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INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

Sarphatistraat 602, Amsterdam – Tel. 626 77 26 – Telex: 13217 intax nl – Telefax: 622 86 58
Please address all correspondence to: P.O. Box 20237 – 1000 HE Amsterdam

Director: H.M.A.L. Hamaekers *Deputy Directors:* B.P. Dik and W.J. Smit

PURPOSE

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

Art. 3

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

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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

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e. by offering co-operation in the publication of third parties;

f. by all other lawful means.

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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", "Taxation in European Socialist Countries" and "Taxation of Individuals in Europe".

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b. de fournir des informations et explications;

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d. de publier;

e. d'offrir sa coopération dans la publication de tiers;

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Les autres publications sur feuilles mobiles du BIDF sont les suivantes: *Supplementary Service to European Taxation, African Tax Systems, Systèmes Fiscaux Africains, Taxes and Investment in Asia and the Pacific, Taxes and Investment in the Middle East, Taxation in Latin America, Taxes and Investment in Canada, Taxation and Investment in the Caribbean, Taxation & Investment in the People's Republic of China, Foreign-related Tax Laws and Regulations of the People's Republic of China, The Tax Treatment of Transfer Pricing,* the *Handbook on the 1989 US–German Tax Convention, EC Corporate Tax Laws,* and *An International Guide to Mergers & Acquisitions.*

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IFA – INTERNATIONAL FISCAL ASSOCIATION

General Secretariat: c/o World Trade Center, P.O. Box 30215 (Beursplein 37), 3001 DE Rotterdam
Telephone: (010) 4052990 Telegrams: IFAGRAM Telefax: (010) 4055031 Telex: 23229 beurs nl, att./ifa

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

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

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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

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First published in 1946, the *Bulletin* aims to report on matters of importance to the international tax community and to provide a forum for discussion of worldwide developments in tax policy, law and reform. The *Bulletin* is the official journal of the International Fiscal Association and publishes the reports of its national branches.

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CONTRIBUTION OF ARTICLES TO THE *BULLETIN*

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The editor will consider for publication manuscripts by contributors from any country. Manuscripts will be subject to a review procedure and accepted manuscripts will be edited to improve the general effectiveness of communication.

Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

The author should submit biographical data, including his or her current affiliation.

THE U.S.–NETHERLANDS TAX TREATY NEGOTIATIONS:

A U.S. PERSPECTIVE

Mary C. Bennett

I. INTRODUCTION

For more than 25 years, the U.S. Government has been striving to arrive at the ideal solution to the problem of treaty shopping as it relates to the U.S. tax treaty network. In recent years, those efforts have resulted in the inclusion, in every newly negotiated or renegotiated U.S. treaty, of an anti-treaty shopping (i.e. a "limitation on benefits") provision. The nature and scope of those provisions have evolved to reflect the developing views on the subject on the part of both the United States and its treaty partners. In June 1990, when U.S. Treasury Assistant Secretary Gideon was testifying to the Senate Foreign Relations Committee about the limitation on benefits provision of the new U.S.–German tax treaty, he stated: "The new treaty creates what we believe to be a new standard for such provisions."[1]

In a sense, however, all of the activity that has taken place so far in this area has merely set the stage for the negotiations currently underway between the Netherlands and the United States. While those negotiations involve a wealth of fascinating issues, the outcome of the limitation on benefits article is the focus of the greatest amount of interest. It is widely recognized that, after the partial termination in 1987 of the U.S.–Netherlands Antilles tax treaty, the current U.S.–Netherlands treaty presents the most serious treaty shopping concerns to U.S. policymakers. All of the U.S. negotiations relating to limitation on benefits provisions over the past years have been undertaken with the knowledge that the Dutch situation would ultimately have to be confronted. The Dutch Government's traditional disfavour of general limitation on benefits provisions is also widely known.[2] This clash of policy interests cannot help but produce a challenging series of negotiations which, if successful, will lead to compromises of their former positions by both Governments.

Obviously, until the negotiations are completed, we cannot know how these matters will be resolved. The purpose of this article is not to try to predict what those results might be, but to try to shed light on some of the difficult policy issues the negotiators are likely to face, particularly as they are perceived from the U.S. side.

Mary C. Bennett, currently of Counsel to the law firm of Baker & McKenzie in Washington, D.C., was formerly Deputy International Tax Counsel at the U.S. Treasury Department, where she served in the Office of Tax Policy from 1985-1990. While at Treasury, she headed the U.S. delegation in tax treaty negotiations with the Netherlands. Ms. Bennett holds an A.B. from Harvard University, a J.D. from Columbia University, and an LL.M. in Taxation from Boston University. Prior to her tenure at Treasury, she was in private practice in London and Boston.

This article represents the personal views of the author, and is not intended to reflect positions of the U.S. Treasury Department.

"What's past is prologue."
– *William Shakespeare*

II. GENERAL CONSIDERATIONS

The current U.S.–Dutch treaty negotiations relating to the limitation on benefits provision are subject to a host of competing considerations from the U.S. side.

A. *Constraints on U.S. flexibility*

1. *Perceptions relative to the Netherlands*

There is no question about the U.S. Government's commitment to including a comprehensive anti-treaty shopping provision in all new treaties, including the Dutch one.[3] Experience has taught U.S. policymakers that treaty shopping can be a potential problem without regard to the particular features of a given treaty partner's domestic tax law. When, however, the particular treaty partner, though not a "tax haven" in the commonly understood sense of that term, has certain features such as those existing in the Netherlands (e.g. lack of withholding taxes on interest and royalties paid to non-residents, a broad treaty network and an infrastructure supportive of holding company arrangements), the traditional U.S. concerns are especially focused.

1. Statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, before the Committee on Foreign Relations of the United States Senate, on 14 June 1990, reprinted in *BNA Daily Tax Reporter*, Special Supplement (18 June 1990), at S-5.
2. See, e.g., M.J. Ellis, "Limitation of benefits: a Netherlands perspective", *Intertax* (August/September 1989), at 344 (discussing the Netherlands State Secretary of Finance's 1987 memorandum on General Tax Treaty Policy).
3. The Treasury Department's International Tax Counsel surprised no one with his recent announcement that the reason for the U.S.-Dutch negotiations is specifically to introduce a limitation on benefits provision into the treaty. Interview with International Tax Counsel Philip D. Morrison, *The Journal of International Taxation* (May/June 1990), at 41.

2. *Interaction with the treaty override problem*

There is also no doubt that the legislative branch is every bit as troubled by treaty shopping practices as the executive branch. As recently as last summer, the Senate Foreign Relations Committee, in its reports on the various tax treaties pending in the Senate, reiterated the view that "the United States should maintain its policy of limiting treaty shopping opportunities whenever possible".[4] Much of the debate between Treasury and Congress on the issue of statutory overrides of treaties has concentrated on the interaction between treaty shopping and the U.S. ability to reflect developments in U.S. statutory tax policy in the U.S. tax treaty network. It is well understood that part of the motivation behind the trend of legislative treaty overrides in recent years has been the Congressional concern that developments in U.S. tax policy could not be reflected in a reasonably timely fashion in the U.S. treaty network if the existence of widespread treaty shopping opportunities meant that foreign taxpayers could always seek the protection of the best available "shoppable" treaty.

This connection was graphically demonstrated with the introduction of the branch tax treaty override provision in the Tax Reform Act of 1986 (P.L. 99-614, §12241(a)), in which Congress provided that the branch tax would override treaties, except in the case of corporations which were "qualified residents" of a treaty country under the statutorily prescribed anti-treaty shopping rule. The same approach was taken in the proposed legislation, the Foreign Tax Equity Act of 1990 (H.R. 4308), which would have imposed a U.S. tax on capital gains realized by certain foreign persons with respect to dispositions of stock in U.S. corporations in which such persons are substantial shareholders.[5]

Thus, there is a clear perception that achievement of an acceptable limitation on benefits provision in the U.S.-Dutch negotiations, while an important policy objective in itself, will also be a significant step in cooling the Congressional fervour on the treaty override issue. The continuing need for further progress on that front is highlighted by several factors. First, the increasingly difficult budget situation in the United States means that foreign investors, like Americans, will continue to be exposed to "revenue enhancement" measures. Second, there is a growing perception, reflected in remarks made by numerous Congressmen within the past year at the time of hearings on foreign investment in the United States, that foreign investors are not paying their "fair share" in Federal taxes. Finally, reports suggest that Treasury's anti-override arguments have not yet convinced all the relevant players in Congress.[6]

B. *Factors favouring U.S. flexibility*

While all of these factors tend to militate in favour of a limitation on benefits provision that adheres very closely to the versions which have already received Congressional approval, other factors tend to suggest that the U.S.-Dutch negotiations will produce a provision which continues the process of evolution.

