment has been rather different from that of most developing countries. It is true that there have been some incentives offered to attract investment to backward, remote or lesser-developed regions, but the main thrust of Chinese policy has been to promote investment in the eastern coastal regions which, comparatively speaking, are among the most economically advanced in the country. This policy, however, may be in the process of being changed.

Although very few regions of China are actually closed to foreign investment, the initial emphasis was upon

5. Income Tax Law of the People's Republic of China concerning Foreign Enterprises, adopted by the 4th session of the Fifth National People's Congress and promulgated on 13 December 1981 (hereafter FEIT Law).
6. Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures, adopted by the 1st session of the Seventh National People's Congress on 13 April 1988.
7. According to recent pronouncements, a unified tax law for enterprises with foreign investment is under consideration and could be introduced by the end of 1988.
8. A 40% refund is granted to both wholly foreign-owned enterprises and cooperative joint ventures on profits reinvested in China for a period of at least 5 years to establish or expand a Chinese-foreign equity or cooperative joint venture or wholly foreign-owned enterprise: Ministry of Finance Notice (87) *Cai shui wai zi* No. 033 of 22 February 1987.

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the 4 designated *Special Economic Zones* (SEZ) – Shantou, Shenzhen and Zhuhai, in Guangdong Province, and Xiamen in Fujian Province – which were established in 1980. In 1984 a further 14 coastal cities were designated, in which *Economic and Technological Development Zones* (ETDZ) were established, enjoying broadly similar incentives for foreign investment. A further expansion occurred the following year, when 3 "delta" areas were opened to foreign investment – the Pearl River and Yangtze River deltas and the so-called "Golden Triangle" in Fujian Province. More recently, in 1988, Hainan Island was declared a new province and an SEZ, 2 further coastal regions – the Liaodong and Shandong peninsulas – with privileges similar to the "delta" areas were established, proposals have been advanced to create another 140 "open" coastal cities or counties, SEZs have been proposed in Xinjiang and Sichuan provinces and other special investment zones have been established or proposed, such as the new "silicon valley" area in Beijing's Haidian District. Although the various tax incentives differ in detail from one preferred region to another, these regions fall into 2 basic groups:[9]

A. SEZs and ETDZs

The 4 original SEZs, Hainan Island[10] and the specially-designated ETDZs of the 14 coastal cities enjoy essentially the same advantages. These are as follows:

1. *Enterprise income tax.* The rate of enterprise income tax, i.e. of both the JVIT and FEIT, for equity and cooperative joint ventures and wholly foreign-owned enterprises, is reduced to 15%. This reduced rate applies only to income earned in the zones.
2. *Local income tax.* The local surcharge may be, and commonly is, waived entirely.
3. *Dividends remitted abroad* by equity joint ventures are exempt from the normal withholding tax.
4. *Tax holidays.* Enterprises engaged in production and scheduled to operate for 10 years or more are exempt in the first 2 profit-making years and taxed at half rate (i.e. at the rate of 7½%) for the next 3 years. SEZ enterprises engaged in service trades, where the amount of the investment exceeds US$ 5 million, are exempt for one year and pay tax at half-rate for the following 2 years; this exemption apparently does not apply in the ETDZs. A conflict exists in the case of an equity joint venture in the service area, scheduled to operate for 10 years or more. The SEZ Tax Regs. grant a less generous tax holiday than that which exists under the regular tax regime. In practice it seems that an enterprise may choose whichever is the more favourable treatment. In Hainan, extended tax holidays of 5 years free from tax and a further 5 years at half-rate are granted to enterprises engaged in developing infrastructure or engaged in agricultural development projects.
5. *Withholding tax.* The normal rate of withholding tax on interest, rents and royalties is reduced to 10%, and special exemptions apply to interest earned by foreign banks.
6. *Other taxes.* Important exemptions are given from CICT and customs duties in respect of goods imported by foreign enterprises, and the rate of tax on the provision of services is commonly reduced to 3% from the normal 5 or 7%. Local taxes and land use fees are also normally reduced or waived.

Table II

SEZ and ETDZ tax incentives

Enterprise income tax	15%
Local income tax	usually exempt
Dividends remitted abroad	0%
Tax holidays:	
exemption	1-2 years
half-rate (7½%)	2-3 years
Withholding tax	0-10%
CICT and customs duties	exemptions

B. "Old city" areas of the SEZs and 14 coastal cities and coastal open economic zones

The ETDZs are special areas established in the 14 designated open coastal cities. Incentives are also provided for investment in the original urban areas of those cities, and of the SEZs, or in designated parts thereof. Investors in the 3 "delta areas", and in the newly-designated Liaodong and Shandong peninsula areas, enjoy broadly similar advantages. The more important of these are:

1. *Enterprise income tax.* The rate of JVIT or FEIT is reduced to 15% if the enterprise in technology- or knowledge-intensive, has a foreign investment exceeding US$ 30 million and requires a long period of capital recovery, or operates in the field of energy, communications or port construction. Other enterprises, engaged in a wide variety of productive activities, benefit from a 20% reduction in the normal rates.
2. *Local income tax.* The local surcharge may be reduced or waived entirely.
3. *Dividends remitted abroad.* Equity joint ventures which qualify for the reduced, 15%, rate of tax may remit profits abroad without further tax liability.
4. *Withholding tax.* As in the SEZs and ETDZs, this is reduced to 10% or, in some cases, waived entirely.
5. *Other taxes.* Exemptions from CICT, customs duties, local taxes and land use fees are generally similar to those in the SEZs and ETDZs.

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9. The tax rules are mostly contained in the Provisional Regulations of the State Council on Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax for Special Economic Zones and the Fourteen Coastal Cities, promulgated on 15 November 1984 (hereafter SEZ Tax Regs.). The Chiangjiang and Zhujiang delta areas, the southern Fujian delta and the Liaodong and Shandong peninsula areas are now governed by the Provisional Regulations of the Ministry of Finance concerning the Reduction of and Exemption from Enterprise Income Tax and Consolidated Industrial and Commercial Tax for the Encouragement of Foreign Investment in Coastal Open Economic Zones, promulgated on 15 June 1988. These are now referred to collectively as the "Coastal Open Economic Zones".
10. Under the Provisions of the State Council on Encouraging Investment to Promote the Development of Hainan Island, promulgated on 4 May 1988, new special tax incentives apply to the entire island. Since 1984 the Hainan Industrial Development Zone qualified for SEZ treatment, under the SEZ Tax Regs.

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TABLE III

Old city areas and coastal open economic zones

	JVIT	FEIT
Enterprise income tax		
(hi-tech and large investment)	15%	15%
(other preferred)	24%	16-32%
Local income tax	usually exempt	
Dividends remitted abroad	exemptions	
Withholding tax		0-10%
CICT and customs duties	reductions or exemptions	

C. Other preferred areas

In recent months the number of other areas which have announced special incentives to attract foreign investment has been increasing rapidly and in a sometimes bewildering manner. These special incentives, it would seem, fall into one of 2 categories:

1. *Local taxes.* The imposition of local taxes, the local income tax surcharge and land use fees, is generally at the discretion of the local authorities, within the limits prescribed by the Central Government. It is consequently within the power of the local authorities to grant reductions in or relief from these taxes, and this is becoming increasingly common.
2. *Central taxes.* Several local authorities have gone further and have announced exemptions from, or reductions in, centrally imposed taxes. In most cases these announcements do no more than repeat concessions which have been established at the national level. In some cases, however, they purport to offer concessions which, technically at least, they have no power to grant. These should consequently be regarded with some degree of caution. It is well known that in China some foreign investors have been able to bargain for tax treatment which is more favourable than a strict interpretation of the law would appear to permit. If they succeed in so doing they may take advantage of their good fortune; but they should not rely unduly upon promises or representations made by local authorities where those authorities lack the real power to make such concessions.

III. PREFERRED FORMS OF INVESTMENT

As already mentioned, the general rules under the JVIT and FEIT Laws, and the special regulations governing investment in preferred regions, make certain distinctions according to the nature of the investment. Concessions are granted for investment in low-profit operations, preference is sometimes given to manufacturing as opposed to service industries, some loans are given preferential treatment, or investment in technology- or knowledge-intensive sectors is favoured. However, 2 major policy objectives are particularly evident; the promotion of exports and the attraction of advanced technology. These objectives found expression in the so-called "Twenty-two Articles" of October, 1986.[11] These contained a variety of provisions to promote or facilitate foreign investment, and in particular granted tax incentives for export-oriented and technologically-advanced enterprises with foreign investment.[12]

A. Export-oriented enterprises

These are defined as production enterprises, the annual value of whose exported products exceeds 50% of gross output value, and which maintain a foreign exchange surplus. To qualify for extended tax holidays, 70% of total output must be exported.

B. Technologically-advanced enterprises

These are production enterprises possessing advanced technology supplied by the foreign investor, which are engaged in developing new products, or upgrading and replacing existing products, in order to increase foreign exchange generated by exports or by import substitution.

The more important tax advantages are:

1. *Reduced rates of income tax.* After the expiry of any other tax holiday to which the enterprise may be entitled, enterprise income tax (under the JVIT or FEIT) is payable at half-rate. In the SEZs and ETDZs a reduced rate of 10%, rather than the usual 15% rate, is payable. In the case of an export-oriented enterprise which exports at least 70% of its annual output, the reduced rate continues for so long as the enterprise qualifies. For technologically-advanced enterprises, however, the extended tax holiday is granted for a maximum of an additional 3 years.
2. *Reinvested profits.* Foreign investors in equity or cooperative joint ventures or in wholly foreign-owned enterprises which reinvest their profits in order to expand or establish export-oriented or technologically-advanced enterprises for a period of operation of at least 5 years, may receive a full refund of the enterprise income tax already paid in respect of the reinvested amount. This contrasts with the 40% refund available in normal circumstances. It seems that the amount may be reinvested in the same enterprise or in so other qualifying enterprise.
3. *Profits remitted abroad.* The special withholding tax of 10% on dividends remitted abroad by equity joint ventures is waived.
4. *Local taxes.* Local authorities are encouraged to grant exemptions from the local income tax surcharge, and this is commonly done.
5. *Land use fees.* These are imposed at reduced rates, and local authorities have power to grant further reductions or exemptions.

[Continued on page 478]

11. Provisions of the State Council for the Encouragement of Foreign Investment, promulgated on 11 October 1986 (hereafter Foreign Investment Provisions).
12. These are granted whether the enterprise is an equity joint venture, cooperative joint venture or wholly foreign-owned enterprise. An enterprise which qualifies as both export- oriented and technologically-advanced may elect to be treated in whichever way is the more advantageous.

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INTERNATIONAL:

A New International Tax Order?

By Leif Mutén

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Professor Richard Bird has written a challenging piece on the international tax order.[1] He is not pleased with what we have; in that respect he finds himself in good company and mine as well. What Professor Bird fails to do, however, is to analyze whether the alternatives would be better. Just as in the case of democracy, which Churchill called the worst conceivable political system with the exception of all others, we have, in international taxation, a clear case of second best choices. This being the case, it will not do to compare the prevailing system, warts and all, with some idealized alternative. We must look at the practical implications and the extent to which our ideal would have to be compromised in a real world adaption of any alternative system before forming an opinion on which would be better.

Professor Bird mentions "the 'fiscal myth' that every subsidiary of a multinational enterprise is a completely separate entity operating at arm's length from its parent and other subsidiaries".[2] This is to turn things upside down. What the usual arm's length rule does is to look beyond the legal reality (and economic myth) that subsidiaries are independent and act accordingly, in favour of a rule which authorizes a departure from the transfer prices used by the taxpayers and thus makes it possible to give justice to the economic reality of dependency. Whether one chooses to adjust transfer prices in all cases or only in the more flagrant ones is a matter of political choice. However, reading the arm's length rule as an indication that those promoting it naively believe that prices and other conditions *are being set* at arm's length seems rather preposterous.

Professor Bird proceeds to argue forcefully against "tax deferral", not only with respect to tax haven cases, but in general. Interesting is the parenthetic note that for reasons, including the use of tax deferral, "the much-discussed problem of 'tax sparing', or the cancelling out of tax concessions granted in poor countries, is much less of a problem in practice than some seem to think".[3] Since Professor Bird wants tax deferral to be abolished, one would have liked to know how he would then deal with the tax sparing issue.[4] On this point, however, he remains silent.

Finally, the main message of Professor Bird's article is that the arm's length principle and separate accounting is a method that has not withstood the test of time, and that the time is ripe for unitary apportionment. Sure, he admits that working out the exact nature of an agreed formula will clearly be no small task.[5] It would have been of interest to know something about the elements that would go into the task. For instance, given the national sovereignty still eagerly maintained in international tax matters, could we avoid each country raising the claim that its tax base be a quota of a worldwide profit established in that country's currency and with that country's tax laws being applied? Those promoting unitary apportionment in California have not unexpectedly taken for granted that world-wide profit is a concept somehow connected with the U.S. dollar. But will that sell in Tokyo and Frankfurt?

1. See Bird, R., "Shaping a New International Tax Order", 42 *Bulletin for International Fiscal Documentation* 7 (1988) at 292 (hereinafter cited as "Bird").
2. Id at 294.
3. Id at 296. As a matter of fact, I made the same observation at the Montevideo IFA Congress in 1968 (XXIIth Congress of IFA, Montevideo, October 1968, Round Table Discussions, Montevideo (1970) at 51) and it is by now, I believe, quite generally accepted, to the point where one wonders who those "some" are.
4. In *Comparative Tax Studies, Essays in Honor of Richard Goode*, edited by Sijbren Cnossen, Amsterdam (1983) at 327-331, I raised a number of arguments against the abolition of deferral, one of which refers to the tax sparing issue. Professor Bird writes about deferral as though its abolition were technically quite a simple operation. The New Zealand project, shelved in its original form, should have made him stop and think.
5. Bird at 299.

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Professor Bird dismisses a "world tax system" approach as utopian.[6] Yet, how will he go about the daunting task of establishing, for a transnational corporation with activities in, say, 100 countries, a complete set of world-wide accounts in each of 100 currencies, applying each of 100 tax laws?[7] And if that were done, who would be able to analyze them in the many small tax administrations involved? California, allegedly, has used published annual reports as an indication of world-wide profits of unitary enterprises based outside the United States. Would that be sufficiently exact?

Moreover, the separate accounting rules make it possible to establish the results of an operation according to basically the same rules as those applied to competing national firms. What would be the result if in a country where the currency has been drastically devalued, the local enterprises still show a profit in terms of the local currency, whereas the internationally-owned subsidiary must register a loss result for the group as a whole, partly or wholly based on the fact that this subsidiary (and perhaps some others as well) have pulled down the result as a consequence of the devaluation? Do we recompute the world-wide result in terms of the devalued currency and establish, for purposes of the tax in the devaluing country, that the world-wide group has made a large profit? Or do we acknowledge that from its own point of view the group had a bad year and therefore that its subsidiary should receive more lenient treatment than its independent local competitors?

Nothing is mentioned about the quotas to be used. Lacking an international body of law we could not exclude that quota computations would differ between sovereign authorities. Moreover, given the assumption that sales would be used as at least part of the quota, could we exclude that the arm's length pricing issue would come back? We could, if we excluded from the quota all sales made inside the unitary group. But how would we then establish some kind of equity between a part of the unitary group working in the market of a rich country, using its turnover as a quota base, and its subservient subsidiary in a poor country, working entirely on contract production for the parent corporation? And how would we establish a quota based on capital investment, without running the risk of unfair apportionment between luxurious headquarters in rich countries and frugal installations in poor ones? And what should be done about the payroll as a quota base, if wages and salaries are much higher in richer countries? Should the rich countries get more tax out of the transnational corporations because salaries are higher there? Would it not be more fair to conclude from the high salary level that the operation were less profitable and hence left a narrower local tax base with more profits allocable to the countries where wages and salaries are lower?

This article is not written with the pretence of being the ultimate truth, far from that. But with all due respect for my former colleague, Richard Bird, I do feel that his article makes matters too simple. We not only could make the argumentation more complicated than that; we must, if we want to be realistic.

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6. Bird at 297.
7. George Kopits and I presented these arguments and others against unitary apportionment in *The State Corporation Income Tax*, Charles E. McLure, Jr., editor (Palo Alto, California: Hoover Institution Press, 1984) at 269-280. See also my argument in *Comparative Tax Studies*, footnote 4 supra at 323-325. Needless to say, many other sources could be quoted in support of the same approach, e.g. *OECD, Transfer Pricing and Multinational Enterprises* (OECD, Paris, 1979); Jacob, F., "Unitary Approaches in International Taxation", 38 *Bulletin for International Fiscal Documentation* 3 (1984) at 99; and U.S. Department of the Treasury, *The Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views* (Washington D.C., U.S. Government Printing Office 1984).

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INTERNATIONAL:

Promissory Estoppel in Tax Assessments

By Har Govind

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INTRODUCTION

The doctrine of "promissory estoppel", also known as "equitable estoppel" is a well-recognized legal principle. The doctrine is being increasingly applied the world over against tax authorities who, in the name of "public interest", are prone to disregard governmental promises and undertakings as well as circulars issued to explain official policy. The extent to which promissory estoppel may be invoked in tax proceedings varies from country to country. This article traces the evolution of the doctrine of promissory estoppel in several countries and compares the benefits and protection available to taxpayers through its application.

CONCEPT OF "ESTOPPEL"

If, by words or conduct, a party makes a clear and unequivocal promise which is intended to create legal relations or effect a legal relationship in the future, knowing or intending that it be acted upon by the promisee and it is in fact so acted upon, the promise is binding on the promisor. He may not retract his promise if it is inequitable to do so in light of the dealings which have transpired between the parties.[1] It is not necessary that the promisee suffer any detriment in acting in reliance on the promise, i.e. he merely needs to alter his position as a result of the promise. The detriment is the prejudice suffered by the promisee if the promisor is allowed to retract the promise.

According to its plain and general definition, estoppel is applicable in cases where a party is precluded from asserting a certain statement of fact as untrue, whether it is true or not. Promissory estoppel is a kind of disability or prohibition which prevents a party from asserting or proving in legal proceedings that a certain fact is otherwise than it has been made to appear in the situation or transaction. It operates to put the party entitled to its benefits in the same position as if the matter represented were true. Estoppel is generally regarded as a rule of evidence.[2]

Distinctive features

Estoppel arises from an act of the parties and may be based on a deed, written agreement or oral promise. Estoppel is based on the equitable principle that one who, by words or conduct, induces another to change his position cannot be allowed to turn around and derive a benefit from the altered position of the other party. Estoppel is distinguishable from the concepts of "res judicata", "admission" and "waiver".

Res judicata arises as a result of a final decision of a competent court. Once a judgment is rendered, it is conclusive on all matters decided therein, i.e. the parties may not raise the same cause of action in a later suit. Res judicata is essentially an "estoppel" against the losing party in a law suit because he is precluded from relitigating matters decided in the first action. He is not, however, prevented from raising issues not decided in the first action.

1. Promissory estoppel cannot be applied if it contradicts a statutory provision. It cannot be invoked to compel the government or a private party to perform an act prohibited by law nor can it be invoked against the exercise of legislative power. The legislature can never be precluded from exercising its legislative function by resort to the doctrine of promissory estoppel.
2. Halsbury's Laws of England, Vol. 15 at 168.

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An "admission" is a concession or voluntary acknowledgement made by a party of the existence of certain facts relevant to the action. Admission, another rule of evidence, can be made ineffective by producing evidence that the statement was wrongly made. Such evidence cannot be tendered or considered in an estoppel case.

Waiver is the voluntary relinquishment of a known right. Waiver is based on the knowledge of both parties of the relevant facts[3]; in contrast, knowledge of the facts by both sides eliminates the operation of estoppel.

Historical perspective

The doctrine of promissory estoppel was first enunciated by the British House of Lords more than a century ago[4], and was more or less rediscovered in 1947 by Mr. Justice Denning in the High Trees case, i.e. a promise made with the reasonable expectation that the other party act on it is binding to the extent the promise is acted upon.[5]

The Supreme Court of India examined promissory estoppel in *Motilal Padampat Sugar Mills Co. Ltd v. State of Uttar Pradesh and others*.[6] The case arose under the Uttar Pradesh Sales Tax Act 1948 and has general application to all tax laws. In reaching its conclusion, the Supreme Court analyzed case law and texts of various countries including Australia, the United Kingdom and the United States. The facts of Motilal and the observations made by the Supreme Court merit a detailed consideration.

Sec. 4A of the Uttar Pradesh Sales Tax Act 1948 confers authority on the government to grant an exemption from the sales tax. On the basis of an announcement in a newspaper that the State of Uttar Pradesh decided to grant a 3-year exemption from sales tax to all new industrial units in the State,[7] the appellant wrote a letter (in October 1968) to the Director of Industries stating it intended to set up an industrial unit for the manufacture of vanaspati. In his response to this letter, the Director confirmed that no sales tax would be levied on the finished product made by the vanaspati factory from the date the factory was connected to the power supply to commence production. Relying on the contents of this letter, the appellant approached financiers to finance the project and initiated negotiations with manufacturers for the purchase of factory machinery. In December 1968, the Chief Secretary to the Government and Adviser to the Governor reiterated the assurance that the appellant would be entitled to the tax holiday. Upon the appellant's request for confirmation, the Chief Secretary (in a reply dated 22 December 1968) confirmed that "the State Government will be willing to consider your request for granting an exemption from Uttar Pradesh sales tax for a period of 3 years from the date of production". The appellant was requested to formally apply to the Secretary in the Industries Department, and in the meantime, to "go ahead with the arrangements for setting up the factory". The financial institutions were not satisfied with that response so the appellant approached the Chief Secretary again and the latter wrote a letter (dated 23 January 1969) to the effect that the appellant "will be entitled to exemption from Uttar Pradesh sales tax for a period of 3 years from the date of going into production", the exemption being applicable to vanaspati sold in the State. The appellant then proceeded to set up the vanaspati factory. In January 1970, the State government made a policy decision that new vanaspati units would only be given a graded partial concession during the first 3 years of production. The State government revised this policy in August 1970, rescinding the partial exemption. In the interim, the appellant had written a letter to the effect that it would be availing itself of the partial exemption.

The appellant filed a writ asserting that the Chief Secretary, acting on behalf of the State government, had conveyed an unequivocal assurance that the 3-year exemption from payment of sales tax would be applicable, intending or knowing that the appellant would rely on the assurance. The appellant invested substantial funds to set up the factory. The appellant argued that the State government was bound to honour its assurance and exempt vanaspati manufactured and sold for 3 years. The High Court rejected the plea. On appeal, the Supreme Court reversed the decision of the High Court, holding that the necessary elements of promissory estoppel were clearly present. Consequently, the government was bound by its representations and the appellant was exempted from sales tax in respect of sales of vanaspati effected by it in Uttar Pradesh for a period of 3 years from the date production commenced.[8]

The rationale articulated by the Court was as follows: as an equitable doctrine, promissory estoppel must yield when equity requires. If the government can demonstrate that in view of the facts which transpired since the promise was made, the public interest would be prejudiced if the government were required to carry out the promise, the court will balance the interests of the individual who acted in reliance on the promise and the extent to which the public interest would suffer if the government were required to carry out the promise. If the balance tips in favour of the government, the promise will not be enforced against the government. However, it is the duty of the court to make this

3. Halsbury's Laws of England, 4th Edition, Vol. 16 at 994 and decision of the High Court of Australia in *Craine v. Colonial Mutual Fire Insurance Co. Ltd.*, 28 Commonwealth Law Reports 305.
4. *Thomas Hughes v. Metropolitan Railway Company,* 2 Appeals Cases (1877) at 439 (House of Lords).
5. *Central London Property Trust Ltd. v. High Trees House Ltd.*, All England Reports (1947) at 256, 1 King's Bench 130.
6. 118 Income Tax Reports at 326.
7. The exemption was intended as an incentive for the establishment of new units in order to boost production of vanaspati to meet increasing public demands. Vanaspati is an hydrogenated solidified edible oil widely used for cooking purposes in India and neighbouring countries.
8. The fact that the appellant had accepted the concessional rate of sales tax was not tantamount to a waiver of the exemption. Waiver means abandonment of a right and it may be either express or implied from conduct but its basic requirement is that it must be "an intentional act with knowledge". There can be no waiver without full knowledge of the right.

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determination, i.e. it is not sufficient for the government to assert the public interest militates against enforcement of the promise or that the public interest would suffer if the government were required to honour the promise. The government cannot claim to be exempt from the duty to carry out a promise on the basis of an indefinite and undisclosed ground of necessity or expediency nor can the government claim to be the sole arbiter of its liability and repudiate its liability on an ex parte appraisement of the circumstances. The government must produce sufficient facts to support its claim that subsequent events warrant exemption from the duty to carry out its promise. A mere change in official policy is insufficient to exonerate the government from liability. The Court must be satisfied, on proper and adequate evidence, that overriding public interest necessitates a ruling that the government not be bound by the promise.[9]

On this basis, the Supreme Court concluded that since Sec. 4A of the Uttar Pradesh Sales Act conferred the power on the government to grant an exemption from sales tax, the government was bound by its promise to exempt the taxpayer from the tax.

A later decision of the Indian Supreme Court in which the doctrine of promissory estoppel found its most eloquent exposition is that of *Union of India v. Anglo-Afghan Union Agencies Ltd.*[10] The company, acting in reliance on the export promotion scheme issued by the Central government, exported woollen goods to Afghanistan. The statutory scheme provided that an exporter of woollen goods would be entitled to import raw materials equal to the total value of exports. On this basis, the company claimed eligibility to obtain an import entitlement certificate from the Textile Commissioner, i.e. in reliance on the promise in the scheme the company exported woollen goods to Afghanistan and was therefore entitled to enforce the promise against the government and obtain an import entitlement certificate for the full value of the exported goods.

The government sought to refute this argument by pleading the doctrine of executive necessity, i.e. that the government could not encumber its future executive power because the scope of this authority should be governed solely by the needs of the community. Accordingly, no promise or undertaking which would restrict the government's freedom of executive action could be binding on the government.

The Supreme Court rejected the government's argument, concluding that it was not exempt from the obligation to keep its promise. Lacking a defined and disclosed ground of necessity, the government could not fail to carry out its promise or claim to be the arbiter of its own obligation to the citizen or make an ex parte assessment of the circumstances under which the obligation had arisen. Therefore the Textile Commissioner was directed to issue an import entitlement certificate for the full value of the exported goods.

THE POLICY OF OTHER COUNTRIES

The legal position relating to promissory estoppel in other countries varies. In some countries it is governed by legislation whereas in others promissory estoppel is based on official instructions. The policies of various countries are discussed below.

A. Australia

The taxation ruling system was introduced in Australia on 1 December 1982. This system introduced a method of publishing and disseminating decisions on interpretation of laws administered by the Commissioner of Taxation. A taxation ruling will be issued following a decision which satisfies one of the following criteria:[11]

(a) it provides an interpretation, guideline, precedent, practice or procedure to be followed in making a decision that affects the rights or liabilities of taxpayers, and
(b) it establishes a new revised interpretation of the administration of taxation laws, or
(c) it affects all taxpayers or a section of the tax-paying community and not just an individual taxpayer.

Tax rulings replace memoranda and other forms of advice from the Commissioner of Taxation relating to new or revised interpretations of tax laws. Tax rulings, however, cannot supplant the express terms of law, and statements or declarations made by the Commissioner of Taxation or his officers do not give rise to an estoppel preventing operation of the tax laws. Tax rulings can be overruled by legislative amendments to the law or by decisions of the Appellate Tribunals. A ruling given in respect of a particular case is only operative in the circumstances of that case.

B. Belgium

In Belgium, administrative rulings, circular letters and statements (which have the same status as rulings) made by the Minister of Finance have no binding force under the law. They cannot be invoked by the tax administration or by the taxpayer. No court will apply them. In short, the approach in Belgium is "formalistic". The text of the law carries great weight and, consequently, the concept of promissory estoppel has no effect in Belgium.

C. Federal Republic of Germany

Under the rule of fair dealing (Treu und Glauben) which governs the relationship between the taxpayer and the government, both the taxpayer and the tax administration may be prevented from changing the legal position upon which the other party reasonably relied. Consequently, the taxpayer will be held to a legal evaluation which he successfully asserted in the

9. Even in the absence of an overriding public interest, the government may be permitted to rescind its promise by giving reasonable notice (which need not be formal) to the promisee so that the promisee has a reasonable opportunity to resume his position. It must be possible, however, for the promisee to restore the status quo, i.e. if the promisee is unable to resume his original position the promise is final and irrevocable.
10. 1968 All Indian Reporter at 71.
11. Australian Freedom of Information Act, 1982, Sec. 9.

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past even if this evaluation turns out to be detrimental to his interests at a later time.[12] Similarly, the government is not permitted to alter its treatment of a particular circumstance to the detriment of the taxpayer in the absence of convincing reasons which justify the change of position.[13] If the taxpayer can show that he received incorrect legal advice from the director of the local tax office and, in pursuance of such advice, altered his position in such a way that his tax position was adversely affected, he can demand to be assessed as if the erroneous advice had not been given. However, he cannot claim the tax benefits that would not have been available to him if he had been given correct legal advice.[14]

The rule that newly-discovered facts or evidence require a correcting assessment is limited by the principle of fair dealing. On this ground, the tax office is estopped from basing the correcting assessment on facts which it knew but discarded as irrelevant in the course of the original assessment or on facts which it did not deem necessary to clarify during its review and investigation of the case.[15] For the same reason, the tax office cannot make a correcting assessment if it led the taxpayer to believe that it did not intend to correct the original assessment because of newly-discovered facts or if the tax office committed itself to a certain evaluation of the case and the taxpayer had altered his position in reliance on this assurance. These rules do not apply if the acts or assurances of the local tax office violated mandatory rules of law.[16] Conversely, the taxpayer is estopped from charging the tax office with negligence in establishing the facts of the case if he himself concealed the relevant facts. In such a case, the government will issue a correcting assessment.[17] Under the same principle, the taxpayer is not permitted to benefit from his failure to make a full disclosure of the pertinent facts to the tax office. For example, the taxpayer cannot request a correcting assessment in his favour if the facts which support his request were willfully concealed or negligently withheld at the time the original assessment was made.

D. France

Two statutory provisions govern in France:

(i) Art. L 80A of the *Livre sur les Procédures Fiscales* (Fiscal Procedure Code) provides that the tax authorities are bound by their interpretation of the law. Any change in interpretation which results in higher taxation can only apply to tax assessments made *after* such a change or to returns filed by taxpayers or payments of tax made *after* the change in interpretation. The interpretation must have been officially published in circular letters, Parliamentary replies of the Finance Minister (published in the minutes), letters to organizations (Chambers of Commerce of trade unions, etc.) or communiqúes issued by ministries. The tax authorities are also bound vis-à-vis an individual taxpayer if the opinion of the authorities is expressed in a letter to that taxpayer.[18]

(ii) Art. 1 of Decree 83-1025 of 28 November 1983 provides that any taxpayer may invoke any ruling or circular letter issued by the tax authorities so long as the ruling or circular does not conflict with the law or other regulations. This provision is not as broad as Art. L 80A. There is no language in Art. L 80A mandating that the ruling or circular not conflict with the law. However, the advantage of the Decree is that it applies to administrative procedures whereas Art. L 80A does not.

E. India

In India, estoppel cannot be applied to negate a statutory provision. A new statute may retrospectively remove what had been granted by an earlier statute. Alternatively, a statute may alter existing rights or create new liabilities. No statutory duties or obligations can be prevented, obstructed, avoided or disobeyed by invoking estoppel because it is only a rule of evidence and does not confer any right in law.[19] The same view is enunciated by the Supreme Court in *Motilal Padampat Sugar Mills* discussed above.

There is no specific provision in the Indian Income Tax Act which allows the taxpayer to assert promissory estoppel. However, as evolved by the courts, promissory estoppel applies to the interpretation of the income tax law. Several Supreme Court judgments have upheld the binding nature of circulars issued by the Central Board of Direct Taxes of the Ministry of Finance. It is a broadly accepted rule of law that Departmental Officers are bound by the instructions issued by the Board.[20] A recent Supreme Court decision reiterates this rule.[21] The Court laid down in categorical terms that Departmental Officers are bound to follow the instructions contained in the circulars issued by the Central Board of Direct Taxes in exercise of the power conferred by Secs. 116 and 119 of the Income Tax Act.

Recently, the Kerala High Court held that instructions which are beyond the scope of a statute cannot be issued by the Board and the Court cannot enforce such instructions regardless of Departmental practice.[22] This decision adopts a new line of reasoning and an authoritative decision by the Supreme Court is awaited on this issue.

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12. Decision of 8 April 1964 of the Supreme Tax Court, published in the Official Tax Gazette 1964 III at 271.
13. Decision of 11 February 1966 of the Supreme Tax Court, published in the Official Tax Gazette 1966 III at 486.
14. Decision of 22 April 1966 of the Supreme Tax Court, published in the Official Tax Gazette 1966 III at 395.
15. Decision of 23 May 1958 of the Supreme Tax Court, published in the Official Tax Gazette 1958 III at 326.
16. Decision of the Federal Constitutional Court of 4 November 1966, published in the Official Tax Gazette 1966 I at 412.
17. Decision of 19 October 1971 of the Supreme Tax Court, published in the Official Tax Gazette 1971 II at 106.
18. Art. L 80A only applies to the taxable base for purposes of tax and not to the taxation procedure.
19. See Sec. 115 of the Indian Evidence Act.
20. The issue concerning the binding nature of a circular which was incorrect under the law has never arisen and therefore has not been specifically considered.
21. *K.P. Varghese v. Income Tax Officer,* 131 Income Tax Reports at 597.
22. *Commissioner of Income Tax v. Malayala Manorams Ltd.,* 143 Income Tax Reports at 29.

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F. The Netherlands

There is no provision in Dutch tax law which allows a taxpayer to invoke a ruling issued by the tax authorities. The Supreme Court (Hoge Raad), however, has developed the doctrine of "fair administration" and, more specifically, the principle that a taxpayer may in good faith rely on the tax authorities' interpretation of the tax law as, for example, published in circular letters or expressed in a letter from the tax authorities to the taxpayer.

A special problem arises in cases where an administrative ruling conflicts with legislation. If the ruling takes precedence over the law, the tax authorities would virtually be able to create their own laws. The 2 principles, i.e. that a taxpayer may rely on the interpretation of the law by the tax authorities and that the tax authorities may not issue rulings which conflict with the law have been interpreted as follows:[23]

(i) An incorrect interpretation by the tax authorities is binding on the latter unless the interpretation is so patently incorrect that it would be unreasonable for a taxpayer to demand its application.