1. *Need to refine the German "model"*

The new U.S.–German treaty's limitation on benefits provision differs from previous versions in that it gives the competent authority of each country the discretion to allow treaty benefits to persons who do not come within one of the safe harbours, and it is accompanied by a memorandum of understanding which, in the view of the Treasury department, "will take much of the uncertainty, for taxpayers and tax authorities alike, out of the process of determining eligibility for benefits".[7] Even the German provision, however, has been criticized as a model for application to the Dutch situation because of, for example, the uncertainty of application of the "active business" safe harbour to corporate groups (where income received by one member is connected with an active business carried on by another member), or the uncertainty of application of the "public trading" safe harbour to Dutch companies which have several classes of shares and which may be traded both on the Amsterdam Stock Exchange and on numerous foreign stock exchanges.[8]

From the U.S. perspective, there has also been a recognition that the German "model" would very likely continue to evolve in subsequent negotiations with other countries.[9] On the other hand, the U.S. negotiator's ability to evolve substantially beyond the German model must be weighed in light of the fact that the Senate Foreign Relations Committee gave only cautious approval to the innovations represented by the German provision itself.[10]

2. *Developments in the EC*

In addition, the increasing integration of the markets within the European Communities (EC) creates a tension for the negotiators. Traditionally, the U.S. limitation on benefits provisions have been narrowly bilateral, and have not included any explicit relaxation of safe harbour standards to

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4. See, e.g., Exec. Rept. 101-27, 101st Cong., 2d Sess. (27 July 1990), at 20 (*Report of the Committee of Foreign Relations,* United States Senate, on Tax Convention with the Federal Republic of Germany).
5. The capital gains tax provision was not ultimately included in the Omnibus Budget Reconciliation Act of 1990, passed by Congress on 27 October 1990.
6. For example, many listeners were disappointed to hear the following sentiments expressed by Senator Sarbanes when he chaired the Senate Foreign Relations Committee's tax treaty hearing on 14 June 1990:

> "I think it is overstating to say that an override by the Congress of a treaty provision as it revises American tax law constitutes a violation of the treaty because it seems to me the parties entering into these treaties know and know full well that the Congress has been prepared to override these tax treaties, and therefore they go into them with that knowledge." (Remarks of Senator Sarbanes, reprinted in *Tax Notes Today: Highlights and Documents* (20 June 1990), at 2953.)

Treasury's International Tax Counsel has also recently expressed concern about the extent to which the anti-override argument has failed to achieve acceptance in Congress. See Interview with Morrison, *supra* note 4, at 42.
7. Gideon testimony, *supra* note 1, at S-5.
8. See, e.g., Ellis, *supra* note 2, at 347.
9. See Leonard B. Terr, "Perspectives on Treaty Shopping", *Tax Notes International* (October 1989), at 379, 383. Commenting on the boundary line in the new U.S.–German treaty between cases that fall within para. 1 of Art. 28 (the safe harbours paragraph) and para. 2 (the competent authority's discretion), Terr said:

> "It was the expectation of the negotiators that paragraph 2 generally would be liberally applied so as not to discourage non-abusive structures representing economically significant investment in the residence country and that, as other treaties were concluded which contained similar limitations articles, the question of the boundary line between paragraphs 1 and 2 might be revisited."

10. The Foreign Relations Committee's Report on the new U.S.–German treaty contained the following language concerning the limitation on benefits article:

> "[I]n exercising any latitude Treasury has to adjust the operation of the proposed treaty, the Committee is particularly concerned that the rules as applied adequately deter treaty shopping abuses... [T]he Committee is aware that implementation of the tests for treaty shopping set forth in the treaty and interpreted in the Memorandum of Understanding may raise factual, administrative, or other issues that cannot currently be foreseen. The Committee emphasizes that the new rules must be implemented so as to serve as an adequate tool for preventing possible treaty shopping abuses in the future."

Foreign Relations Report, *supra* note 5, at 20.

reflect the close economic links between enterprises of a treaty partner and enterprises or residents of other jurisdictions. While the existence of close economic links does not eliminate treaty shopping concerns, it may well suggest that treaty shopping motivations are less likely to provide the explanation for certain investment patterns than would be the case in the absence of such links.

The Memorandum of Understanding (MOU) accompanying the pending U.S.–German treaty contains a specific reference to this point when it says that the discretionary authority granted to the competent authorities under Article 28(2) "is particularly important in view of, and should be exercised with particular cognizance of, the developments in, and objectives of, international economic integration, such as that between the member countries of the European Communities and between the United States and Canada". A likely tension in the U.S.-Dutch negotiations will be whether such considerations should move certain cases from the purely discretionary granting of benefits to coverage under a safe harbour. The fact that the corporate tax systems within the EC continue to vary widely will temper the U.S. enthusiasm for such movement,[11] as will the continuing differences among the various EC member country tax treaties with the United States.

III. SPECIFIC ISSUES IN THE LIMITATION ON BENEFITS ARTICLE

With the general considerations outlined above in mind, one can focus on a number of specific issues arising under the limitation on benefits article with a better sense of the U.S. Government's concerns.

A. *Active business safe harbour*

1. *Affiliate situations*

Article 28(1)(c) of the new U.S.–German treaty contains the so-called "active business safe harbour".[12] The literal language of that safe harbour appears to limit the protection to cases where the German recipient of the U.S. income is itself carrying on a business in Germany to which that income is related. The MOU clarifies, however, that the German income recipient may be able to benefit from the active business safe harbour in cases where the U.S. income it receives is related to an active business carried on in Germany by a person "related" to the German income recipient.[13]

The MOU does not try to define what is meant by "related" for this purpose. Domestic U.S. tax law contains dozens of separate tests for determining "related" status. The ambiguity under the German treaty concerning the scope of the attribution of the active business from one person to a related person which is the income recipient will likely lead to efforts to define that scope more clearly under the new U.S.–Dutch treaty.

Such clarification could be relatively straightforward if attribution is limited to cases involving members of a U.S. consolidated group or the Dutch equivalent, a fiscal unity.

Efforts to go beyond such cases quickly lead to substantial definitional and policy issues.

For example, should a minority shareholder be considered a related person whose income is connected with the business carried on by a corporation, and, if so, how small a minority interest (i.e. at what point does it become difficult to say that there is a true connection between one person's active business and the other person's income)? Should a business carried on in the treaty country by a resident of a third country be attributed to a related resident of the treaty country for this purpose? Should two treaty country residents which are subject to the common control of a third country owner be treated as related persons, and, if so, would there be administrative problems in verifying such persons' entitlement to treaty benefits? Should a business carried on by a minority shareholder be attributed to a treaty country company if treaty benefits claimed with respect to the company's "connected" income accrue primarily to other, third country resident shareholders? How is the "substantiality" of the treaty country business measured relative to the "connected" income item where the business may be attributed to numerous related persons, each of which may want to claim treaty benefits for their own income items?

The complexity of current-day corporate structures makes it inevitable that such questions will have to be faced for purposes of applying a limitation on benefits active business safe harbour. These types of questions clearly demonstrate, however, that the boundary line between coverage under the active business safe harbour and coverage under a competent authority's discretionary authority must be established with careful consideration to the often competing concerns of certainty, administrability and policy.

2. *Headquarters operations*

The active business safe harbour of the new U.S.–German treaty does not cover the business of "making or managing investments". It has been argued that this language, if applied to the Netherlands, would inappropriately deny protection to the so-called "active" holding companies or "headquarters" companies set up in the Netherlands by multinational groups to perform various managerial, administrative, financing and other support functions.[14] The argument says that these activities, at least when they reach a certain level, constitute "real" business activities that should be recognized as an integral part of the Dutch economy, and not just as investment activities.

While there is some merit to this argument, the problem of drawing proper boundaries here is a very troublesome one from the U.S. perspective. To begin with, there is no universally accepted definition of what is meant by "headquarters" operations. Sometimes that term is used to refer to so-called "supporting, preparatory, or auxiliary activities" of the type allowable to Belgian coordination centers[15] or to

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11. On the other hand, the 23 July 1990 vote by the EC Finance Ministers to approve three long-pending corporate tax directives for the elimination of double taxation risks on cross-border operations may be taken as a sign of some progress towards harmonization.

12. The relevant language is:

> "1. A person that is a resident of a Contracting State and derives income from the other Contracting State shall be entitled, in that other Contracting State, to all the benefits of this Convention only if such person is:
>
> . . .
>
> (c) engaged in the active conduct of a trade or business in the first-mentioned Contracting State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business. . ."

13. See, e.g., Example II of the MOU.

14. See, e.g., Ellis, *supra* note 2, at 346-347.

15. See Jean-Pierre Lagae, "Coordination Centers", 41 *Bulletin for International Fiscal Documentation* (August/September 1987), at 359.

Dutch "central management" operations like those covered by the 1985 cost-plus circular letter of the Dutch Finance Ministry.[16] These may include certain activities (e.g. research, coordination of advertising, centralization of data processing), but may stop short of centralized decision-making or policy establishment. To the extent that the activities are limited to those types of supporting, preparatory or auxiliary activities, it is understood that the U.S. Treasury Department generally does not believe that the activities are covered by the active business safe harbour, although "the determination on this issue as on other similar issues will have to be assessed after presentation of the facts of each case".[17]

The German MOU states that the competent authorities, in carrying out their discretionary authority under Article 28(2), should "consider . . . whether and to what extent a *substantial* headquarters operation conducted in a Contracting State by employees of a resident of that State contributes to [a] valid business nexus [between the income-earning entity and the activity giving rise to the income], and should not, therefore, be treated merely as the "making or managing [of] investments within the meaning of paragraph 1(c) of Article 28" (emphasis added). Example VII of the MOU illustrates the discretionary granting of treaty benefits by the U.S. competent authority to a German corporation which acts as the "general headquarters" of a manufacturing joint venture made up of three EC (German, French and Belgian) investors. The example indicates that significant factors in the decision to grant benefits include (1) the clear business purpose for the formation and location of the joint venture; (2) the significant headquarters functions performed by that company in addition to financial functions; and (3) the fact that all of the joint ventures are companies resident in EC member countries in which they are engaged directly or through their affiliates in substantial active business operations.

The example leaves unresolved a number of issues that are likely to form the basis of significant discussion during the U.S.-Dutch negotiations. For example, would the United States have been willing to grant benefits, even on a discretionary basis, if there had been no German investor or no operating business conducted in Germany, or if the other investors had not been from other EC countries, or if only a small number of personnel had been required to carry out the headquarters functions? Is it possible to define a category of headquarters functions which are sufficiently "active" or "substantial" that they warrant coverage under the active business safe harbour? Would any such definition necessarily involve minimum absolute thresholds (e.g. in levels of personnel, space, equipment or other costs) that would result in a bias in favour of enterprises of a certain minimum size?

These issues will be extremely difficult for the negotiators, especially if there is any concern that Dutch headquarters operations may, in certain cases, enjoy tax benefits similar to those available in Belgium to coordination centres. The Senate Foreign Relations Committee, in its 1988 report on the Belgian protocol, specifically instructed Treasury, in renegotiating the Belgian treaty, to "examine this issue [i.e. whether third country-owned Belgian coordination centres that pay little or no tax to Belgium will receive treaty benefits] more closely to ensure that the primary objective of U.S. treaties – to eliminate double taxation, rather than all taxation – is preserved". Thus, the U.S. negotiators will have to proceed cautiously in this area.

B. *Public trading safe harbour*

1. *Substantial and regular trading*

The so-called "public trading safe harbour" (see Article 28(1)(d) of the new German treaty) guarantees treaty benefits to a company "in whose principal class of shares there is substantial and regular trading on a recognized stock exchange". The public trading safe harbour has traditionally been thought to have a two-pronged justification: first, that such a company could be assumed to be predominantly owned by residents of the country where the stock is traded, and second (and perhaps more importantly), that the typical size and diversification of ownership of such companies make them unlikely candidates for the classic treaty shopping "incorporated pocketbook" designation.

In applying the somewhat comparable standard of the U.S. branch tax provision's public trading safe harbour,[18] the IRS has established a "turnover" rule which requires that trades in the relevant class of shares be effected, other than in *de minimis* quantities, on at least 60 days during the taxable year, and that the aggregate number of shares of that class traded on the market during the taxable year be at least ten percent of the average number of shares outstanding in that class during the year.[19] Where stock in a foreign corporation is traded on a U.S. exchange, the branch tax regulations effectively treat the stock as "regularly traded" if it is regularly quoted by brokers or dealers making a market in the stock (i.e. without regard to whether the company can establish that trading in its stock satisfies the general turnover standard).

It can be expected that the Dutch negotiators will seek to have a similar "presumption" of regular trading apply to stock listed on the Amsterdam exchange.[20] The U.S. negotiators will likely find it difficult, however, to accept such a presumption with respect to a foreign stock exchange with which they are not familiar.[21]

C. *Ownership/base erosion safe harbour*

The so-called "ownership/base erosion safe harbour" (see Article 28(1)(e) of the new German treaty), if incorporated in a new Dutch treaty, would effectively guarantee treaty benefits to a Dutch company if (i) more than 50 percent of each class of the company's shares is owned, directly or

16. Resolution No. 084-2737, an English translation of which is reprinted in *Intertax* (June/July 1986), at 144.

17. *Report of the Committee on Foreign Relations of the United States Senate on the Protocol to the Tax Convention with Belgium,* September 1988.

18. Internal Revenue Code, Sec. 884(e)(4)(B), which provides in relevant part as follows:

"A foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if –

(i) the stock of such corporation is primarily and regularly traded on an established securities market in such foreign country . . ."

19. See Treasury Regulations §1.884-5T(d)(4), as amended by Notice 89-80, 1989-2 C.B. 394, 399.

20. At least one commentator has complained that the Amsterdam Stock Exchange's rules would make it difficult to demonstrate that the "substantial and regular trading" standard was met. See Ellis, *supra* note 2, at 347.

21. Their reluctance would not be without foundation. Reports suggest that recent legislation in the Netherlands, which sought to ensure that Dutch investment institutions (similar to U.S. regulated investment companies) were not the "captive" investment vehicles of a single corporation, had to be amended before enactment when it was discovered that mere listing of an investment institution on the Amsterdam exchange was not sufficient to ensure that there was adequate trading and diversification of ownership. See *Tax Planning International Review* (June 1989), at 37.

indirectly, by any combination of individual residents of the Netherlands or the United States, U.S. citizens, certain publicly traded companies, either of the two Governments, or certain tax-exempt organizations (i.e. so-called "good owners"); and (ii) not more than 50 percent of the company's gross income is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons other than those in the good owner categories.

The basic purpose of the base erosion portion of this test is to ensure that the company does not "erode" its Dutch tax base by making deductible payments to persons not entitled to benefits under the treaty. In a certain sense, it operates to backstop the general conduit principles, pursuant to which particular income items may not enjoy treaty benefits if, by virtue of a conduit transaction, they are considered to pass through the hands of an intermediary entity claiming treaty benefits and to be derived by another person not entitled to claim treaty benefits.[22] In another sense, however, it is intended to deny treaty benefits, even in the absence of a classic conduit transaction, where the level of deductible payments suggests that there is little risk of double taxation (as between the United States and the treaty country) and the economic benefit of the treaty benefit is effectively passed on to persons who are not themselves eligible to claim the treaty benefit.

Lingering uncertainty about the scope of the base erosion provision has caused some governments to ask that it be limited to payments of interest and royalties, and one could reasonably expect the Dutch Government to make the same request. The one recent case in which the United States did this – the 1987 protocol with Belgium – elicited an unfavourable reaction from the Senate Foreign Relations Committee.[23] None of the treaties concluded since then has limited the provision to interest and royalties, and it would be difficult to justify doing so in the case of the Dutch treaty.

IV. RELATED ISSUES

A. *Derivative benefits*

One aspect of the U.S. Government's limitation on benefits policy which many observers find the most difficult to understand is the unwillingness to grant "derivative" treaty benefits. Proponents of the derivative concept argue that a third-country resident should not be considered to be treaty shopping when he establishes or uses an entity in a country which has a treaty with the United States through which he derives U.S.-source income if his home country also has a similar treaty with the United States. Such circumstances warrant, the argument goes, a special safe harbour in the limitation on benefits provisions.

These arguments have, of course, some intuitive appeal. In the "early modern" period of the U.S. limitation on benefits campaign, the derivative concept did achieve some acceptance. It was reflected in Article 17(3) of the 1981 protocol to the U.S. treaty with Jamaica,[24] as well as in the 1982 Discussion Draft of Article 16 (limitation on benefits) of the Draft U.S. Model Treaty. Congress also adopted a derivative provision in a 1986 amendment to Internal Revenue Code Section 883(c), relating to the reciprocal exemptions for shipping and aircraft income.

In more recent years, however, Treasury has resisted including derivative safe harbours in tax treaties. The German MOU does not even mention the existence of a tax treaty with the ultimate investor's country as one of the factors the competent authorities should take into account in exercising their discretionary authority to grant treaty benefits under Article 28(2) of the new treaty.

One can easily understand why the U.S. negotiators would be opposed to the very blunt form of derivative provision urged by some commentators. Under such a proposal, a company resident in the Netherlands would be entitled to any benefit offered by the U.S.–Dutch treaty if the company was owned by one or more persons resident in third countries with which the United States has in force a comprehensive tax treaty. It is axiomatic, however, that the limitation on benefits provision is intended to prevent third-country residents from obtaining the benefit of a U.S. tax treaty through use of a company resident in the treaty country if they would not be entitled to the same or similar benefits under a treaty between the United States and their home country.

For example, the Treasury Department is currently under pressure from U.S. taxpayers and Congress to renegotiate the U.S.–France treaty to obtain a zero withholding rate on royalties; the current treaty has a five percent rate.[25] France's willingness to grant this concession, however, is reduced to the extent that French residents may obtain an exemption on their U.S.-source royalties by contributing the royalty-producing property to a Dutch holding company. France's willingness to trade an exemption for French-source royalties might also depend upon the existence of a potential U.S. concession on some provision in the U.S.–France treaty other than the royalty article. If, however, French residents can effectively obtain that desired U.S. tax benefit by routing their investment through the U.S.–Dutch treaty, the United States' bargaining power with respect to the royalty article in the U.S.–France treaty is similarly reduced. In other words, the mere existence of a treaty between the United States and France does not guarantee that the United States might not be harmed by French residents' treaty shopping use of the U.S.–Dutch treaty.

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22. See, e.g., Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; and Rev. Rul. 87-89, 1987-1 C.B. 195.

23. In its Report, the Committee said:

"Because the rule is limited to payments of interest or royalties to persons not entitled to benefits, the provision may not be broad enough to achieve its intended purpose. The Committee understands that the Treasury Department is continuing to examine the scope of the base erosion rule to ensure that its breadth is adequate. It may be that other forms of payments, such as management fees or payments under various compensation arrangements, will have to be included when the treaty is renegotiated."

24. That article provides in relevant part:

"The requirements of para. 2 [concerning absence of a treaty shopping "principal purpose"] are satisfied, in particular, where a company resident in Jamaica and owned by individual residents of third States derives income with respect to which the company claims United States tax benefits under this Convention, the company does not use such income in the manner described in para. 1(b) [relating to base erosion] and: . . .