(ii) An incorrect interpretation of the law or incorrect information supplied by the tax authorities is not binding unless the taxpayer, relying on this information, suffers damages. The interpretation, however, must have been so patently incorrect that the taxpayer was unreasonable in relying on the information.[24]

G. United Kingdom

The issue of promissory estoppel in the United Kingdom is not very topical and the general approach of the judiciary is restrictive and cautious. In a recent case the Court held that the taxpayer cannot rely on incorrect statements made by a tax official.[25] The facts of this case are as follows: the taxpayer was a British subject who worked in the United States for 20 years before returning to the United Kingdom in 1978. As a result of contributions made under the Federal Insurance Contribution Act (FICA) during his period of employment, the taxpayer became entitled to a retirement benefit payable monthly by the Department of Health, Education and Welfare in Philadelphia. The Inland Revenue took the view that the foreign income received by the taxpayer was assessable to tax under Schedule D, Case V as "income arising from possessions out of the United Kingdom, not being income consisting of emoluments of any office or employment". The taxpayer claimed that he had relied on information given to him by the Revenue over the telephone that such income would not be subject to tax in the United Kingdom and that it was unfair and oppressive for the Revenue to assess him to tax on the income. The General Commissioners upheld the assessments and declined to make any findings of fact on the question of whether the taxpayer had been wrongly advised by the Revenue over the telephone or whether he had relied on such advice to his detriment. The assessments were upheld on appeal on the basis that: (1) the payments received by the taxpayer under FICA were liable to tax as Schedule D, Case V income;
(2) the functions of the commissioners was to look at the facts and decide whether the assessment had been made properly in accordance with the law and the commissioners were correct to confine themselves solely to that question; and
(3) whether (on the basis of facts alleged by the taxpayer) it was an abuse of power by the Revenue to raise the assessment was a matter for which the only remedy available was by way of judicial review. The remedy was exclusively within the jurisdiction of the High Court. Thus even if the commissioners were to find the facts alleged by the taxpayer as true, a decision could not be rendered. The appeal was therefore dismissed.

H. United States

Revenue rulings are widely relied upon in the United States. A revenue ruling is "an official interpretation" by the Internal Revenue Service (IRS) that has been published in the Internal Revenue Bulletin. The policy of the IRS is to publish all rulings and other communications involving substantive tax law. Revenue rulings apply retroactively unless they explicitly provide otherwise but rulings which revoke or modify previously published rulings normally include a prospective-only qualification. The IRS has almost untrammeled authority to amend or revoke a revenue ruling (at least prospectively) if it concludes the ruling erroneously interprets applicable law and regulations.[26]

Another category of rulings in the United States are known as taxpayer letter rulings. These differ from the revenue rulings in some important aspects. Taxpayer letter rulings can be safely relied upon by the taxpayers to whom they are issued even though they are not vested by statute with the force of final assessments. A ruling will not be retroactively modified or revoked as to the taxpayer to whom it was issued or whose tax liability was directly involved if (1) no false statement or omission of material facts was made; (2) the facts as subsequently developed are not materially different from those on which the ruling was based; (3) the applicable law has not been changed; (4) the ruling was issued with respect to a prospective or proposed transaction; and (5) the taxpayer relied on the ruling in good faith and retroactive revocation would be to his detriment.

CONCLUSION

This analysis of the application of the doctrine of promissory estoppel to tax issues demonstrates that there is no uniform trend or commonly accepted norm.

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23. Fiscale Encyclopedia de Vakstudie, Algemeen Deel, Vol. 4 Art. 1, note 15.
24. Practically speaking, reality lies somewhere in between these 2 concepts.
25. *Aspin v. Estill (Inspector of Taxes)*, CH. D. See also Simon's Tax Cases (1986) at 323-326 and (1987) at 723-7.
26. *Couzens v. CIR*, 11 Board of Tax Appeals at 1040 (1928).

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The situation varies from country to country. Of the 8 countries discussed only France has express provisions in its Fiscal Procedure Code. In Australia and the United States, promissory estoppel finds some backing in revenue or taxation rulings. In India, the Federal Republic of Germany and the Netherlands the doctrine has developed through court decisions. In the 2 remaining countries, i.e. Belgium and the United Kingdom, the issue is not topical. It would be useful if international tax organizations like the International Fiscal Association, the International Chamber of Commerce and international bodies of attorneys and chartered accountants develop this subject in their seminars so that the doctrine of promissory estoppel evolves as a strong defensive force for the international tax-paying community.

[Continued from page 470]

Table IV

Export-oriented and technologically-advanced enterprise

Reduced income tax (additional tax holiday)	
export-oriented	half-rate indefinitely
technologically-advanced	half-rate for further 3 years
Reinvested profits	full refund
Profits remitted abroad	exemption
Local taxes and land use fees	reductions or exemptions

IV. TAX TREATIES

During the past 4 or 5 years, China has negotiated tax treaties with many of its major trading partners. Already in force are treaties with Belgium, Canada, Czechoslovakia, Denmark, Finland, France, Germany (Federal Republic), Japan, Malaysia, the Netherlands, New Zealand, Norway, Singapore, Sweden, Thailand, the United Kingdom and the United States. Treaties with the German Democratic Republic, Italy, Poland, Spain and Yugoslavia have been signed and await ratification, and negotiations are in progress with Australia, Austria, Romania and Switzerland. It is important to remember, however, that the greater part of foreign investment in China originates in Hong Kong, and does not benefit from any tax treaty.

Tax treaties as such do not provide investment incentives but, in so far as they modify domestic tax rules, their effect must be taken into account. In particular, they modify, and normally reduce, rates of withholding tax applied to transfers of income between Contracting States and, where relief from double taxation is secured by way of exemption in the home State, or where "tax sparing" is adopted, they ensure that the benefit of tax incentives accrues to the investor rather than to the home country of the investor.

A. Withholding tax

As has been seen, a common incentive offered by China to attract foreign investment is a reduction in the usual rate, or a complete waiver, of withholding tax on dividends, interest, rents and royalties. However, in most of China's tax treaties withholding taxes are reduced to 10% and, in the case of many royalty payments, to 6 or 7%. "Special" reductions, therefore, may not be so special after all.

B. Relief from double taxation

A number of treaties (e.g. those with Belgium, France, Germany, Norway and Sweden) provide that business profits earned and taxable in China will not be taxed in the other Contracting State. Thus, the full benefit of tax holidays and exemptions is preserved. Most of the other treaties, with the exception of that with the United States, adopt "tax sparing" in a variety of forms, either granting credit for taxes which would have been payable but for some specified incentive provision or by deeming tax to have been withheld at a stipulated rate, whether or not the tax has been actually levied.

V. CONCLUSION

Tax concessions are among the most important incentives offered by China in order to attract foreign investment. However, the number of such incentives has multiplied rapidly in the past year or so, with the result that the potential investor is confronted with a wide variety of choices. Although the gaps in the Chinese legislative framework governing foreign investment are rapidly being filled, there are still areas of uncertainty and it remains true to some extent that the tax position of foreign investors is open to negotiation. Nevertheless, it can be concluded that the existing tax regime, as it appears on the statute book, is a relatively hospitable one and should certainly not act as a deterrent to foreign investment.

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HONG KONG:

The Draft Basic Law of Hong Kong and the Constitutional Constraints on Budgetary Expenditure and Revenue

By Joseph S.H. Tang

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INTRODUCTION

When the People's Republic of China (hereinafter "PRC") resumes the exercise of sovereignty over Hong Kong on 1 July 1997[1], the PRC shall establish the Hong Kong Special Administrative Region (hereinafter "HKSAR") of the PRC. The National People's Congress of the PRC shall enact and promulgate a Basic Law of the HKSAR (hereinafter "Basic Law") of the PRC in accordance with Art. 31 of the PRC's Constitution.[2] The Basic Law will stipulate that after establishment of the HKSAR, the socialist system and policies shall not be practiced in the HKSAR and that Hong Kong's previous capitalist system and lifestyle shall remain unchanged for 50 years.

In April 1988 the draft Basic Law was released for solicitation of opinions. Chapter 5 of the draft Basic Law deals with "Economy". This chapter contains 7 sections: Public Finance and Taxation; Money and Finance; External Trade Economic Relations; Industry, Commerce and Other Trades; Land Leases; Shipping; and Civil Aviation. The Public Finance and Taxation Section contains 5 articles (Arts. 104-108). Arts. 105 and 107, the so-called balanced budget and low tax policy articles, have generated considerable controversy. Both articles have received negative comments from the public. During the 3-year drafting process, the Drafting Committee engaged in heated debates over the wording and spirit of these 2 articles. Some drafters felt both articles could be dropped completely.

This article traces the historical development of the policies underlying Arts. 105 and 107 and reviews critically their rationale. The article concludes with recommendations for a structural improvement of the Public Finance and Taxation Section.

ART. 105: BALANCED BUDGET ARTICLE

Art. 105 states:

> The government of the Hong Kong Special Administrative Region shall follow the principle of measuring expenditure by revenues in drawing up its budget. The government of the Hong Kong Special Administrative Region shall, over a number of fiscal years taken as a whole, maintain a basic balance between total budgetary revenues and expenditure. In principle, the rate of increase of the budgetary revenues and the expenditure of the Hong Kong Special Administrative Region shall not exceed that of the gross domestic product over a number of fiscal years taken as a whole.

Art. 105 was amended several times before it was set forth in its present form. Before commenting on this article, I would like to refer to the original motion of Mr. P.Y. Wong, co-convenor of the Economic Special Subject Sub-group of the Drafting Committee (ESSS) at the 1986 Shenzhen Meeting. Mr. Wong moved that the Basic Law should clearly specify that "the expenditure of the government of the Hong Kong Special Administrative Region shall not exceed 20% of the Gross Domestic Product (GDP)". In other words, 20% is the upper limit of the relative size of the public sector in Hong Kong. According to the minutes of that meeting, the purpose of this motion was to constrain the HKSAR government's spending power to control the gradual increase of the relative size of the public sector and to limit the free-spending capability of the elected members of the HKSAR Legislative Council. Mr. Wong argued that such an article could guarantee the fiscal stability of the HKSAR government and insulate the economy from interference of excessive welfare expenditure. One Hong Kong drafter even suggested a 15% ceiling for the relative size of the public sector.

Several technical issues concerning Mr. Wong's proposal must be addressed before the merit and validity of Art. 105 can be appraised. First, the question of how to define the relative size of the public sector must be answered; in other words, what approach is to be used to calculate the total government expenditure and the GDP? Currently, the Financial Secretary uses the Consolidated Account Total Expenditure (CAE) to represent total government spending. The Consolidated Account is comprised of expenditure by the

1. See para. 1 of the Joint Declaration of the government of the United Kingdom and the government of the PRC on the question of Hong Kong, signed on 26 September 1984.
2. Art. 31 of the PRC Constitution stipulates that "the state may establish special administrative regions when necessary. The systems to be instituted in special administrative regions shall be prescribed by laws enacted by the National People's Congress in the light of the specific conditions".

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Urban Council, Regional Council and the Housing Authority, expenditure financed by certain statutory funds and all expenditure charged to the General Revenue Account. Expenditure by institutions in the private or quasi-private sector is included to the extent of their subventions. The activities of government departments which are partly financed by charges raised on a commercial basis (e.g. airport, waterworks) are also included. However, expenditure by organizations (including statutory organizations) in which the government has only an equity position, such as the Mass Transit Railway Corporation (MTR) and the Kowloon-Canton Railway Corporation (KCR), is not included. How the expenditure of departments which provide services on a commercial basis is calculated would affect to a significant extent the relative size of the public sector. For example, inclusion of the MTR would increase the relative size of the public sector by 2%, which is about one eighth of the current size of the public sector. Yet there is no absolute standard as to the exact definition of total government expenditure and it is up to the government to decide.[3]

Second, calculation of GDP is at best a scientific estimating exercise. GDP can be estimated in various ways. Before 1984 the Hong Kong Census and Statistics Department (CSD) used the expenditure approach. The first estimate of the current year's GDP (growth rate and amount) is announced in the February Financial Budget Speech and the draft estimate is revised every 6 months (5 times consecutively) before arriving at its final estimate. Table I demonstrates that because of the estimation error, there are deviations among all 7 GDP estimates of the same year. In particular a wide margin of difference appears between the first draft estimate and the actual growth rate. We do not know to which estimate of GDP Art. 105 refers. Regardless of which GDP estimate is chosen, it would be quite arbitrary and difficult to control the corresponding growth rate of the total government expenditure.

Table I
Growth rates of real GDP in Hong Kong (1976-88)

GDP growth rate%	*Year 76*	*77*	*78*	*79*	*80*	*81*	*82*	*83*	*84*	*85*	*86*	*87*	*88*
1. Budgetary draft estimate	9.0	7.0	9.0	7.0	9.0	8.0	8.0	4.0	6.0	7.0	4.5	6.2	5.0
2. Half-year revised estimate	16.0	8.0	10.0	12.0	10.0	10.0	6.0	6.0	8.0	4.5	5.6	12.0	—
3. Preliminary estimate	16.2	11.6	10.0	11.5	9.0	10.4	2.4	5.9	9.6	0.8	8.7	—	—
4. Revised preliminary estimate	17.8	11.4	10.0	11.0	10.1	11.0	2.4	5.2	9.4	0.8	11.0	—	—
5. Provisional estimate	16.9	11.9	10.0	8.6	9.8	10.9	1.1	5.1	9.3	0.6	—	—	—
6. Revised provisional estimate	16.7	11.9	9.2	8.6	11.7	10.9	2.2	6.5	9.8	–0.1	—	—	—
7. Final estimate	17.1	12.5	9.5	11.7	10.9	9.4	3.1	6.5	9.5	—	—	—	—

Sources: *Estimates of Gross Domestic Product*, Census and Statistics Department, Hong Kong Government, various issues. *Financial Budget*, and *Half-Year Economic Report*, Hong Kong Government, various issues.

Moreover, 2 major revisions of the series of GDP estimates were made in the 1980s. In 1980, with the availability of survey data on construction output, the GDP series was revised upward by 3% to 10%. In 1984 the CSD adopted the production approach in calculating GDP and, based on more recent survey data on manufacturing, the new GDP series was, in general, 20% higher than the old series.

Because of the upward revision of the GDP series, the relative size of the public sector was correspondingly reduced.

Table II shows 3 series of the relative size of the public sector, corresponding to various series of the GDP final estimates. Table III compares the budgetary estimate and the actual figure of the relative size of the public sector.

One can see that because of the inaccuracy and the time element involved in the estimation of GDP, it would be very difficult to enforce Art. 105.

Third, how should the "proper" relative size of the public sector be determined? Too large a public sector would crowd out scarce resources from the private sector and generate inefficiency. Too small a public sector would not provide adequate infrastructure to promote economic development. What is the relationship between any proposed "proper" size and the currently existing position?

Mr. Wong's proposal of a 20% ceiling is not without historical precedent. In the 1976/77 Financial Budget, then Financial Secretary Sir Philip Haddon-Cave proposed a 20% ceiling. He stated:

> Public expenditure tends to be determined by *political* and *social* (emphasis added), as well as economic, considerations, and so it is important that the size of the public sector does not exceed a certain limit. Otherwise, there is a risk that public sector activities will damage the growth rate of the economy. It is a matter of opinion when this limit is reached, but it is clearly lower in an open economy such as ours, necessarily dependent on

3. The inconclusive result of the budget debate since the early 1980s between Miss Lydia Dunn, the senior member of the Legislative Council, and the Financial Secretary over this issue is a classic example of the ambiguity in defining total government spending.

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> a relatively narrow range of industries manufacturing for export, than in a closed economy. But, in my opinion, if one measures the size of the public sector in terms of the ratio of total public expenditure to the GDP, the *outside limit should be set at 20%* (emphasis added); and, when the economy is enjoying strong growth, the ratio should fall. Inevitably, the ratio rose in the two years of economic recession 1974 and 1975, to just over 19%.... In the coming year, the ratio will rise a little further to just over 20%....[4]

The actual size of the public sector did rise to 10.5% in 1980/81 due to a rapid increase in expenditure in the late 1970s. Sir Philip began to soften his position on the upper limit and argued that the increase was within the capability of the enlarged and more sophisticated economy.[5] Sir Philip went on to reverse his 1976/77 position by arguing that:

> It is not really possible to set an upper limit to the relative size of the public sector but, clearly, the implications of sharp increases or decreases need to be carefully considered.[6]

Sir Philip repeated the same statement in 1981/82 when the actual size of the public sector did exceed the 20% ceiling (see Table II, column 2).

The Legislative Council engaged in heated debates on the sharp increase of the relative size of the public sector. Mr. Oswald Cheung argued that setting an upper limit was arbitrary and suggested an increase in the limit to 25% so that, for the time being, the Financial Secretary did not need to worry about hitting the ceiling. In response to Mr. Cheung's plea for a 25% arbitrary ceiling, Sir Philip said:

> I have refrained recently from being too specific about an upper limit for the relative size of the public sector for, as our economy is enlarged, so a relatively larger public sector can be tolerated.[7]

Sir John Brembridge, Sir Philip's successor, was concerned with only the trends of growth of expenditure rather than the relative size of the public sector. He convincingly put forth his argument that:

> There exist no rules of logic which postulate what is a proper share of resources for the public sector.... Naturally there tends to be a lack of common factors, which

Table II
Relative size of the public sector in Hong Kong (72/73-88/89)

Fiscal year	*(1)*	*(2)*	*(3)*
72/73	16.1	15.0	12.9
73/74	16.4	15.0	12.9
74/75	18.8	17.3	15.0
75/76	17.6	16.2	14.2
76/77	15.6	14.2	12.4
77/78	16.7	15.4	13.3
78/79	19.6	17.4	14.9
79/80	19.6	17.5	14.6
80/81	—	19.5	16.1
81/82	—	21.4	17.8
82/83	—	24.2	19.1
83/84	—	24.1	18.6
84/85	—	—	16.4
85/86	—	—	16.5
86/87	—	—	16.0
87/88	—	—	15.0
88/89	—	—	15.6*

Note: * budgetary estimate
Series (1) based on the GDP figures before the 1980 revision.
Series (2) based on the GDP figures after the 1980 revision.
Series (3) based on the GDP figures after the 1984 revision.

4. See *1976/77 Financial Budget,* Finance Branch, Hong Kong Government, para. 210.
5. See *1980/81 Financial Budget,* Finance Branch, Hong Kong Government, para. 91.
6. See *1980/81 Financial Budget,* Finance Branch, Hong Kong Government, para. 92.
7. See *1981/82 Financial Budget,* Finance Branch, Hong Kong Government, para. 12.

Table III
Relative size of the public sector in Hong Kong:
Comparison of budgetary and revised estimates

	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*	*(11)*	*(12)*
1977/78	17.6	17.2	16.7	15.4	15.4	15.4	15.4	13.3	13.3	13.3	13.3	13.3
1978/79	—	18.4*	19.6	17.4	17.4	17.4	17.4	14.9	14.9	14.9	14.9	14.9
1979/80	—	—	19.6*	18.7	18.1	17.5	17.5	14.6	14.6	14.6	14.6	14.6
1980/81	—	—	—	19.7*	21.2	20.3	19.5	16.1	16.1	16.1	16.1	16.1
1981/82	—	—	—	—	22.4*	22.9	21.4	17.8	17.8	17.8	17.8	17.8
1982/83	—	—	—	—	—	23.7*	24.2	19.4	19.1	19.1	19.1	19.1
1983/84	—	—	—	—	—	—	24.1*	19.4	18.6	18.6	18.6	18.6
1984/85	—	—	—	—	—	—	—	18.3	16.4	16.4	16.4	16.4
1985/86	—	—	—	—	—	—	—	—	16.0*	16.5	16.5	16.5
1986/87	—	—	—	—	—	—	—	—	—	16.7*	16.5	16.0
1987/88	—	—	—	—	—	—	—	—	—	—	16.6*	15.0
1988/89	—	—	—	—	—	—	—	—	—	—	—	15.6*

Note: * budgetary estimate
Figures in the same row correspond to the same fiscal year. For example, in 1977/78, the figure in column (1) 17.6% is a budgetary estimate, and 17.2% in column (2) is a revised estimate of 1977/78 published in the 1978/79 Budget, and 16.7% in column (3) is a revised estimate of 1977/78 published in the 1979/80 Budget, etc. Because of the revisions of the GDP figures in 1980 and 1984, the corresponding figures on the size of the public sector are also affected.
This is shown in columns (4) and (8), respectively.
Source: Financial Budget, Hong Kong Government, various issues.

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> indeed differ widely.... Having been engaged in many debates on this issue in this Chamber, *I do not personally think that for Hong Kong anyway there is any ideal percentage figure* (emphasis added).[8]

Abolishing the ceiling does not imply unrestrained growth of the public sector. It only gives the government more flexibility to respond to the needs of the economy. There are still many fiscal guidelines to control the growth of expenditure.[9] Mr. Piers Jacobs, Sir John's successor, echoed Sir John's viewpoint by stating:

> Given the inevitable volatility of Hong Kong's economy, externally oriented as it is, it is nevertheless *neither possible nor desirable* (emphasis added) to lay down a precise year by year relationship between the growth rate of public expenditure and the growth rate of GDP.[10]

Mr. Jacobs's viewpoint can be regarded as the government's response to Mr. Wong's 20% ceiling proposal. Informal sources revealed that a senior government official expressed concern to the Hong Kong branch of the Xinhua News Agency Service[11] over the 20% ceiling proposal. Considering the negative response from the general public and realizing the technical difficulties in applying the ceiling, the Basic Law Drafting Committee, after a lengthy session of elaboration and debate, rejected Mr. Wong's motion at the June 1987 Guangzhou Meeting.

THE NEW STAGE OF DEVELOPMENT

Immediately after the ceiling motion was dropped, a drafter (possibly Mr. Wong Po-yan), proposed another motion as follows: "The financial budget of the Hong Kong Special Administrative Region shall maintain a basic balance." The new motion was extended in the following August 1987 Beijing Meeting:

> The financial budget of the Hong Kong Special Administrative Region shall maintain a basic balance. In principle, the rate of increase of budgetary expenditure and revenues of the Hong Kong Special Administrative Region shall not exceed that of the gross domestic product.

Some drafters have expressed strong reservations about inclusion of the second paragraph. During the December 1987 Guangzhou Meeting, the first paragraph of the motion was further amended to read: "The government of the Hong Kong Special Administrative Region shall enforce the rule of basic balance in drawing up its budget." A General Working Party was formed after the December 1987 Guangzhou Meeting with a specific mandate to fine tune the wording and presentation of all articles to conform to the spirit of the Basic Law Drafting Committee's resolutions. However, the General Working Party, outside its terms of reference, revised Art. 105 to its present form. The previous first paragraph was divided into 2 paragraphs (1 and 2). The new version not only discusses budgetary policy but also stipulates the actual budgetary result. The previous second paragraph was augmented by adding a crucial phrase: "over a number of fiscal years taken as a whole", and was renumbered as the third paragraph.

The drafter who proposed the second paragraph of Art. 105 insisted that such a clause could avoid adoption of a "welfare state" policy in Hong Kong, the same philosophy implicit in the 20% ceiling motion. Since the 20% ceiling motion has been rejected, there is no reason why the new Art. 105 should stand in its present form. Now let us look at Art. 105 in greater depth.

Para. 1 of Article 105

"The government of the Hong Kong Special Administrative Region shall follow the principle of measuring expenditure by revenues in drawing up its budget."

What is the meaning of "measuring expenditure by revenues"? Should this principle be adhered to in every fiscal year? The draft Basic Law divulges no clue and consequently it is subject to interpretations of the HKSAR government, the Court of Final Appeal in the HKSAR and the Standing Committee of the National People's Congress of the PRC. In a radio panel discussion on the Economy chapter of the draft Basic Law (on 23 June 1988, Radio Hong Kong), Mr. Wong, the co-convenor of the ESSS, said explicitly that the purpose of the first paragraph of Art. 105 was to prevent the HKSAR government from having a deficit budget. But Mr. Wong did not explain the underlying reasons.

Table IV shows that out of the 43 financial budgets beginning in 1946/47 right after the Second World War, there are 21 deficit budgets, 21 surplus budgets and 1 balanced budget, respectively. Mr. Wong's statement contradicts the history of public finance in Hong Kong.

It is obvious that every government should be entrusted to implement fiscal policy to stabilize the economy, albeit to different degrees: prohibiting the government from having budget deficits would withdraw an important fiscal function of the government. Lacking valid reasons, such a drastic change from the prevailing policy would not be acceptable.

Para. 2 of Article 105

"The government of the Hong Kong Special Administrative Region shall, over a number of fiscal years

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8. See *1982/83 Financial Budget,* Finance Branch, Hong Kong Government, paras. 24-25.
9. There are several ratio guidelines among recurrent expenditure, recurrent revenue, capital expenditure, capital revenue, surplus on the recurrent account, deficit in the capital account, public debt issuing and fiscal reserves. Please refer to Joseph S. Tang, "The Budgetary Guidelines and the Articles on Public Finance and Taxation of the Basic Law", *Hong Kong Economic Journal Monthly,* (in Chinese) 10 (1987) at 58-63.
10. See *1987/88 Financial Budget,* Finance Branch, Hong Kong Government, para. 41.
11. The Xinhua News Agency Services is China's official organization in Hong Kong. The Agency engages in a wide range of activities and represents China's political and economic interests in Hong Kong.

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taken as a whole, maintain a basic balance between total budgetary revenues and expenditure."

Several technical issues are involved in this paragraph. First, what is the length of "over a number of fiscal years taken as a whole"? Would it be 3 years, 5 years or 10 years and why is it chosen? It is an unenforceable statement. Secondly, what is the definition of "a basic balance"? Would a small surplus or deficit be acceptable as basically balancing the budget? Is a basically balanced budget *sufficient* to maintain a *satisfactory* level[12] of fiscal reserves in real terms, and how would it affect the relationship between fiscal reserves and total government expenditure? These questions are left unanswered.

Table IV
Actual surplus/deficit compared with estimated surplus/deficit in Hong Kong (HK$ Million)

Fiscal year	Estimated surplus (+) deficit (–)	Actual surplus (+) deficit (–)
1946-47	– 116.5	– 3.5
1947-48	0.0	+ 36.6
1948-49	+ 1.1	+ 35.0
1949-50	+ 0.2	+ 82.1
1950-51	+ 3.3	+ 40.0
1951-52	+ 13.1	+ 32.7
1952-53	+ 2.1	+ 72.8
1953-54	+ 20.5	+ 41.5
1954-55	+ 1.2	+ 61.1
1955-56	– 35.4	+ 52.3
1956-57	– 43.3	– 40.1
1957-58	– 53.7	+ 51.5
1958-59	– 94.1	+ 39.4
1959-60	– 92.4	– 45.3
1960-61	– 226.1	+ 13.9
1961-62	– 160.9	+ 77.2
1962-63	– 163.9	+ 139.8
1963-64	– 163.0	+ 98.5
1964-65	– 114.3	+ 77.8
1965-66	– 60.0	– 137.4
1966-67	– 94.1	+ 11.7
1967-68	– 37.0	+ 133.5
1968-69	– 13.0	+ 208.1
1969-70	+ 53.4	+ 448.5
1970-71	+ 191.1	+ 618.7
1971-72	+ 256.0	+ 640.0
1972-73		
1973-74	+ 200.0	+ 71.6
1974-75	+ 98.0	– 378.0
1975-76	– 431.0	+ 232.0
1976-77	– 355.0	+ 917.0
1977-78	+ 30.0	+ 1225.0
1978-79	– 20.0	+ 1486.0
1979-80	+ 2318.0	+ 2975.0
1980-81	+ 9323.0	+10512.0
1981-82	+ 7881.0	+ 6535.0
1982-83	+ 2326.0	– 3500.0
1983-84	– 3167.0	– 2993.0
1984-85	– 2091.0	– 559.0
1985-86	– 1155.0	+ 98.0
1986-87	+ 348.0	+ 4920.0
1987-88	+ 2400.0	+10590.0
1988-89	+ 5500.0	——

Para. 3 of Article 105

"In principle, the rate of increase of the budgetary revenues and the expenditure of the Hong Kong Special Administrative Region shall not exceed that of the gross domestic product over a number of fiscal years taken as a whole".

Besides the same definitional issue concerning the length of "over a number of fiscal years taken as a whole", many more technical issues crop up in this paragraph. I shall discuss the revenue part first. Table V tabulates the time series of the growth rate of GDP, total revenues and recurrent revenues. It is also divided into 3 categories: budgetary draft estimates, revised estimates and actual figures.

Recurrent revenue includes direct and indirect taxation and fees and charges. Total revenue is the sum of recurrent revenue and capital revenue (i.e. revenue mainly from estate duty, tax concessions and land sales). Recurrent revenue is affected both by tax items and tax rate schedule. With the sharing of revenues from land sales since 1985 between the Hong Kong government and the future HKSAR government, the importance of revenues from land sales has gradually been diminishing and the emphasis has shifted from capital revenues to recurrent revenues. From Table V it is clear that there is no observable relationship among GDP, total revenue and recurrent revenue because the structure of the tax system adjusts periodically to accommodate economic development and fiscal needs and the Financial Secretary does not set up fiscal guidelines on the relationship between the growth rates of the GDP and total revenues.

A more sophisticated approach is to calculate the elasticities of recurrent revenue, direct tax and indirect tax revenue with respect to GDP, respectively. Using the 1971/72-1985/86 data, Tang calculated the revenue elasticities (see Table VI). All the calculated revenue elasticities include changes of tax items and rate schedule during the period under investigation. Tang concluded that recurrent revenue elasticity was greater than unity, i.e. whenever the GDP grows by 1%, the recurrent revenue will grow by more than 1%.

The above finding is quite interesting. It implies that if para. 2 of Art. 105 were approved, the emphasis of the current tax system should be shifted from direct to indirect taxation since it had lower than unity elasticity. If so, the already underemphasized redistributive function of the Hong Kong tax system would be reduced. The recent 1986 mid-term Population Census produced a deteriorating Gini coefficient which indicates that income disparity has increased since the 1970s. One dominant factor is the low tax policy in

12. There are 6 requirements of the Hong Kong tax system. The first and most important requirement is that the tax system should help generate sufficient recurrent revenue to finance a major part of a given level of total public expenditure and to maintain government's fiscal reserves at a *satisfactory* level (see 1978/79 Financial Budget, para. 160). By "satisfactory", it is suggested that fiscal reserves, after deducting one third of the contingent liabilities, should be at least 15% of the total budgetary expenditure in the following fiscal year.

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Table V
Growth rates of GDP, total revenues and recurrent revenues in Hong Kong

	Budgetary estimate			*Revised estimate*			*Actual figure*		
Fiscal year	*GDP* %	*Total revenue* %	*Recurrent revenue* %	*GDP* %	*Total revenue* %	*Recurrent revenue* %	*GDP* %	*Total revenue* %	*Recurrent revenue* %
1976-76/77	5.3	14.0	13.3	15.8	18.3	14.9	27.7	19.8	17.2
1977-77/78	15.4	12.0	9.5	6.0	23.2	17.9	16.1	25.2	19.0
1978-78/79	17.7	11.0	11.6	7.8	31.9	21.9	17.8	32.6	24.5
1979-79/80	18.5	12.2	15.5	28.8	33.0	30.2	31.9	35.0	24.5
1980-80/81	23.1	29.5	12.0	20.0	72.7	36.4	28.0	79.7	40.7
1981-81/82	19.1	12.2	12.1	19.7	15.2	18.8	20.3	10.9	26.7
1982-82/83	13.7	8.8	3.6	11.6	–8.0	5.0	12.9	–7.2	3.6
1983-83/84	12.3	4.7	13.8	11.0	–2.6	9.0	11.4	–2.2	9.5
1984-84/85	16.0	19.5	12.3	20.0	14.9	11.1	19.8	19.5	12.2
1985-85/86	14.7	6.4	15.2	6.8	9.8	15.9	5.0	13.5	19.2
1986-86/87	9.0	–0.3	7.8	10.7	4.5	12.9	14.8*	6.4	14.9
1987-87/88	10.2	7.2	10.1	20.1	26.7	30.0	—	—	—
1988-88/89	11.3	20.3	20.9	—	—	—	—	—	—

Note: The above growth rates are in money terms.
* provisional estimate
Source: *Estimates of Gross Domestic Product, Census and Statistics Department*, Hong Kong Government, various issues.
Financial Budget, Hong Kong Government, various issues.

Table VI
Tax elasticities in Hong Kong

Taxes	*Elasticity*
Recurrent Tax Revenues	1.0623
Direct Tax Revenues	1.2069
Indirect Tax Revenues	0.8955

Source: S.H. Tang, *Structure of the Tax System in Hong Kong*, unpublished manuscript, 1987, Time Period: 1971/72-1985/86.

Hong Kong. Insisting on inclusion of para. 2 of Art. 105 would exacerbate income inequalities in Hong Kong.

Tying the growth rate of budgetary expenditure to GDP would cause additional problems. The draft estimate of expenditure is not very accurate. The normal budgetary process starts in September when departments submit budget requests to the Finance Branch. In consultation with departments, the Finance Branch reviews and amends the departmental budgets to arrive at an integrated budget which comports with the overall budgetary strategy. The budget proposal must be ready for printing by the next January. In other words, the Financial Secretary has at most 9 months budgetary data for the current fiscal year to formulate the financial budget for the next fiscal year. There are bound to be errors in these estimates. The actual expenditure would deviate from its budgetary estimate. It is relevant to inquire whether para. 2 of Art. 105 refers to the draft estimate or to the actual figure.

To be fair to the drafters who advocate this paragraph, we must discuss the fiscal guideline adopted by the Financial Secretary on the growth rate of total expenditure. The difference between the fiscal guideline and Art. 105 will be discussed later.

Table VII
Budgetary guideline on growth of total expenditure

Time period	*Budgetary guideline*
1976/77-1982/83	The annual growth rate of total expenditure should be limited to 10% in real terms (1977/78 Financial Budget, para. 103, and 1980/81 Financial Budget, para. 89)
1983/84-1985/86	The annual growth rate of total expenditure should be limited to 10% in money terms (1983/84 Financial Budget, para. 52)
1986/87-present	Total expenditure growth should not in real terms exceed the growth in GDP (1986/87 Financial Budget, Appendix A, General Economic Assumption 7)

Table VII gives the fiscal guideline on the growth of total expenditure since the mid-1970s when there was rapid expansion of the public sector to promote economic growth and income equity. The guideline during that period in real terms was around 10%. During the 1982 world economic recession, Hong Kong experienced a huge budget deficit. Consequently, the Financial Secretary changed the 10% growth rate from real terms to money terms in 1983/84. In 1985 there was another economic recession, and Hong Kong experienced a negative growth rate of GDP, the first time since the Second World War. The Financial Secretary changed the guideline again in 1986/87. None of the above guidelines made it clear whether they were in terms of budgetary draft estimates or actual figures. But the financial budget did apply the guideline to discuss the draft estimate and the actual figure. Table VIII compares the growth

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Table VIII
Growth rate of the GDP and the CAE (%)

Fiscal year	*Budgetary GDP%*		*Estimate CAE%*		*Revised GDP%*		*Estimate CAE%*		*Actual GDP%*		*Figure CAE%*	
1976-76/77	9.0		—		16.0		—		17.1		5.2	
1977-77/78	7.0		—		8.0		—		12.5		15.5	
1978-78/79	9.0		—		10.0		—		9.5		21.0	
1979-79/80	7.0	8.14%	—		12.0	10.3%	—		11.7	10.6%	7.0	13.1%
1980-80/81	9.0		—		10.0		21.4		10.9		17.8	
1981-81/82	8.0		12.8		10.0		21.8		9.4		15.0	
1982-82/83	8.0		10.7		6.0		17.4		3.0		10.4	
1983-83/84	12.3		11.7		11.0		12.6		11.4		8.2	
1984-84/85	16.0	14.3%	9.5	10.9%	20.0	12.6%	6.1	9.5%	19.8	12.0%	3.3	6.8%
1985-85/86	14.7		11.5		6.8		9.8		5.0		8.9	
1986-86/87	4.5		3.8		5.6		4.1		11.2*		3.5	
1987-87/88	6.2	5.2%	4.9		13.6		4.6		—		—	
1988-88/89	5.0		—		—		—		—		—	

Note: 1976/77-82/83 in real terms
1983/84-85/86 in money terms
1986/87-present in real terms
* provisional estimate

Sources: *Estimates of Gross Domestic Product*, Census and Statistic Department, Hong Kong Government, various issues.
Financial Budget, Hong Kong Government, various issues.

rates of the GDP and the Consolidated Account Expenditure to determine whether the guideline was observed and followed.

Reviewing the historical development of the above guideline, one can see that it serves only as a tool for financial management. The guideline has no legal status and is subject to change in order to cope with the needs of government finances and the economy. Para. 2, although very similar in wording to the existing fiscal guideline, does provide a legal or constitutional imprint to which the HKSAR government must comply. Thus it turns what was previously regarded as an instrument, into the very objective of the fiscal policy. In this sense, it is inappropriate and unacceptable and contrary to the spirit of independent finances for the HKSAR government.

One implication of Art. 105 concerns the size of the public sector. Since the real growth rate of total expenditure shall not exceed those of GDP, the relative size of the public sector will gradually be diminishing, with the 1997/98 Financial Budget setting the upper limit. It is therefore more stringent and undesirable than the previous 20% ceiling motion and, following the rejection by the Basic Law Drafting Committee of the 20% ceiling, no clear justification is apparent for accepting Art. 105.

On several occasions, the advocates of para. 3 used constitutional and statutory provisions on public finance of the 50 states[13] of the United States as an example to strengthen the case for Art. 105. It was also argued that having constitutional limits for expenditure and taxation is not uncommon and that the Basic Law Drafting Committee should not be blamed for doing something unconventional and undemocratic. This argument is valid if and only if the situations are genuinely similar and comparable. Unfortunately, this is not the case for the following reasons:

1. The HKSAR government is given financial independence by the Central People's Government of the PRC. The Central People's Government will not levy tax in the HKSAR and the tax revenue will be used exclusively in the HKSAR whereas in the United States the states have maintained a fiscal relationship with the Federal Government through a tax revenue sharing scheme, grant-in-aid scheme and the Federal Government's provision of certain important public services. Moreover, the power to tax among various tiers of governments (i.e. local, state and federal) is clearly enunciated in the U.S. Constitution, whereas the HKSAR government enjoys independent finances and has the exclusive power to tax. On the other hand, a state in the United States can always escape or circumvent the rigidity of constitutional limits by resorting to the Federal Government's assistance; the HKSAR government does not have this avenue at its disposal.

2. In most states in the United States, citizens are endowed with the constitutional right to vote in referendums on tax and expenditure matters (e.g. approving new taxes, setting limit on tax revenues collected or expenditure ceilings), whereas the draft Basic Law does not grant this constitutional right to the HKSAR citizens.

3. Stabilization and income redistribution functions in the United States reside largely with the Federal Government while the resource allocation function is mainly performed by the state government. Hong Kong as a city-state assumes all these fiscal functions. Art. 105 would constrain the capacity of the HKSAR

13. Please refer to Table 6.14 of *The Books of States*, Council of State Governments, 1988/87 edition, Lexington, Kentucky, at 246. Table 6.14 tabulates that there are 29, 5 and 15 states having passed constitutional, statutory, and both constitutional and statutory provisions for a balanced-budget requirement, respectively.

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government to implement discretionary fiscal policy on stabilization and income redistribution. Constitutional limits suitable to a state government need not be applicable to the HKSAR government.

The effectiveness of constitutional limits should be a crucial factor in determining the acceptability of Art. 105. The experiences in the United States have demonstrated that, in general, constitutional limits are ineffective. There are means of avoiding these fiscal limitations. For example, some states exclude debt service or retirement of debt from the calculation of such limits. Earmarked funds for transportation, special projects, pensions or aid to localities are exempt from the constitutional limits in many instances.[14]

In Tennessee, a limit on the growth of appropriations applies only to "appropriations funded by tax revenues". On the other hand, many states exclude revenues received from the Federal Government from the constitutional limit. Brennan and Buchanan[15] argue that effective implementation of the ratio-type constitutional limit requires: (1) abstract definitions of these aggregates; and (2) expert measurement by specific criteria. Neither of these are well-defined and are subject to governmental manipulation which is still within the allowable fiscal powers of the constitution.

The empirical findings of Abrams and Dougan support the above hypothesis.[16] Abrams and Dougan used single-equation regression to analyze the effects of constitutional data for the 50 states, they estimated several empirical models of state and local government spending. In addition to the socio-economic variables suggested by an interest-group model of public expenditure, they included in the regression equations a set of variables, representing the different political, institutional and constitutional aspects of each of the 50 states. Each independent variable considered has the potential to alter the marginal political support for or opposition to government spending and revenue collection. One striking result of the regression is that constitutional limits are statistically insignificant in every instance which supports the prediction that these constraints would not be binding. Abrams and Dougan concluded that:

> The empirical evidence on the influence of several widely discussed constitutional arrangements indicates that by and large they do not exert a significant independent effect on aggregate budget decisions. States that have adopted balanced-budget requirements or constitutional limits on government spending or taxes seem to spend at the same levels as those without such provisions ceteris paribus.[17]

The above result may not be directly applicable to the HKSAR due to its different political and constitutional setting. Further research such as using simultaneous regressions might shed more light on this important issue. However, it is reasonable to suppose that the future government of the HKSAR would also be likely to manipulate various techniques within its legal fiscal powers to circumvent the constitutional expenditure and taxation limit specified under Art. 105, and eventually to render Art. 105 ineffective.

Art. 107: A low tax policy article

Art. 107 provides: "The Hong Kong Special Administrative Region shall continue to practice a low tax policy".

The most controversial aspects of Art. 107 are how to define the degree of "lowness" of tax rate and to which taxes the low tax rate applies. It was reported in early 1987 that some drafters advocated a 20% ceiling on the standard tax rate.[18] However, the June 1987 Guangzhou Meeting resolved to include only "a low tax policy" without specifying a ceiling on the standard tax rate. The problem of defining the "low" tax rate still remains. Is the prevailing 15.5% standard tax rate low? Or is 20% high? The tax rate is not the only factor in determining tax liability; it also depends on the items and amounts of tax deductions and allowances. If the government raises the standard tax rate, and simultaneously increases tax deductions and allowances, we might end up paying less tax. Moreover, the balance between direct and indirect taxation cannot be interpreted from "a low tax policy". On the whole, it is very difficult to understand what is meant by "a low tax policy".

In the 43 years of Hong Kong tax history since the Second World War the standard tax rate has never reached 20%. The business sector considers 20% a psychological threshold to guard against over taxation. Whenever the Financial Secretary proposed to raise additional revenues to finance budget deficit through a higher standard tax rate, prominent businessmen expressed grave concern over the detrimental impact on investment and business confidence and demanded that the standard tax rate should not be raised to more than 20%. A classic statement by Mr. H. Barton, Member of the Legislative Council, in the debate on the 1962/63 Financial Budget is worth quoting:

> In my speech in this debate last year, I stressed the need to keep down our rate of direct taxation. This year I shall stick my neck out, and I am referring to my own neck not that of my unofficial colleagues, by suggesting that the ceiling for direct taxation in this Colony should be 20% – that is to say about half what it is in neighbouring countries – in the belief that any increase, or even the fear of any increase, over this figure would do irreparable damage to the Colony's economy. Sir, when the time comes for the rate of direct taxation to be increased, I would urge my honourable Friend the Financial Secretary to give some *assurance* that the rate will not be raised beyond 20%, until every other means

14. J.R. Aronson & J.L. Hilley, *Financing State and Local Governments*, Brooking Institute, Washington, D.C. (1986) at 224.
15. G. Brennan & J. Buchanan, *The Power to Tax: Analytical Foundations of the Fiscal Constitution*, Cambridge University Press (1980) at 201.
16. B. Abrams & W. Dougan, "The Effect of Constitutional Restraints on Governmental Spending", *Public Choice* (1986).
17. Id. at 101-116.
18. In Hong Kong, all direct taxes (e.g. profits tax, salaries tax, interest tax, property tax) are subject to one uniform rate, i.e. the standard tax rate of 15.5%. The profits tax is also subject to a 1.5% surcharge. The salaries tax is subject to a progressive marginal rate schedule starting from 3% up to the maximum 25%, but the total salaries tax payable should not exceed the amount by applying the standard tax rate (which is lower than the maximum marginal rate) to the taxpayer's net assessable income.

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> of raising funds, i.e. local or foreign borrowing and further increase in indirect taxation, have been exhausted.[19]

Mr. John Cowperthwaite, in concluding the debate on his first Budget Speech, responded quite negatively to Mr. Barton's suggestion. Mr. Cowperthwaite replied that:

> My honourable friend Mr. Barton has asked for a public assurance that the rate of direct taxation will not go above 20% until every other means of raising funds have been exhausted. I do not think it is really necessary for me, or proper, to give such an assurance and thereby impose a commitment not on me, I hope, but on my successor, in circumstances we cannot now foresee. That is not because I am not fully conscious of the importance of our economy of a low rate of direct taxation or have any reason to suppose that Mr. Barton's wish will not be realized in the event.[20]

Mr. Cowperthwaite's response was appropriate and reasonable, and it illustrated the difference between a public assurance (commitment) and a prevailing policy. Art. 107 of the draft Basic Law reflects the same, yet even more difficult problem, because it gives the "low tax policy" requirement a legal status.

In the 1974 economic recession, Sir Philip Haddon-Cave, then Financial Secretary, expressed the same view on the ceiling of a standard tax rate in the 1974/75 Financial Budget. He said:

> I turn now to our reserve of direct tax taxability. I do not wish to take a firm public view on this just now.... I shall have to contemplate raising the standard rate in 1975/76, the first year of the forecast period and, as it happens, 10 years after the rate was last raised by 2.5 percentage points to 15%. But I shall not allow fiscal considerations to override economic realities.[21]

Sir Philip did impose a 1.5% surcharge on profits tax in 1975/76, and 0.5% in 1976/77. Later, in 1984/85, after the government experienced a huge budget deficit during the 1982 economic recession, the Financial Secretary, Sir John Bremridge, increased the standard tax rate by 2% to 17% to raise additional revenue. The 20% ceiling on the standard tax rate was never mentioned when the increases in surcharge or standard tax rate took place (since 1975/76).

Advocates of a 20% ceiling on the standard tax rate did not provide any theoretical justification. One related theory in public finance is the so- called "critical limit hypothesis"[22] which provides that inflation necessarily occurs when the public sector, as measured in terms of taxes and other receipts, exceeds 25% of GDP. The hypothesis is alleged to be true even under circumstances when the budget remains imbalanced. However, the critical limit hypothesis has received limited support from public finance economists since it lacks strong empirical support, and since inflation is a phenomenon characterized by multiple determinants. Even if we accept the hypothesis at its face value, it still cannot be applied to Hong Kong because the hypothesis refers to a ratio of total revenues and GDP, not to the standard tax rate. In Hong Kong, the ratio of total revenues to GDP has never reached 15%, which is far less than the 25% critical limit.

After all, what is the objective of a low tax policy? Mr. Barton's argument, that a tax rate higher than 20% inflicts irreparable damage on the economy, was concerned primarily with its impact on business investment and on overall economic development. A low tax policy, of course, would promote business confidence and stimulate investment but it would also exert a very low built-in stabilizing effect on the economy and would make little contribution in reducing income disparity. For any economic and fiscal policy, there are bound to be trade-offs among various objectives. Proper consideration must be given to all objectives; otherwise it will create social tension, conflict and injustice.

Unfortunately, regardless of its undesirable consequences, Art. 107 was in fact strongly supported by wealthy industrialists. The minutes of the Seminar on Industry held on 16 August 1986 organized by the local industrialists who were members of the Basic Law Consultative Committee say that "taxation should maintain the basic principles of the prevailing system, i.e. simple and low, including the rate on Earnings and Profits Tax. Moreover, the tax system should not be used as an instrument for income redistribution." We all realize that no one government can ever implement a completely neutral tax system and policy: every tax system will have an effect on income redistribution, whether directly or indirectly. Equitable distribution of the tax burden remains one of the 6 requirements of the present Hong Kong tax system, albeit with a rather low priority. Even the Hong Kong government would not dare to openly proclaim that the tax system should not be used as an instrument for income redistribution. The Financial Secretary has been very cautious not to discuss this sensitive issue in the Financial Budget. Fortunately, the Basic Law Drafting Committee, although subject to intensive lobbying, did not incorporate the above biased statement into Art. 107, wishing to avoid inflicting more wounds on the already inegalitarian society.

The Hong Kong tax system is relatively stable. There have been only several small changes in the standard tax rate and only a few new indirect taxes have been introduced. These changes have been gradual and of such small magnitude that no drastic tax reform has ever been contemplated or implemented. However, starting from 1987/88, the Financial Secretary, Mr. Piers Jacobs, has studied the feasibility of introducing a broad-based consumption tax, the purpose of which is to ensure revenue stability, particularly during recessions when the direct tax would fluctuate with the business cycle. The additional revenue from indirect consumption tax would be used to reduce the standard tax rate. The Financial Secretary argues that such a reform can maintain a low tax system which is beneficial both to the business sector and the general public.

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19. See *Hong Kong Hansard 1961/62,* Hong Kong Government at 68.
20. See *Hong Kong Hansard 1961/62,* Hong Kong Government at 127.
21. See *1974/75 Financial Budget,* Finance Branch, Hong Kong Government, para. 198.
22. Herber, *Modern Public Finance,* Irwin (1971) at 381.

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However, such a tax reform proposal would shift the fiscal balance from direct to indirect taxation and render the tax system more inequitable. A majority of Legislative Council members spoke against such a tax reform proposal during the last 2 budget debates. Such a low tax policy has no marketable value even now and I do not see any reason why it should become an article of the Basic Law.

Every tax system should change or reform to keep up with the changing business practice and to promote economic development.

In a complex and growing economy such as Hong Kong, it is ironic that there is not much difference between the present tax system and the system of 2 decades ago. Stability of the tax system may be important to the business sector but stability should not be used as an excuse to prevent necessary changes and reforms. Many areas of the present tax system need to be reviewed and changed. The Financial Secretary has been unduly cautious in dealing with the overall review of the Inland Revenue Ordinance.[23] Before launching an overall review and arriving at a professional judgement on the characteristics of the present tax system, it would be misleading to label it categorically as a low tax system, and it would be even more biased and dangerous to set it as the sole objective of the tax policy for the future HKSAR government.

CONCLUSION

The Basic Law, as the constitution of the HKSAR, must be definitive, operative and enforceable. This is the necessary condition for a successful experience of the "One Country-Two Systems" unprecedent political design. Arts. 105 and 107 of the draft Basic Law cannot satisfy these requirements and should be dropped. Art. 104 should be retained, and the other articles[24] should be rewritten as the following 2 new articles:

> The Hong Kong Special Administrative Region shall deal on its own with financial matters, including disposing of its financial resources and drawing up its budgets and its final accounts to the Central People's Government for the record.
>
> The Hong Kong Special Administrative Region shall practice as independent taxation system. The types of taxes, the tax rates and tax exemptions shall be prescribed by law. The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region.

23. Since the inception of the Inland Revenue Ordinance in 1947, there have been 3 overall official reviews of the Ordinance; the first one in 1952, the second in 1966 and the third in 1976.

24. Arts. 104, 106 and 108 of the draft Basic Law are as follows:
Art. 104: "The Hong Kong Special Administrative Region shall have independent finances. The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People's Government."
Art. 106: "The Hong Kong Special Administrative Region shall practice an independent taxation system. The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region."
Art. 108: "The types of taxes, the tax rates and tax exemptions in the Hong Kong Special Administrative Region shall be prescribed by law."

IFA news

BRITISH BRANCH

The British Branch of IFA held two meetings in October 1988.

On 3 October the National Reports which will be discussed during the 1989 Annual Congress (to be held in Rio de Janeiro, Brazil) were discussed. The subjects were: (i) The disregard of the legal entity for tax purposes (Reporter: David Ross, tax partner of Neville Russell) and (ii) Administrative and compliance costs of taxation (Reporter: Ken Etherington, Group Tax Manager, BAT Industries Plc).

On 19 October the subject of the discussion was: "The tax implications of residence, domicile and cross border migration". Speakers were Giles Clarke (barrister) and Peter Shaywer (tax partner with Touche Ross, London). The meeting was dedicated to the implications of the Inland Revenue's consultative document on residence in the United Kingdom together with wider issues relating to cross migration in other countries.

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AUSTRALIA:

Taxes in Australia for the Expatriate

By Arthur Young International, Australia

INDIVIDUAL INCOME TAXES IN AUSTRALIA

There are many differences between the taxation of individuals in Australia and the taxation of individuals from other countries. This article addresses a number of tax questions commonly asked by foreign citizens living in, or contemplating moving to, Australia. The article is not intended to answer everyone's individual tax problems but should assist in identifying factors that may be relevant.

The first major difference is that Australia has a 30 June tax year end. It is not possible in Australia for a husband and wife to file a joint return so each taxpayer must file separately and must include in his or her own return the appropriate assessable income attributable to that taxpayer. There is no differentiation in tax rates for married individuals or single people although a tax rebate may be allowed in respect of a dependent spouse.

Whereas the United States imposes a tax obligation on all its citizens, wherever they are located around the world, Australia only seeks to impose a tax liability on residents of Australia in respect of their world-wide income and on non-residents of Australia in respect of their Australian-source income.

There are exceptions to the above general rules where certain employment income which is sourced and taxed in a foreign country may be exempted from tax in Australia. This does not apply to dividend income, nor does it apply to interest or royalty income. From 1 July 1987 most foreign-source income of residents of Australia is fully taxable in Australia, but subject to a comprehensive foreign tax credit system. The tax laws are to be amended to include a system of controlled foreign corporation taxation which may impact upon Australian residents deriving foreign-source income. It is anticipated these rules will not come into force until the 1989-90 income year.

Tax returns in Australia are due for filing in accordance with tax lodgement programmes for tax agents, which normally provide for 50% of tax returns to be filed by 31 October each year with the remainder spread over a further period to 28 February. Any outstanding Australian tax due is not payable at the time of filing the tax return but is based on an assessment procedure. The Australian Taxation Office assesses the liability to tax and issues a notice of assessment and the tax payable is usually due about one month after the notice issues. Penalties can be imposed for late filing of tax returns as well as for late payment of the assessed tax liability.

Residents of Australia are entitled to a tax-free step in the tax rate schedules, whereas non-residents do not receive the benefit of the tax-free step. The determination of the residential status of the individual is of great importance in determining the liability to Australian income tax. Resident is defined in the Australian Income Tax Assessment Act to mean a person who resides in Australia. A resident of Australia includes a person whose domicile is in Australia, or who has been in Australia continuously or intermittently for more than one-half of the year of income, unless the Commissioner of Taxation is satisfied that his usual place of abode is outside of Australia and that he does not intend to take up residence in Australia. As a general rule, an expatriate who arrives in Australia with his family to work for a period exceeding 183 days will be regarded as resident of Australia from the date he arrives in Australia and the onus will be on the taxpayer to challenge that presumption if he wishes to be regarded as a non-resident.

Australia imposes a capital gains tax which applies to assets acquired or deemed to be acquired after 19 September 1985. It is to apply on realization of assets at the full marginal tax rate but the acquisition basis is to be indexed for inflation.

Capital gains tax applies to real gains on all assets disposed of, or deemed to be disposed of, where the assets were acquired after 19 September 1985. It applies to overseas assets but does not apply to gains on a principal residence. Where an expatriate arrives in Australia to take up residence, any assets located outside Australia which were acquired after 19 September 1985 will be deemed to be acquired at the date of arrival in Australia to take up residence at market value (in Australian dollars) at that date. Similarly, such assets will be deemed to be disposed of at market value at the date of ceasing Australian residence. A limited exemption is granted where ex-Australian assets held at the date of arrival are still held at the date of departure and the expatriate has been a resident of Australia for less than 5 years of the preceding 10-year period.

Since 1941 the Commonwealth Parliament has been the only Parliament to levy income tax. Federal Governments have allowed the states of Australia to levy their own income tax but, for political reasons, they have not chosen to take up this facility. Presently, there is no income tax levied by any state government in Australia.

TAXATION OF RESIDENTS

Taxable income

The assessable income of a resident includes the resident's gross income derived directly or indirectly from

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all sources, whether in or out of Australia, and which is not exempt from income tax by a specific statutory provision. The income tax is levied on taxable income, which is determined as follows:

	Gross income
Less:	Exempt income
Equals:	Assessable income
Less:	Allowable deductions
Equals:	Taxable income

All non-Australian income received by Australian residents is taxable in Australia from 1 July 1987, except for certain employment income that has been taxed in the country of source. Foreign tax credits are available to resident taxpayers in receipt of foreign-source income which is not exempt income. The credit allowed is the lesser of the foreign tax imposed or the Australian tax payable on that income.

Assessable income

A taxpayer's assessable income includes income under ordinary concepts as well as other amounts which, although not income under ordinary concepts, are to be included in assessable income under one of the statutory provisions of the Tax Act. Income under ordinary concepts will include salary remuneration, business profits, dividends, interest, rent and pensions. In relation to employment, where benefits are provided to an employee in kind rather than in cash, employers have to pay a fringe benefits tax based on the value of fringe benefits provided to employees. This also applies to any cost of living and/or housing allowances paid in cash to expatriates.

Income is included in assessable income when it is derived, which in the case of remuneration is usually when the amounts are received. The Tax Act does allow the Commissioner of Taxation to include certain amounts in a taxpayer's assessable income even though it has not been received in cash but is dealt with on the taxpayer's behalf or as he directs.

There is a separate capital gains tax in Australia applicable to property, such as land, shares, etc., acquired on or after 19 September 1985. Any profit arising from the sale of property acquired after 19 September 1985 is taxed at full marginal rates although the acquisition basis is to be indexed for movements in the Consumer Price Index, where the property is held for at least 12 months.

Any business profits will usually be taxable on an accrual basis. Income from property, such as interest, dividends and rental income from real property, will be taxable when received. For U.S. citizens working in Australia, any business profits or rental income from U.S. sources will be taxable in Australia, but any losses resulting from those activities will not be deductible against other assessable income in Australia. U.S.-sourced interest and dividends derived while resident in Australia will be fully taxable. U.S. capital gains are taxable in Australia from 1 July 1987.

Allowable deductions

A deduction is subtracted from gross income in computing taxable income upon which gross tax is calculated. The general rule is that expenses are deductible to the extent they are incurred in the production of assessable income, or in carrying on a business for that purpose. Records to substantiate tax deductions should be kept although these need not be included in the tax return. Outgoings of capital, of a private or domestic nature, or those incurred in the production of exempt income are not deductible.

Deductions are not allowable in Australia for contributions to an IRA, interest on home mortgage loans to purchase a family residence or for alimony and maintenance payments.

Deductions are allowable for donations to prescribed charities in Australia. A limited tax rebate is allowed in respect of net medical expenses, although because of the threshold before the rebate is allowed (similar to the zero bracket amount for U.S. itemized deductions) this rebate is usually of little benefit to expatriates.

There are no allowances or personal exemptions for taxpayers or their dependent children. However, a rebate of tax may be allowed in respect of a dependent spouse who is resident in Australia. The rebate will be reduced where the spouse has a separate net income.

In lieu of personal exemptions for dependent children, the Australian Government pays a family allowance to mothers on a monthly basis, according to the number of dependent children. This allowance is not taxable in Australia. Generally, expatriates will be entitled to the allowance once they have been resident in Australia for a period of 12 consecutive months.

Calculation of tax liability

Income tax in Australia is calculated at graduated rates, as set out in Appendix I, and those rates vary for residents and non-residents as the latter are not entitled to the tax-free step. Variations to the tax tables require Acts of Parliament and there is currently no automatic indexing of the tables to counter the effects of inflation on the average tax rate.

The primary tax liability is then reduced by any tax rebates for net medical expenses and spouse, as discussed above.

Foreign taxes paid on foreign-sourced income, which is included in taxable income, may be claimed as a credit against the Australian tax on that income. The credit is limited to the lesser of the Australian tax and the foreign tax on that income. There is no provision allowed to carry forward or carry back any excess foreign tax credits.

Special provisions apply in respect of the rates of tax on non-salary income derived by persons under 18 years of age. Generally, such income is taxed as above

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except that a maximum of A$ 416 is tax-free and the excess is generally taxed at 49%.

Pay-as-you-earn (PAYE) tax

Employers make deductions of tax from employees' gross wages on a pay-as-you-earn basis. This group tax is imposed on wages or salaries paid to employees in accordance with prescribed rates. A credit is allowed against the tax payable when the annual tax return is assessed.

Generally, where an expatriate employee is seconded to an Australian company but remains in the employ of an overseas company which does not have a permanent establishment in Australia, no such deductions are made. Although there is a technical requirement to withhold PAYE taxes, the Australian Taxation Office rarely seeks to enforce such a withholding.

Provisional tax

Provisional tax is an income tax levied in advance on the "provisional" income of an individual for the current income year which covers all income not subject to PAYE deductions, such as dividends on shares, interest received, royalty payments to individuals and trust allocations.

Provisional tax is payable by residents and non-residents alike, except that in the case of non-residents it is not payable on dividends and interest which has been subject to withholding tax.

Provisional tax is calculated by reference to the provisional income included in the taxable income of the preceding year. Payment of provisional tax is due by quarterly instalments and the payment is allowed as a credit against the tax payable when the annual tax return is assessed.

Withholding tax

Withholding tax is a tax deduction from the payment of dividends, interest and royalties to non-residents under certain circumstances.

a. Dividends

Withholding tax is normally payable at the rate of 30% (or 15% where tax treaties apply) on dividends from a resident company paid to a non-resident who does not carry on business in Australia through a permanent establishment. The rate of withholding tax is imposed on the gross amount of the dividend and no deduction is allowed for expenses incurred in earning that dividend. Dividends paid to non-residents on or after 1 July 1987 out of profits which have been subject to the full corporate rate of tax (i.e. "franked" dividends) will be exempt from withholding tax.

b. Interest

Interest derived by a non-resident is normally subject to withholding tax of 10% of gross interest to the extent that the interest is an outgoing of an Australian business. If derived from ex-Australian sources it is exempt from Australian tax. The 10% tax is the final liability to Australian tax of the non-resident. The rate is unaffected by tax treaties.

c. Royalties

Royalties derived by non-residents from Australian sources, or if outgoings of an Australian business, are subject to tax by normal assessment unless tax is limited by a tax treaty to a percentage of the gross royalty (usually 10%).

Taxing of fringe benefits

A fringe benefits tax applies to all employers in respect of the prescribed value of non-cash fringe benefits provided to employees. The tax is payable by all employers irrespective of their tax status, at 49% of the prescribed value. Payments are to be made quarterly. Employers are not entitled to a tax deduction for fringe benefits tax.

The following fringe benefits fall within this tax:

(1) Motor vehicles.
(2) Free or low interest loans.
(3) Expenses paid on behalf of employees (such as education expenses, home leave, medical insurance, utilities).
(4) Subsidized accommodation.
(5) Goods and services provided by an employer.
(6) Tax reimbursements.
(7) Cost of living and housing allowances.
(8) Costs of preparing U.S. tax returns.

An exemption from fringe benefits tax may be allowable in respect of housing provided to expatriates if they are resident in Australia for a limited period and they can make a declaration that when they return to their home country they intend to reside in the same city or district in which they formerly resided.

Most moving expenses to and from Australia are exempt from fringe benefits tax.

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For further details, see

TAXES AND INVESTMENT IN ASIA & THE PACIFIC

(loose-leaf, in 8 binders)

APPENDIX I

Individual tax rates – 1978/88 and later years

Non-resident tax (before credits and rebates)

Income			*Tax*
From		*To*	
$ 0	–	$ 19,500	Nil + 29%
19,500	–	35,000	$ 5,655 + 40% of excess
	Over	35,000	11,855 + 49% of excess

Resident tax scale (before credits and rebates)

Income			*Tax*
From		*To*	
$ 0	–	$ 5,100	Nil
5,100	–	12,600	Nil + 24% of excess
12,600	–	19,500	$ 1,800 + 29% of excess
19,500	–	35,000	3,801 + 40% of excess
	35,000	and over	10,001 + 49% of excess

(a) Non-residents do not benefit from the zero step in the tax scale.
(b) In addition to the above, a levy is imposed based on taxable incomes to cover the cost of basic medical benefits under the Government's Medicare scheme. For 1987/88 and later years, the levy is 1.25% of taxable incomes.
(c) The tax-free threshold in the above is only available on a pro rata basis in the case of expatriate employees in the year of their arrival in Australia and the year of departure.
(d) The Government has not proposed to introduce any form of filing joint returns; thus it remains tax effective for expatriates with investment income to transfer those investments to their respective spouses so that the spouse pays tax at the lower Australian tax rates on that income.
(e) At the time of writing, it appears as if the tax rates applicable for the 1987/88 year will remain unchanged for the 1988/89 year.

APPENDIX II

Example of 1988/89 Australian tax computation

Assume the following:

1. Taxpayer is married with 2 children under 18.
2. Taxpayer is full-year resident of Sydney, Australia.
3. All workdays are spent in Australia.
4. Taxpayer received $ 1,500 interest from taxable U.S. sources.
5. All other income and deductions are as indicated below.
6. All amounts are in Australian dollars.

Computation

Income

Base salary		$ 50,000
Bonus (current year)		10,000
Tax reimbursement		30,000
Cost of living allowance		5,000
Housing – paid by company	$ 12,000	
Less: employee contribution	7,500	4,500
Moving expenses		12,000
Relocation allowance		6,000
Total compensation		117,500
Interest (U.S.-source)		1,500
Interest (Aust.-source)		1,000
Dividends (U.S.-source – Joint names)		6,000
Total income		$ 126,000

The employee is also provided with a fully maintained company car, cost price $ 20,000.

Income tax
Taxable income

Base salary	$ 50,000		
Bonus (current year)	10,000		
Relocation allowance	6,000		
Taxable compensation	66,000		
Interest	2,500		
Dividends (taxpayer's share)	3,000		
Total assessable income	71,500		
Less: allowable deductions			
taxable income	$ 71,500		
Tax on taxable income	$ 27,886		
Medicare levy	894		
Less: spouse rebate	(350)	($ 1,030 reduced for net income of spouse)	
Net tax	28,430		
Less: foreign tax credit			
– 15% dividends	(450)		
– 10% interest	(250)		
Income tax payable	$ 27,730		

Fringe benefits tax

Cost of living allowance	$ 5,000
Tax reimbursement	30,000
Company car:	
– Cost price $ 20,000	
– Taxable value 24% of $ 20,000	4,800
Taxable value	$ 39,800
Fringe benefits tax at 49% (payable by employer)	$ 19,502

Note:
(1) Moving expenses assumed to be exempt from fringe benefits tax.
(2) Housing paid by employer is assumed to be exempt from fringe benefits tax – see text.

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AUSTRALIA:

Taxation of Foreign-source Income

By Richard Vincent

Mr. Vincent is partner of Berg Partners, Sydney, Australia.

A foreign tax credit system has applied since 1 July 1987 to foreign-source income derived by Australian residents. In the Treasurer's 25 May 1988 Economic Statement it was announced that significant changes are to be made to the taxing of foreign-source income.

Under the present system, Australians operating through non-resident companies and trusts are able to defer Australian tax on the profits of those entities simply by not remitting the profits to Australia. In comparison, Australian entities operating in foreign countries through branch operations do not enjoy this tax benefit.[1] The Government has determined that this ability to defer Australian tax by retaining profits outside Australia is to the detriment of the Australian economy. On this basis, the Government has drafted a Consultative Document outlining a system for taxing foreign-source income to apply as from 1 July 1988.

The 2 key elements of this reform package are:

(1) new rules governing the taxation on an accruals basis of the income of non-resident entities in which Australian residents have interests, where the income has been derived in a low tax country or has benefited from a designated tax concession in another country; and

(2) an exemption from the foreign tax credit system (FTCS) for dividends received by companies from direct investments (i.e. those involving 10% or greater voting interest) in non-resident companies or from other investments which have been subject to accruals taxation.

This accruals taxation system will operate on the basis of the country of source of the foreign income, or the country of residence of the entity in which Australian residents have an interest. The accruals system will apply where the country of source or residence is a "designated low tax country". The Government has drawn up a list of 49 countries which it considers to be "designated low tax countries". Basically a country will qualify for the list if its nominal tax rate on corporate income or profits is below 25%. This percentage was determined on the basis that a 25% or more tax rate, together with a dividend withholding tax rate, produces an overall tax rate of 36.25% or more. This rate is considered comparable to the Australian corporate tax rate of 39% and is sufficient to discourage most blatant tax abuses.

In addition, there is a further list of 7 countries which do not qualify as low tax countries although low tax rates apply to certain classes of income. The accruals taxation system will apply to entities resident in those countries to the extent that income is derived which is subject to the low tax rates. Income not subject to the low tax rates is not subject to the accruals system and will be exempt from Australian tax when remitted. Regardless of the tax rate applying in a country, the accruals taxation system will not apply unless the country has been officially listed as a "designated low tax country". This list includes most common tax havens.