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

25. See, e.g., 18 April 1990 letter from Senator Claiborne Pell, Chairman, Foreign Relations Committee, to Treasury Secretary Nicholas Brady, reprinted in Tax Analysts' *Highlights & Documents* (7 May 1990); and 25 October 1989 letter from Howard P. Charnas, Chairman, Tax Treaty Committee, National Foreign Trade Council, Inc., to Treasury International Tax Counsel Philip Morrison, reprinted in Tax Analysts' *Highlights & Documents* (7 November 1989).

Accordingly, at the very least, any acceptance of a derivative concept in a limitation on benefits provision would have to be based upon the existence of a specific provision in the treaty between the United States and the country of residence of the investor which grants a U.S. tax benefit that is at least as favourable as the benefit claimed under the hypothetical U.S.–Dutch treaty. Once that level of specificity is introduced, the complexity of the potential provision increases exponentially.

For example, the Jamaica treaty's derivative rule provides that a third-country resident can be counted as a "good" owner of a Jamaican company under the ownership/base erosion safe harbour only if such resident is an individual who would, had he earned the income directly, have been entitled to the same or substantially similar U.S. tax benefits (under his home country treaty with the United States) as are claimed by the Jamaican company. Query whether, if the Jamaican company is seeking to claim the benefit of the Jamaican treaty's ten percent withholding rate on direct investment dividends with respect to a U.S. subsidiary, an individual owner of the Jamaican company could be treated as a "good" owner if he is a resident in a country (e.g. France) whose treaty with the United States provides for a five percent withholding rate on direct investment dividends but a 15 percent rate on dividends received by individuals. In other words, the more rational focus for a derivative provision might be whether the Jamaican company would, if it were resident in the country of residence of its individual owner, be entitled to a U.S. tax benefit at least as favourable as that claimed under the Jamaican treaty.

Even that type of focus, however, can give rise to ambiguities in many cases. For example, the new treaty with Germany has a zero rate of withholding on interest, and the new treaty with Spain generally has a ten percent rate of withholding. Had the treaty with Spain incorporated a derivative provision with this type of focus, one might reasonably anticipate that interest paid by a U.S. company to a German-owned Spanish company should be taxed by the United States at not more than ten percent. On the other hand, if the interest were paid to a German company with respect to an "equity kicker" loan (a debt obligation carrying the right to participate in profits), Article 10(5) of the new German treaty would allow the United States to impose its domestic law 30 percent withholding tax, whereas the U.S.A.–Spain treaty has no such provision denying the availability of its ten percent rate. Should the existence of the equity kicker provision of the German treaty mean that the German treaty should not be considered to provide a benefit "at least as favourable" as the Spanish treaty in the case of interest paid on an equity kicker loan to a German-owned Spanish company?

Examples of these types of questions abound. Even though treaties may be broadly similar, their particular provisions vary significantly and can be much more complicated than one might expect by reviewing a chart of withholding rates across a treaty network. For example, variations in permanent establishment thresholds can affect not only the applicability of the business profits provisions, but also the issue of whether income items such as dividends, interest or royalties are treated as falling under the business profits article or the article specific to that type of income. Efforts to evaluate the relative benefits applicable to a particular income item under a derivative approach can become fiendishly difficult because of such variations, especially if there are multiple derivative owners of the income recipient who are resident in various jurisdictions. Proponents of derivative provisions typically underestimate the complexity of drafting self-executing rules to deal with such problems, and they certainly underestimate the complexity of applying those rules.

Even in situations where the application of the rules would be relatively straightforward, other concerns can arise. For example, given that a derivative investor's home government has entered into a double taxation treaty with the United States under the general understanding that U.S. tax benefits would apply to U.S.-source income items flowing into that country's tax base as a residence jurisdiction, one might wonder whether that government would happily see those bargained-for benefits apply, because of a derivative provision, to income items which are being received and accumulated by the investor in an intermediary country company. Proponents of derivative benefits argue that this should not be a concern of the U.S. Government, and that the investor's home government, if it wants to retain its current tax base, can implement rules, similar to the Subpart F regime in the United States, which would tax its residents currently on income earned by foreign corporations they control. This argument is not necessarily wholly satisfactory to the U.S. Government officials whose responsibility it would be to explain the derivative approach to the investor's home government.

In a similar vein, administrability and information exchange issues loom large in the derivative context. For example, the limitation on benefits provisions which have appeared in most U.S. treaties thus far have been considered capable of broad monitoring by the IRS with the assistance of information from the particular treaty country's tax authorities. Those authorities are capable of assisting the IRS in ascertaining that the particular entity both meets the substantive conditions for claiming the treaty benefit and is, for example, owned by individual residents of that country.

A derivative approach could require the IRS, in its monitoring function, to determine whether a particular entity's owners are in fact resident in the third country and whether the entity satisfies the substantive conditions for claiming treaty benefits by derivative reference to that third country's treaty. The tax authorities from the entity's country of residence may not be capable of assisting the IRS in this verification, and the tax authorities from the third country may not be willing to provide such assistance, especially if the income in question is being accumulated outside their borders. Moreover, the third country's tax authorities might take the position that they have no obligation to assist the IRS with such an inquiry pursuant to the information exchange article in their treaty with the United States, on the theory that the desired information would not be necessary for purposes of carrying out the provisions of either the domestic law of the United States or the treaty between the United States and that third country, but only for purposes of carrying out the provision of the treaty between the United States and the intermediary entity's country of residence. Such problems could prove equally troublesome to any withholding agents who might be required to obtain verification of an income recipient's entitlement to a treaty's exemption or reduced rate.

Similarly, information about the third country investor which the IRS might obtain from the tax authorities of the entity's country of residence could generally not be turned over to the third country tax authorities without the consent of the entity country's tax authorities, because of limitations imposed by treaty exchange of information articles on the use of information obtained thereunder. In light of the concern about erosion of the third country's current tax base, it would be difficult to imagine the United States' agreeing to a derivative provision without obtaining blanket approval to pass on information to the third country tax authorities.

The concept of derivative benefits is certainly worthy of careful thought as a step in the evolution of the limitation on benefits provisions, and the problems described above are not intended to suggest that any derivative provision would be fatally flawed. Nevertheless, any step in that direction would have to be taken with the utmost caution.

B. *Dual resident Dutch companies*

While not precisely a treaty shopping question, an issue has arisen about the potential status under a new U.S.–Dutch treaty of a Dutch-incorporated company which is effectively managed in a third country (e.g. the United Kingdom or the Netherlands Antilles) to which the Netherlands has ceded residence-based taxing jurisdiction pursuant to a treaty's dual resident corporation tie-breaker provision. In a 1988 policy decision, the Netherlands Under Minister of Finance decided not to grant Dutch residence certificates to such companies for purposes of treaties between the Netherlands and third countries (e.g. potentially the United States) where such third country treaties provide that the term "resident" of the Netherlands does not include "any person who is liable to tax in [the Netherlands] in respect only of income from sources in [the Netherlands]".[26]

There can be little doubt that the United States would agree that such dual resident Dutch-incorporated companies should not be treated as residents of the Netherlands for purposes of the U.S.–Dutch treaty. Some commentators have questioned the validity and effect of the Under Minister's decision,[27] and one could therefore anticipate that the new U.S.–Dutch treaty would contain an explicit resolution of the issue.

C. *Dutch companies' third country permanent establishments*

Another problem which is likely to be the topic of considerable discussion in the U.S.-Dutch negotiations concerns the U.S.-source income received by a foreign permanent establishment (e.g. an Antilles or Swiss branch) of a Dutch resident company. Because the Netherlands, either by treaty or by domestic law, exempts certain income received by foreign permanent establishments of Dutch companies, including in cases where little or no third country tax may be paid on such income, the United States will likely want to include a provision in the new treaty which would deny U.S. treaty benefits to such income in appropriate cases.

The Dutch Unilateral Relief Decree (URD) relieves potential double taxation by exempting business income earned by a foreign permanent establishment of a Dutch resident company. Theoretically, Dutch law imposes a "subject to tax" test for this exemption to apply; in other words, the exemption is available under the URD only to income which is subject to a foreign income tax in the country where the income is earned (presumably where the permanent establishment is located). In practice, however, the fact that little or no foreign tax is actually paid (e.g. because of a local investment incentive or other tax holiday) will not necessarily deprive the Dutch company of relief. Moreover, it appears that income, such as interest or royalties, which would not normally qualify for the exemption method of relieving double taxation, can effectively be made to qualify for that method by routing it through such a permanent establishment. The Netherlands' tax treaties have followed this basic approach of exempting income attributable to a Dutch company's permanent establishment located within the treaty partner's jurisdiction.

There is nothing new about the problem faced by a source state in granting treaty benefits to an entity established in a residence state in cases where the income in question is derived by a permanent establishment in a third state and is therefore exempted from tax in the residence state by that state's domestic law or treaty obligations. The potential abuses inherent in this kind of "triangular case" situation have been the subject of discussion recently at Working Party 1 of the OECD's Committee on Fiscal Affairs and in other fora.