Income of entities in "designated low tax countries" or income sourced in such countries will be subject to Australian tax under the accruals system calculated on the basis of Australian tax laws. This will require calculating the taxable income of such entities under Australian tax laws. The taxable income of such entities will be subject to tax in Australia to the extent that Australian residents have an interest in that taxable income.

An Australian interest in a company will be calculated on the basis of the issued share capital beneficially held by the resident or his entitlement to dividends, whichever is greater. For partnerships, it is calculated on the share of the partnership income to which an Australian resident is entitled. Where the foreign entity concerned is a trust, a different basis for calculating the interests of Australian residents applies. This is discussed in further detail below.

Tracing provisions will apply to prevent Australian residents avoiding the operation of the accruals taxation system by interposing a foreign entity resident in a non-designated country. The interposed entity will be subject to the accruals taxation system if it earns "attributable income". "Attributable income" is defined as foreign income which will be attributed to the taxpayer, including income derived by entities in "designated low tax countries" and income derived by entities in other countries that has benefited from designated tax concessions. On the basis of the Consultative Document, it will technically make no difference how many entities are interposed between the Australian resident and the entity in the "designated low tax country". The tracing provisions will be designed to look through each entity. It remains to be seen how practical this may be.

A de minimis threshold will apply where a foreign entity is resident in a non-designated country but earns attributable income. Only if the attributable income of the foreign entity exceeds the lesser of 10% of the entity's total profits or A$ 20,000 will it be subject to accruals taxation.

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1. The foreign tax credit system is also costly to administer in relation to income from countries with tax rates similar to those in Australia.

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ACCRUALS TAXATION SYSTEM

Accruals taxation system is a system whereby Australian residents will be taxed on their share of the income derived by a non-resident entity in which they have interest, at the time that income is derived by the entity. Income subject to the accruals taxation system will be attributed to all classes of Australian taxpayers (i.e. individuals, companies and trusts) with interests in non-resident entities. Interests will not be traced through resident entities. Therefore the tracing provisions will stop at the first Australian resident. Specific exemptions will exclude certain interests in non-resident public companies and certain de minimis interests.

Australian residents holding less than a 10% interest in a non-resident public company will be exempt from the accruals taxation system. In determining whether a resident holds less than a 10% interest, his interest will be added to the interests held by any associated resident. Further, anti-avoidance tracing rules are also to apply to prevent residents artificially reducing their interests in non-resident public companies.

A resident individual will also be exempt from the accruals taxation system if the market value of all his interests in foreign entities does not exceed A$ 20,000.

These exemptions have been allowed to reduce the compliance requirements of resident taxpayers where only a minimal amount of tax is involved. One of the principal concerns of persons commenting on the Consultative Document is that the 10% threshold has been set too low and will result in unwarranted difficulties for taxpayers in obtaining the necessary information to comply.

There will be no requirement for an Australian resident to control a non-resident entity before the accruals taxation system applies. The Government has opted not to apply a control rule because of the compliance complications such a rule imposes on shareholders and tax administrators. Commentators on the system have argued to the contrary that without the control rules shareholders are placed in a difficult position because they are required to provide information to which they may have no right due to their lack of control over an entity.

The basic problem is that the attributable income of a foreign entity must be calculated according to Australian tax law to determine the amount included in the assessable income of the resident. Without control of the foreign entity it is considered that many residents will be unable to obtain the information needed to comply. The Government has attempted to counter this problem by stating that where the resident is unable to obtain the necessary information, consideration will be given to allowing the use of the reported commercial profit to determine the amount to be included under the accruals taxation system.

TAXATION OF NON-RESIDENT TRUSTS

The problem in dealing with non-resident trusts is that unlike companies often it is impossible to determine who has an interest in the income of a trust until it is distributed. The Government has determined that in the absence of any resident being presently entitled to the income of a non-resident trust, the accruals taxation system will apply to include attributable income in the assessable income of a resident who has transferred assets or services to the non-resident trust. To the extent that those assets or services have derived attributable income, that income will be attributed to the resident transferor.

Consistent with the measures applying to companies, the accruals taxation system will only apply to a non-resident trust deriving 10% or more of its income, or more than A$ 20,000 of income from "designated low tax countries".

The accruals taxation system will apply where a resident transferor directly or indirectly transfers property (including money) or provides services for no consideration or under a non-arm's length arrangement to a non-resident trust in a "designated low tax country". Again tracing provisions will apply to prevent avoidance by interposing entities in non-designated countries between the trust resident in the "designated low tax country" and the resident transferor.

TAXATION OF FOREIGN-SOURCE INCOME

As from 1 July 1989, it is proposed that Australian residents will be subject to tax on foreign-source income on the following basis:

(a) Australian resident company

(1) Where an interest of less than 10% is held in a foreign public company deriving attributable income, the resident company is only subject to Australian tax on receipt of dividends.

(2) Where an interest of more than 10% is held in a foreign public company deriving attributable income, the resident company is subject to the accruals taxation system and any dividends received are exempt.

(3) Where an interest of more than 10% is held in a foreign company (whether public or private) not deriving attributable income, the resident company is not subject to the accruals taxation system and any dividend received is exempt.

(4) Where an interest is held in a foreign private company deriving attributable income, the resident company is subject to the accruals taxation system and any dividend received is exempt.

(5) A resident company operating through a branch in a non-designated country will be exempt on the income of that branch.

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(6) A resident company operating through a branch in a "designated low tax country" will be subject to Australian tax on the branch income with a credit for any foreign taxes thereon.

(b) Australian resident individuals

(1) Where a resident individual holds less than a 10% interest in a foreign public company, he will only be subject to Australian tax on receipt of dividends.

(2) Where a resident individual holds an interest of 10% or more in a foreign public company deriving attributable income, he will be subject to the accruals taxation system and any dividend received will be taxed to the extent that it exceeds income previously taxed under the accruals system.

(3) Where a resident individual has an interest in a foreign private company deriving attributable income, he will be taxed on the same basis as in (b)(2) above.

(4) Where a resident has an interest in a foreign private or public company not deriving attributable income, he will only be subject to Australian tax on receipt of dividends.

Where a dividend from a foreign company is subject to Australian tax it will also be subject to the foreign tax credit system.

AUSTRALIA:

Amnesty – It's Real and Too Good to Miss[1]

Apart from the gentleman who offered to hand in his gun, and the odd angry caller wanting to be excused for tax evasion, the majority of people phoning the Tax Office's amnesty hotline have found an offer they think too good to refuse.

Some have needed to make the call just to reassure themselves that their mates aren't having them on, or that there was not a mistake in the amnesty advertisement they read.

Others are so nervous about taking the plunge into the taxman's arms that they resort to spirituous fortification and make their calls from the pub.

The attitudes, fears and initial disbelief of those calling the 008 hotline have made life interesting for the 23 tax officers and their four supervisors who have been staffing the national hotline in Melbourne since 26 May.

They have spoken to more than 25,000 callers enquiring about their eligibility, and the terms of the amnesty under which penalties for being late are waived. The amnesty came into force on 30 May and expires on 31 October 1988.

To meet the terms of the amnesty a taxpayer must properly complete and lodge any tax returns outstanding from the last five years, that is, since the 1982-83 tax year.

The Tax Commissioner, Mr. Trevor Boucher, who has briefly manned the hotline himself, has found that his clients are many and varied, particularly under the amnesty.

Among the estimated 360,000 Australians – about 4% of taxpayers – who should be lodging tax returns but aren't, is the male caller who wanted to know if he had to declare how he earned the money for which he had never filed a tax return.

When told, "No, not precisely", he said: "Oh good, I grow pot and sell it".

He went away happy in the knowledge that for the Tax Office's purposes he is a primary producer.

Another male caller asked if his wife should claim amnesty for her earnings from prostitution. "Yes, if she earns enough money to have a taxable income", was the response.

One case which interested the Commissioner was that of the woman who asked the hotline for some help with her boyfriend's tax returns.

"My boyfriend is going to have a bit of trouble lodging during the amnesty. He won't be able to get all his documents", she said. When told that she could be appointed as his agent she said: "The only thing is that I can't see him because he's not allowed visiting rights in jail".

"Do you know how long he's going to be there?" asked the tax officer.

"Well, it could be a while. He was charged with murder last week . . .", she said. "He's been in and out for the

1. Australia Tax Office, Media Release 88/26, 1 July 1988.

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last 18 years. By the way, should he declare the proceeds from his last job?"

Tax advice was that: "Well, since it's probably part of his trade it mightn't be a bad idea to declare it".

Other callers are not only nervous but suspicious that their conversation is being recorded, or their calls traced. They announce that they are calling from a public telephone, or in at least one case, a car phone, to protect their identity!

(Hotline callers can identify themselves if they wish, and have information mailed to them. Many are in fact asking that this be done. There is no recording or trace taken on any caller, and all calls are totally confidential.)

One caller asked if the amnesty meant that the Tax Office was getting a bit soft and that he didn't really have to worry about the taxman coming this year.

He was told: "Well, if you think the Easter Bunny will come this year and Santa Claus, just like they do every year, the taxman will come too".

Some callers have phoned asking if the amnesty applies to income not declared in returns already lodged and when told that it does not, have become angry or abusive and said: "Well, I owe $ 250,000"; or "I haven't declared $ 50,000, and you'll just have to come and get me".

One man who said he was a pensioner, aged 85, asked for reassurance that the amnesty did not mean he had to start now filing tax returns. When told: "No, it does not", he asked the operator's name and said he would send her an invitation to his funeral.

The hotline operators say he is like many pensioners – seeking reassurance that any change in tax requirements does not mean that they have to begin lodging returns when they have previously not had to and still do not have a tax liability. They have been receiving this reassurance from the hotline.

Most callers, the operators say, go away happy, and are very friendly "because we are offering them a service".

"There are a few very happy people", one operator said.

And, many of those who take advantage of the amnesty will in fact be getting a refund from the Tax Office – Mr. Boucher estimates that up to $ 30 million a year could be paid back to people who have not been lodging returns.

THE HOTLINE NUMBER: 008 033 476

Conference Diary

NOVEMBER 1988

International Transfer Pricing and Profit Attribution, London, 1-2 November, Munich 3-4 November (English):
European Study Conferences Ltd., Douglas House, Queen's Square, Corby, Northants NN17 1PL, United Kingdom.

Taxovers & Acquisitions; Law, Tax and Practice – Preparing for 1992. Paris, 2 November; Madrid, 25 November (English):
Legal Studies & Services Limited, Bath House, 56 Holborn Viaduct, London EC1A 2EX, United Kingdom.

European Trends in Taxation facing 1992. Antwerp, 2-3 November (English, French, Dutch, Spanish, Italian and German):
Europea – Photon Services S.A., Avenue Jules César 14, 1150 Brussels, Belgium.

Belasting-Controle – Spelregels in Praktijksituaties. Noordwijk, 3, 10 and 17 November (3-day course) (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, the Netherlands.

Beleggingsvarianten en de Fiscus. Amsterdam 10 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Doing Business between the European Community and the Comecon (CMEA) Countries, Budapest, 10-11 November (English):
Seminar Services SA, Blvd de Pérolles 7a, CH-1700 Fribourg, Switzerland.

47th Annual Institute on Federal Taxation, New York, 13-19 November (English):
New York University, School of Continuing Education, Continuing Education in Law and Taxation, 11 West 42 Street, New York, New York 10036, U.S.A.

Informations- und Aussprachetagung. Zurich, 14 November (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postfach Ch-8022 Zürich, z.Hd. Frau Steinemann, Switzerland.

11th Annual Congress – New Developments in U.S. – European Taxation. 16-19 November (English):
The American Tax Institute in Europe, 14, rue Jean Mermoz, 75008 Paris, France.

Current Issues and Trends in Taxation and Investment in the Asian-Pacific Region. Singapore, 17-18 November (English):
APTIRC, 2 Nassim Road, Singapore 1025.

Inhoud en Consequenties Commissie Oort. Amsterdam, 18 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Het Belonen van Topfunctionarissen. Amsterdam, 21 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Hong Kong Seminar. Hong Kong, 21-22 November (English):
Elizabeth Walters, ITPA, Membership and Conference Liaison Office, 33A Warwick Square, London SW1V 2AQ, United Kingdom.

Het Verwerken van Belastingen in de Jaarrekening. Maarssen, 23 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Planning and Executing Successful International Acquisitions and Divestitures – An insight into the techniques. Brussels, 28-30 November (English):
The Customer Service Department, Management Centre Europe, Postbus 95, NL-3417 ZH Montfoort, the Netherlands.

DECEMBER 1988

Joint Ventures in der Sowjetunion – sowjetische und deutsche Experten antworten. Cologne, 1 December (Deutsch):
Deutsche Gruppe der Internationalen Handelskammer, Kolumbastrasse 5, Postfach 10 04 47, 5000 Köln, Federal Republic of Germany.

Taxation of Branches and Subsidiaries. 1-2 December (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium.

Participatie in Winst & Vermogen door Directies en Werknemers, Rotterdam, 6 December (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands.

Inhoud en Consequenties Commissie Oort. Amsterdam, 9 December (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

47th Annual Institute on Federal Taxation. San Francisco, 11-17 December (English):
New York University, School of Continuing Education, Continuing Education in Law and Taxation, 11 West 42 Street, New York, New York 10036, U.S.A.

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BRAZIL:

The Brazilian Experience in International Tax Agreements for the Avoidance of Taxation

22nd CIAT General Assembly

This report was supplied by the 22nd CIAT General Assembly held between 9-13 May 1988 in Brasilia.

INTRODUCTION

Double taxation arises when countries adopt different criteria for defining tax liability.[1] The most commonly used criteria to ascertain tax liability are source, residence and nationality. As a general rule, more than one of these criteria is adopted. If the international community selected only one of these items as the exclusive criterion to define tax liability, double taxation would be reduced. Conflicting interests, however, preclude the use of a single criterion.

Difficulties incident to double taxation may be avoided either through application of unilateral measures or international tax agreements. Taking into account the uncertainties inherent in unilateral measures (which are variable at any given time), tax treaties offer an appropriate method to avoid double taxation. Nevertheless, the various solutions proposed during the negotiation process reveal disparities in taxation techniques which result in serious economic repercussions. This report briefly summarizes Brazil's policies with respect to international tax treaties, including the economic and political context in which the treaties develop.

The balance between the flow of income between treaty countries is always a relevant factor. When income flows are approximately equal, the tax problem can be minimized because loss of income in one country (because a particular criterion is adopted) is compensated by the profit obtained by taxing income moving in the opposite direction. In such a case, the international agreement may be considered a simple distribution of equivalent revenue without imposing a greater burden on either country. Predominance of any criterion – source or domicile – does not cause much concern.

The situation alters when the relationship between developed and developing countries is taken into account. Since the developing country imports capital and technology, there is a strong flow of income towards the developed country. One can clearly observe that the selection of any criterion (source, domicile or nationality) will occasion an unfair sacrifice for the respective countries. Cognizance of this disparity has impelled developing countries to re-examine the principles underlying application of various criteria. It is generally felt that the *source* criterion is the most equitable; it has a firm basis in legal doctrine and economic theory and furthers the elimination of under-development. Accordingly, income should be taxed by the country in which it is derived.

Developed countries, however, refuse to accept the source principle. Even though the Cartagena Agreement[2] approved a treaty model which fundamentally adopts the source criterion, the model has not been used.[3] For its part, Brazil adopts the United Nations Model Treaty (hereinafter "U.N. Model"), making significant changes in appropriate circumstances.

Brazil has concluded double taxation agreements with 15 countries: Argentina, Austria, Belgium, Canada, Denmark, Finland, France, Germany (Federal Republic), Italy, Japan, Luxembourg, Norway, Portugal, Spain and Sweden. The oldest treaty is the one with Japan (signed in 1967 and amended through the Protocol of 1976).

Brazil has signed treaties with Czechoslovakia, Ecuador and Hungary although these treaties have not yet entered into force. At the technical level, agreements have been concluded with India and South Korea. Agreements are being negotiated with Chile, Malaysia, the Netherlands, Nigeria, Paraguay, Rumania, Tobago, Trinidad, the United Kingdom, the United States and the U.S.S.R.

When negotiating treaties, Brazilian negotiators strive to achieve the following goals:
(1) to attract foreign capital to Brazil;
(2) to minimize the cost of importing money and technology;

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1. Double taxation hinders the international flow of capital and technology, and obstructs scientific and cultural research and the exchange of information.
2. The Cartagena Agreement (the Andean Pact) was signed in Bogota on 26 May 1969. The purpose of the agreement is to create a sub-regional common market and accelerate integration of the less-developed Andean countries by, inter alia, gradually reducing tariffs on intra-regional trade, and harmonizing economic policies, investment incentives and a common tax treatment of foreign capital, patents, trade marks, licences and royalties.
3. *Editor's note:* use of the Andean Pact has been limited but it is indeed taken into account.

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(3) to render feasible the Brazilian government's use of tax instruments in carrying out economic policy by preventing elimination of sectoral and regional incentives because of another country's fiscal legislation; and
(4) to support the activities of Brazilian enterprises situated abroad.

To achieve these ends, it is important that treaty negotiations are carried on in an environment favourable to the following principles:

- Brazilian-source income must be exempt from tax in the investor's country of domicile. If not, the country of domicile should grant a credit for the corresponding Brazilian tax applied to such income.
- When Brazil grants tax exemptions or reductions on the income of companies, dividends, interest, royalties or income derived from technical assistance paid to persons domiciled abroad, the country of residence must maintain the exemption or, if this income is taxable, allow a corresponding credit for the Brazilian tax that would have been paid if the exemption or reduction was not granted.
- Any eventual reduction of Brazilian tax through application of the treaty must be to the benefit of the investor (without this constituting a transfer of income to the Treasury of the country of domicile).
- Brazilian-source income derived from dividends, interest, royalties and technical assistance is subject (in Brazil) to maximum rates when taxable by the country of domicile.
- Income obtained in the other country by residents of Brazil, or Brazilian companies operating in that country, are entitled to a tax reduction.
- Relevant aspects of Brazilian legislation with respect to the taxation of income produced in Brazil and obtained by residents abroad must be protected.

TAXES COVERED BY THE AGREEMENT

Initially, Brazil subjected all of its income tax to the tax convention (as in the cases of Japan and Sweden) but excluded "incidences on excess remittances and activities of minor importance".[4] The "excess remittances" are related to the so-called "complementary income tax", established in Brazil under Art. 43 of Act 4131/62 (with the new text of Art. 1 of Act 4390/64). According to this provision, excessively profitable activities are subject to higher taxation. This subject is dealt with in Art. 1 of Decree-Law 2973/83 which provides that:

> The amount of liquid profits and dividends[5] relative to investments in foreign currency, distributed to individuals or corporations established abroad, are subject to a complementary income tax[6], provided that the average distributions over a 3 year period (counted as from the reformulation made in 1984) exceed 12% of the capital and reinvestment registered in accordance with the terms of Arts. 3 and 4 of Act 4131/62.

The complementary income tax, however, is not applied to dividends and profits reinvested in the country under the terms of Art. 7 of Act 4131/62.

"Activities of minor importance" refer to companies whose capital is applied to economic activities of less significance to the national economy.[7]

The only Brazilian tax covered by double taxation conventions is the federal income tax. Brazil operates under a federal structure and the Union has exclusive authority to establish income tax. However, the new constitutional text prepared by the Constituent Assembly grants Member States of the Federation the power to institute their own income tax[8]; the individual States may impose taxes which heretofore were not covered by tax treaties.

Tax treaty partners, however, have subjected a variety of taxes to the convention, taking into account peculiarities of domestic legislation. For example, Japan includes income tax and corporate tax; Portugal includes real estate tax, tax on the agricultural industry, industrial contribution, capital tax, professional tax, complementary tax, tax for overseas defence and valuation, capital gains tax and taxes established for local governments and "whose account is determined in accordance with the aforementioned taxes". The Federal Republic of Germany applies the agreement to income tax and corporate tax (including the surtaxes on both), capital tax and trade tax. Argentina includes the profit tax and tax on windfall profits.[9] Denmark applies the treaty to income and municipal taxes. Belgium includes individual and corporate tax, non-resident tax, including the withholding tax (précomptes) and supplements to the withholding tax, the addendum to such taxes and withholding taxes as well as the additional municipal rate to the individual tax. Norway applies the agreement to taxes on national, community and municipal income (including tax on income originating from the exploitation of petroleum and pipeline operations), national and municipal taxes on capital, national taxes on income of non-resident artists, national contributions for the tax equalization fund and tax applied to sailors.

PERMANENT ESTABLISHMENT

In accordance with the U.N. Model, a country can only tax income derived in its territory by non-residents if such income is obtained through a permanent establishment situated there.[10] As a result, it is necessary to reformulate the concept of permanent establishment as defined in Art. 5 of the U.N. Model. For

4. This exclusion was contained in the treaty with Norway which entered into force in 1969.
5. *Editor's note:* liquid profits and dividends refer to the distribution of such after deduction of the 25% standard withholding tax.
6. *Editor's note:* an "excess profits tax".
7. These activities are defined by Executive Decree in consultation with the National Monetary Council as provided in Art. 44 of Act 4131/62.
8. A new constitution was adopted in Brazil on 2 September 1988 and is scheduled for official publication on 5 October 1988.
9. *Editor's note:* capital gains.
10. See Art. 5 of the U.N. Model Treaty.

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example, under the U.N. Model, a permanent establishment includes "works" whose duration exceeds 6 months. If the 6-month term is not exceeded, income obtained by the foreign company cannot be taxed in the source country. The 6-month period is arbitrary. Advances in modern technology are such that a company can conclude important projects in less than 6 months so there is no logical reason to deny the source country the right to tax profits derived in such a case.

The concept of permanent establishment should be reassessed because it fails to include specific activities such as the "use of facilities exclusively devoted to storing or exposing goods or merchandise belonging to the company" or to the "maintenance of stock belonging to the company for exclusive storage or exposition purposes". Accordingly, multinational enterprises devoted to the sale of products may acquire them in a country, store them there and then sell them at a large profit. The profit derived is obtained in the country where the goods were stored and therefore should be taxed by that country.[11]

Brazil generally grants a reduction in the taxation of a permanent establishment (by fixing the maximum rate at 15%) when such income is exempt abroad or (in the worst of cases) when tax sparing is granted.

DIVIDENDS

Brazilian law provides for a 25% withholding tax on dividends remitted abroad. The rate is generally reduced to a minimum of 15% under tax treaties. However, the reduction is only granted on condition that the treaty partner exempts such income from tax in the investor's country of residence. Brazil may accept a matching credit concession of 25% in substitution of the exemption.

INTEREST

The remittance of interest abroad is subject to a 25% withholding tax. The rate may be reduced to 15% when the country of residence of the beneficiary grants a tax exemption on such income. If no exemption is granted, a minimum 20% matching credit is applied.

ROYALTIES AND INCOME FROM TECHNICAL ASSISTANCE

As is the case with dividends and interest, royalties and income from technical assistance are subject to a 25% withholding tax at source when remitted abroad. The tax may be reduced to 15% if the country of residence grants a minimum 20% matching credit. However, Brazil has not reduced the rate on the remittance of royalties deriving from the use of patents and trade marks nor does Brazil consider (for tax purposes) income derived from the rendering of technical assistance as royalties.

Brazil does not permit royalties and income for technical assistance paid by a Brazilian company to a parent company situated abroad as deductible items from gross income and Brazil will not accept any alteration in this policy by virtue of a tax treaty.

CAPITAL GAINS

All profits derived from the sale of stock must be taxed in the country of source.

INDEPENDENT PROFESSIONALS

Brazil maintains the right to tax income obtained by professionals living abroad when the income is paid by a permanent establishment located in Brazil or by a corporation resident in Brazil.

OTHER INCOME

Brazil also insists on the right to tax any income obtained in its territory which is not included in the treaty.

CONCLUSION

The above presentation briefly summarizes the perspective with which Brazil examines proposals for international double taxation conventions. The relationship between developed and developing countries, which is more favourable to the developed country with respect to flows of income, requires that one be cognizant of the importance of the agreement as an instrument of economic policy. Developing countries must not relinquish the right to strive for social justice. One factor which accommodates this goal is the tax stimulus. Use of the source criterion surpasses the immediate aim of providing resources for the Treasury and evinces its real significance, i.e. to allow the developing country, by granting tax exemptions and reductions, to attract valuable resources and channel those resources to the appropriate regions and sectors.

The possibility of reaching an agreement with Brazil depends on the sensitivity of potential treaty partners to these policies. An agreement to avoid double taxation should not lose its essential characteristics and become a vehicle for exclusively strengthening political and friendly relationships. A serious and beneficial agreement mandates observation of Brazil's principles.

11. In spite of these observations, Brazil has continued to adopt the definition of permanent establishment as found in the U.N. Model.

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INTERNATIONAL:

CONCLUSIONS APPROVED DURING THE THIRD MEETING ON TAXATION: PROTECTION OF TAXPAYER RIGHTS AT THE INTERNATIONAL LEVEL

The Third Meeting on Taxation was successfully conducted in May 1988 in La Plata, Argentina. The following is a translation of the resolutions of Team I. The English translation was made by Mr. M.A. García Caballero of the IBFD and is an unofficial translation. The official text is in Spanish.

SUBJECT I:

Protection of taxpayer rights at the international level

In consideration of:
the national reports submitted by Dr. Beatriz S. Gonzalez de Rechter and Dr. Ramón Valdés Costa and the intervention of Drs. Héctor B. Villegas, Enrique Bulit Goñi, José O. Casas, Alberto Lopéz, José L. Shaw, Alberto Faget and Carlos Dubra and the remarks made during the working session;

The Third Meeting on Taxation has reached the following conclusions:

(1) The Inter-American Convention on Human Rights has extended protection of the rights of taxpayers to the discussion (with due guarantees) of tax questions before magistrates within the judiciary system and taxpayer access to the Commission and the Court. This marks a new and considerable development in comparative law and constitutes a precise and fair limitation on the exercise of fiscal power at the supra-national level which must be respected by the Signatory States;

(2) Nevertheless, as is clear from the papers presented and the resulting debates, the Convention contains deficiencies in its provisions and these deficiencies impede effective and adequate exercise of taxpayer rights. These difficulties should be attributed to peculiarities of finance law which require special and different solutions from those provided for the protection of traditional human rights in civil and criminal matters;

(3) Consequently, it is desirable that the provisions of the Convention be improved either by means of additional protocols or otherwise in order to fully guarantee rights in fiscal matters which is undoubtedly the purpose of the Convention;

(4) Among the problems requiring particular attention are recognition of legal persons as holders of rights covered by the Convention, before the Commission and the Court under the same conditions as individuals;

(5) It is also desirable to develop more precision with respect to the concept of free access to justice and legal protection as provided by Arts. 8 and 25 with regard to important tax matters such as:
(a) abolition of the rule "solve et repete" in countries which still maintain this rule on the ground that it constitutes a privilege of the State because it runs counter to equality of the parties in legal proceedings;
(b) recognition of the penal nature of sanctions imposed by the administration when such sanctions have the characteristics of real penalties;
(c) the necessity of the impartiality of administrative tribunals and the review of their decisions by bodies jurisdictionally independent of the executive power.

(6) If the preceding conclusions are not adopted by express provisions, it is hoped that the Commission and the Court, as well as internal bodies of the Signatory States, broadly interpret and apply the current text of the Convention, thus making possible, through jurisprudence, attainment of the goals pursued by the Convention.

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OECD: Press Release

DEVELOPMENTS IN TAX LEVELS AND STRUCTURES*

The ratio of total tax revenues to Gross Domestic Product is widely used as an indicator of the relative weight of taxation in any one country over a period of time or when countries are compared for the same period. For valid comparisons to be made, all taxes and compulsory contributions have to be included in a consistent manner. Data published by the OECD for many years are designed to do this. The lates figures just published relate to 1986 with provisional estimates for 1987. They show that for 1986 Belgium, Denmark, the Netherlands, Norway and Sweden had the highest ratios (over 45%) and Japan, Spain, Turkey and the United States, the lowest ratios (30% or less) – see Table 1 and Graph 1.

Between 1985 and 1986, 16 countries experienced an increase in the tax ratio and 7 a decrease. Provisional estimates for 1987 show that in 7 of the 14 countries where data are available, the level of taxation increased and in 7 it fell. It should be recalled that the movement in the ratio is determined by changes in both the numerator (total tax receipts) and the denominator (GDP).

The publication enables comparisons to be made of the relative reliance upon different sources of revenue in Member countries. In 1986 (see Table 2) Australia, Denmark, Finland and New Zealand obtained more than 50% of tax revenue from taxes on income and profits, whereas consumption taxes were the major source of revenue in Austria, Greece, Ireland, Norway and Portugal and social security contributions in France, Germany, the Netherlands and Spain.

Journalists may obtain a copy of the report from the OECD Press Division, 2, rue André Pascal, 75775 Paris Cedex 16 (Tel. 45.24.80.89).

* Paris, 1 September 1988.

"TAX CONSEQUENCES OF FOREIGN EXCHANGE GAINS AND LOSSES"*

Few countries have any specific legislation covering the taxation of gains ans losses resulting from currency fluctuations. Most look for guidance to recognised accountancy practice. A report just published by the OECD considers the problems involved and extensively reviews existing country practices as an aid to greater clarification and consistency of practice in these matters.

The report first describes situations in which foreign exchange gains and losses may arise and then provides a comprehensive description of the main issues that are raised when determining the tax treatment. Among the latter are such questions as:

- Should the gain or loss be recognised before or at realisation?
- Should it be characterised as ordinary income or as a capital gain?
- Should it be assimilated to interest receipt, trading receipt, or something else?
- Should it have a domestic or a foreign source?
- How should the tax system deal with the flows of income and capital which arise as a result of the use by enterprises of various financial instruments to protect themself from the effects of currency fluctuations?

In addition to the above questions the translation of a transaction in a foreign currency into a domestic currency also raises a number of unresolved queries. Should each transaction be translated at the time it is made? Should only the net results (i.e. the profit or loss) be translated or should it be the net income or loss? What is the appropriate rate of exchange to be used? Is it the rate at the time of the transaction, the rate at the end of the financial year or another rate such as an average annual rate? The report discusses these questions and how they interrelate, and reviews country practices.

The report also sets out the main concern of tax administrations in this area, that of a lack of rules in domestic tax law, and describes how taxpayers feel their main concern, that of uncertainty, should be dealt with. In a final section the report offers a number of suggestions as to how the impact of the taxation of foreign exchange gains and losses could be made more equitable and certain, both for the taxpayers and the tax authorities.

Journalists may obtain a copy of the report to the OECD Press Division, 2 rue André Pascal, 75775 Paris Cedex 16 (Tel. 45.24.80.89).

* Paris, 14 September 1988.