Inasmuch as the permanent establishment cannot claim the benefits of a tax treaty that may exist between the third state and the source state (e.g. between Switzerland and the United States), because the permanent establishment is not an entity "resident" in the third state in treaty parlance, the proper solution is not necessarily a total denial of source state treaty benefits under the source state-residence state treaty. On the other hand, serious consideration would have to be given by the United States as the source state to some sort of targeted denial of benefits. In crafting such a provision, the U.S. negotiators may want to consider such factors as the level of tax paid to the third state relative to the level of tax that would have been paid to the Netherlands if the income had not been exempted there, and the existence of a tax treaty between the United States and the third state that might have offered U.S. tax benefits to the permanent establishment if it had been incorporated as a subsidiary there.

D. *Informal capital*

Another area of concern for the U.S. tax authorities involves the so-called "informal capital" loans. Basically, this structure involves a third country parent company which makes an interest-free loan to its Dutch subsidiary, and the Dutch subsidiary re-lends the funds on an interest-bearing basis to a U.S. affiliate. Under Dutch case law, the Dutch subsidiary can be treated as paying (deductible) interest at an arm's length rate to the foreign parent, and then having that "interest" recontributed to itself as capital.

At one point, the Dutch tax authorities had been granting advance rulings in these informal capital cases to bless the interest deduction of the Dutch company on the condition that an appropriate spread (e.g. 1/8 of one percent) was left in the Netherlands. A moratorium on the issuance of these rulings has now been in effect for some time,[28] but it appears that Dutch taxpayers may still be able to rely on the case law without having an advance ruling.

This structure is clearly a troublesome one from the U.S. perspective. Much of the problem could presumably be solved by agreement on a satisfactory limitation on benefits article. Short of that, there is also the possibility that the

26. Art. 4(1) of the 1977 OECD Model Income Tax Convention. See Rijkele Betten, "Denial of Certificate of Residence to Dual Resident Company", *European Taxation* (November 1989), at 371.
27. See, e.g., Prof. Dr. Kees van Raad, "Dual Residence and 1977 OECD Model Treaty Art. 4(1), Second Sentence", *European Taxation* (January 1990), at 27.
28. See Maarten J. Ellis, "Developments in Ruling Practice", *Tax Notes International* (August 1989), at 177.

U.S. tax authorities may want to attack this situation through an application of general conduit principles (e.g. through an extension of Rev. Rul. 854-152 to cover deemed interest payments by the Dutch company).

V. CONCLUSION

The crafting of an appropriate limitation on benefits provision presents formidable challenges to the treaty delegations of the Netherlands and the United States. A successful tax treaty negotiation, like any other negotiation, requires a careful sifting and weighing of competing interests, priorities and constraints, the ability of each side to comprehend the other's concerns and the flexibility to design responsive solutions. While the foregoing discussion is intended to highlight the U.S. perspective on these issues, a proper appreciation of the ultimate agreement will require a corresponding understanding of the perspective from the Dutch side. Only such a dual perspective will allow one to judge accurately whether a new U.S.-Dutch limitation on benefits provision, which will inevitably differ from provisions previously agreed by either Government, represents a reasonable step forward.

Conference Diary

JANUARY 1991

Fundamental Elements of U.S. Federal Taxation. Lenham, 7-8 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

U.S. Taxation of International Joint Ventures, Partnerships Trusts. Lenham, 7-8 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

U.S. International Taxation: Tax Strategies for Cross Border Activities. Lenham, 9-11 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

U.S. International Reorganizations. Lenham, 9-11 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT. United Kingdom. Tel.: 01 935 7502. Fax: (071) 935 6951.

Steuerplanung und Steuerpraxis Europa – U.S.A. 28. Tagung des Internationalen Steuerseminars in St. Moritz/Schweiz. St. Moritz, 14-18 January (German):
Internationales Steuerseminar, c/o Bank Leu AG, STER-KEW, Postfach, CH-8022 Zürich, Switzerland.

Beginners Course on the Principles of International Taxation and the Tax Systems of Selected Countries from an International Perspective. Amsterdam, 14-25 January (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

Recent U.K. Double Taxation Treaty Developments. London, 15 January (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Tel.: 071 936 3000.

Fiscale Concernstructuren. Garderen, 15-16 January (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608811; Fax: 040 449895.

The Eighth Annual Waidring Conference – The Transnational Person / 1992. Waidring, 20-26 January (English):
University of the Pacific, McGeorge School of Law. Att. Mr. Stanley E. McCaffrey International Programs Center, Ferdinand-Porsche-strasse 6/II, A-5020 Salzburg, Austria. Tel.: (0662) 75 5 20; Fax: 662 75 5 23.

Tax Efficient Treasury Management. London, 21-22 January (English):
IIR Ltd., P.O. Box 293, 28th Floor, Centre Point, 103 New Oxford Street, London WC1A 1QL, United Kingdom. Tel.: (071) 412 0141; Fax: 071-412 0145.

U.S. Expatriate Taxation: Estate & Gift, Benefits/Retirement Plans & Financial Planning; U.S. Individual/Expatriate Taxation. London, 21-25 January (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel. (071) 935 7502; Fax: (071) 935 1308.

Efficient Management of VAT in Financial Institutions. London, 28 January (English):
IIR Ltd., P.O. Box 293, 28th Floor, Centre Point, 103 New Oxford Street, London WC1A 1QL, United Kingdom. Tel.: (071) 412 0141; Fax: 071-412 0145.

Supervised Study Programme on Double Taxation Treaties. Amsterdam, 28 January-22 February (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

Grensoverschrijdende Arbeid. Rotterdam, 29 January (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608811; Fax: 040-449895.

FEBRUARY 1991

Änderungen des Steuerrechts 1990. Badgastein, 4-8 February (German):
Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41, Germany. Tel.: (0221) 40 30 28/29; Fax: (0221) 40 30 20.

Recent Tax Cases. London, 6 February (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Tel.: 071 936 3000.

MARCH 1991

Beginners Course on the Principles of International Taxation and the Tax Systems of Selected Countries from an International Perspective. Amsterdam, 4-15 March (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

The Harmonisation of Direct Tax in Europe. London, 5 March (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Tel.: 071 936 3000.

Advanced International Tax Course on Controlled Foreign Corporations, Transfer Pricing, International Joint Ventures, the Use of Tax Treaties, Treaty Shopping. Amsterdam, 18-21 March (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: (31) 20 267726; Fax: (31) 20 228658.

APRIL 1991

Vennootschapsbelasting. Velp, 10-12 April (Dutch):
Studiecentrum voor Bedrijf en Overheid, t.a.v. Mädy van der Linden Vooren, Postbus 828, 5600 AV Eindhoven, The Netherlands. Tel.: (3140) 608888.

Internation Tax Management Techniques. Brussels, 11-12 April (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium. Tel.: (322) 516-1911, ext. 934. Fax: (322) 513-7108.

THE U.S.–NETHERLANDS INCOME TAX CONVENTION

HISTORICAL EVOLUTION OF TAX TREATY POLICY ISSUES INCLUDING LIMITATION OF BENEFITS

William P. Streng

This article is based on background information developed for purposes of a presentation (at which the author was the moderator) at the August 1990 joint meeting in Amsterdam of the Dutch and U.S. Branches of the International Fiscal Association. The subject matter of this discussion was the present U.S.–Dutch income tax treaty and, particularly, the continuing income tax treaty discussions for the revision of that treaty. The discussion at that joint meeting concentrated particularly on possible rules to limit those persons entitled to the benefits of a revised U.S.–Dutch income tax treaty. This IFA meeting dialogue also encompassed the likely future for the Act of the Kingdom with the Netherlands Antilles, including Aruba.[1]

Mr. Streng is the Vinson & Elkins Professor of Law at the University of Houston College of Law where he teaches courses in federal income tax, corporate tax, estate planning and international taxation. From 1980-85, Mr. Streng was the partner in charge of the tax department at Bracewell & Patterson, a Houston-based law firm with offices in Washington, D.C., Dallas, London and Austin. He continues as a consultant with the firm. Prior to joining Bracewell & Patterson in 1980 he was (1973-79) a Professor of Law, Southern Methodist University, Dallas.

Mr. Streng graduated from the Northwestern University School of Law in 1962. Thereafter, he served as Law Clerk to the Honorable Lester L. Cecil, Chief Judge, U.S. Court of Appeals for the Sixth Circuit (1963-64); as Attorney-Advisor, Office of Tax Legislative Counsel (Office of the Assistant Secretary for Tax Policy), U.S. Department of the Treasury, Washington, D.C. (1970-71); and, as Deputy General Counsel, Export-Import Bank of the United States, Washington, D.C. (1971-73). He has been a Visiting Professor at the New York University School of Law (1990), the Ohio State University College of Law, and Rice University.

Mr. Streng has authored numerous books and articles on taxation and international financing. He is a member of the American Law Institute and its Tax Advisory Group, the International Fiscal Association, the American Bar Association's Section of Taxation, the Tax Management Advisory Board, and various other professional organizations.

I. THE PRESENT U.S.–DUTCH INCOME TAX TREATY

A. *History of the treaty*

The present U.S.–Dutch income tax treaty has been effective since 1948. The treaty between the Unites States and the Netherlands was signed, ratified and entered into force in 1948.[2] A supplementary treaty was signed in 1965. This supplementary treaty was ratified and entered into force in 1966.[3] No other protocols are applicable. Negotiations have been conducted between the Netherlands and the United States since 1981 for a proposed new treaty.[4] Negotiations were scheduled to continue during late 1990.