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Table 1
Total tax revenue as percentage of GDP at market prices[1]

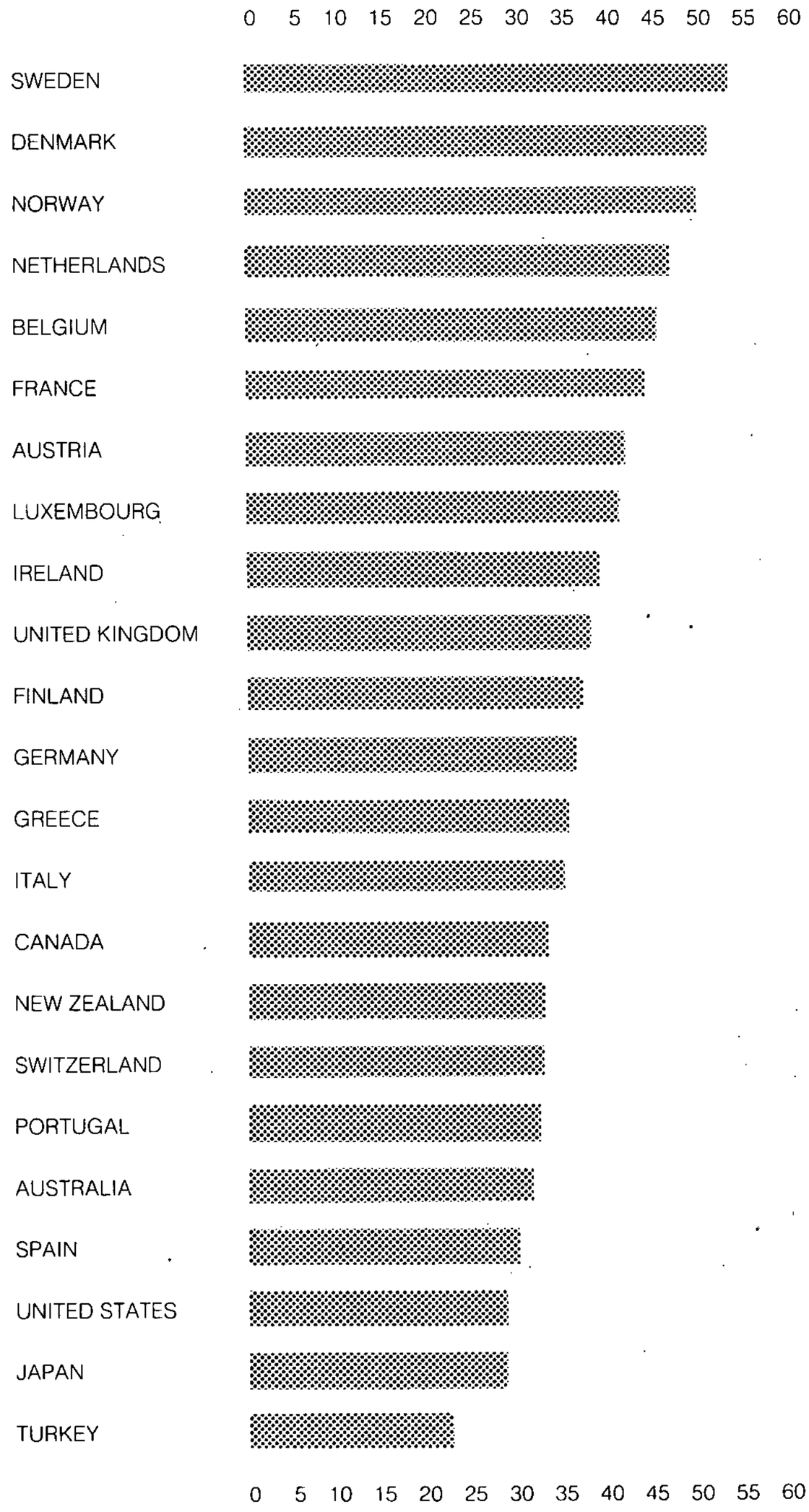
	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987**
Sweden	49.4	51.1	49.9	50.6	50.3	50.6	53.5	55.8
Denmark	45.5	45.3	44.5	46.5	47.6	48.7	50.6	51.8
Norway	47.1	48.7	47.9	46.6	45.8	47.4	49.8	48.3
Netherlands	45.8	45.2	45.4	46.7	45.0	45.1	45.5	47.3
Belgium	43.5	44.0	45.4	45.4	46.4	46.6	45.4	
France	41.7	41.9	42.7	43.6	44.6	44.5	44.2	44.7
Austria	41.2	42.5	41.2	41.1	42.3	42.9	42.6	42.2
Luxembourg	40.9	40.7	40.9	44.8	42.6	42.9	42.4	
Ireland	34.0	35.2	36.8	38.6	39.4	39.0	40.2	40.1
U.K.	35.3	36.7	39.3	37.9	38.3	38.1	39.0	38.0
Finland	33.0	34.6	34.0	34.0	35.5	36.8	38.4	36.6
Germany	38.0	37.6	37.4	37.3	37.5	37.9	37.5	37.6
Greece	28.6	29.1	31.8	33.3	34.9	35.2	36.7	
Italy	30.0	31.1	33.7	35.9	35.1	34.7	36.2	
Canada	31.6	33.7	33.5	33.0	32.9	32.9	33.2	33.0
New Zealand	33.0	34.0	34.9	32.8	33.1	33.8	32.9	
Switzerland	30.8	30.6	31.0	31.6	32.3	32.0	32.6	32.0
Portugal	28.7	30.4	31.0	32.8	32.2	31.5	32.4	
Australia	29.0	30.0	30.2	29.5	30.9	30.8	31.4	
Spain	24.1	25.5	25.8	27.9	29.2	28.8	30.4	32.8
U.S.A.	29.5	30.0	29.9	28.4	28.4	29.2	28.9	
Japan	25.5	26.2	26.7	27.2	27.4	28.0	28.8	
Turkey	21.7	23.4	22.4	20.7	17.3	19.7	22.7	24.4
Unweighted average:								
OECD Total	35.1	36.0	36.4	36.8	36.9	37.3	38.1	
OECD Europe	36.6	37.4	37.8	38.6	38.7	39.0	40.0	
EEC	36.3	36.9	37.9	39.2	39.4	39.4	40.0	

1. Ranked by the 1986 figures.
Blank = not available.

Table 2
Tax revenue of main headings as percentage of total taxation

	1000 Income & profits	*2000 Social security*	*3000 Payroll*	*4000 Property*	*500 Goods & services*	*6000 Other*
Australia	55.6	—	5.9	8.0	30.5	—
Austria	26.8	31.9	5.8	2.4	32.1	1.1
Belgium	40.4	33.6	—	1.9	24.0	0.1
Canada	45.9	13.7	—	9.4	29.7	1.3
Denmark	56.2	3.1	0.5	4.7	35.4	0.2
Finland	51.9	9.0	—	3.1	35.8	0.2
France	18.2	42.7	2.0	4.8	29.4	2.9
Germany	34.5	37.2	—	3.1	25.2	—
Greece	17.5	32.6	1.6	2.7	45.4	0.1
Ireland	36.1	14.2	1.7	3.9	44.1	—
Italy	37.9	34.3	0.5	2.7	24.6	—
Japan	45.7	29.8	—	10.9	13.4	0.3
Luxembourg	43.2	25.6	0.6	6.2	24.5	—
Netherlands	27.7	42.5	—	3.6	26.0	0.3
New Zealand	70.5	—	1.0	1.7	26.9	—
Norway	36.1	22.2	—	2.1	38.8	0.6
Portugal	21.2	28.1	—	1.9	48.0	0.9
Spain	25.2	39.1	—	3.2	32.0	0.6
Sweden	42.8	25.0	4.5	2.8	24.8	0.2
Switzerland	41.2	31.6	—	8.4	18.8	—
Turkey	39.0	12.8	—	3.3	31.5	13.4
U.K.	38.2	17.9	—	12.9	30.9	—
U.S.A.	42.4	29.8	—	10.3	17.5	—
Unweighted average:						
OECD Total	38.9	24.2	1.0	4.9	30.0	1.0
OECD Europe	35.2	26.9	1.0	4.1	31.7	1.1
EEC	33.0	29.2	0.6	4.3	32.5	0.4

Chart I
Total tax revenue as percentage of GDP 1986



Countries have been ranked by their total tax to GDP ratios.

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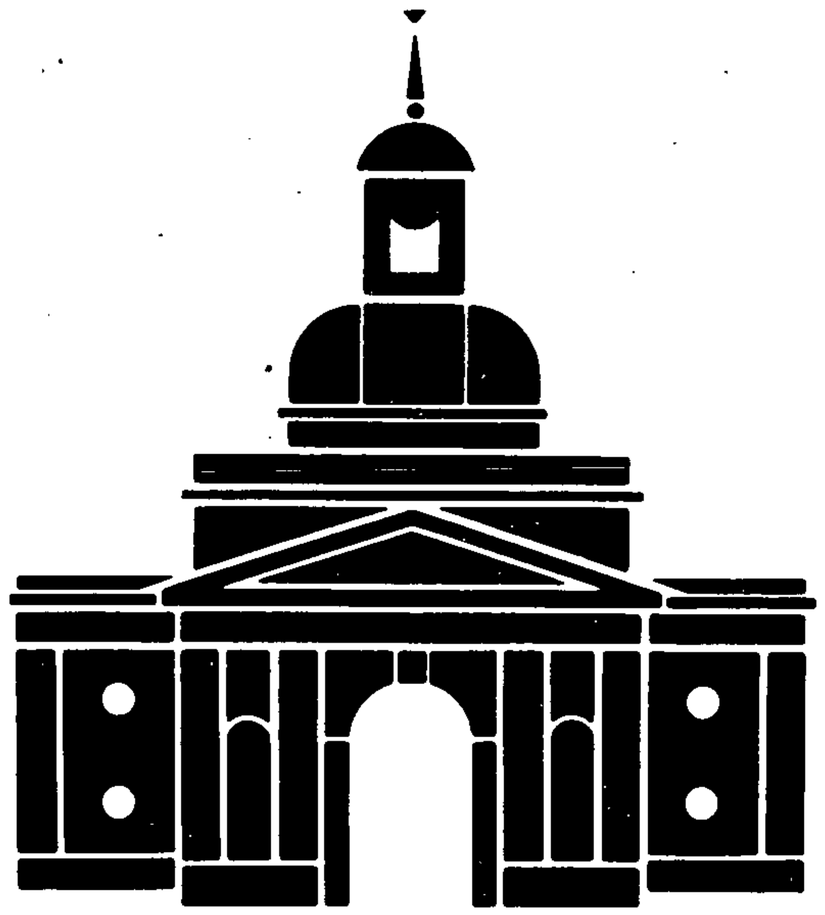

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Man findet die Basis für die Kompetenz der U.S.A., Information über Steuersachen mit anderen Ländern auszutauschen, in den administrativen Bestimmungen, die zu Doppelbesteuerungsabkommen gehören und die die zuständigen Behörden der Vertragsstaaten berechtigen, solche Information auszutauschen. Dieser Artikel anaiysiert die amerikanische Praxis in Bezug auf routinemässigen und besonderen Informationsaustausch. Der Artikel befasst sich auch mit anderen Formen von besonderen Austauschmöglichkeiten, sowie gleichzeitige Bücheruntersuchungen, spontaner Informationsaustausch, Informationsaustausch in besonderen industriellen Bereichen und beschränkte Steuerabkommen, die besonders für den Informationsaustausch abgeschlossen wurden.

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U.S. Internal Revenue Service:
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Le prix de transfert est une méthode par laquelle les sociétés multinationales essaient de réduire leurs charges fiscales mondiales en répartissant leurs pertes et profits entre les différentes autorités fiscales. Les problèmes de prix de transfert entraînent la possibilité d'une double imposition à moins que les administrations fiscales s'accordent quant aux montants des bénéfices transférés. Cet article montre l'approche de l'administration fiscale dans son examen des problèmes fiscaux internationaux liés à la détermination du prix de transfert.

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K.A. Gofran:
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R.G.L. de Silva:
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Arthur Young International:
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pour les expatriés: imposition sur le revenu
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U.S. Internal Revenue Service:
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Multinationale Unternehmen versuchen oft, durch die Bestimmung von Verrechnungspreisen ihre Gewinne und Verluste in solcher Weise über die verschiedenen Steuerhoheiten zu verteilen, dass ihre gesamte weltweite Steuerbelastung minimiert wird. Andererseits können die mit den Verrechnungspreisen zusammenhängenden Probleme eine Doppelbesteuerung zur Folge haben, wenn nicht die Steuerbehörden der verschiedenen Staaten über die Preise zu einer Übereinstimmung kommen. Dieser Artikel beschreibt die Vorgehensweise des amerikanischen Internal Revenue Service bezüglich internationaler Steuerprobleme, die mit Verrechnungspreisen zusammenhängen.

Pierre Gravelle:
Kanada: Doppelbesteuerungsabkommen, Konzepte,
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Randolph Kong:
Trinidad und Tobago: Die Zusammenarbeit zwischen
Steuerbehörden zur Bekämpfung von internationaler
Steuerhinterziehung und -Umgehung *526*
Trinidad und Tobago hat mit verschiedenen entwickelten Ländern Doppelbesteuerungsabkommen abgeschlossen, welche eine Informationsaustauschklausel enthalten, die sich entweder auf dem OECD Musterabkommen von 1963 oder auf dem von 1977 basiert und ausserdem vom Musterabkommen der Vereinten Nationen beeinflusst ist. Dieser Artikel beschreibt die Art und Weise, in der Information ausgetauscht wird – sowohl mit Vertragspartnern, als auch in einer Situation, in der kein Doppelbesteuerungsabkommen existiert. Der Autor macht einen Vorschlag, welche Rolle CIAT spielen könnte, um Mitgliedstaaten bei der Bekämpfung von internationaler Steuerhinterziehung und Steuerumgehung behilflich zu sein.

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M.A.Gª Caballero:
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Das neue Einkommensteuerreformgesetz ist ab 1. Juni 1988 in Kraft getreten. Diese Notiz beschreibt die wichtigsten Merkmale der Besteuerung von inländischen Arbeitnehmern und von inländischen Personen, die eine freiberufliche Tätigkeit ausüben, sowie die Besteuerung von Einkünften ausländischer Steuerpflichtiger.

K.A. Gofran:
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Der Verfasser vermittelt einen Überblick über die Themen, die vom Finanzminister anlässlich der Präsentierung des Budgets 1988-89 analysiert wurden. Er bespricht namentlich besondere Änderungen in der Besteuerung der verschiedenen Wirtschaftsbereiche.

R.G.L. de Silva:
Sri Lanka: Das auf die Körperschaftsteuer
angewendete Anrechnungssystem *537*
Die neue Gesetzgebung, die in Sri Lanka ab 1. April eingeführt wurde (Inland Revenue (Amendment) Act No. 31 of 1988), enthält die Bestimmungen bezüglich des Anrechnungssystems, wie es in Sri Lanka auf Körperschaftsgewinne Anwendung findet. Dieser Artikel beschreibt die Schwerpunkte des neuen Gesetzes und gibt Beispiele aus der Praxis, um die Wirkung des Anrechnungssystems auf inländische Körperschaften und inländische Aktionäre zu erklären.

Arthur Young International:
Eine Einführung zu den Steuern in Singapur für
ausländische Arbeitnehmer: Einkommensteuer *541*
Dieser Artikel ist der zweite in einer Serie, die sich mit der Besteuerung von ausländischen Arbeitnehmern befasst. Er beschreibt die wichtigsten Merkmale der singapurischen Einkommensteuer, u.a. Begriffe wie Wohnsitz, das Steuerobjekt, die Besteuerung von bestimmten vom Arbeitgeber gewährten Vorteilen, Abzugsposten und Sozialversicherung.

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INTERNATIONAL FISCAL ASSOCIATION news

Mr. Spierdijk Appointed Secretary General of IFA

Mr. Jan Frans Spierdijk has, as of September 1988; succeeded Prof. Dr. Jan Christiaanse as Secretary General of the International Fiscal Association. Mr. Spierdijk was born in Rotterdam in 1932. He obtained his degree in Taxation and Law at the Rotterdam Academy for Taxation and at Amsterdam University.

Mr. Spierdijk worked for the Dutch Revenue until 1961 when he joined the firm of Loyens & Volkmaars, the oldest and largest independent tax advisory firm in the Netherlands where he is now a managing and senior partner. He has been working primarily in the field of international taxation.

Mr. Spierdijk has been an IFA member since 1962, the Honorary Secretary of the Dutch Branch of IFA since 1964 and a long-time member of the General Council of IFA. He was on the Organizing Committee of the 1969 Rotterdam Congress and the 1988 Amsterdam Congress. In 1971 he was the national reporter for the Washington Congress on the subject of international allocation of items of income and expense.

Mr. Spierdijk is a member of the Dutch Association for Fiscal Science where he has served on several committees and he is an Executive Director of the American Chamber of Commerce in the Netherlands and Chairman of its Tax Committee. He has authored several articles and reports in various tax periodicals, primarily on the subject of transfer pricing.

He has been an Alternate Justice in the Appellate Court of Amsterdam (Tax Chamber) since 1982.

We are confident that Mr. Spierdijk will set a course comparable to his predecessor and maintain IFA's reputation as the leading authority in the field of international taxation.

DUTCH BRANCH

On 22 October 1988 the Dutch Branch of IFA met in Amsterdam for its annual General Assembly.

The commemoration of IFA's 50th Anniversary during its annual Congress in Amsterdam proved to be a big success. A committee of 3 persons, i.e. Messrs. De Nerée tot Babberich, Van Haaren and Overbosch representing the Dutch Branch, supervised the organization of this Congress attended by more than 2,000 delegates. Compliments on the subjects offered and the organization of the Congress were received from the President of IFA and many other persons.

During the Amsterdam Congress in September 1988, Mr. J.F. Spierdijk was appointed Secretary General of Central IFA; consequently, he retired as Honorary Secretary of the Dutch Branch. The Honorary Treasurer Mr. A. Overbosch was appointed as Mr. Spierdijk's successor so that he will combine the functions of Honorary Secretary and that of Honorary Treasurer. Mr. H. Marseille was appointed as a member of the Board of the Dutch Branch.

A large part of the meeting was dedicated to the discussion of the report for the next Annual Congress of IFA which will be held in September 1989 in Rio de Janeiro (Brazil). Mr. J.P.W. Mies is the reporter for Subject I (The disregard of a legal entity for tax purposes) and Mr. F.W. Imhof for Subject II (Administrative and compliance costs of taxation).

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The following four papers were presented during the 22nd General Assembly of the CIAT, held from 9-13 May 1988 in Brasilia, Brazil. The International Bureau of Fiscal Documentation gratefully acknowledges CIAT's permission to publish the papers. Some editorial changes have been made by the editors of the *Bulletin*.

UNITED STATES:

Exchange of Information – U.S. Administrative Practice

By the U.S. Internal Revenue Service

INTRODUCTION

Information exchanged under U.S. income tax treaties falls into the following main categories: (1) routine information, which generally relates to investment income received by residents of each country from sources within the second country and taxes withheld on this income by the second country; (2) specific information on a particular taxpayer made pursuant to a request by a tax treaty partner; and (3) information concerning any changes which have been made in a treaty country's tax laws.

This paper discusses U.S. administrative practice with reference to exchange in general, and routine and specific exchanges in particular. Other specialized forms of exchange, including simultaneous examinations, spontaneous exchanges and industry-wide exchanges are covered, as well as limited tax treaties which are exclusively designed for information exchange.

AUTHORITY FOR EXCHANGE

The authority for exchange of tax information by the United States with other countries is found in the administrative provisions of tax treaties which empower the competent authorities of each country to engage in such exchanges. The exchange article (Art. 26) of the income tax treaty between Japan and the United States provides a typical example of treaty exchange provisions. It reads in main part as follows:

> (1) The competent authorities of the Contracting States shall exchange such information as is pertinent to carrying out the provisions of this Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than those (including a court or administrative body) concerned with assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of this Convention.
>
> (2) In no case shall the provisions of paragraph (1) of this article be construed so as to impose on a Contracting State the obligation –
>
> (a) To carry out administrative measures at variance with the laws or the administrative practice of that Contracting State or the other Contracting State;
>
> (b) To supply particulars which are not obtainable under the laws or in the normal course of the administration of the Contracting State; or
>
> (c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.
>
> (3) The exchange of information shall be either on a routine basis or on request with reference to particular cases. The competent authorities of the Contracting States shall agree on the list of information which shall be furnished on a routine basis.

This treaty authority underlying exchange of information is amplified by Internal Revenue Code (IRC) Sec. 6103, which deals with confidentiality of taxpayer returns and return information and the conditions under which returns or return information may be disclosed to certain parties. IRC Sec. 6103(K)(4) provides in this connection:

> A return or return information may be disclosed to a competent authority of a foreign government which has an income tax convention with the United States but only to the extent provided in, and subject to the terms and conditions of such convention.

AUTHORITY TO OBTAIN INFORMATION FOR EXCHANGE

Generally, information previously obtained under U.S. revenue laws is available for exchange under tax treaties. With respect to information which is not already in the possession of the United States, U.S. law gives broad powers to the Internal Revenue Service

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(IRS) to compel production and examination of documents in the possession of taxpayers and third parties. The principal means by which U.S. tax authorities obtain information, if the taxpayer does not furnish it, is through the issuance of a summons to persons to appear and give testimony relevant to the tax inquiry. In addition, U.S. courts have jurisdiction to compel attendance, testimony or production of documents of any person summoned, and to punish such person for default or disobedience.

The basic authority for the examination for tax purposes of books, records and witnesses of a taxpayer is found in IRC Sec. 7602. While Sec. 7602 gives the tax authorities broad powers of examination, IRC Sec. 7605(b) provides that no taxpayer shall be subjected to unnecessary examination or investigation and that only one investigation shall be made for each taxable year unless the taxpayer requests otherwise or the IRS gives the taxpayer written notice that additional inspection is necessary.

The question has arisen as to whether the powers granted by Sec. 7602 could be exercised to obtain information specifically requested by a treaty country about a U.S. taxpayer which the IRS did not have in its files. The objection was raised that Sec. 7602 applies only in cases of U.S. tax investigations and not to those of a foreign country. The objection was rejected, however, on the ground that such an interpretation would render the exchange of information provisions a nullity. On this basis, a 1975 Federal Circuit Court decision upheld enforcement of summonses that compelled a U.S. corporation to produce information about a Canadian company that was the subject of a Canadian, but not a U.S. tax investigation. *United States v. Burbank & Company Ltd.* 525 F.2d 9 (2d Cir. 1975). The court held that enforcement of these summonses was compelled under the income tax treaty between Canada and the United States.

Accordingly, it is clear that the broad powers of Sec. 7602 can be exercised to obtain information requested by a treaty partner, subject to the same legal defenses which the taxpayer could invoke in the case of a U.S. tax investigation. A further restriction, of course, is that the purpose of the foreign tax investigation must be determination of the liability for taxes with which the applicable treaty is concerned.

ROUTINE EXCHANGE OF INFORMATION

The U.S. program for routine exchange of information has several purposes: to furnish information to other treaty countries so they can more effectively enforce their income tax laws; to identify persons not entitled to the reduction of taxes provided by the treaty with respect to U.S. source investment income; and to identify items of foreign source income which U.S. taxpayers may not have reported.

Under its routine exchange of information program, the United States routinely and automatically, without prior request, sends to tax treaty partners an information document (OECD Standard Document) which reflects payments of U.S. source income to residents of the treaty partner country. U.S. withholding agents report this information to the IRS on Form 1042S, which is used to generate the OECD form. The OECD Standard Document, which is computer generated by the IRS, contains: the names and addresses of income recipients, the type of income (i.e. dividends, interest, etc.), the amount of tax withheld by the United States from such income, if any. In 1986, the United States transmitted approximately 381,000 information documents and received approximately 705,000 (the majority of these from Canada). In terms of volume of documents exchanged and taxpayers involved, routine exchange represents by far the largest information exchange program.

Under the routine exchange program, only information documents are furnished to treaty countries. Copies of income tax returns are never furnished. Also, information furnished under the routine exchange program generally relates only to foreign nationals who are recipients of U.S. source income. An information document relating to a U.S. citizen should never be furnished to a foreign country if the tax affairs of the U.S. citizen have been properly handled. In such cases, the withholding agent should be advised that the recipient of the income is a U.S. citizen, and therefore not subject to withholding of tax at source on behalf of another country. In this case, the withholding agent would prepare a different form (Form 1099) in lieu of Form 1042 and no information document would be furnished to the foreign country.

The other side of the routine exchange program involves documents that the United States receives from its treaty partners reporting income paid to U.S. persons. These foreign information documents are processed at the Philadelphia Service Center in an effort to perfect them for use in IRS compliance programs. Some of the documents received cannot be processed for a variety of reasons (i.e. late receipt, no taxpayer identification number, etc.). To resolve some of these problems, the United States has encouraged treaty partners to submit information on a more timely basis in order to permit computer matching of the data. Experience indicates that processing information received on magnetic tape is limited to the Federal Republic of Germany and Canada at this point. Discussions are being held with other countries in an effort to expand the use of tapes.

Another problem is the variety of different forms in different languages used by treaty partners. To resolve this obstacle, the Organization for Economic Co-operation and Development (OECD) has developed a uniform information document to be used in the exchange of routine information. The United States and many treaty partners have supported the development and use of the form, which overcomes language and format problems. In recent years, a number of such documents have been received from several treaty partners and it is expected that more will be received in the future. As noted above, the United States now uses this form in providing information to treaty partners.

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EXCHANGE OF SPECIFICALLY REQUESTED INFORMATION

Specific exchanges are generated by requests from our treaty partners for specific information on a particular taxpayer or taxpayers, and conversely by similar U.S. requests. A preponderance of requests to the United States involve non-resident aliens and foreign corporations. Such requests concern, for example: residence and citizenship, financial transactions, liability for U.S. tax and the amount thereof, ownership of securities and other properties, control of U.S. companies, inquiries as to whether a company or individual is engaged in business in the United States, whether there is U.S. source income, the reporting of specific items in U.S. returns, the existence and value of assets in the United States, and copies of documents of a financial and legal nature. Although reference to U.S. tax returns may provide the information requested, the primary source of data is generally the taxpayer's books and records or those of third parties such as banks, brokerage firms, etc. In applying administrative provisions of tax treaties, it is generally recognized that competent authorities must exercise discretion and judgment in both requesting and furnishing of information. A competent authority is not obligated to provide information automatically upon another's request.

Accordingly, the U.S. competent authority considers every specific request for information on an individual basis. If securing of the information is determined to be administratively more difficult than justified when balanced against the reasons given for the request, or an encroachment on the rights and privileges of the person who is the subject of the information requested, or in violation of, or contrary to the sovereignty, security or public policy of the United States, the request will be denied. Also, as a condition to the furnishing of information by the United States, the treaty partner is expected to have previously exhausted those means under its own tax laws to obtain the information.

It is general policy of the United States not to furnish copies of complete tax returns or portions thereof. However, when a treaty country specifically requests copies of such documents, the request will be granted if the requesting country justifies a need for the returns. Thus, the treaty country should clearly indicate that the person is involved in business or other transactions which are subject to the tax laws of that country and also that receipt of the information in the return is pertinent and material in a determination of tax liability in the case.

Under U.S. policy, any request for information should be specifically concerned with the determination of the income tax liability of a particular taxpayer. Thus, the request should be of a specific nature and indicate the information desired and the reason why such information is needed. One element which should be present in every request is an explanation or other clear indication to the effect that the foreign country has reason to believe that the item of income or expenses involved in the request was erroneously treated in the tax return filed with the foreign country, or that the taxpayer failed to report income. Under this reason-to-believe policy, general "fishing expeditions" are not permitted.

Treaty exchange articles generally include a limitation to the effect that the information requested will be kept confidential by the requesting tax authorities except to the extent that disclosure might be required in the operation of normal administrative or judicial processes in the tax system of the requesting country. If information furnished for tax purposes were improperly disclosed or used for other than tax purposes, the United States would register a protest at such action. If the practice were not discontinued, necessary steps would be taken, including possible halting of further exchanges and termination of the information exchange provisions of the treaty.

A basic concept inherent in the specific request program is that of reciprocity. Full reciprocity requires that information requests by a treaty country will be generally restricted to the types of data which that country would be prepared to supply if it were to receive a similar request.

There are various factors which may limit the information that a country will supply, such as restrictions in its internal law or public policy. Whatever the basis for these limitations, reciprocity should be the guiding rule, for in its absence one-sided exchanges of information are subject to stringent criticism by legislators and others in the cooperating country and tend to erode the spirit of mutuality which is an essential foundation of the treaty.

Limitations in a country's internal law restricting its right to obtain information from its taxpayers or third parties are probably the greatest single obstacle to the reciprocity needed for effective action to reduce tax evasion and avoidance. Accordingly, it is the U.S. view that every effort should be made by the treaty countries involved to eliminate or reduce these barriers to productive cooperation.

SIMULTANEOUS EXAMINATIONS

An extension of specific exchanges of information which is specially adapted for use in ongoing audits is the simultaneous examination. Under this procedure, both treaty countries separately examine corporate taxpayers in their jurisdictions which are closely affiliated (e.g. parent-subsidiaries). Initially, one or both countries recommend one or more taxpayers and then agree on which to select for examination. After the selection, the designated representatives of each competent authority (usually the case managers) meet before the examination begins to discuss audit plans and potential audit issues (simultaneous issues) and establish target dates. Then each country notifies the taxpayer under its jurisdiction that it is under simultaneous examination with the applicable treaty partner.

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No physical interchange of audit personnel occurs during these examinations. However, the designated representatives meet periodically to discuss the case's progress and exchange information. Any such exchange is accomplished under a written request between the competent authorities and in accordance with the provisions of the treaty, including those which safeguard confidentiality of taxpayer information. After an examination is completed, each participating country assesses the examination and recommends changes to the program if necessary.

The broad objective of this audit technique is to improve international compliance through coordinated examinations and interrelated exchanges of information. Although the number of simultaneous examinations has been limited, the IRS has been very pleased with their results. The information obtained has enabled audit teams to gain a more comprehensive and accurate understanding of the worldwide operations of the taxpayers and to obtain information otherwise not available. Significant tax issues with substantial tax recoveries have resulted.

The next logical step is to conduct simultaneous examinations with more than one treaty partner; i.e. a series of bilateral simultaneous examinations conducted concurrently. This multilateral approach has been discussed with several treaty partners. The growth of multinational enterprises makes the multilateral simultaneous examination an interesting possibility, and a logical response to the fact that the operations of these enterprises transcend political boundaries. One taxing authority operating alone, or even with bilateral exchanges, often cannot effectively examine and evaluate the financial affairs of a multinational enterprise, even for the limited purpose of determining its correct tax liability within that taxing authority's jurisdiction.

INDUSTRYWIDE EXCHANGES

In dealing with multinational enterprises, we need to understand entire industries in seeking to evaluate whether their transactions and practices (pricing goods and services, assessing interest, overhead and other charges, etc.) meet acceptable arm's length standards. To assist in this evaluation, the United States and several of its treaty partners have developed programs of bilateral industrywide exchanges. In conducting these exchanges, U.S. and other treaty country officials meet periodically to discuss current industry developments of mutual interest, jointly explore recurring issues that are of common concern, pool resources to engage in special industry studies, discuss comparative methodology in establishing arm's length standards, conduct seminars on major industrial subjects, etc. Specific taxpayers are not discussed during industrywide exchange.

The primary objective of industrywide exchanges with treaty partners is to secure comprehensive data on worldwide industry practices and the operating patterns of selected industries. This provides tax administrators with a more effective and knowledgeable background for review of the tax returns of multinational corporations and for reinforcing cooperative compliance efforts.

At present, the United States has industrywide exchange arrangements with Canada, the United Kingdom, the Federal Republic of Germany, France and Norway. Bilateral studies and exchanges have dealt with such industries, for example, as petroleum, pharmaceuticals, banking and insurance. These industry exchanges complement the IRS' industry specialization program, and provide both the IRS and treaty partners with information and techniques to examine taxpayers within an industry more effectively.

We would like to see industrywide exchanges because the major corporations in many industries are situated in more than two countries. This would require greater coordination due to the increased complexity of multilateral exchanges. For example, greater care would have to be taken to assure that, in a multilateral context, exchanges of industrywide information would not violate disclosure and trade secret restrictions.

SPONTANEOUS EXCHANGES

A relatively recent development is the spontaneous exchange of information which is uncovered during an examination or other investigation and which indicates noncompliance with the tax system of a treaty partner. Such information is furnished to the latter even though it has made no request and in most instances is unaware that such information exists.

Spontaneous exchanges operate when there is a clear understanding between the treaty partners that cooperation will be reciprocal and that each country will provide as well as receive such spontaneous data. The Unites States initially implemented spontaneous arrangements with the United Kingdom, the Federal Republic of Germany and France but has now expanded them to include all treaty partners which can and will reciprocate.

LIMITED (EXCHANGE OF INFORMATION) TAX TREATIES

The previous discussion deals with exchange of information under full-scale tax treaties which, in addition to provisions for exchange, include an array of other treaty articles covering various substantive and administrative provisions (exemptions, reduced tax rates, tax credits, non-discrimination rules, etc.). In some situations, countries interested in exchange of information may not wish to be committed to a full-scale treaty for various reasons. A possible alternative is a treaty limited to exchange of information. Such a treaty would appear to be entirely feasible both from a legal and a functional standpoint.

In content, an exchange of information treaty could incorporate the standard provisions of the exchange article of more recent tax treaties (e.g., see the lan-

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guage of Art. 26 of the U.S.–Japanese income tax treaty, supra). Presumably, it would also specify the taxes covered, include definitions, if necessary, provide for mutual agreement procedures to cover operational difficulties and other contingencies, and also include entry into force and termination provisions.

If the treaty partners desired, an exchange treaty could expand the standard exchange article to incorporate a variety of additional measures for exchanges and mutual assistance. These could include, for example, procedures for questioning taxpayers and third parties; for production of books, records and original documents; for providing testimony under oath, etc. A limited treaty could also be expanded to cover administrative assistance in collection of revenue and conservancy of taxes.

In conclusion, the United States conducts a number of information exchange programs under its tax treaties with other countries. These programs are increasingly proving their worth as a valuable compliance tool in an age of international transactions and multinational taxpayers. Accordingly, we are committed to expanding the scope and improving the effectiveness of information exchanges.

UNITED STATES:

Transfer Pricing Among Related Companies[1]

By the U.S. Internal Revenue Service

In an effort to minimize their worldwide tax burden, multinational corporations have an incentive to exercise control over the allocation of profits and losses among taxing jurisdictions. Transfer pricing provides a convenient vehicle for accomplishing this purpose; consequently, it is a concern to fiscal authorities throughout the world.

Fiscal authorities share a mutual goal of promoting international trade and to adopt policies which reduce barriers to free trade. It is generally recognized that an impediment to trade is multiple taxation of income. Accordingly, fiscal authorities through tax treaties and other joint ventures have adopted rules and conventions to determine which taxing authority shall be entitled to the tax on income which one or more taxing authorities claim the right to tax. Nevertheless, the emergence of transfer pricing issues raises the specter of double taxation unless the taxing authorities can mutually agree to the price of tangible property, intangible property or other benefits being transferred. Further, it is recognized that transfer pricing issues may result in the transfer of funds between fiscal authorities. Consequently, transfer pricing issues should be addressed on a multilateral basis.

The United States, through the provisions of its tax treaties, provides for competent authority consideration of issues involving double taxation and under the exchange of information provisions, encourages open and frank discussions of issues with treaty partners. As a participating member of the OECD, the United States has worked, together with other nations, to establish common guidelines for determining transfer prices between affiliates. It is in the same spirit of cooperation that the United States welcomes the opportunity to present the approach adopted by the Internal Revenue Service (IRS) with regard to international tax issues associated with transfer pricing.

SECTION 482

The authority for the IRS to allocate income is provided in Sec. 482 of the Internal Revenue Code (IRC). Under this code section, where 2 or more organizations, trades, or businesses are owned or controlled by the same interests, Congress gave the Secretary the authority to distribute, apportion or allocate gross income, deductions, credits, or allowances between or among controlled organizations, trades, or businesses if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such related entities.

Treasury regulations elaborate on the scope and purpose of Sec. 482 providing: "The purpose of Sec. 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer...". This is to be accomplished by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. "... The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." The true taxable income is defined in the Treasury Regulations

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1. The U.S. Treasury Department recently issued a "White Paper" on transfer pricing. An article examining this "White Paper" will appear in a forthcoming issue of the *Bulletin*.

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as taxable income which would have resulted to a controlled taxpayer had it in the conduct of its affairs dealt with the other member or members of the group at arm's length. When the regulations require that related parties deal at arm's length, they are saying, in effect, that the taxpayer must deal with controlled entities as with uncontrolled entities. The form in which a particular transaction is cast is not determinative, but rather economic reality of the transaction.

STANDARDS FOR APPLICATION OF SEC. 482

Federal Regulation 1.482-2 sets forth standards for the application of Sec. 482 to cases involving the pricing of tangible property sold by one member of a controlled group to another, and cases in which intangible property, such as patents, copyrights and trademarks are made available by one member to another. The regulation also sets forth standards for determining taxable income of controlled groups in cases involving loans, the rendering of services and the sale or use of intangible property.

1. Loans or advances

Interest should be charged on loans or advances made by one member of a controlled group to another. If the creditor is regularly engaged in the business of making loans or advances, the arm's length interest rate should be charged. Upon failure to do so, the District Director can determine what interest should have been charged. Where the creditor is not in the business of loaning money or making advances, either an arm's length rate based on the facts and circumstances or a "safe haven" rate is acceptable. The safe haven rate is specified in the regulations.

2. Performances of services

Where a service by one member of a group to another member is rendered for less than an arm's length charge, the District Director may make appropriate allocations to reflect an arm's length charge for that service. The arm's length charge is equal to the costs (direct and indirect) or deductions incurred by the member performing the service, except in cases where the service is an integral part of the business activity of either member.

3. Use of tangible property

If tangible property is made available by one member of the group to another, the latter should be charged the arm's length rental charge. If neither party is in the business of renting, the allocation generally would be an amount equal to the sum of allowable depreciation plus 3% of the depreciable basis of the property and the amount of all direct or indirect expenses (exclusive of interest expense) connected with the property.

4. Use or transfer of intangible property

If intangible property (such as patents, copyrights or trademarks) is transferred, sold, assigned, loaned, or otherwise made available by one member of the group to another member for other than an arm's length consideration, the District Director may make the allocation.