The Dutch–U.S. income tax treaty was extended to the Netherlands Antilles in 1955. A 1963 protocol to the treaty was made applicable only to the Netherlands Antilles. However, as noted below, the U.S.–Netherlands Antilles treaty has been largely terminated, primarily because of the perceived use of the Netherlands Antilles as a conduit country for funnelling investment flows into the United States from third countries not parties to income tax treaties with the United States.

B. *Important issues in present U.S.–Dutch tax treaty negotiations*

A variety of issues exist in the current negotiations concerning the possible revision of the U.S.–Dutch income tax treaty. Most importantly, these include questions concerning the "limitation on benefits" provision.[5] For example:

(1) What local ownership requirements should be imposed to be eligible for the treaty benefits?
(2) Who is entitled to derivative benefits?
(3) How should these rules be adapted to the increased integration of the European Common Market and business enterprises within the EC?[6]
(4) What should constitute an "active trade or business" for purposes of these rules?
(5) Should headquarters companies be treated as residents of the Netherlands?
(6) Should the publicly traded company rules be relaxed because the shares of Dutch companies are often traded on exchanges outside the Netherlands?

1. An unofficial translation of the Netherlands–Netherlands Antilles and Aruba (Income, Gift, Inheritance, Stamp and Motor Vehicle) Tax Treaty is included at Kramer, Roeloffs & Walboom, "Business Operations in the Netherlands Antilles", *Tax Management Portfolio,* No. 263, Worksheet 16, reprinted there with the permission of the International Bureau of Fiscal Documentation.
2. TIAS No. 1855, 1950-1 C.B. 93.
3. TIAS No. 6051, 1967-2 C.B. 472.
4. See IRS Announcement 81-165, 1981-42 I.R.B. 26.
5. See "Treaty Ratifications on Target, Treasury Official Reports: Reporting Regs 'Weeks'

Other controversial issues exist, for example, in defining the concept of "permanent establishment", particularly in the offshore drilling context.

Some of these questions are identified below in the summary of recent Internal Revenue Service (IRS) rulings. However, the discussion of the income tax treaty ultimately returns to the questions of limitations of scope of benefits, and the complementary issue of the authority and appropriateness of the U.S. Congress in periodically taking action to "override" tax treaties.

C. *IRS interpretations of the current U.S.–Dutch treaty*

1. *Ruling issues*

The IRS has periodically interpreted provisions of the U.S.–Netherlands income tax treaty, and several of those interpretations are summarized here. A variety of IRS published rulings and private letter rulings have been issued concerning the U.S. activities of Dutch investors. Most recently, the concept of "industrial or commercial profits" has been under examination in these rulings, as noted below. Many of these rulings evidence an effort to constrict opportunities to utilize benefits otherwise seeming to be available under the treaty.

2. *The permanent establishment concept*

In Rev. Rul. 87-5,[7] amounts were received by a Dutch bank without a permanent establishment in the United States pursuant to a dollar denominated interest rate swap with a U.S. person. The gain arising was treated as industrial or commercial profits.[8] This income was treated as earned in the active conduct of the Dutch bank's trade or business and was "not covered by any other article of the Convention". Therefore, the income was not treated as interest income of the bank, i.e. income exempt from withholding under the treaty.

In Rev. Rul. 86-156,[9] photocopy machines were manufactured by a Dutch corporation without a U.S. permanent establishment and leased to its U.S. subsidiary. The profits received by the Dutch corporation were treated as subject to Article III, the industrial or commercial profits article. These payments were not treated as subject to the royalties article,[10] which provides that the term royalties includes rental or other amounts paid as consideration for the use of, or the right to use, a variety of identified property "or other like property or rights". Photocopy machines are not enumerated in the royalty article and, further, were not treated as "other like property" as specified in that article.[11] Therefore, net income tax treatment applicable to a U.S. permanent establishment was applied.

In both cases the amounts received by the Dutch corporation were exempt from U.S. tax.

3. *Withholding at source issues*

(a) *Interest*

In a relatively recent technical advice memorandum, the IRS identified a position concerning conduit arrangements through the Netherlands for the payment of interest.[12] A third country individual had loaned money to his Dutch corporation. The Dutch corporation had loaned the funds to its U.S. subsidiary for investment in U.S. real estate. Interest was paid and was sought to be exempted from U.S. withholding tax.[13] However, the IRS stated that the Dutch corporation never had dominion and control over the payments. The Dutch corporation was treated as acting merely as a conduit. The Dutch corporation had actually endorsed the interest checks over to the corporate owner and the funds then were directly deposited into the owner's account. The IRS rejected eligibility to the Dutch corporation interest recipient for immunity from withholding tax on interest, concluding that, in substance, the interest was paid to the third country owner.[14]

(b) *Dividends*

Important outstanding IRS rulings concerning the dividends article of the U.S.–Netherlands tax treaty are Rev. Rul. 75-118[15] and Rev. Rul. 81-132.[16] In Rev. Rul. 75-118, the five percent reduced rate[17] was applied to a dividend paid by a U.S. corporation to its Dutch parent corporation. The Dutch corporation was itself wholly owned by another Dutch corporation. Pursuant to Rev. Rul. 81-132, to qualify for this reduced five percent withholding rate on direct dividends, the participation must have been directly owned by the Dutch recipient throughout the required holding period. Under the facts presented in this ruling a Canadian corporation owned the Dutch corporation. Although the five percent rate was not deemed to be applicable, the 15 percent rate under the treaty was deemed applicable. The effect of this ruling (not withdrawn) was, thereby, to recognize treaty rate reduction eligibility for a conduit arrangement. Of course, significant questions exist concerning the continuing viability of any rulings where a conduit arrangement has previously been permitted.

(c) *Royalties*

The IRS interpretation of the royalty article in the current treaty is evidenced by the *cascading royalty* ruling, Rev. Rul. 80-362.[18] The IRS there considered a transaction where a third country national (who was not a beneficiary of a bilateral income tax convention with the United States) licensed for a fixed royalty annually the U.S. rights to a patent to a Netherlands corporation. This Dutch corporation was stated to be a bona fide corporation which was unrelated to the licensor. The Netherlands corporation, in turn, relicensed the right to use the patent to a U.S. corporation for use in the United States. The licensing fee was based on the number of units produced by the U.S. licensee under the patent. The ruling indicates that amounts paid to

Away", 4 *Tax Notes,* No. 4 (22 October 1990), at 386, quoting Marcia D. Field, director of international taxation in the U.S. Treasury Department's Office of Tax Analysis, as indicating that the key to the U.S.–Dutch tax treaty discussion is the limitation of benefits article and "[t]he issue is how to craft an article that does not adversely affect a company's legitimate business decision to operation in the Netherlands, especially with European Community integration set for 1992".
6. Consider, for example, the concept of the European Economic Integration Grouping (EEIG). See Lambooij and Boon, "Reading the Implications of the Netherlands Circular Letter", Vol. 1, *International Tax Review,* No. 8 (July/August 1990), at 19.
7. 1987-1 C.B. 180.
8. See Treaty Art. III.
9. 1986-2 C.B. 297.
10. Art. IX(2).
11. See also GCM 39595 (5 January 1987).
12. Technical Advice Memorandum 8722009.
13. See Treaty Art. VIII(1).
14. See Treaty Art. VIII.
15. 1975-1 C.B. 390.
16. 1981-1 C.B. 603.
17. See Treaty Art. VII(1)(b).
18. 1980-2 C.B. 208.

the Dutch corporation are exempt from U.S. tax under the U.S.–Dutch treaty. However, amounts paid by the Dutch corporation to the third country national are categorized as U.S.-source income. This treatment is based on the provision[19] which specifies that royalties paid in consideration for the privilege of using a patent in the United States are treated as income from U.S. sources and this treatment is irrespective of the fact that the payor is a foreign corporation.

The IRS did not treat the Dutch corporation as a conduit in this ruling. No reference was made as to whether the Dutch corporation made a profit. The question consequently arises, therefore, concerning the acceptability of back-to-back transactions if (1) the parties are unrelated and (2) the two transactions are different.[20]

II. ABROGATION OF THE U.S.–NETHERLANDS ANTILLES PROTOCOL

The U.S.–Netherlands Antilles income tax treaty previously provided an effective means for tax reduction for foreign investment into the United States and for U.S. enterprises to obtain foreign capital on a tax efficient basis through the use of the Netherlands Antilles finance company. However, that treaty was terminated by the United States, effective 1 January 1988, except for Article VIII and ancillary provisions. Although this treaty termination occurred some years after the initiation of the U.S.–Netherlands tax treaty negotiations, and the relative bargaining power in these two different situations is dramatically dissimilar, the U.S. action concerning the U.S.–Netherlands treaty relationships does provide perspective on the evolving attitudes on the U.S. side towards expectations in the current U.S.–Netherlands tax treaty negotiations.

Article VIII provides an exemption for interest where the recipient is not engaged in a trade or business through a permanent establishment in the source country. Pursuant to the 1963 protocol, a Netherlands Antilles company would not enjoy the benefits of this provision unless it waived its entitlement to the special low rates of 2.4 percent to 3 percent, or was Dutch owned. However, even during the continued effectiveness of this article, the Netherlands Antilles companies are subject to scrutiny on IRS audit. This scrutiny occurs through the application of conduit, back-to-back and substance over form rules.

III. SPECIFIC TREATY NEGOTIATION ISSUES CONCERNING THE LIMITATION OF TAX TREATY BENEFITS

A. *The U.S. model income tax treaty – Article 16*

1. *Structure of the provision*

Article 16 (as revised) of the 1981 U.S. model income tax treaty provides limitation of benefits concepts intended by the U.S. Department of the Treasury to be incorporated into subsequently negotiated U.S. income tax treaties.[21] Article 16(1) specifies the rule which determines a corporate resident's eligibility for the relief from taxation which is provided in the treaty. The rule indicates that a corporation is not eligible for treaty relief unless (1) the stock of the corporation is listed on a recognized stock exchange; (2) the corporation is not controlled by individuals resident outside the two contracting states; or (3) it was not a principal purpose of the corporation or of the shareholders to use the corporation or to conduct its business in a manner to obtain tax treaty benefits.

A corporation is presumed to meet the standard of this Article 16(1) if it can demonstrate that more than 75 percent of its stock is owned by individuals resident in the two contracting states, or in a state which has a treaty with the contracting state from which relief is claimed and such convention provides relief from taxation not less than the relief claimed under the convention. Further, the income of the company must not be used in substantial part to directly or indirectly meet liabilities of persons not resident in the contracting states, or U.S. citizens.

Article 16(2) would provide a subjective test for companies that would not otherwise qualify for treaty benefits under Article 16(1) but which can demonstrate that the maintenance of such person and the conduct of its operations did not have as a principal purpose the obtaining of treaty benefits. Further, Article 16(3) would limit the application of treaty benefits to prevent companies which are subject to special low tax regimes in the other contracting state from obtaining reduced rates of tax.

2. *Evolution of limitation of benefits provision*

The U.S. negotiating position on the limitation on benefits article evolved over the decade of the 1980s.[22] Various refinements to the 1981 model have been reflected in a number of tax treaty provisions that have been negotiated or ratified. Refinements have also been included in the *qualified resident* definition under the branch tax provisions of the IRC. Under the IRC, the 1989 German treaty,[23] the 1988 Belgian protocol,[24] the 1988 French protocol,[25] the 1988 Indonesia treaty,[26] the 1986 China protocol,[27] and the 1984 Barbados treaty,[28] for example, an entity is entitled to

19. Internal Revenue Code (IRC), Sec. 861(a)(4).
20. However, see the back-to-back loan ruling, i.e. Rev. Rul. 87-89, in the text below.
21. Article 16 provides:
"1. A person (other than an individual) which is a 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 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
(b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.
For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.
2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as its principal purpose obtaining benefits under the Convention.
3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State."
22. See the U.S. Congress Joint Committee Print JCS 1-90, as prepared by the Staff of the Joint Committee on Taxation, of January 1990 hearings.
23. See Art. 28. The German–U.S. income tax treaty limitation on benefits provision specifies that the competent authorities in each country have the discretion to allow treaty benefits to persons who do not come within one of the safe harbours. An accompanying memorandum of understanding further elaborates on the interpretation of the limitation on benefits provision.
24. See Art. 12A of this protocol.
25. See Art. XI of the protocol, replacing Art. 24A of the treaty.
26. See Art. 28, entitled "General Rules of Taxation".
27. See Para. 1 of this protocol.
28. See Art. 22 of this treaty.

treaty benefits if it meets one of three tests: ownership and base erosion, good business purpose or public company.

Meeting the public company test is typically similar to meeting the ownership test under the 1981 model by virtue of the entity's stock being traded on a recognized treaty country stock exchange. The ownership test may often be satisfied if the entity is beneficially owned (over a threshold percentage) by a combination of U.S. citizens or residents, or residents of the other country. Meeting the good business purpose test may require (absent approval by the source country competent authority) being engaged in the active conduct of a trade or business in the entity's residence country. This would not include the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. The income derived from the source country would be required to be received in connection with, or be incidental to, that trade or business.[29]

The Joint Committee on Taxation has indicated that latitude exists for disagreement over the proper criteria for determining that an entity is treaty shopping. As the branch tax definition of "qualified resident" (included in the IRC) and the recent treaty limitation on benefits clauses demonstrate, numerous criteria can be considered in this context. Some are quite difficult to apply in practice. For example, some treaty shopping rules are based on the identities of the beneficial owners of the entities that seek treaty relief. Such identification can be problematic, especially in large organizations with diverse ownership interests. Base erosion rules are based on the identities of the beneficial owners of payments from the entity, a criterion even more remote from the knowledge of tax administrators. Other criteria can include the location of an exchange on which the entity's stock is traded.

Such a criterion may be based on an expectation that public trading in a corporation's stock suggests that the entity is regulated in some way that precludes its use as a nominee solely for the tax purposes of foreign controlling interests. More simply, the justification is made that local residents tend to be more likely than foreign persons to own shares in companies traded on a local exchange. However, the location of the exchange may more properly be viewed as immaterial in a globally integrated stock market. Further, the identity of the stockholder (or other interest holder) can be itself an uncertain guide to beneficial ownership of the activities and the income generated by the corporation. This is particularly apropos in light of the variety of ownership interests that can be accorded under the name "stock", and when noting that stockholders can be relatively insignificant relative to the interest of other investors or recipients of payments from the corporation.

Further, the Joint Committee on Taxation indicated that criteria based on business activities of the entity in the treaty country, or the tax status of the entity in the treaty country, can be used as indicators of treaty shopping. Depending upon how strictly such criteria are applied, they may produce incompatible patterns with world-wide markets, or rational business administration. Alternatively, however, these criteria may be insufficiently strict to prevent substantial levels of treaty shopping.[30]

B. *Significant U.S. court decisions and IRS rulings*

A variety of U.S. court decisions and IRS rulings (other than those interpreting the U.S.–Dutch income tax treaty (as discussed above) have considered various aspects of tax treaty conduit arrangements. Alternatively, various forms of sham transaction or substance over form analyses have been presented in these contexts.

1. *Aiken Industries*

In *Aiken Industries, Inc. v. Commissioner,*[31] a Honduran company was interposed into a related company loan structure to receive interest from a related U.S. company. The sole purpose of this structure was to ultimately transfer the outbound interest payment to a related Bahamian corporation which was the original lender. The objective was to utilize the U.S.–Honduras income tax treaty[32] exemption for interest received by Honduran persons from U.S. persons. Interest paid directly to Bahamian lenders would not have been eligible for this benefit, the interest being subject to withholding at source at the applicable statutory rate.

The Tax Court held that the interest paid was not protected by the treaty exemption because the Honduran company did not really receive the interest as contemplated by the treaty. For purposes of the treaty exemption, the recipient must receive the interest for its own use and not subject to an obligation to transfer it to another. This represented early evidence of the rejection of a conduit arrangement.

2. *The 1984 IRS conduit rulings*

During 1984 the IRS published two important rulings dealing with the application of conduit principles in the tax treaty context: Rev. Rul. 84-152[33] and Rev. Rul. 84-153[34]. In Rev. Rul. 84-152, a Swiss parent company loaned funds at ten percent to its Netherlands Antilles subsidiary for the express purpose of having the Netherlands Antilles company reloan the funds to the Swiss company's subsidiary in the United States. The loan from the Netherlands Antilles lending subsidiary could not have been made without the loan from the Swiss parent to the Netherlands Antilles company. The IRS held that the interest had not been economically derived by the Netherlands Antilles subsidiary, as contemplated by the U.S.–Netherlands Antilles treaty. Rather, the Netherlands Antilles subsidiary was treated as only temporarily obtaining physical possession of the interest from the U.S. borrower and as not obtaining complete dominion and control over such interest payments. Therefore, the Netherlands Antilles company, although a valid corporation, was considered as transparent for purposes of this transaction, and the interest was considered as flowing from the U.S. subsidiary to the Swiss parent. A five percent withholding rate under the U.S.–Swiss treaty was deemed to be applicable, rather than the exemption for interest under the U.S.–Netherlands Antilles treaty.

In Rev. Rul. 84-153, the parent corporation was a U.S. company, rather than a Swiss corporation. A loan of funds from the parent's Netherlands Antilles subsidiary to the parent's U.S. subsidiary was made to supply the U.S. subsidiary with working capital. The funds for this purpose were raised on the Eurobond market. The IRS held that the primary purpose of this arrangement was also to obtain treaty benefits and that the Netherlands Antilles subsidiary did not have dominion and control of the interest payments.

29. E.g. German treaty, Art. 28.1(c).
30. In support of this analysis the Committee Print noted Rosenbloom, "Tax Treaty Abuse: Policies and Issues", 15 *L. & Pol. Int'l Bus.* (1983), at 763.
31. 56 T.C. 925 (1971), acq. on another issue, 1972-2 C.B. 1.
32. This treaty is no longer effective.
33. 1984-2 C.B. 381.
34. 1984-2 C.B. 383.

Therefore, the interest was deemed to flow from the U.S. parent corporation directly to the Eurobond holders.

Rev. Rul. 84-152 and Rev. Rul. 84-153 were modified and clarified in Rev. Rul. 89-110[35] which indicates that, notwithstanding the partial termination of the U.S.–Netherlands Antilles tax treaty, the principles of these rulings continue to apply to similar provisions under other treaties. Further, in Rev. Proc. 87-39,[36] the IRS had indicated that it will not issue a private letter ruling concerning whether a foreign recipient of payments is ineligible to receive the benefits of a tax treaty between the United States and a foreign country due to the application of the principles of Rev. Rul. 84-152 and Rev. Rul. 84-153.[37]

3. *Plantation patterns*

In a domestic situation, *Plantation Patterns, Inc. v. Commissioner,*[38] more than $ 600,000 was advanced to a corporate borrower by an unrelated third party. The funds were used to acquire capital assets, rather than being used as working capital. Only $ 5,000 in equity was contributed to commence the venture. The controlling shareholder guaranteed the corporate debt, a necessary condition to obtain the loan.