New rules are provided by the Tax Reform Act of 1986 governing the allocation of the income of intangibles. For transfers of intangible property or licenses granted after 16 November 1985, in tax years beginning after 1986, the income with respect to the transfer or licence will be considered to be commensurate with the income that is attributable to the intangible.

5. Sales of intangible property:

Where one member of a group of controlled entities sells or otherwise disposes of tangible property to another at other than an arm's length price, a proper allocation will be made between the seller and the buyer. The Regulation describes in detail 3 methods which may be used in determining the arm's length price:

(a) *Comparable uncontrolled price method*
This method must be used if there are comparable uncontrolled sales (sales between outsiders or a member and an outsider where the property sold and the circumstances involved are identical, or nearly identical, to those in the controlled sale). To the extent they are not identical, adjustments are made.

(b) *Resale price method*
If there are no comparable uncontrolled sales, the resale price method must be used if the standards for their application are met. A typical situation where this method is required is when a manufacturer sells products to a related distributor who, without further processing, resells the products to unrelated parties.

(c) *Cost plus method*
If the standards for application of the resale price method are satisfied, either that method or the cost plus method is used, depending on which is more feasible and will produce a more accurate arm's length price. Normally, the cost plus method is appropriate where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by use of its intangible property (trademark, for example) before resale.

Under both the comparable uncontrolled price method and the resale price method, market conditions faced by the affiliate are taken into account. Thus, goods may be sold, for a period, at a price which is below the full cost of manufacture in order to establish or maintain a market.

Assuming the requirements of one of the above 3 methods are met, it must be used unless the taxpayer can show that some other method is clearly more appropriate. Where none of the 3 methods can reasonably be applied, some other appropriate method can be used.

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ADMINISTRATION OF SEC. 482

The IRS has addressed transfer pricing issues over a range of industries including aluminum, automobile, electronics, oil, and pharmaceuticals. Issues have ranged from the pricing of commodities to finished goods. IRS personnel have had to give consideration to the valuation of intangibles, as well as to assess differences being performed in the marketing and distribution functions.

USE OF SPECIALISTS

To develop these issues the IRS has relied on the skills of trained specialists. These specialists include the international examiner and the economist.

The international examiner is an internal revenue agent who has received specialized training within the IRS in international issues. The international examiner, in cooperation with the district agent, will develop the examination plan pertaining to international aspects of the examination and will evaluate, analyze and interpret the information obtained with a view to the expeditious completion of that phase of the examination. The international examiner is responsible for preparing a report of his findings which, after approval by the international group manager, will be sent to the district agent for inclusion in his report.

Economists have been assigned to key regions/districts to supplement the legal and accounting skills of IRS personnel. The economists assist examination personnel in dealing with the economic aspect of issues under consideration, particularly those arising in international cases. The economist may be asked to evaluate the substantive economic factors involved in a particular case including such items as the following:

(1) the value of intangibles,
(2) royalty and commission rates,
(3) industry and trade practices,
(4) profits and profit ratios,
(5) arm's length pricing,
(6) the value of functions performed,
(7) distribution patterns,
(8) marketing activities,
(9) presentation of economic and statistical data.

The economist may also be asked to participate in broader activities. Examples of these activities include the following:

(1) aid in the development of audit plans or reevaluate such plans in view of subsequent developments;
(2) review audit plans;
(3) evaluate, analyze, and interpret data in case files;
(4) review proposed adjustments for conformity with economic realities and for uniformity in the economic approach to issues;
(5) locate and identify sources of pertinent economic data;
(6) identify and study problem areas to obtain required or vital economic data;
(7) prepare for and participate in discussions or conferences between the IRS and taxpayers or their representatives.

Upon completion of his/her study, the economist will submit a final report. The report will outline the economist's position. The economist may serve as an expert witness. At other times the economist may identify and locate independent witnesses or consultants to provide expert testimony on economic matters.

The Tax Treatment of Transfer Pricing

(2 binders)

- an in-depth introduction to transfer pricing, with country surveys including methods of arm's length pricing, price adjustments and corresponding adjustments, specific transactions, transfer pricing rules in tax treaties, etc.
- texts of relevant documents and provisions in laws and regulations

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INFORMATION REQUIRED TO BE FILED WITH RETURN

Certain corporations are required to file information which is of direct bearing to issues associated with transfer pricing between affiliates. A U.S. corporation owning 10% or more of a foreign corporation must file an information return (Form 5471, Information Return with Respect to a Foreign Corporation) with its U.S. income tax return. This form requires the reporting of transactions between the parent and subsidiary, such as sales/purchases of goods, commissions paid or received, compensation for technical services, etc. The regulations now require the reporting of transactions between foreign corporations (brother-sister) owned by the same U.S. corporation.

A U.S. corporation or foreign corporation engaged in a trade or business in the United States which is controlled by a foreign person (or corporation) must also file an information return (Form 5472, Information

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Return of a Foreign Owned Corporation) with its U.S. income tax return. This information return requires the reporting of transactions between the taxpayer and the related foreign corporation. The transaction includes sales/purchases of goods, commissions, rents, and fees for technical services.

As a result of an inordinate time between the submission of an information document request and the date the request is complied with, the IRS is taking under consideration the following modifications to Forms 5471 and 5472:

(1) require an attestation that intercompany transactions fall within the arm's length standard of Sec. 482;
(2) identify the method used in pricing the intercompany transaction.

In addition, the IRS is proposing that the support for intercompany transfer pricing available at the time of return preparation be made available within 30 days of the start of any IRS examination.

In a recent study of Sec. 482, 74% of those responding to a questionnaire indicated that Forms 5471 and 5472 were instrumental in the initial identification of transfer pricing issues.

ISSUE IDENTIFICATION AND DEVELOPMENT

Primary responsibility for identifying transfer pricing issues rests with the international examiner. Nevertheless, the process of issue identification may involve the coordinated activity for the National Office, the various regions, and the districts.

Currently, there is concern within the IRS that U.S. corporations controlled by foreign ownership are not paying income tax commensurate with their level of economic activity performed within the United States, whether measured in terms of revenue or investment in assets. To address this concern, certain regions were selected for analysis. A listing was made of those returns subject to foreign control. It was possible to group these returns by level of economic as well as by principal business activity. Based on an analysis of return data, certain returns of this group were selected for examination.

International examiners are primarily responsible for developing and evaluating information available from the books and records of the taxpayer and related entities. Upon being assigned to a specific case, the international examiner will study the operations of the U.S. taxpayer and those of its foreign affiliates. Financial statements of all related entities will be secured. These statements will cover the years under examination as well as both prior and subsequent years in order to establish patterns and trends. The taxpayer will be requested to provide detailed schedules, including intercompany allocations of income and expenses by product line or other relevant criteria.

Reports filed with other governmental agencies will be reviewed. These reports would include federal, state, and local tax returns, reports filed with the Securities Exchange Commission, Department of Commerce and U.S. Customs.

Other sources of information include annual reports and articles contained in trade publications. Additional information will be secured through on-site analyses of taxpayer's operations in both the domestic and international areas including marketing, supply and distribution, research and development, as well as the manufacturing process.

Learning the operations of the taxpayer should take place beyond the confines of the tax department. International examiners conduct interviews of line function personnel. Members of the taxpayer's tax department frequently are not abreast of the overall operation.

International examiners must be aware of the relationship between the U.S. parent and the foreign subsidiaries and the role the parent plays in carrying out the activities of the group. In their review of the relationship, the following questions are addressed:

(1) Are the parent and subsidiary manufacturing the same product and using the same technology? If so, is the subsidiary paying the parent for its use?
(2) How is ongoing technology transferred to the subsidiary?
(3) If the subsidiaries market the product they manufacture, are they using marketing intangibles developed by the parent? These intangibles can include marketing staff, advertising formats, and the actual advertising material and commercials.
(4) Which members of the group performed the research and development activity and how are these results disseminated amongst the entire group?

The international examiner will select a few subsidiaries and review the functions required to carry out activities of such business segments. The international examiner will review staffing of these subsidiaries to determine if they are sufficient enough to perform the necessary functions required.

If it is determined that staffing is insufficient, the international examiner will determine if certain necessary functions are being performed by the parent.

SALES OF TANGIBLE PROPERTY

During the course of the development of the factual background, international examiners will evaluate the transfer pricing practices adopted by the controlled group and will secure pertinent information available from the group with regard to comparable third-party transactions.

The international examiner will obtain reasonably detailed information concerning the questioned transactions as they actually happened. For example, what products are involved; in what form are the goods sold, i.e. bulk, small packages, unbranded, etc.; at what prices were they sold; in what quantities; on what credit terms; if resold, at what prices and to whom; if

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not resold, what use did the buyer make of them, etc. The international examiner will obtain copies of price lists, including all relevant price changes used during the years under examination.

The IRC 482 Regulations discuss in some detail methods to be employed in arriving at an arm's length charge for a variety of transactions. In some cases the available information will permit or even require more than one method or approach to be employed or checked out in order to arrive at the best estimate of an arm's length charge. The international examiner must keep an open and objective mind and be willing to consider all relevant data, including that urged by the taxpayer to arrive at the most accurate determination in accordance with the regulations.

In the search for arm's length comparables, the international examiner attempts to exhaust the possibilities of obtaining acceptable comparables from within the controlled group's own operations. In most cases identical transactions with unrelated parties will not be found but transactions which economically are substantially similar are sometimes available. When this occurs, it may be possible to isolate significant differences, if any, measure them, and arrive at a good comparable after-adjustment. In some cases profit margins realized by the taxpayer in dealing with independent parties may be a measure of arm's length income from transactions with a related organization.

When a measure of the terms of arm's length dealings, i.e. a comparable, cannot be found within the taxpayer's own organization or other members of the controlled group, resort must be made to wholly third-party data.

Regardless of where the comparable or comparables are obtained, it is important to develop sufficient information to show that they are, in fact, comparable. This will require details as to the terms at which the comparable transactions were handled and the circumstances of such transactions, including a comparison between functions performed by each party involved in the comparable transactions and functions performed by the taxpayer and the related organization in the questioned transactions.

In some cases a single "best" comparable may not be found. Instead, there may be several independent transactions, each of which differs from the questioned transactions in some particular which cannot be adjusted with great accuracy. However, taken together, the several independent transactions determine the terms of the arm's length dealing within an acceptable range. In these situations information on all of the independent transactions must be obtained.

Congress has taken steps to insure that there is correlation between intercompany transfer prices and prices utilized for customs valuation. Specifically, the Tax Reform Act of 1986 added Sec. 1059 to the IRC. Briefly, this code section provides that transfer prices on import transactions between related parties after 18 March 1986 not exceed those used for U.S. customs purposes. Examiners will consider the U.S. customs values as another method of determining an arm's length price. The facts and circumstances of each case must still be considered.

INTANGIBLES

It is extremely difficult to determine an arm's length royalty in those cases where the parent company supports the subsidiaries in their manufacturing, marketing, financial and other efforts by developing and transferring intangible property to the subsidiary. This is because a cluster of intangibles may be involved instead of one isolated transfer, as is the usual case of third-party dealings. Proper analysis of what is being transferred, and development of an arm's length price for the cluster of intangibles requires the support of economists, engineers, marketing experts, as well as experts in the field of licensing tangibles.

If a licensing arrangement is being examined, the information on the details of the transaction should include:

(1) What is being licensed?
(2) Who developed and who owns the intangible?
(3) What are the terms of the license?
(4) How much was paid under the license in the years under examination?
(5) Is the controlled licensee using the intangible in his own manufacturing operation, is he relicensing it, or is he doing both? If relicensing, to whom, on what terms, and how much was paid under the relicensing contracts in the years under examination?
(6) Copies of all license and relicense agreements and any correspondence modifying such agreements should be obtained.
(7) If the license fee or royalty is based on production, the production figures should be obtained.

USE OF THE ECONOMIST AND THE FUNCTIONAL ANALYSIS

During the course of issue development the international examiner will be assisted by the economist assigned to the case. The economist will participate in the evaluation of data secured from the taxpayer, and will be responsible for providing supplemental information pertaining to industry practices and trends. In many instances, it is not possible to derive a comparable solely from the books and records of the controlled group, and it becomes the responsibility of the economist to furnish pertinent statistical data pertaining to arm's length transactions within the industry.

In most cases involving transfer pricing issues, a determination must be made as to what functions were performed in accomplishing the questioned transactions and who performed such functions. This determination is made through a functional analysis. The functional analysis looks beyond the form of the transactions and inquires into their economic substance. Essentially 6 questions must be resolved:

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(1) What was done?
(2) What economically significant functions were involved in doing it?
(3) Who performed each function?
(4) What is the measure of the economic value of each function performed by each party?
(5) What economic risks were taken?
(6) Are there any valuable intangibles used in performing the given function?

Some functions are performed by individuals such as sales efforts, engineering and accounting services, etc. Other economically significant functions are performed by capital such as patents and other intangibles, capital put at risk in carrying accounts receivable, in purchasing and using machinery.

No facts regarding comparables, which are simply the measures of economic value, will be helpful unless it has first been determined with accuracy just what should be measured. A properly developed functional analysis generally requires the application of the combined skills of the economist and the international examiner.

IMPORTANCE OF BALANCE SHEETS AND PROFIT AND LOSS STATEMENTS

It is a standard practice to obtain balance sheets and profit and loss statements of the organizations involved in the questioned transactions. As a minimum, these must cover the years under examination. The most detailed reports together with supporting schedules are required. The taxpayer may give a glowing description of the functions performed by the subsidiary, but an analysis of the expenses incurred may tell another story.

In *E.I. DuPont de Nemours and Company v. United States* (608 F.2d 445 (Ct. Cl. 1979)), DuPont organized a Swiss trading subsidiary known as DISA to sell its products to unrelated customers in Europe and throughout the world. DISA received substantial assistance from DuPont and other related subsidiaries. In addition, DuPont insulated DISA from loss and credit risk. During the years under audit the profit split between DuPont and DISA was 50-50. The court agreed with the Commissioner's findings that the allocation of this profit was economically unrealistic, giving DISA too great a share. DuPont attempted to convince the court that the gross profit margins were in line with 21 unrelated distributors. Although the gross profit margins were similar, the court responded that there was no evidence that the operations of DISA were similar as to products, services performed and geographic areas served. Based upon this finding the resale price method could not be used by DuPont because there were no substantially comparable uncontrolled resellers. The reason DISA was earning an unrealistic net profit was not because it was paying too little for the products; rather it was not incurring the normal below-the-line costs. These expenses were incurred by DuPont thus relieving DISA of substantial costs. The results obtained in the DuPont case emphasize the importance of a functional analysis and financial statement analysis as indispensable tools in conducting an examination with international transactions.

The IRS recognizes the practical applications of financial statement analyses and is taking specific steps to insure that international examiners are adequately trained to make the best possible use of this tool.

USE OF COUNSEL

Timely resolution of transfer pricing issues requires early identification of potential issues followed by timely developed information document requests. During an audit, if the international examiner is of the view that an adjustment under IRC 482 should be made, Counsel will be available to render advice as to the type of information necessary to defend in court any proposed IRC 482 adjustment.

SECURING INFORMATION FROM FOREIGN SOURCES

Information maintained by U.S. entities generally is readily available. The question may arise with regard to records and information in the custody of a foreign subsidiary or other foreign member of the domestic taxpayer's group. IRC Sec. 982 provides an incentive to the domestic taxpayer to secure such information. This code section (entitled Admissibility of Documents Maintained in Foreign Countries) prohibits the introduction into civil proceedings by the taxpayer of any foreign-based documentation that was requested by the IRS through a formal document request.

INDUSTRYWIDE PRICING PROGRAM

In an effort to insure uniform and consistent application of Sec. 482 among companies within the same industry, the IRS has initiated industrywide pricing programs in certain industries. These programs provide benefits to both taxpayers and the IRS through the development of expertise within the IRS.

The Petroleum Industry Program in the Southwest Region is currently charged with the responsibility of resolving inter/intracompany transfer pricing issues associated with foreign-produced crude oil and refined products. The Electronic Component Industry Program in the Western Region is studying the marketing and distributing activity associated with electronic components imported into the United States for purposes of addressing issues associated with transfer pricing.

During the course of these studies, taxpayers may be requested, on an industrywide basis, to provide information with regard to transactions entered into with unrelated parties. Analysts working within these programs may establish liaison with other governmental

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agencies for purposes of securing and analyzing statistical information.

INDUSTRYWIDE EXCHANGES OF INFORMATION

The United States has entered into tax treaties with other governments in a mutual effort to reduce the hazard of double taxation and to prevent tax evasion. These tax treaties provide for the exchange of information to carry out the provisions of the convention. The scope of an industrywide exchange is established by an exchange of letters between the United States and the treaty partner's competent authority.

Industrywide exchanges with treaty partners promote international cooperation in understanding the worldwide operations of selected major industries. The principal objective of the exchanges is to secure comprehensive data on worldwide industry practices and operating patterns. This information enables a more effective and knowledgeable review of the tax returns of multinational enterprises.

CONCLUSION

Although significant efforts have been made by taxing authorities to develop objective standards for determining appropriate transfer prices between controlled affiliates, these standards are applied within a complex economic setting requiring the skills of trained specialists. The United States encourages a cooperative working relationship among the various taxing authorities. Through joint undertakings there evolves understanding and an opportunity to resolve complex issues in a mutually acceptable manner. Equally important, a working relationship provides the opportunity to address potentially complex pricing issues as they arise and to develop procedures, guidelines and conventions which will ultimately reduce the work effort at the examination level and lead to expeditious resolution of these complex issues.

CANADA:

Tax Treaties: Concepts, Objectives and Types

By Pierre Gravelle*

Some years ago, at the 22nd Conference of the Canadian Tax Foundation, Mr. Alexander B. McKie, in discussing the objectives of tax treaties, said:

> The taxpayer hopes the treaty will prevent the double taxation of his income; the tax gatherer hopes the treaty will prevent tax evasion; and the politician just hopes.

As with all quotes which are worthy of repeating, this one contains humour but also provides a not completely inaccurate description of the objects of the exercise.

The domestic tax systems of the world are becoming ever more complex, and evidence for this is visible in the number of countries which have recognized the need for reform. The desire for simplicity fights a constant battle with the appeal of the tax system as a means of delivering social and economic policy. This complexity, along with an increase in the volume of international transactions and the sophistication of multinational corporations, has created a clear need to establish instruments which attempt to reconcile and preserve the integrity of these complex and different tax systems.

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Canada is presently in the midst of the implementation of a tax reform which is intended to improve the fairness of the income tax system. The last major tax reform took place in 1971 and introduced many new concepts into the Income Tax Act and Regulations. One of these new elements was designed to ensure that foreign operations of a Canadian resident bear an appropriate tax burden. An integral part of that policy was the development of a treaty network. In the last 16 years, Canada has revised, or put in place, over 40 tax treaties.

PROMOTING ECONOMIC DEVELOPMENT

There are several ways in which tax treaties can impact on the economic development of a country. A treaty can provide stability, it can reduce compliance problems and it can reduce double taxation. Treaties between developed and developing countries can also serve to ensure that tax relief given in a developing

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* Deputy Minister, Revenue Canada, Taxation.

country to encourage foreign investment is not negated by the tax system in the treaty partner's country. As can be seen by these objectives, it has been recognized, and it is important to accept, that treaties serve to assist economic development by reducing its impediments.

Stability

A treaty provides some insurance to a potential investor in a country's economy that the impact of tax policy changes in that country will be minimized because the treaty sets limits on the rates of taxation of certain types of income and restricts the right to tax in certain circumstances. A formalized relationship is also established between the 2 tax administrations which can be used to resolve difficulties arising for taxpayers within the scope of the treaty.

Compliance

A more basic but still very important benefit of a tax treaty is its direct effect on the burden of compliance that a taxpayer encounters when he enters into operations in another country. The treaty can eliminate the need to file returns in the country of the source of income when operations there are minimal. The requirement for source deductions can be eliminated where a treaty provides a tax exemption. These are important encouragements for an investor who has seen an opportunity for expansion into another country and is assessing all of the pros and cons of proceeding.

Elimination of double taxation

While the elimination of double taxation is an objective which is usually stated in its title, in reality a treaty is more correctly described as an instrument which refines and improves existing provisions in the domestic legislation which are designed to accomplish that end, i.e. most countries have in their own tax law provisions which are designed to alleviate double taxation and the treaty serves to assist in that process and better integrate it with the corresponding provisions in the treaty partner's law.

Countries can utilize 3 approaches when incorporating rules into their tax legislation for the elimination of double taxation. They can allow a deduction of taxes paid to foreign countries in computing taxable income or in determining tax payable or they can provide exemptions for foreign-source income. To some extent, the Canadian system uses all 3 methods but, primarily, taxpayers are allowed to deduct taxes paid to another country on income earned therein from their tax otherwise payable to Canada in respect of that income. Some countries exempt all or some types of foreign-source income and others only allow the amount of foreign-source income to be reduced by the tax paid.

It is apparent from this brief description of these methods that the question of the source of income is important in all cases and it is here that tax treaties contribute the most to their objective of reducing double taxation.

To illustrate this point, I will describe how Canada's tax treaty network attempts to provide rules for agreeing with its treaty partners on the determination of the source for various types of income. There are 3 basic types of income dealt with in tax treaties:
(1) income from a business;
(2) income from employment; and
(3) investment income.

Typically, agreements are concluded which provide that a resident of one country will only be taxed by the other country on his income from a business to the extent that income is attributable to a fixed place of business in the latter country. Business income is exempt unless it is earned through a place of business that has some degree of permanence. Income from employment must relate to a fixed place of business of the employer in a country in order to be taxed by that country and investment income must generally be received from the country in order for it to have a right to tax.

Having agreed with the treaty partner on these rules for the rights to tax, there is then added one more rule which states that the source of a particular item of income is the country which has the first right to tax under the treaty.

Thus our treaties add to the rules in our domestic tax law in eliminating double taxation. They provide some exemptions from foreign tax laws where the operations in that country are minimal and they also provide more specific rules for the determination of source which is an integral part of our foreign tax credit system.

One last element of tax treaties which aids in the elimination of double taxation deserves mention. Each treaty, in addition to its other rules which attempt to contemplate and deal with as many real situations as possible, contains a mutual agreement procedure which provides that the 2 tax administrations can engage in negotiations to resolve problems of double taxation not specifically dealt with in the treaty. This procedure could be used, for example, to agree on the meaning of a term in the treaty or whether a taxpayer did operate through a fixed place of business in a particular fact situation. However, in our experience, most of the cases which need the assistance of the mutual agreement procedure involve transfer pricing problems where the price charged by a parent company to its subsidiary in another country is in dispute. As an indicator of the potential significance of this latter process, we find that, at any given time, there are about 70 such cases in our inventory with the majority involving Canada–United States transactions.

PREVENTION OF TAX EVASION

A primary interest for the tax gatherer in the process of concluding an income tax treaty is the provision

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contained therein which sanctions the exchange of taxpayer information between the 2 administrations. Each of our treaties contains such a provision and it is this part of the treaty which is intended to enable the 2 parties to combat tax evasion. With the ever-increasing complexity of domestic tax laws and sophistication of the tax evader, it has become obvious that the most useful tool of the tax administrator is information.

The treaty article seeks to make available, to one party to an agreement, taxpayer information which is available to his treaty partner pursuant to the latter's own legislation. In so doing, measures are taken to safeguard the confidentiality of the information by stipulating that access shall be governed by the legislation in the country being asked to provide it and that all information exchanged shall be treated as secret. Only officials involved in the enforcement of the taxes covered by the treaty are allowed access to such information.

Specific requests

These exchanges of information can take many forms, the most common of which are specific requests. This occurs where one party to an agreement has reason to believe or suspects that one of its residents is somehow suppressing income and that the treaty partner may have some useful information in this regard. An example of such a situation would be where a taxpayer corporation has recorded purchases of inventory or capital assets at inflated prices using falsified invoices from a vendor in another country. It is a simple matter, when a treaty exists between these 2 countries, to request the other tax administration to use its domestic law to determine if the figures in question are correct. In a typical year, we process some 200 such specific requests for information to and from our treaty partners.

Industry studies

Another area where the exchange of information provisions in our treaties are very useful, and becoming more so every year, is in the area of specific industries. We find it beneficial to meet with our counterparts in a treaty country to exchange experiences with respect to a particular industry. Typically, this will involve an industry which has complicated international business dealings and one of the parties to an agreement can greatly benefit from information which has been gathered by the other party after a long and arduous process. Occasionally, it has been found that the efforts of one tax administration to uncover and prosecute offenders who have been involved in a tax evasion scheme which crosses international borders will lead the players in the scheme to seek another country for a new market. An exchange of information on a timely basis in such circumstances has obvious benefits.

Spontaneous and routine exchanges

Not all information exchanges fit into the above categories and this last example above can lead to what we refer to as a spontaneous information exchange, i.e. one country can make an unsolicited overture to its treaty partner where it has information useful to the other. In addition to this situation, there are routine exchanges where, for example, we deliver forms itemizing interest payments made to non-residents to a treaty partner who then uses those forms to cross-check the tax returns filed by its residents whose names appear on the forms.

Domestic legislation

The apparent benefits that are derived by these and other methods of exchanging information with treaty partners makes us all the more conscious of the problems that arise in dealing with tax evasion where important elements of the transactions take place in non-treaty countries. In an effort to deal with this problem, our Minister of Finance is implementing legislation modelled on that existing in the United States. This legislation requires the Canadian taxpayer to produce books and records located in a foreign jurisdiction to substantiate his position where it is reasonable to do so. In the event that the taxpayer does not comply with such an order, the assessment will be made on the basis of the best available information and the taxpayer will not be allowed to produce the books and records in question as evidence at a subsequent time.

As our experience grows in the area of international tax we become more convinced of the necessity to develop our information networks and the tax treaties provide a basic instrument for facilitating this process.

TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Canada has 45 tax treaties in force and over 20 of them are with developing countries. The above-described benefits for investors and the Canadian tax administration were relevant in the desire to negotiate these treaties.

Higher taxation at source

Developing countries, because of their dependence on foreign investment as a revenue source, have certain concerns when it comes to the negotiation of a tax treaty which are not as relevant in a negotiation between developed countries. There is a desire on the part of policymakers in developing countries to maintain a higher level of taxation on income derived by non-residents. In our experience, this has lead to variations in our treaties, as they compare to those we have with developed countries, in the limits on withholding rates applicable to investment income and the level of operations a business must have in a country before its business operations are considered to be taxable there.

With respect to investment income, we normally provide in treaties for a 10% or 15% limit on the taxation of dividends in the source country. This is considerably

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lower than the rate usually imposed by a developing country and it causes some concern about revenue losses. While we are prepared to accept higher rates, it is our position that this concern of the impact of revenues of a lower rate has to be balanced against the increased level of revenue that will come from Canadian investors with the implementation of a tax treaty. Similar compromises take place with respect to interest and royalties.

With respect to business profits, we also find that the Canadian Model Convention, which we use in negotiations with developed countries, is somewhat modified for developing countries. A broader definition of fixed place of business or permanent establishment is utilized in these cases to increase the scope for taxation in the source country. Thus, for example, the furnishing of services for a specified period of time may constitute enough of a connection to allow the source country to tax under such a treaty where it would not in a treaty between 2 developed countries.

Tax sparing

The second type of variation from the Canadian Model which appears in our treaties with developing countries is commonly referred to as tax sparing. This is a provision which seeks to enshrine and protect in the treaty special tax incentives which are offered by developing countries to foreign investors. If, for example, a developing country wishes to attract a certain type of investor by offering a lower than normal rate of tax on his income, the benefit could be negated by the fact that the investor's country of residence taxes that same income based on his residence status. A tax sparing provision stipulates that the developed country will assume that the investor has paid the tax to the developing country at the normally high rate and thus allow him a credit against the tax he would otherwise pay to his residence country. In this way, the relief granted is protected and the investor's incentive remains in place.

OECD MODEL CONVENTION

The Draft Model Double Taxation Convention published in 1963 by the Organization for Economic Co-operation and Development (OECD) was last revised in 1977 and forms the basis for almost all tax treaty negotiations in the world today. This consensus document produced by the OECD member countries and, perhaps more importantly, its extensive commentary, contribute to the standardization of bilateral tax treaties and their interpretation.

The 1977 OECD Model consists of the following 7 sections:

(1) *Scope of the convention*
The taxes to which the convention applies and its territorial scope are identified here.

(2) *Definitions*
This section defines such things as what constitutes a resident and place of business for the purposes of the treaty.

(3) *Taxation of income*
The various types of income are identified here and the rights to tax are assigned first on a source basis and then on residence.

(4) *Taxation of capital*
For those countries which impose taxes on capital this provision performs a similar function as the above section.

(5) *Methods for elimination of double taxation*
This section includes the provisions which grant foreign tax credits.

(6) *Special provisions*
The provisions for information exchanges and mutual agreement on solutions to the other double taxation problems are contained in this section.

(7) *Final provisions*
This section provides the rules for how the treaty will enter into force and how it can be terminated.

UNITED NATIONS MODEL CONVENTION

In 1967, the United Nations noted the desirability of encouraging the conclusion of bilateral tax treaties between developed and developing countries and established a committee to produce a model treaty to be utilized in such negotiations. The final text of this convention was approved and released in December of 1979. This Model Convention has the same structure as the OECD Model and, for the most part, contains the same provisions. It does, however, differ from the OECD Model:

(1) the description of fixed place of business is broader to allow taxation in the source country in more circumstances;
(2) there is more flexibility to allow higher withholding rates on investment income;
(3) the U.N. Model contemplates the use of tax sparing to ensure the effectiveness of tax relief granted by a developing country.

SUMMARY

Tax treaties are an important element in the framework within which a taxpayer with interests and operations in several different countries must function. In assessing the implications on proposed actions of the tax systems in the foreign country and the country of residence, the tax treaty will have an impact on the decision of whether or not to proceed. The treaty will ensure that the tax environment the taxpayer has decided to enter will remain stable and that some of its compliance burden will not apply. It will also provide a means of enhancing the chances of not being subjected to double taxation.

For the tax administrator, the treaty provides a connection to a counterpart in the other country which facilitates greater co-operation. This encourages the sharing of experiences and information. The treaty is

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particularly useful as an instrument for the exchange of taxpayer information, and it is this process which the tax administrator looks to when seeking to reduce tax evasion. Information can be specifically requested or it can be given spontaneously or automatically. Lastly, the examination of the operations of a multinational entity can be enhanced by a co-operative simultaneous audit undertaken by the 2 administrations.

Tax treaties also play a more purely policy role for the treaty partners. This is apparent in the special provisions that exist in agreements between developed and developing countries designed to protect the revenue source from foreign investment which is important to developing countries.

This article attempts to explain the objectives and benefits of tax treaties, and to show how they are implemented through the various provisions developed in the OECD and United Nations treaty models. I hope it provides an adequate introduction to the topic and stimulates further interest.

TRINIDAD AND TOBAGO:

Cooperative Approaches among Tax Administrations to Prevent and Counteract International Tax Evasion and Avoidance

By Randolph Kong

Mr. Kong is chairman of the Board of Inland Revenue, Trinidad and Tobago.

Trinidad and Tobago (hereafter "Trinidad") is a developing country with a population of 1.2 million people. The experience of Trinidad in relation to the exchange of information between countries is largely based on bilateral double taxation conventions with developed countries. Trinidad has not concluded double taxation conventions with developing countries, other than a multilateral treaty between the more developed countries (MDCs) and the less developed countries (LDCs) of the Caribbean Community (CARICOM). Trinidad has existing treaties with Canada (1966), Denmark (1969), Norway (1969), Italy (1971), the United States (1971), Switzerland (1973), the LDCs of CARICOM (1974), the Federal Republic of Germany (1976), the United Kingdom (1983), Sweden (1984) and France (1987).[1] Trinidad is presently conducting negotiations with Brazil and Jamaica.

EXCHANGE OF INFORMATION UNDER TAX TREATIES

The Fiscal Committee of the OECD, which is comprised of 20 developed countries[2], prepared the Model Draft Double Taxation Convention which was published in 1963 (hereafter "1963 OECD Model"). A revised text was prepared in 1977 (hereafter "1977 OECD Model") which took into account the experience gained by member countries either in negotiating new conventions or in the practical operation of existing treaties. In 1968 the Secretary General of the United Nations, in accordance with Resolution 1273 of 4 August 1967, set up the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries. The group was composed of tax officials and experts from both developed and developing countries. The work of the Ad Hoc Group culminated in the United Nations Model Convention published in 1980 (hereafter "U.N. Model").

With respect to exchange of information clauses, there are few differences in substance between the various Model Conventions. The 1977 OECD Model specifically provides that information received by a Contracting State may be disclosed in public court proceedings or in judicial decisions. The Commentary to this provision suggests that if either or both Contracting States object to disclosure of information in this manner or object to the information being used for other purposes because it is not the normal procedure under domestic law, a provision to this effect should be expressly included in the treaty. Trinidad has no difficulty with this provision and has included it in its later treaties. Court proceedings are held in secret in Trinidad, except in criminal cases (such as fraud). However, once an appeal is taken from a decision of the tax court, the matter becomes public.

The treaties negotiated by Trinidad all include an exchange of information provision. In earlier treaties, the provision was based on Art. 26 of the 1963 OECD Model and the later treaties on the 1977 OECD Model, with one of the amendments introduced by the U.N. Model which reads as follows:

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1. Some of these treaties are being re-negotiated.
2. The committee is comprised primarily of European countries but includes the United States and Canada.

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> The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made including, where appropriate, exchanges of information regarding tax avoidance.

The U.N. Model introduced the phrase "and in particular for the prevention of fraud or evasion of such taxes". This provision was not intended to affect the interpretation of the OECD text of Art. 26 but merely to emphasize that exchange of information under Art. 26 of the OECD Model did cover the prevention of fraud and tax evasion.[3]

For purposes of this presentation, I shall quote the exchange of information provision (Art. 27) in Trinidad's treaty with France which became effective in 1987:

> 1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is not contrary to this Convention. The exchange of information is not restricted by Art. 1 (Personal scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic law of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchange of information regarding tax avoidance.
> 2. In no case shall the provisions of para. 1 be construed so as to impose on a Contracting State the obligation:
> (a) to carry out administrative measures at variance with the law and administrative practice of that or of the other Contracting State;
> (b) to supply information which is not obtainable under the law or in the normal course of the administration of that or of the other Contracting State;
> (c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

Information under this article may be exchanged in 3 ways:

(1) *automatically or routinely:* for example, when information about one or more categories of income arising in one Contracting State and received in the other State is transmitted systematically to the other State;
(2) *on request, with a particular case in mind:* it is understood that the regular sources of information available under internal procedures should be relied on before a request for information is made to the other State; and
(3) *spontaneously:* for example, during the course of an investigation a State acquires information which it supposes to be of interest to the other State.

Automatic or routine exchanges

Activity under this procedure takes place in direct relation to the economic activity between Trinidad and its treaty partners. Thus there is a greater flow of information between Trinidad and the United States, the United Kingdom and Canada than with other treaty partners. Information supplied under the category of automatic or routine exchanges relates to interest, rents, royalties, management charges, premiums, commissions, fees and annuities which are supplied as duplicates of the Withholding Tax Form (W.T. Form C5) and dividends and other distributions which are supplied as duplicates of the Withholding Tax Supplementary Form 2. This information is sent to the United States, the United Kingdom and Canada in the early part of the current year in respect of income of the preceding year; it identifies the income in the treaty country, the type and amount of income and the amount of Trinidad tax withheld. Trinidad receives comparable information from the United States in the form of computer print-outs based on Form OECD. The information received is useful in assessment of Trinidad residents because there is a tendency for such persons to exclude income arising out of Trinidad.

On request exchanges

The Commentary to the U.N. Model suggests that the competent authorities should develop rules for the transmission of specific requests by the receiving country and the response by the transmitting country. The rules should cover:

(a) the specificity of detail required in the request, the form of the request and the language of both the request and the reply;
(b) the extent to which the receiving country must pursue or exhaust its own administrative procedures and possibilities before making a specific request. Presumably, the receiving country should make a bona fide effort to obtain the information itself before resorting to the specific request procedure; and
(c) the conditions affecting the nature and extent of the response by the transmitting country. This aspect should include the ability of the transmitting country to provide documentary material when the requesting country needs material in that form for use in judicial (or other) proceedings, including appropriate authentication of the documents.

Trinidad exchanges information with its treaty partners based on specific requests. These exchanges

3. It is interesting to note that our treaty with the United States includes such a provision in the exchange of information article although the treaty became effective in 1971.

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also take place principally between Trinidad and the United States, the United Kingdom and Canada. The requests concern particular taxpayers and the questions are usually specific in relation to items such as residence, sources of income, particular transactions, ownership of property and bank information. Sometimes copies of filed returns are also requested and supplied. These requests for information from Trinidad are also useful to the tax administration because the requests provide information which would not normally be available.

Trinidad has experienced a problem where, for example, Country A requests information from Trinidad and in the request provides what information it has and indicates that Country A has information on the same matter from Countries B and C but is unable to disclose that information because of secrecy provisions. Notwithstanding that Trinidad may also have treaties with Countries B and C, Trinidad must still make a specific request to those countries. This dilemma could be eliminated by providing for automatic joint consultation where all the countries are directly linked by bilateral treaties.

Some developed countries have devised procedures and treaty provisions which are sufficiently flexible to enable them to extend their cooperation to multi-country consultation and exchange arrangements. They even carry out joint audits of multinational companies and meet on a regular basis. An extension of these procedures to include developing countries would assist developing countries in the difficult task of auditing and assessing large multinational companies. Of course such an extension depends on cost and the technical ability of the tax administration of the developing country.

It seems clear that adequate implementation of exchange of information provisions requires a universal effort among tax administrations to obtain and develop (under national laws) a capacity for securing information and a competence in utilizing information that is appropriate to a high level of efficient and equitable tax administration.

Spontaneous exchanges

It would appear that it is entirely within the discretion of a country whether to transmit information obtained during the course of its own activities which it believes is important to the treaty partner. Trinidad has received information of this nature which was particularly helpful in that it identified the use of tax havens by a certain multinational corporation in order to evade taxes. Information of this nature is more readily available to developed countries who have sophisticated systems, laws and technology to discover methods and practices employed to evade and avoid taxes. To the extent developed countries are prepared to share this information with developing countries, the benefits to be derived from a double taxation agreement with a developed country become more apparent.

EXCHANGES OF INFORMATION WITHOUT TAX TREATIES

It is interesting to note that the Eighth Report of the Group of Experts (published in 1980) identified CIAT as one of the first organizations to put forward the idea of establishing an international forum to deal with direct taxation problems and to create some degree of coordination and cooperation. Indeed this topic was discussed at the 10th General Assembly held in San Salvador from 16-21 May 1976.

During that Assembly, the United States presented a case study which identified the difficulties inherent in seeking to develop a network of bilateral or multilateral treaties dealing only with administrative matters, i.e. exchange of information and other related provisions for consultation and mutual agreement by competent authorities. The paper indicated that a simple exchange of information treaty would not contain the protective barrier placed around the taxpayer in the context of a comprehensive tax treaty. Examples revealed the possibilities of discrimination against nationals of one of the countries to the agreement and the lack of reciprocity because of the laws of one of the countries.

The questions concerning the possible conclusion of a multilateral agreement on the exchange of information was also discussed by the Group of Experts in its Seventh Report (published in 1978). They concluded as follows:

> While the idea of working out a multilateral agreement on the exchange of information was considered by most members to be premature, there was a general consensus on the usefulness of a forum for sharing technical experiences in the field of tax administration. It was recognized that the establishment of such a forum would not require a formal multilateral agreement. Therefore, the United Nations Secretariat, in close cooperation with competent inter-governmental organizations and tax administrations in both developed and developing countries, should consider the possibility of undertaking preparatory work for such a project.

However, despite the difficulties and lack of optimism with respect to the possibility of the development of multinational exchange of information agreements in the near future, it should be noted that the United States has been able to make what could be considered as a break-through with the Caribbean Basin Exchange of Information Agreement. Several Caribbean countries have entered into this type of agreement with the United States notwithstanding the fact that double taxation conventions already exist between these countries and the United States. Each of these agreements is bilateral in nature; however, considering that the agreements are similar in form and must satisfy the requirements of the 1983 Caribbean Basin Economic Recovery Act, the countries involved are, in reality, one step away from a multinational agreement. This recent development could be considered as an advance towards multinational agreements on the exchange of information.

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CIAT'S ROLE

Information which is regarded as secret under domestic laws of most countries must relate to a particular taxpayer. There must be a considerable amount of information which could be made available to member countries of CIAT that is not regarded as secret by those countries. The Commentary to the U.N. Model referred to certain types of information which need not be confined to requests regarding particular taxpayers, such as information on particular types of transactions or activities. For example:

(a) information on price, cost, commission or other such patterns in the transmitting country necessary to enable the tax administration of the receiving country either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under or over-invoicing of exported or imported goods, the payment of commissions on international transactions and the like;
(b) information on the typical methods by which particular transactions or activities are customarily conducted in the transmitting country;
(c) information as to whether a particular type of activity is being carried on in the transmitting country which may have effects on taxpayers or tax liabilities in the receiving country.

Information which may not be regarded as secret may also extend to requests for information regarding certain economic relationships between countries which may be useful to a country as a check on the effectiveness of its tax administration activities. For example:

(a) the volume of exports from the transmitting country to the receiving country;
(b) the volume of imports into the transmitting country from the receiving country;
(c) names of banks dealing in the transmitting country with branches, subsidiaries, etc. of residents of the receiving country.

It is in this area that CIAT can play an immediate role in collecting and collating information that would be of assistance to its members in counteracting international tax evasion and avoidance. It is also possible that consideration could be given to having a multilateral exchange of information convention between CIAT member countries. CIAT could also develop a draft exchange of information agreement broad enough to be acceptable to the governments of CIAT member countries.

What is being suggested is not new. Indeed a CIAT Work Group on Multinationals submitted a report (dated 19 March 1976) which was presented to the El Salvador Assembly (10th General Assembly) and which recommended, inter alia:

> That CIAT establish a program to collect and compile information on the following:
> (1) Areas that would be of interest or of no interest to member countries with regard to entering tax treaties;
> (2) Legal provisions existing in each country that represent obstacles to exchange of information agreements and what possibilities exist for overcoming those obstacles.

Additionally, the Eighth Report of the Group of Experts published in 1980 also contained suggestions for action by a forum on international tax issues.[4]

CONCLUSION

The ideas on the exchange of information discussed at the El Salvador assembly in 1976 may have been premature or ahead of their time. Since that time, however, there has been a great deal of discussion and development in the field. The Group of Experts have, to a large extent, adopted the ideas espoused by CIAT. The U.N. Model Convention has also dealt with the concern of developing countries and has removed or minimized apprehensions of some developing countries that double taxation conventions may not be in their interest.

It is left to CIAT to implement the ideas and recommendations discussed many years ago. CIAT could

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4. The Report suggested:
(a) A survey of devices used in developed and developing countries to evade or avoid taxes with regard to transactions occurring in an international context; among the matters to be considered in such a survey would be the following:
(i) Evasion or avoidance in or through international transactions by residents of the various countries;
(ii) Evasion or avoidance in or through international transactions by non-residents deriving income from sources within the various countries;
(iii) The evasion or avoidance problems particularly related to transfer pricing in international transactions;
(iv) The evasion or avoidance problems particularly related to the use of tax havens;
(v) The evasion or avoidance problems particularly related to the improper utilization by residents of one country of tax treaties between 2 other countries, and other abuses of tax treaties.
(b) A study of possible solutions to the matters of tax evasion and avoidance listed under (a) above; among the matters to be considered in such a study would be the following:
(i) A survey of the procedures and methods now being used in various countries to combat such tax evasion and avoidance;
(ii) An assessment of the need for changes in national tax laws, bilateral treaties or other national or international rules and procedures to assist in combating such tax evasion and avoidance;
(iii) A survey of situations in which exchanges of information on tax matters would be helpful in combating such tax evasion and avoidance, including an assessment of the effectiveness of existing bilateral and other arrangements concerning such exchange.
(c) A study of the feasibility of standardizing concepts, principles and criteria of interpretation in international taxation as a first step towards the possible drafting of an international convention on exchange of information for the prevention of tax evasion and avoidance.
(d) A survey of existing bilateral and multilateral arrangements concerning mutual administrative assistance for the collection of taxes, a critical assessment of their effectiveness and an evaluation of the feasibility of concluding such arrangements on a bilateral basis between developed and developing countries or on a multilateral basis with the participation of developing countries.
(e) The impact of direct taxation on international trade and transfer of technology.
(f) A study of the feasibility of establishing a direct tax cooperation council.

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conceivably form its own group of experts drawn from, for example, the United States, Canada, the more developed countries of Latin America and the less developed countries of Latin America and the Caribbean.

Each member country could agree to supply CIAT with certain information of a general nature on the understanding that the information could be made available to any other member country.

If member countries are interested in entering either a bilateral or multinational agreement, CIAT could be used as a forum for discussions. Should CIAT decide to form its own group of experts, it can assist in formulating the types and nature of information to be exchanged. A standardized form could be considered. A model exchange of information agreement could be formulated which the governments of member countries may wish to consider. The possibilities for future development in the cooperative approaches among the tax administrations for preventing and counteracting international tax evasion and avoidance are exciting and the time for implementing the futuristic ideas of CIAT espoused at the El Salvador Assembly has arrived.

Conference Diary

NOVEMBER 1988

Het Belonen van Topfunctionarissen. Amsterdam, 21 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Hong Kong Seminar. Hong Kong, 21-22 November (English):
Elizabeth Walters, ITPA, Membership and Conference Liaison Office, 33A Warwick Square, London SW1V 2AQ, United Kingdom.

Het Verwerken van Belastingen in de Jaarrekening. Maarssen, 23 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

Single European Market: 1992; ATI Brussels International Tax Round Table. Brussels, 23 November (English):
The American Tax Institute in Europe, 8/10 Bulstrode Street, London W1M 5FT, United Kingdom.

Actueel Invorderingsrecht. Rotterdam, 23 and 30 November (Dutch):
PAO Belastingwetenschap, Postbus 533, 2300 AM Leiden, The Netherlands.

Pensioen-Actualiteiten. Amsterdam, 24 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands.

EEC VAT Law. Brussels, 24-25 November (English):
European Study Conferences Limited, Douglas House, Queen's Square, Corby, Northants NN17 1PL, United Kingdom.

First East European Investment Seminar. Budapest, 24-27 November 1988 (English, German, Hungarian):
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Recent Changes in Brazil

By Luiz Fernando Teixeira Pinto

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THE NEW BRAZILIAN CONSTITUTION[1]

On 2 September 1988, the National Constituent Assembly finished voting on the new Brazilian Constitution, approximately 19 months after the 569-member Assembly convened.[2] The culmination of all these months of work was a 250-article text which will introduce substantial changes in the political and economic scenario of the country.

Departing from the Brazilian tradition of having constituent assemblies preparing an initial draft, the new Constitution results from the work of 36 sub-committees whose drafts were put together by committees. The various drafts were consolidated in a first draft taken to the floor of the Assembly earlier this year and was submitted to 2 rounds of votes. In addition to the work of representatives, about 12,000 proposals generated by unions, organized groups, lobbies and various other organizations were finally voted on.

In certain aspects, the Constitution is an entirely new document. The bill of rights, with which the Constitution begins, has been unanimously acclaimed as the most liberal the country has ever had or could have wished for. A full range of civil rights and liberties are included in the text, ranging from absolute freedom of speech to the right to demand from a court of law a ruling on constitutional provisions which have been left unregulated by the legislators. The Constitution also provides for the direct election of the President of the Republic, a right which has been denied to Brazilians since 1960 when the last presidential election took place. However, much of the criticism of the new Constitution has been targeted at the economic provisions. In a world where even Eastern European countries have decided to open up their economies and markets to foreign investment and some sort of free enterprise, the new Brazilian Constitution has laid down principles that guarantee companies controlled by Brazilian citizens preferences over other companies located in Brazil. The possibility of limiting certain sectors of the domestic market to domestic investment and a 12% limit on "real interest" (a term yet to be defined by law) are examples of provisions which have led the business community to voice strong criticism of parts of the text.

SPECIAL EXPORT ZONES

For the last 2 years, heated debates have taken place regarding the new economic model Brazil is to adopt. Underlying the debates is the fact that the import substitution model, adopted between the 1940s and the 1980s, has been exhausted and a new model must be found. Notwithstanding the differences in size and diversification of the economy between Brazil and the Pacific Basin countries, Asian countries have been selected by some as the model to be observed. The idea of creating special export zones (such as those in Taiwan and Korea) where certain facilities are granted to new foreign enterprises has been at the center of the debates. While opening the Brazilian economy to foreign competition is defended by most interest groups, the degree to which the economy should be opened varies considerably. Competition between companies located in the free trade zones and other companies has been considered unfair by most of the business community.

Decree-Law 2,452 of 29 July 1988 creates the so-called Export Processing Zones (ZPE). ZPEs basically consist of free trade areas which are isolated from the rest of Brazil by trade and industrial barriers. It is anticipated that foreign industries will be attracted to such areas by the tax incentives and foreign exchange facilities offered in the Decree. Art. 1 states that the purpose of the ZPEs is to enhance the Brazilian balance of payments, reduce regional economic imbalances and promote the diffusion of technology and economic growth.

The location of each ZPE will depend on the interest of the states and municipalities. Either the states or the municipalities may submit a proposal to the National Council of ZPEs stating that the state or municipality will assume all of the costs of the works and expropriations required for the ZPE and that it will provide proof of available funds to bear these expenses. Decree-Law 2,452 expressly prohibits the Federal administration from assuming, either directly or indirectly, the burden of these costs. The Council will review the proposal taking into account certain criteria (inter alia, access to ports and airports and the availability of infrastructure).

A company interested in establishing itself in a ZPE must also submit a proposal evidencing that the operations will be beneficial to Brazilian exports. If approved, the company will be required to execute a commitment to open a foreign currency denominated account in Brazil, spend (in Brazil) a minimum amount of money for installation costs and agree not to produce goods subject to the export quota system on the date of commitment.

In return, a company established in a ZPE will be exempt from the following taxes and duties: (i) import

1. An article discussing the tax implications of the new Brazilian Constitution will appear in a forthcoming issue of the *Bulletin*.
2. Promulgation of the new Constitution took place on 5 October 1988 when the Assembly met for the last time as a Constituent Assembly.

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duty; (ii) tax on manufactured products; (iii) contribution to the Social Development Fund (FINSOCIAL); (iv) additional charge to the Freight for the Renovation of the Merchant Navy; (v) tax on credit, exchange and insurance transactions; (vi) tax on transactions with securities; and (vii) income tax on any remittances and payments abroad.

Such companies will be subject to income tax on the profits earned in their ZPE operations. However, the companies may import any goods, equipment, raw materials and parts necessary to their manufacturing activities. No license will be required for any such imports, nor will a license be required for exports from ZPE's with the exception of licenses required under sanitary, environmental protection and national security regulations. There will be no control on foreign exchange transactions to and from a company located in a ZPE.

In order to protect companies located elsewhere in the country, sales from companies located in a ZPE to companies located in other areas will be subject to a 10% tax, called the "denominating tax". Any sale from a ZPE to other areas of Brazil will be treated as an import; conversely any sale to a ZPE will be treated as an export transaction.

SALE OF FUEL TO FOREIGN SHIPS

DECAM Communique 1,110 was issued on 3 August 1988 by the Department of Foreign Exchange of the Central Bank of Brazil.[3] The Decree provides that the supply of fuel to foreign ships is subject to the export license system and the sale to a bank authorized to deal in foreign exchange of the foreign currency received in payment for the fuel supplied. The Decree also sets forth the rules for settlement of the sale of the foreign currency by fuel suppliers.

TAX COLLECTION PERIOD

Struggling with a federal public deficit of 4% of the GNP, the federal administration is searching for new ideas to help reduce the deficit. Decree-Law 2,450 of 29 July 1988 provides that, as from 1 August 1988, the period for determination and collection of the tax on industrialized products shall be 15 days. Previously the period was 30 days, which gave companies an advantage in that the tax amount could be invested during this period of time.

3. The Central Bank has the power to regulate foreign exchange transactions in Brazil.

COSTA RICA:

Income Tax Reform:

Assessment of the Income Tax on Employees for the Tax Period 1988 and Other Relevant Measures

By M.A.Gª Caballero

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General information

The new Income Tax Reform Act[1] applies as of 1 June 1988, at which date the former income tax legislation[2] was repealed. Consequently, as the Costa Rican tax period 1988 runs from 1 October 1987 through 31 September 1988, the former income tax legislation[3] applies with respect to income accrued during the first 8 months, i.e. 1 October 1987 through 31 May 1988; the new provisions apply with respect to income accrued during the other 4 months, i.e. 1 June through 30 September 1988. The former income tax legislation required all resident taxpayers to assess the tax on their annual income. Under the new income tax provisions, employment income earners are no longer required to file an income tax return for the year, but are instead taxed under a simplified tax which is withheld from their monthly gross salary/wages by the employer/payor.

Capital gains derived by resident individuals

Capital gains realized by residents from the transfer of movable or immovable property are excluded from gross (taxable) income provided the individual is not conducting a business.

Procedure for assessment of income tax by resident individuals for the period 1988

Under instructions provided by the General Directorate of Direct Taxation, resident employees are required to make 2 different tax assessments, as follows:

1. Law 7,092 of 21 April 1988.
2. Law 837 of 20 December 1946, as amended.
3. Implemented by Decree 18,130-H/88 which adjusted the income tax table and personal credit scheme.

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(1) The first assessment, which comprises the amount of income earned in the first short tax period 1 October 1987 through 31 May 1988 is to be made in accordance with the former legislation. The tax rate table to be applied on such 8-month income and the pertinent personal credits are established by Decree 18,130-H/88. As to the tax credits[4], the appropriate amount is calculated dividing the amount of each credit by 12 (months) and multiplying by 8 (months). The tax rate table to be used in this first assessment is as in Table I:

Table I

Annual taxable income (in ₡)	Tax liability (in ₡)	Rest of taxable income up to the next (in ₡)	Marginal rate on the excess (in %)
—	—	160,000	5
160,000	8,000	40,000	10
200,000	12,000	50,000	14
250,000	19,000	85,000	17
335,000	33,450	105,000	19
440,000	53,400	100,000	21
540,000	77,400	120,000	26
660,000	105,600	140,000	29
800,000	146,200	450,000	34
1,250,000	299,200	635,000	39
1,885,000	546,850	615,000	46
2,500,000	829,750	1,270,000	49
3,770,000	1,452,050	any higher amount	50

(2) The second assessment, which comprises the amount of income earned in the second short tax period 1 June through 30 September 1988, is to be made in accordance with the new legislation. The tax rate structure to be applied on such 4-month income and the pertinent personal tax credits established by Law 7,092 are as in Table II:

Table II

Monthly earnings (in ₡)	Tax liability (in ₡)	Rest of monthly earnings up to the next (in ₡)	Marginal rate on the excess (in %)
0	—	40,000	0
40,000	0	20,000	10
60,000	2,000	any higher amount	15

Remuneration in the form of allowances, bonuses, participating rights, etc. of executives, directors, supervisors and other officers of companies are subject to income tax at the final rate of 10% on the gross amount.

Under the new personal tax credit scheme, only 2 types of creditable amounts are available to these taxpayers, i.e. for each dependent child 150 ₡ monthly and for the dependent spouse 200 ₡ monthly (i.e. 150 × 4 + 200 × 4) for this second assessment purpose.

In making these assessments, taxpayers must use the ad hoc declaration form R-1 which must be filed with the tax authorities by 30 November 1988. As of 1 October 1988 the tax on employment income must be withheld monthly by the employer taking into account the new table and credit scheme under "2".

4. The tax credits are as follows:
(a) for the taxpayer: 19,000 colones;
(b) for a dependent spouse: 11,000 colones;
(c) per dependent child: 7,000 colones;
(d) per other qualifying dependent: 2,500 colones.

Taxation of income derived by self-employed individuals

Under the new income tax legislation, self-employed individuals who are resident of Costa Rica are subject to tax with respect to their annual taxable income and must self-assess the tax for the *entire* 1988 tax period in accordance with Table III:

Table III

Annual taxable income (in ₡)	Tax liability (in ₡)	Rest of taxable income up to the next (in ₡)	Marginal rate on the excess (in %)
0	—	200,000	0
200,000	0	100,000	10
300,000	10,000	200,000	15
500,000	40,000	500,000	20
1,000,000	140,000	any higher amount	25

The new tax credit scheme available to self-employed individuals consists of 1,800 ₡ for each dependent child and 2,400 ₡ for the dependent spouse.

Taxation of earnings derived by non-resident foreigners

Costa Rican-source gross earnings derived by non-resident foreigners are taxed at the final rates of either 15% (where the payment is in consideration for the rendering of any kind of independent services) or 10% (for employment income, pensions and remuneration paid in consideration of dependent services).

Other measures

Income Tax Reform Law 7,092 contains, inter alia, the following additional measures:

- the progressive corporate income tax rates are replaced by a 30% flat rate. Small enterprises are taxed at 10% if their gross receipts are not above 3,000,000 colones and at 20% if they exceed such amount but are not above 6,000,000 colones;
- the rates on income paid to non-residents are, as a rule, 15% for dividends (5% for dividends on shares listed on a stock exchange and purchased therein), 15% for interest (in some cases exempt), 25% for royalties and technical assistance fees and 30% for non-specified income.

However, the tax administration is empowered to grant a total exemption from the otherwise applicable Costa Rican final withholding tax where the non-resident recipient can prove to the satisfaction of the tax authorities that such Costa Rican-source income is effectively taxed in his country of residence. If the country of residence grants a credit for only a portion of the Costa Rican tax, the Costa Rican exemption will apply with respect to the excess of the credit.

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BANGLADESH:

Some Highlights of the 1988/89 Budget

By K.A. Gofran

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The National Budget of the People's Republic of Bangladesh for the fiscal year 1988/89 envisages revenue receipts of 5,569 crore[1] Tk. and expenditure of 5,250 crore Tk., leaving a surplus of 319 crore Tk. The Annual Development Programme (hereafter "ADP") or Capital Budget has been projected at 5,315 crore Tk. Finance Minister Mr. M.A. Munim, who presented the budget in Parliament, proposed fiscal measures which are likely to yield an additional revenue of 603.10 crore Tk. to partially finance the ADP. An additional sum of 65 crore Tk. will be borrowed from banks to close the gap for the development programme. According to the budgetary proposals, the Development Budget will be financed to the extent of 85.68% from foreign aid and 14.32% from domestic resources.

The 1988/89 ADP contains 2 priority areas, i.e. agriculture and education. 1,088 crore Tk. has been allocated for agriculture and water resources as opposed to 923 crore Tk. in the current year's revised programme.[2]

According to the budgetary documents, gross domestic product (GDP) growth in the fiscal year 1987/88 is likely to decline by 2.6%. This decline is due to the unfavourable agricultural conditions caused by flooding as well as the decline in the industrial sector because of reduced purchasing power in rural areas. The Economic Survey for 1987/88 reveals that agricultural output is estimated at 0.32% less than last year as against the projected increase of 3.7%. Growth in the industrial sector is less than 5.2% of the targeted 8.7%. These declines have affected the overall development of the country.

The Minister pointed out that from December 1987, an upward trend in the inflation rate became discernable because of increases in the price of non-food commodities. He called for caution in monetary policy and overall economic management. The money supply has increased by 9.86% since January 1988.[3] The trade deficit for the year is estimated at 5,469 crore Tk. (US$ 1,750 million). According to the Economic Survey, the export earnings of the country will be 3,750 crore Tk. (US$ 1,200 million) resulting in the above deficit trade balance.

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THE NEW FISCAL MEASURES

The Finance Minister emphasized the need for increased mobilization of domestic resources with a view to stimulating development activities. He pointed out that fiscal policy plays an important role in achieving socio-economic balance. The Minister spoke of the desirability of deriving increased revenue from locally-manufactured goods by levying excise duties and he referred to the increased role of direct taxes as a source of revenue.

Import duties

To rationalize import duties on goods used for development activities and manufacturing industries, the Minister announced a reduced rate of duty on various steel raw materials.[4] Similarly, concessions have been announced for a number of imports in order to develop domestic science and technology.

Excise duties

Excise duty has been imposed on a number of consumer and household items, i.e. billets, aluminum fittings and fixtures, crockery and cutlery, sewing machines, creams and polishes and heat-resistant bricks. Excise duty is now levied, inter alia, on passenger boats, cargo vessels, barges, tankers and trawlers.

Income tax

Income tax is the principal source of revenue from direct taxes. A number of changes have been proposed in order to broaden the tax base, check tax evasion, utilize tax measures to promote investment, employment opportunities and production and to encourage exports. Some of the most significant changes relating to the income tax are as follows:

1. To stimulate investment in the private sector, it is proposed to continue to allow taxpayers other than companies to declare income of any amount by paying income tax at the rate of 20% under the head "income from other sources". If an assessee avails himself of this option, no questions will be asked about the return. If 90% of the amount declared is invested in specified industries within 2 years, the taxpayer only must pay 10%.

2. Under existing provisions, a tax clearance certificate is not required for the alienation of agricultural land. However, non-agricultural land situated in mu-

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1. 1 crore = 10,000,000.
2. This increased amount is designed to increase agricultural productivity so as to achieve autarky in food production by 1990.
3. The overall money supply increased by 1,367 crore Tk. raising the total amount to 15,231.88 crore Tk. During the same time period last year the money supply grew by 7.29%.
4. Import duty has, however, been imposed on crude soybean oil, buses and minibuses in "completely knocked down" condition.

nicipal areas is also being transferred on the basis of old records describing it as being located in agricultural areas. This practice deprives the Government of revenue from capital gains. Individuals living in rural areas are required to obtain tax clearance certificates to sell uncultivated land and homesteads. To eliminate these inequities, the law has been amended to the effect that land situated within a municipal area cannot be transferred without a tax clearance certificate and no certificate is required to transfer agricultural land situated outside municipal areas. Non-agricultural land, the value of which does not exceed 100,000 Tk., can also be transferred without a tax clearance certificate.

3. No tax clearance certificate is required to mortgage immovable property to any bank provided the value of the property does not exceed 100,000 Tk.

4. Under existing provisions, individual taxpayers are entitled to an investment allowance up to one third of total income; no maximum ceiling is imposed on this allowance. It is now proposed to restrict the allowance to one third of total income or 200,000 Tk. whichever is less.

5. The Income Tax Ordinance 1984 contained no provisions to charge and collect surcharges. Following the unprecedented floods of 1987, a surcharge was levied under the Relief and Rehabilitation Surcharge and Levy Ordinance 1987 and under the Relief and Rehabilitation Surcharge and Levy Ordinance 1988. The Income Tax Ordinance has now been amended to provide for a 10% surcharge for the assessment year 1988/89.

6. Under existing law, both the Controller of Capital Issues and the National Board of Revenue (NBR) are authorized to approve companies whose stock and shares qualify for investment allowances. This dual authority creates complications so an amendment has been made in the law relating to investments charging the NBR as the sole authority for granting such approval.

7. Currently, an exporter is entitled to relief at a fixed rate in respect of income tax attributable to profits derived from the export of goods from Bangladesh. This rebate is also available in respect of the sale of locally-manufactured machinery, equipment and other finished products within Bangladesh to any agency against its procurement programmed in foreign exchange. In order to further encourage exports, it is proposed to extend the rebate to the supply of domestic raw materials and other input against domestic back-to-back letters of credit to export-oriented industries within the meaning of "export sales".

8. Under present law, if the owner of assets makes a settlement of income arising from such assets for a period exceeding 6 years or for life and if the owner derives no benefit from the income, the income is not assessable in his hands until the settlement is revoked. This is considered a device to avoid tax by splitting income and it has been repealed by an amendment to the law.

9. The Income Tax Law now provides for deduction or collection of tax at source in respect of several classes of income or persons. However, the prevailing system is considered inadequate to meet the revenue needs of the Government so the scope of deductions and collection of tax has been expanded to broaden the overall tax base and ensure collection of revenue. Several provisions have been made:

(a) In addition to the Government, a local authority and a statutory corporation (including units of a corporation), a public limited company and a banking company must now deduct tax at source when paying contractors, suppliers or persons rendering services.
(b) The government, local authority, statutory corporation, public limited company and banking company (including cooperative banks and insurance companies) are now required to deduct tax at the maximum rate of 7½% in all cases where annual rents exceed 48,000 Tk. The tax is to be deducted at the time the rental payment is made.
(c) Advance collection of income tax at the rate of 6.25%[5] of the fees or services charged on account of exporting manpower is made from the exporters of manpower.[6]
(d) Collection of tax at source on travel agency commissions is made at the rate of 5%.
(e) A 5% tax at source is deducted on shipping agency commissions.
(f) A 3% tax at source is collected on the sale price of goods or property sold by public auction.[7]
(g) Producers of films must deduct a 5% tax[8] at source on the remuneration paid to film actors and actresses if the remuneration exceeds 36,000 Tk. annually.

10. The initial capital allowance in self-assessment cases[9] has been raised from 150,000 Tk. to 200,000 Tk. in normal cases and to 300,000 Tk. if the investment is made in small or cottage industries. The increased allowance is designed to promote economic activity. However, to prevent abuse of the facility, new assessees engaged in a business or profession must file a bank certificate along with the return of income.

Wealth tax

At present no time limit is prescribed to complete wealth tax assessments. Consequently, wealth tax assessments have accumulated and collection of the tax has been hindered. The law has now been amended to

5. 6.25% is the rate set forth in Income Tax Rule 17C. The Finance Act 1988 sets the rate at 7.5%.
6. The Director General, Bureau of Manpower, Employment and Training will act as the collecting authority for this purpose.
7. The government, a local authority, a statutory corporation, a public limited company will be the collecting authority for this tax.
8. 5% is the rate set forth in Income Tax Rule 17E. The Finance Act 1988 sets the rate at 7.5%.
9. Under this provision, initial capital may be put into the business without any questions being asked.

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require completion of assessments within 2 years from the end of the assessment year in which the net wealth was first assessable.[10]

Shop tax

The shop tax was introduced in 1984. The following measures have been taken to expedite assessment of shop tax and ensure its collection:
(1) a best judgement assessment can be made in case of default;
(2) an assessment must be completed within one year; and
(3) the time limit for filing a return has been reduced from 3 months to 2 months.

No trade licence may be renewed unless the shop tax is paid.

Air ticket tax

Passengers travelling by air now pay an air ticket tax of 30 Tk. on domestic flights and 100 Tk. on international flights. The tax on international flights has been increased to 150 Tk.

Insurance premium tax

In his Budget Speech, the Finance Minister noted that the insurance business (in particular the general insurance business) has expanded substantially. General insurance coverage extends not only to international trade but also to marine, air and road transportation and industry and agriculture and the premium receipts from these sources are considerable. In order to raise additional revenue, a new tax (the insurance premium tax) has been imposed at a rate of 5% of the premium paid on a general insurance policy. The tax is effective as of 1 July 1988.

Development levy

An additional sum of 86 crore Tk. is expected as non-tax revenue. Of this amount, 36 crore Tk. is expected from development levies[11] in place of the relief and rehabilitation levy which has been discontinued as of this year. The development levy will be imposed at a rate of 4% on:
(1) interest or shares of profits on all savings deposits and fixed deposits in any bank;
(2) all deposits of post office savings accounts, fixed deposit accounts and bonus accounts; and
(3) all dividend income from shares, stocks, mutual funds and unit trusts.

Rates of income tax

The rates and schedule of income tax applicable for the fiscal year 1988/89 are unchanged.[12]

10. With respect to pending cases (i.e. those as of 1 July 1988), the time limit is 3 years from that date.
11. The remaining 36 crore Tk. is expected from telephones.
12. See *Taxes and Investment in Asia and the Pacific,* Vol. I, Bangladesh, C.13.1.2.

The Editors of the *Bulletin* wish all subscribers a happy and prosperous New Year

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SRI LANKA:

Imputation System for Corporate Taxation

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INTRODUCTION

Before 1959 companies in Sri Lanka were taxed under the "imputation system", i.e. full imputation credit in respect of income tax paid by a company on its profits was available to the company shareholders when such profits were distributed. With the introduction of "Kaldor Reforms" of 1959/60, the imputation system was replaced by "the classical system" of taxation under which profits earned by a company are first taxed in the hands of the company and when the balance profits are distributed such profits are taxed again in the hands of the shareholders. This results in economic double taxation and high effective rates of tax.

As a result of repeated representations made by professional bodies and taxpayers against economic double taxation, Sri Lanka's Minister of Finance & Planning announced on 17 November 1987 that an imputation system would be introduced in Sri Lanka for taxation of company profits. In his Budget Speech for Fiscal Year 1988, the Minister stated:

> Representations have been made to me repeatedly regarding the double taxation on company profits which exists in the present tax law. A company's profit is taxed first in the hands of the company itself, and it is taxed again in the hands of the shareholder when a dividend is declared by the company out of the same profits. This results in a very high effective rate of tax, sometimes as high as 68%. Many countries now relieve double taxation on corporate income by what is known as the "imputation system", since they believe that double taxation on company profits militates against company formation and investment in company shares. The countries which have adopted the imputation system include Singapore, Malaysia, Australia, New Zealand, the United Kingdom, France and Germany, among many others. In Sri Lanka too, I am very anxious to encourage company formation in order to develop the country's share market and to encourage widespread share ownership by Sri Lanka nationals. I propose therefore to introduce the imputation system for taxing company profits in Sri Lanka.

LEGISLATION

The Inland Revenue Act No. 28 of 1979, which is the principal law imposing income taxation in Sri Lanka, was recently amended to give legal effect to the above Budget proposals. Provisions relating to the imputation system are contained in the Inland Revenue (Amendment) Act No. 31 of 1988 (certified by Parliament on 5 September 1988) which takes effect from 1 April 1988. This article discusses the relevant provisions in the law with regard to the imputation system.

Classification of companies

Sri Lanka tax law recognizes (for tax purposes) 4 major categories of resident companies:
(i) quoted companies
(ii) unquoted companies
(iii) people's companies
(iv) small companies

A "people's company" is a company resident in Sri Lanka which is not a private company within the meaning of the Companies Act and which conforms to the following requirements:

(a) the number of shareholders of the company exceeds 100 and the nominal value of each share does not exceed 10 Rs.;
(b) any person may invest in one or more shares of the company at any allotment of shares or in the open market;
(c) no person either individually or with his wife or minor children holds directly or through nominees more than 5% of the issued share capital;
(d) no other company holds any share of the company directly or through nominees;
(e) the directorate of the company consists of at least 3 directors each owning one or more shares; and
(f) none of the directors of the company holds office as director of any other people's company (Sec. 33(2)(a)).

A "small company" is a company resident in Sri Lanka:

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(a) the issued capital of which does not exceed 500,000 Rs.;
(b) which has not reduced its capital on or after 15 November 1978;
(c) which has not been formed on or after 15 November 1978 by the reconstruction of an existing company or by the acquisition of any plant, machinery, fixtures or building of an existing company; and
(d) the taxable income of which does not exceed 333,333 Rs. for any year of assessment commencing on or after 1 April 1988 (Sec.33(2)(b)).

These companies are taxed at different tax rates as specified in the Second Schedule to the Act as set out below:

Quoted company – 40%
Unquoted company – 50%
People's company – 40%
Small company – (i) Taxable income up to 250,000 Rs. at 33⅓%;
(ii) Taxable income in excess of 250,000 Rs. but less than 333,333 Rs. at 100%.[1]

The rates of tax applicable to capital gains are as follows:

Period between acquisition and sale of property	*Maximum rate of tax*
0 - 2 years	Normal rates of tax
2 - 5 years	25%
5 - 15 years	17.5%
15 - 20 years	12.5%
20 - 25 years	5%
Over 25 years	0

Withholding tax on dividends

A resident company is required to withhold tax at the rate of 20% on any dividend payable out of its profits to shareholders. This tax withheld and deducted from the dividend is allowed to a shareholder against the tax payable by him.

PROVISIONS RELATING TO THE IMPUTATION SYSTEM

Advance company tax

Under Sec. 22A(1), every resident company is liable to pay a tax statutorily referred to as "advance company tax" (ACT) at specified rates[2] on every "qualified distribution". Sec. 163 defines "qualifying distribution" as follows:

> "qualifying distribution" means the whole or part of any gross dividend distributed in any year of assessment commencing on or after 1 April 1988, by a resident company to a shareholder in the form of money or of an order to pay money, out of such profits of the company which, if taxable for that year of assessment, would be taxed at the appropriate rate specified in the Second Schedule to this Act, as the rate applicable to companies of that class, but does not include any dividend distributed out of –
> (i) profits or income which accrued, or arose, to such company prior to 1 April 1988;
> (ii) its exempt income; and
> (iii) any income from dividends received by such company.

According to this definition, a distinction is made between profits accruing prior to 1 April 1988 and after 1 April 1988. The "imputation" will apply only to a distribution made out of profits or income arising or accruing after 1 April 1988. It will not apply to capital gains. The rates of tax applicable to "qualifying distributions" as specified in the 7th Schedule to the Act are as follows:

Quoted company – 33⅓%
Unquoted company – 50%
People's company – 33⅓%
Small company – 25%

Deduction of ACT from company tax

A company is entitled to deduct the ACT paid for any year of assessment from the tax (hereinafter referred to as "mainstream company tax" or "MCT") payable on its profits at rates specified in the 2nd Schedule to the Act. However, as the scheme is only a half imputation scheme, such deduction shall not exceed 50% of MCT payable for that year of assessment (Sec. 33A(2)).

If a company has paid ACT for a year of assessment in excess of 50% of the MCT, the excess amount will not be refunded to the company but will be carried forward and deducted from MCT payable by the company for the next succeeding year of assessment and so on, provided the total deduction for any year of assessment on account of ACT shall not exceed 50% of MCT payable for that year of assessment (Sec. 33A(3)).

Treatment of dividends declared out of "qualifying distributions"

When a resident shareholder other than a company receives a dividend in relation to which ACT has been paid, the income of the shareholder from such dividend (for tax purposes) is deemed to be a sum equal to the aggregate of the gross dividend and the ACT attributable thereto and the shareholder is entitled to deduct (in addition to the withholding tax deducted by the company) such ACT from the tax payable by him.

Where the tax credit in respect of the ACT and the withholding tax in relation to a dividend received by a resident shareholder exceeds the tax payable by him, he will be entitled to a refund of this excess tax credit.

The following examples illustrate the "imputation system" in relation to a resident company and a resident shareholder.

---

1. A small company having a taxable income of over 333,333 Rs. ceases to be a "small company".
2. The rates differ according to the "class" of a company.

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Example A

(1) *In relation to a resident company taking into account the advance company tax and the withholding tax*
Note: It is assumed in the example that (a) the taxable profit is 100,000 Rs. and (b) the balance profit after tax is fully distributed to the shareholders.

	Quoted Co./ People's Co.	*Unquoted Co.*	*Small Co. profit*
	100,000	100,000	100,000
Tax (MCT) thereon will be (at 40%)	40,000	(at 50%) 50,000	(at 33⅓%) 33,333
Balance profit available for distribution	60,000	50,000	66,667
If the balance profit is fully distributed – viz.:	60,000	50,000	66,667
the withholding tax at 20% to be deducted and paid to the Revenue will be	12,000	10,000	13,333
and the net dividend payable to the shareholder will be	48,000	40,000	53,334
ACT payable by the Company (being 33⅓%, 50% and 25% of the distribution made by a Quoted Co./People's Co., Unquoted Co. and Small Co., respectively) will be	20,000	25,000	16,667
Company's liability to tax on profits	40,000	50,000	33,333
The amount deductible on account of ACT paid	20,000*	25,000*	16,667*
Balance tax payable	20,000	25,000	16,667

* Paid at the time of declaration of dividends out of "qualifying distribution" (see below).

Example B

(2) *In relation to the shareholder*

	Dividend from Quoted Co./ People's Co.		*Dividend from Unquoted Company*		*Dividend from Small Company*
Dividend received	48,000		40,000		53,334
Tax withheld	12,000		10,000		13,333
	60,000		50,000		66,667
Add ACT	20,000		25,000		16,667
	80,000		75,000		83,334
Tax thereon at 40%	32,000		30,000		33,333
Less withholding tax 12,000		10,000		13,333	
imputation (half) 20,000	32,000	25,000	35,000	16,667	30,000
Balance tax payable	NIL		**(5,000)		3,333

* Assuming that the shareholders are liable to tax at 40%, i.e. the maximum rate of tax applicable to an individual for year of assessment 1988/89 and subsequent years.
** The shareholders will be entitled to a refund.

When a company (resident or non-resident) receives from a resident company, a dividend in relation to which a deduction has been made on account of withholding tax or ACT, such dividend is deemed not to form part of the assessable income of the recipient company. No tax credit or refund will accrue to the recipient company in respect of the withholding tax or ACT deducted. However, where a resident company makes a distribution out of a dividend in relation to which withholding tax or ACT has been deducted, a non-corporate shareholder receiving a distribution out of such dividend will be entitled to credit for the ACT and withholding tax attributable thereto.

Payment of ACT to the Revenue

Sec. 97(4) requires that the ACT on a qualifying distribution payable by a company be remitted to the Revenue at the time the qualifying distribution is made. The dividend will be deemed to be distributed on the date on which the dividend is declared. However, if it is declared to be paid on a future date, the distribution of the dividend will be deemed to be on the future date. Remittance of the ACT should be accompanied by a statement in such form as may be prescribed by the Commissioner General of the Inland Revenue.

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Tax on dividends under double tax conventions

Most of the double tax conventions concluded by Sri Lanka provide that the tax on a dividend (whether withheld or charged directly) paid by a company which is a resident of Sri Lanka to a resident of the other country shall not exceed 15% (10% in some cases) of the gross dividend. In cases where the double taxation treaty provisions apply, the excess tax withheld or charged will be refundable.

Obligations of a resident company under the "imputation system"

Every resident company is required under Sec. 33C to maintain a record indicating:

(a) dividends received from other companies, classified under
  (i) exempt dividends;
  (ii) dividends on which ACT has not been paid (i.e dividends declared out of profits prior to 1 April 1988);
  (iii) dividends on which ACT has been paid, further classified according to the rate of ACT applicable to such dividend.
(b) Profits and income other than dividend income, classified under
  (i) exempt profit and income;
  (ii) profits and income taxable at rates other than normal rates prescribed in the 2nd Schedule (i.e. capital gains, etc.);
  (iii) other profits and income.
(c) Details of dividends paid out of each category and sub-category set out above.
(d) Appropriations made from each category and sub-category of income set out above for reserves and payment of taxes.

When issuing a dividend warrant, a company is also required to furnish a statement indicating, inter alia, the composition of the gross amount of the dividend and the ACT paid thereon.

CONCLUSION

The law relating to "the imputation system" in Sri Lanka is rather complex due to the multiplicity of tax rates applicable to different classes of companies and different types of income (i.e. tax rates applicable to capital gains vary from 5% to 25%), the non-applicability of the "imputation system" to the distribution made out of profits earned by a company prior to 1 April 1988 and the collection of taxes at different rates at various stages. It is hoped that with the experience gained from implementation of the present system of imputation, Sri Lanka will, in the near future, evolve a simple system of imputation for corporate taxation with 100% tax credit.

In forthcoming issues:

A Survey of the Nepalese Tax System
– By *Rup Bahadur Khadka*

Vietnam: The Laws on Foreign Investment and Import/Export Taxes
– By *Arno Wohlgemuth*

Individual Income Taxes in Puerto Rico
– By *Arthur Young International*

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Belgium–U.S. and France–U.S. Protocols:
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Direct Taxation in the Sudan
– By *A. A. Salama*

IFA: Papers Presented during the Joint Seminar of the Canadian and British Branches of IFA, 9-10 September 1988

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An Introduction to Taxes in Singapore for the Expatriate: Individual Income Tax

By Arthur Young International

The Singapore tax year (known as the year of assessment) is the calendar year. The basis of assessment is the preceding year's income. Normally, the annual returns for individuals are issued by the Comptroller by the end of January in the year of assessment. The return has to be filed within 21 days of the date on the face of the assessment. However, extension for filing is generally granted for 2 or 3 months.

Tax returns are declarations indicating the gross income and deductions of the taxpayer. Most assessments (in response to filed returns) or estimated assessments (where no returns have been filed) will be issued in March, April and May of each year. A person's tax liability must be paid within one month of the date of the notice of assessment. Installment payments can usually be arranged if required; the maximum number of installments is 12, commencing from January.

A wife may elect that her earned income as well as income arising from investments made out of her earned income be taxable in her own name.

Employers are not required to withhold tax from employees' earnings, unless instructed by the Revenue to do so in specific cases. Where the employer is not incorporated/registered in Singapore, the employee may be required to furnish a letter of guarantee for his estimated tax liability.

GENERAL DISCUSSION OF RESIDENCE

The extent to which an individual will be taxed by Singapore depends upon the residency status of the individual. For tax purposes, individuals are classified as either resident or non-resident.

"Resident in Singapore", in relation to an individual, means a person who resides in Singapore except for such temporary absences therefrom as may be reasonable and not inconsistent with a claim by such person to be resident in Singapore, and includes a person who is physically present or who exercises an employment (other than as a director of a company) in Singapore for 183 days or more during the year. A non-resident is a person who is not "resident in Singapore" within the above rules.

Physical presence in Singapore for 183 days or more automatically constitutes residence for tax purposes. However, presence for a lesser period may still be regarded as residence if it is the intention to establish residence in Singapore. The current practice of the Inland Revenue is to treat an individual as resident if his period of stay in Singapore spans 3 consecutive calendar years. For instance, assume that an individual starts employment in Singapore on 1 September 1987 and leaves on 15 February 1989. The tax authorities would regard the individual as a resident for Years of Assessment 1988, 1989 and 1990 even though in 1987 and 1989 his physical presence in Singapore would be less than 183 days in each calendar year.

However, the Inland Revenue's practice is not necessarily conclusive. The important criterion is whether the individual intends to establish residence in Singapore and the decision will depend upon the circumstances of each particular case.

SCOPE OF TAX

Individuals resident in Singapore for tax purposes are liable to tax on:

(1) all income derived from or accruing in Singapore; and
(2) all income derived elsewhere but received in Singapore from outside Singapore (i.e. remitted to Singapore).

Non-resident individuals are only liable to Singapore tax in respect of item (1) above, but are not liable to tax on income remitted into Singapore.

If an individual's employment requires him to perform duties outside Singapore, i.e. on a regional basis, the remuneration in respect of the duties performed outside Singapore is non-Singapore-source income. For example, where the employment covers the whole year, the resident individual would be taxed on the greater of either:

(a) $\frac{\text{Time spent in Singapore}}{365} \times$ Total remuneration,

or

(b) Total remuneration received in Singapore.

While the Singapore tax authorities have in practice accepted this concept of taxation (commonly known as the "area representative basis"), they impose the following stringent conditions:

(i) the individual must perform his duties in various locations in the region besides Singapore;
(ii) the individual must be employed by a non-resident employer who has no permanent establishment in Singapore;
(iii) the employment costs relating to non-Singapore duties must not be borne by or charged to the

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accounts of the Singapore permanent establishment; and

(iv) the individual must have a written contract of employment or a letter of assignment stating the specific duties to be performed both in and outside Singapore.

Although conditions (ii) and (iii) are not necessarily relevant, in practice, the Inland Revenue would insist on the following information being supplied:

(a) details of the individual's duties both in and outside Singapore and the company/companies for whom such duties are performed, together with a schedule of his absences from Singapore;
(b) the nature of business of the non-resident employer and the Singapore company to whom he is assigned;
(c) whether his salary, allowances and office expenses are charged to the accounts of the Singapore office; and
(d) his contract of employment or letter of assignment in respect of his Singapore employment.

In the case of resident individuals, where the area-representative basis is claimed, it is important that the income attributable to the non-Singapore duties be received and kept outside Singapore wherever possible.

GROSS INCOME

Employment income

Individuals are taxable on all "gains or profits from any employment". This term includes all remuneration paid or granted to the employee either in cash or

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in kind such as the value of any food, clothing or lodging provided or paid for by the employer. Certain items of compensation are accorded special treatment.

Home leave airfare

The Inland Revenue gives concessionary treatment as follows: only 20% of the home leave cost will be taxed as income of the employee. The concession covers one return passage a year to the home country for the employee and his wife and 2 passages a year for each child. In many cases, the tax authorities have requested details of the cost of airfare, including invoices, to substantiate the claim.

Housing provided by employer

Where accommodation is provided by the employer (for example, if the rent is paid by the employer), the amount assessable on the employee as the value of accommodation is limited to the lower of 10% of the Singapore employment income or the actual rent paid. However, if a rent allowance is paid in cash to the employee, the whole of the cash allowance is included in Singapore earnings and is taxable. Consequently, the direct provision of accommodation by the employer reduces the tax liability of the employee considerably in most cases. Where the accommodation is furnished, certain nominal values (ranging from S$5-30 per month) are imputed for the use of the furniture, fittings and equipment.

Automobile provided by employer

In respect of an employer-provided automobile, the taxable benefit is, in practice, calculated at 10 Singapore cents per private mile traveled if the employee pays for the gasoline, or 30 Singapore cents per mile if the employer pays for the gasoline.

Other payments in kind

In respect of payments in kind, generally, costs incurred by the employer would be used to calculate the taxable benefits.

Examples:

House servants – the benefit is the actual salary of the servant paid.

Gardener – the value of the benefit is S$ 35 per month.

Investment income

In the case of a resident, income from investments (i.e. interest and dividends) is taxable if it is either from Singapore sources or is remitted to Singapore. Capital gains, on the other hand, are not taxable in Singapore. Investment income of a non-resident from a non-Singapore source is not taxable by Singapore whether remitted or not.

MAJOR DEDUCTIONS

Personal allowances (available to residents only)

(a) Self		S$ 2,000
(b) Earned income –	The amount of earned income up to a maximum of	1,000
	For individual above 55 years but below 61 years up to a maximum of	3,000
	For individual above 60 years up to a maximum of	4,000
(c) Spouse		1,000
(d) Dependent children		
First child		750
Second child		750
Third child		750

There are special reliefs for children educated overseas and children of qualified women.

Life insurance premiums and pension contributions

Approved life insurance premiums and pension and provident fund contributions are usually deductible up to a maximum of S$ 5,000 per year (including Central Provident Fund (CPF) contributions). Where CPF contributions exceed S$ 5,000, the full amount of CPF will be given as a relief. No relief, however, will be given for insurance premiums.

NATIONAL INSURANCE (CENTRAL PROVIDENT FUND)

For every individual employed in Singapore, the employer must contribute 35% of his monthly salary (maximum contribution is S$ 2,100 per month) to the CPF. The employer can recover 25% monthly from the employee. There is no ceiling on contributions in respect of special compensation such as bonuses and tax reimbursements. The employer's contribution is not taxable to the employee when withdrawn provided the amount contributed does not exceed the statutory rate (effective 1 July 1988, the total contribution to the employee's CPF account will be 36%, i.e. 24% from the employee and 12% from the employer).

For expatriates employed in Singapore, application for exemption may be made for the following expatriate employees as soon as possible from the date of commencement of employment in Singapore:

- those who have been provided with social security/pension/provident fund schemes by their home countries or their employers;
- those who are in Singapore on short-term attachments/assignments/employment contracts of not more than 6 months;
- those who are employed by a foreign company

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before arrival in Singapore and are employed by the same company or the same group of companies in Singapore; and
- any other employees who are not considered to be in need of old-age protection in Singapore.

Generally, an individual is allowed to withdraw from the CPF the amount to his credit if he/she meets any of the following requirements:
- has reached the age of 55 years;
- not being a citizen of Singapore, has permanently left Singapore with no intention of returning; and
- is mentally or physically unable to continue any employment.

RATES OF TAX

A. Non-residents

There shall be exempt from tax, any income derived from an employment exercised in Singapore for not more than 60 days in the basis period for any year of assessment by a person who is in Singapore *for some temporary purpose only* and who is not resident in Singapore in that year of assessment.

If a non-resident employee is in Singapore between 61 and 182 days, he is liable to tax at a flat rate of 15% on his employment income, or to the amount of tax payable by a resident in the same circumstances, whichever is greater.

Directors' fees earned by non-resident directors of companies are taxed at 33%. Non-residents who derive income other than from employment are also taxed at 33% on such other income.

B. Residents

Residents are taxed at graduated rates which range from 3.5% to 33% as set forth in Appendixes A and B.

PENALTIES FOR FAILURE TO FILE AND LATE PAYMENT OF TAX

A penalty may be imposed for late filing of a return. This may be compounded in the case of a first or second offense. A penalty may also be imposed, ranging from 5% up to a maximum of 17%, on tax unpaid within the prescribed period, which is one month from the date on which the Notice of Assessment is served.

APPENDIX A

GENERAL TAX COMPUTATION

Following is an example of the general tax calculation in Singapore:

Mr. X, a U.S. citizen resident in Singapore for all of 1987, is married with 2 dependent children. During 1987, Mr. X received compensation of S$ 150,000 of which S$ 100,000 was paid in Singapore and the balance was deposited in a U.S. bank account and not remitted to Singapore. He has regional responsibility for his employer and in fact spent 60 days working outside of Singapore. Mr. X's employer also provided Mr. X with a house at a cost to the company of S$ 30,000. Mr. and Mrs. X earned dividends from U.S. investments of S$ 3,000 of which S$ 1,000 were remitted to Singapore. Mr. X contributed S$ 18,000 to the CPF during 1987 (i.e. S$ 6,000 p.m. – maximum, × 12 × 25%).

Year of assessment 1988

Income

Salary (see below)*		S$ 125,342
Taxable value of housing		12,534
Dividends from U.S. corporations remitted to Singapore		1,000
Total		S$ 138,876
Deductions		
Personal reliefs		
1. Taxpayer	S$ 2,000	
2. Earned income	1,000	
3. Spouse	1,000	
4. Children	1,500	
5. CPF contributions	18,000	
Total deductions		(23,500)
Taxable income		S$115,376
Tax on 1st 100,000		S$ 17,175
Tax on next 15,376 at 26%		3,998
		S$ 21,173
Less: Rebate		(79)
Income tax payable		S$ 21,094

* Greater of (a) or (b)

(a) $\frac{\text{Time spent in Singapore}}{365} \times \text{Compensation} = \frac{305}{365} \times 150{,}000 = 125{,}342$

(b) Compensation received in Singapore = 100,000

APPENDIX B

Year of assessment 1988
(income earned in 1987)

Taxable income

(A) Lower limit	(B) Upper limit	Tax on Column A	Tax rate on excess over Column A
S$ 0	S$ 5,000	S$	3.5%
5,001	7,500	175	6.0
7,501	15,000	325	8.0
15,001	20,000	925	9.0
20,001	25,000	1,375	12.0
25,001	35,000	1,975	14.0
35,001	50,000	3,375	17.0
50,001	75,000	5,925	21.0
75,001	100,000	11,175	24.0
100,001	150,000	17,175	26.0
150,001	200,000	30,175	28.0
200,001	400,000	44,175	31.0
400,001 and over		106,175	33.0

Note: For the year of assessment 1988 there is a 15% rebate on the tax payable on the first S$ 10,000 of taxable income.

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Resolutions XLII IFA Congress, Amsterdam 1988

SUBJECT I:

Recognition of Foreign Enterprises as Taxable Entities

Resolution (original version)

The XLII IFA Congress:

Recalling its Resolutions taken at the 27th Congress (1973) in Lausanne on Subject II – Partnerships and joint enterprises in international tax law – and at the 41st Congress (1987) in Brussels on Subject I – The fiscal residence of companies;

Taking note of the 28 National Reports and of the General Report as published in the *Cahiers de droit fiscal international,* Volume LXXIIIa, and of the discussions held during the Congress on September 12 and 13, 1988;

Observing that:

1. When a group of persons jointly undertakes business activities abroad, dissimilar characterisation for income tax purposes of the vehicle established (hereinafter referred to as "entity") can give rise to multiple taxation;
2. The criteria according to which States characterise an entity are not uniform and may differ depending on whether the entity is domestic or foreign, resident or non-resident;
3. Multiple taxation arises primarily because the States i) of residence of the entity ii) of residence of the participators and iii) of the source of business profits do not adopt the same characterisation, one or more of them considering the entity as being the entrepreneur and consequently the taxpayer while the other(s) consider the participators as being the entrepreneurs and consequently the taxpayers for their share in the business profits. Furthermore in many instances transparent entities or their participators have no access to treaty relief;
4. Where a dissimilarity in characterisation occurs, the entity – if considered in the State of its residence as a taxable subject – may not be able to obtain relief for tax levied on the participators in the source State. Secondly, the participators – if taxed personally in their residence State for their share in the entity's business profits – may not be able to obtain relief for the tax imposed on the entity in the State where it operates nor for the tax imposed on the entity in the State where it is considered to be a resident. Thirdly, the participators – if taxed in their residence States as the recipients of dividends distributed by an entity of another State – may not be able to obtain relief for the tax they have personally suffered in the source State. Fourthly, where the participators are taxed personally in their residence States on their share in the entity's profits they may not get any relief for the tax at source levied in the residence State of the entity.
   Such consequences will occur mainly where the tax systems of the States involved are not all based exclusively on the principle of territoriality and are due either to shortcomings of unilateral relief rules or to inaccessibility to treaty benefits;
5. The mutual agreement procedures under the treaties have not proven satisfactory to avoid multiple taxation in the cases under consideration, failing any requirement for the authorities to reach agreement;

Considering that the multiple taxation arising from such circumstances is undesirable and should be eliminated;

Recommends that:

1. States adopt both in their domestic law and in their treaties measures aimed at eliminating multiple taxation due to the disparity in characterisation of entities in the residence State of the entity, in the residence States of the participators and in the source State. The duty to grant relief should rest primarily with the residence States of the entity and the participators.
2. The OECD further clarify the issue in the commentary to its model convention and devise appropriate model clauses.

Review of the Resolution on Subject I by Prof. Dr. Walter Ryser (Switzerland), Chairman of the Resolutions Committee

The first subject submitted to the deliberations of the 42nd Congress focused on the considerable difficulties arising when the States involved do not characterise similary an entity formed by a plurality of persons in order to transact business in another State. They occur when the States do not all consider the entity to be non-transparent or when they do not all deem the entity to be transparent. Many cases of double or multiple taxation can arise from such mismatching in qualification. While the 27th Congress was devoting its attention mainly to bilateral situations, the 42nd Congress considered more particularly tripartite situations, involving the State of residence of the entity, the State(s) of residence of the participators and the State(s) of source (in particular the State(s) where business is being carried out through a permanent establishment). Shortcomings both in domestic rules for the granting of unilateral relief and in treaty provi-

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sions were identified. The recognition that multiple taxation may be much less likely to occur if the tax systems of the States involved were all strictly based on the principle of territoriality is of no great practical help. It was therefore felt that the States should be invited to take proper measures aimed at eliminating double or multiple taxation arising from disparities in characterization of business entities.

The Resolution, however, does not suggest along what lines remedies should be sought. While considering the point, the Committee eventually decided not to include references to that effect. It may, however, be of interest to outline some of the avenues which could be explored in order to bring about practical solutions. Here are a few suggestions:

a. *At domestic level:*
- States may consider the granting of tax credits for foreign taxes despite a lack of identity of the taxpayers, provided that the tax substance is the same.
- States, which usually give relief by tax credit, may consider granting exemption exceptionally where disparity in characterization could be an obstacle to the granting of tax credits.
- States may consider granting participators resident in their territority an exemption from tax on the profits distributed by an entity considered resident abroad and (additionally) a relief for the foreign tax at source on such distributions despite such exemption, where the participators have already been personally taxed on their proportionate share in the underlying profits.

b. *At treaty level:*
- States may consider adopting consistent criteria for the characterization of entities as transparent or non-transparent and pledging to apply the same criteria regardless of whether they find themselves in the role of the residence State of the entity, of the residence State of the participators or of the source State.
- States may consider inserting in their treaties provisions making it clear that transparent entities are considered resident for treaty purposes of the State where they are organized or where their principal place of business is situated. Should this not be feasible, they should at least consider the adoption of provisions recognizing transparent entities the quality of residents for treaty purposes (i) of the State where participators entitled or (ii), as a further alternative, of the State where the principal place of business of the entity is situated (or where any other test creating unlimited tax liability would otherwise be met) to the extent participators resident in such State derive income through such entities.
- States may consider adopting a text at least as explicit as that of Art. 23B(1) (or 23A(1)) of the OECD Model Treaty in order to overcome the obstacle consisting in a possible lack of subject identity for the granting of a tax credit or an exemption.

c. *Concerning the appeal to OECD:*
- The need for clarification would seem to concern firstly the commentary to Art. 23B(1) (and similarly 23A(1)). Words to the effect that Art. 23(1) does not postulate any strict subject identity when the foreign tax has been levied upon another person due to a dissimilarity in characterization (or similar technical causes), provided that the same object has been taxed, would be very welcome.
- The devising of new provisions may, for instance, concern an extension of the benefit of Art. 7(1) of the model treaty to the participators of an entity (as if they were conducting the business personally), where the entity itself is not considered a resident of the other State.

As can be seen, there is still ample room for further study in this field and it is hoped that the 42nd Congress will have drawn the attention of the authorities to the problems involved (incidentally), similar problems will arise in the field of estate and inheritance taxes).

SUBJECT II:

Tax Treatment of Computer Software

Resolution (original version)

The XLII IFA Congress:

Taking note of the twenty-four National Reports and the General Report as published in the *Cahiers de droit fiscal international,* Volume LXXIIIb, subject two, and

Taking further note of the discussions held during the Congress on 13th and 14th September 1988, in which it was generally recognised that:
1. development, transfer and use of software have grown enormously in recent years and are expected to expand further;
2. computer software can be technically described as a set of instructions in any language and on any carrier medium directing a computer to perform a function;
3. in view of the dynamic nature of software any classification, such as between systems software (i.e. software for the computer's basic operation) and application software (i.e. software for general or cross-industry application and for industry specific application), is necessarily temporary and should not be governing for tax purposes;
4. software itself is by nature an intangible and in most countries is for legal purposes considered intellectual property which is protected by copyright laws;
5. software development requires considerable investment and therefore royalty rates are higher than for most other industrial or commercial property rights.

Considering that:
1. with respect to income and profits tax neither the

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1977 OECD Model Treaty, nor the 1980 UN Model Treaty, nor any bilateral tax treaty currently in effect provides separate and comprehensive rules for the international tax treatment of software, and that at the national level only a few countries have enacted specific tax rules relating to software;

2. with respect to import duties the GATT has ruled that in determining the customs value of imported carrier media bearing data or instructions, only the cost or value of the carrier medium itself shall be taken into account provided the value of the medium is shown separately;
3. with respect to capital taxes and indirect taxes, such as value added tax (VAT) and sales tax, national and international treatment of software may vary, especially since the basic distinction between the supply of goods and of services is interpreted differently from one country to another;
4. software transactions are generally treated as involving the transfer of intellectual property. However, it should be noted that:
   a. tax treatment of bundled software integrated into the hardware is uniform throughout the reporting countries, i.e. as part of the hardware being a tangible asset,
   b. canned software for general use which is sold and purchased in off-the-shelf form is treated as goods, and
   c. customized software or customization of existing software is generally treated as a service;
5. in 1987 the Business and Industry Advisory Committee to the OECD (BIAC) has submitted a position paper to the Fiscal Committee of the OECD with respect to software;

Recommends:

1. the legal and economic characteristics rather than the form of payment (front-end lump sum, periodic or a combination of both) for the transfer of software should determine the classification of the transaction (transfer of intellectual property, of goods or supply of services or any combination of all three) and thus will determine the tax treatment of the transfer of software;
2. the consideration for software transactions involving the license of intellectual property should as a general rule be treated as a copyright royalty for income taxation purposes, with the following reservations:
   a. the transfer of bundled software integrated into the hardware should be regarded as part of the hardware transfer,
   b. the transfer of canned software for general use which is sold and purchased in off-the-shelf form should likewise be treated as the sale of goods,
   c. the provision of customized software or the customization of existing software should be treated as a service;
3. the International Bureau of Fiscal Documentation be invited to compile systematically documentation on the tax treatment of computer software in order to study this subject further within the International Fiscal Association, because of the dynamic and highly innovative character of the development of software.

Review of the Resolution on Subject II
by Dr. Han A. Kogels (Netherlands), Chairman of the Resolutions Committee
(available in English only)

The subject has been discussed in the two working sessions during the 42nd Congress under four major headings:

Treatment under domestic income tax law, Research and development, International treatment and Treatment under sales tax, value added tax and excises. The panel members were Mr. M.O. Penney (U.K.), Mr. J. Gonzalez Bendiksen (Colombia), Mr. Se Won Chang (Republic of Korea) and Prof. G. Grosskopf (Sweden). Mr. D.G.H. Bowman (Canada) acted as Discussion Leader.

Computer software – for technical purposes to be described as a set of computer instructions on any carrier medium – has an innovative and dynamic character. Even where certain software is used for more than 20 years, frequent upgrading is quite normal. Most software, however, becomes obsolete within a relatively short period. Research and development activities play a crucial role in software industry.

For legal purposes software – being an intangible by nature – in most countries is considered intellectual property. The considerable investments required and the highly innovative character of software result in royalty rates higher than for most other industrial or commercial property rights.

With respect to tax treatment IFA considered that at a national level only a few countries have specific tax rules relating to software. Separate and comprehensive rules for software have neither been taken up in the two model treaties of the OECD and the U.N. nor in the various bilateral tax treaties. It has been mentioned that in 1987 the Business and Industry Advisory Committee (BIAC) has submitted a position paper to the OECD in which it is concluded that the 1977 OECD Model Convention provides adequately for the international tax treatment of software. However, BIAC has suggested that the OECD would add language to the model treaty commentary emphasizing that payments for the use of software eligible for copyright protection should be classified as copyright royalties, whereas payments for other software will constitute business profits. The taxability of the latter would depend upon the existence of a permanent establishment in the source country.

With respect to software transactions IFA has come to the basic conclusion that the tax treatment of the transfer of software should be determined by the legal and economic characteristics of the transfer itself rather than by the form of payment (front-end lump sum, periodic payments or a combination of both).

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Against this background IFA has made the following recommendations with respect to income tax treatment of software transactions.

As a general rule the consideration for software transactions involving the licence of intellectual property be treated as a copyright royalty. However, reservations are made for three situations.

The transfer of *bundled software* integrated into the hardware should be regarded as part of the hardware transfer. *Canned software* for general use which is sold and purchased in off the shelf form should be treated as the sale of goods. And the provision of *customized software,* as well as the customization of existing software, should be treated as a service.

Although, in its recommendation, IFA has acknowledged a classification of software, it has emphasized the temporary character of certain software classifications. In particular, any classification related to the software functions, such as the distinction between systems software (i.e. software for the computer's basic operation) and application software (i.e. software for the general across-industry and industry specific application), should not be governing for tax purposes.

It was a general feeling that the rapid development of software itself and the various forms in which it is transferred (tangible carrier media, wire and satellite), require further studying of the tax practice in this field. Therefore, IFA has suggested that its sister organization, the International Bureau of Fiscal Documentation, be invited to compile systematically documentation on this subject. The 1988 IFA Congress can be regarded as the first international discussion on this subject which could be followed by an updated study within four or five years.

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