The Court determined that the lender had actually made the loan not to the corporation but to the shareholder/guarantor. The shareholder was treated as subsequently making a contribution to the capital of the corporation equivalent to the amount of the purported loan. This case is often used to support a conduit arrangement argument, including in the international context.

4. *Back-to-back loans*

In Rev. Rul. 87-89,[39] the IRS ruled that loans by a foreign bank to another party will be treated as loans from the bank's depositor to the borrower when the bank loan is dependent upon the deposit of funds from the depositor. For example, in one situation in the ruling a foreign corporation made a deposit with a bank and the bank, in turn, made a loan to the depositor's domestic subsidiary. The bank was in a country exempting outbound interest from withholding tax at source. The use of the bank was treated as being made merely to access the tax treaty exemption. The loan was considered as if made directly from the foreign parent to the U.S. subsidiary, with the 30 percent withholding tax on interest therefore being applicable. In essence, the bank loan will only be independently respected if the deposit and the loan are detached transactions and the loan from the bank would be made or maintained on the same terms irrespective of the deposit.

C. *U.S. Congressional implementation of treaty shopping rules*

1. *U.S. income tax legislation*

Various limitation on benefits rules are included in certain provisions of the IRC. This includes particularly the branch profits rules, the shipping rules and the earnings stripping rules.

2. *Branch profits tax*

The branch profits tax provision specifies that no treaty between the United States and a foreign country shall exempt any foreign corporation from the branch profits tax unless (1) the treaty is an income tax treaty and (2) "the foreign corporation is a qualified resident of such foreign country".[40] The term "qualified resident" means, with respect to any foreign country, any foreign corporation which is a resident of such foreign country unless (a) 50 percent or more (by value) of the stock of the foreign corporation is owned by individuals who are not residents of that foreign country and who are not U.S. citizens or resident aliens, or (b) 50 percent or more of that corporation's income is used directly or indirectly to meet liabilities to persons who are not residents of such foreign country or citizens or residents of the United States.[41]

A foreign corporation is considered to be treaty shopping, therefore, in either of two situations. Treaty shopping occurs if 50 percent or more of the stock of the foreign corporation is owned directly or indirectly by individuals who are not residents of the United States or the treaty country, or U.S. citizens. A foreign corporation is also treaty shopping where 50 percent or more of its income is used to meet liabilities to persons who are not residents of the country in which the corporation is a resident and who are not U.S. citizens or residents.

For branch profits tax purposes a special rule exists for publicly traded corporations. A foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of that foreign country if (1) the stock of such corporation is primarily and regularly traded on an established securities market in that foreign country, or (2) that foreign corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in such foreign country and the stock of which is so traded.[42] A further exception exists for corporations owned by publicly traded domestic corporations. A foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of the foreign country if (1) the corporation is wholly owned directly or indirectly by a domestic corporation, and (2) the stock of the domestic corporation is primarily and regularly traded on an established securities market in the United States.[43]

3. *Transportation income exemption residency rule*

Gross income derived by a corporation organized in a foreign country from the international operation of a ship or ships is exempt from U.S. income taxation if the foreign country grants an equivalent exemption to corporations organized in the United States.[44] Gross income derived by a corporation organized in a foreign country from the international operation of aircraft is exempt from U.S. income taxation if the foreign country grants an equivalent exemption to corporations organized in the United States.[45]

This exemption does not apply, however, to any foreign corporation if 50 percent or more of the value of the stock of that corporation is owned by individuals who are not residents of such foreign country or another foreign country meeting the requirements of such paragraph.[46] This limitation rule does not apply to any corporation which is organized in a foreign country meeting the exemption require-

35. 1989-2 C.B. 275.
36. 1987-2 C.B. 514.
37. This ruling position was reaffirmed in Rev. Proc. 90-6, 1990-3 I.R.B. 6, Sec. 4.01(12).
38. 462 F.2d 712 (5th Cir. 1972), affirming T.C. Memo 1970-182.
39. 1987-1 C.B. 195.
40. IRC Sec. 884(e)(1).
41. IRC Sec. 884(e)(4)(A).
42. IRC Sec. 884(e)(4)(B).
43. IRC Sec. 884(e)(4)(C).
44. IRC Sec. 883(a)(1).
45. IRC Sec. 883(a)(2).
46. IRC Sec. 883(c)(1).

ments noted above and the stock of which is primarily and regularly traded on an established securities market in that foreign country, another foreign country meeting the requirements of such paragraph, or the United States.[47] Further, any stock in another corporation which is owned directly or indirectly by a corporation meeting the exemption requirements is to be treated as owned by individuals who are residents of the foreign country in which the corporation meeting the exemption requirements is organized.[48]

4. *Earnings stripping limitation*

A special earnings stripping rule was enacted in the Revenue Reconciliation Act of 1989 to limit the benefit of tax-exempt interest being paid to certain foreign lenders. Where treaties eliminate tax on interest paid by a corporation to certain related persons the IRC denies the interest deductions at the corporate payor level. A limit is imposed to the extent that the payor's net interest expenses exceed 50 percent of adjusted taxable income.[49] The amount of the disallowance is limited, however, by the amount of tax-exempt interest paid to related persons. Further, a corporation's interest deduction for a taxable year will not be denied or limited under this earnings stripping provision unless the ratio of debt to equity of the corporation as of the close of the taxable year (and on such other days during the taxable year as regulations may prescribe) exceeds 1.5 to 1.

A taxpayer's adjusted taxable income is generally its taxable income computed without regard to net interest expense, net operating loss carry-overs, or any deduction allowable for depreciation, amortization or depletion, and computed with such other adjustments as are provided by regulations. For these purposes a recipient is treated as related to the payor of the interest if the recipient and the payor would be treated as related under certain usually applicable rules for determining such relationships.[50]

If a treaty between the United States and any foreign country reduces, but does not eliminate, the U.S. tax imposed on interest that the taxpayer pays to a related person, the interest is subject to disallowance in the same proportion as the rate reduction in the treaty (from the 30 percent rate) bears to 30 percent.

In the accompanying Ways & Means Committee Report,[51] that Committee noted that the IRS is directed to issue regulations appropriate to prevent avoidance of the purposes of the Bill. The Committee noted that such regulations should treat back-to-back loans through third parties (whether related or unrelated), as well as similar arrangements, like direct loans to related parties. As particularly relevant for this discussion of conduit arrangements, this Report noted, as an example, a situation where a U.S. corporation borrows money from a Dutch bank that has borrowed money from the foreign parent corporation of the U.S. corporation. Interest payments are to be treated like payments to the foreign parent corporation. Similarly, where a U.S. corporation borrows money from a Dutch bank and the loan is guaranteed by the foreign parent corporation of the U.S. corporation, interest payments to the Dutch bank should be treated like payments to the foreign parent corporation.

IV. TAX TREATY OVERRIDE CONSIDERATIONS

A parallel issue to the treaty/conduit inquiry is whether a treaty partner has the authority and, if so, should exercise that authority, to override a treaty provision by national legislation.[52] In the United States such legislation is periodically sought to be implemented to correct perceived treaty/conduit abuse. However, the attitude of the Dutch Government is that this is unacceptable action.[53]

The Code provides that "[f]or purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or Law".[54] Prior to the enactment of that provision this section specified that "[n]o provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title".[55] The obvious tenor of these changes is to no longer enable deferral to an income tax treaty as the controlling authority.

The controversy over tax treaty overrides is particularly highlighted during 1990 by the report of the OECD Committee on Fiscal Affairs which notes opposition to "the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations".[56] In that report the Committee noted the Vienna Convention on the Law of Treaties[57] which contains rules applicable to treaties concluded (after the Convention came into force) between countries that are parties to the Convention. Under the precepts of this Convention treaties are to be observed by the parties so long as they are valid and unless they have been formally denounced. The United States is not a party to this Convention. The argument is made, however, that the principles embodied in the Vienna Convention have been derived from customary international law and, therefore, the terms of this treaty must be performed by the several parties in good faith.

The Conference Committee Report to the Omnibus Budget Reconciliation Act of 1989 (dealing with that legislation's

47. IRC Sec. 883(c)(3)(A).
48. IRC Sec. 883(c)(3)(B).
49. See IRS Sec. 163(j).
50. See IRC Secs. 267(b) and 707(b)(1).
51. H. Rpt. 101-247, at 1246.
52. See generally, Eilers, "Override of Tax Treaties Under the Domestic Legislation of the U.S. and Germany", 19 *Tax Management International Journal,* No. 7 (13 July 1990), at 295; and Doernberg, "Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Abrogation of Authority", 42 *Tax Lawyer* (1989), at 173.
53. See van Kempen & Westendorp, "Netherlands and Netherlands Antilles", *International Business Lawyer* (April 1990), at 174, 176, noting the Dutch Government's view that the Netherlands Government considers "treaty override" by a treaty party unacceptable. "A unilateral override of rules agreed upon with another state creates double taxation which is precisely what the treaty aims to prevent. The Netherlands Government does not intend to retaliate through not applying the provision which is overridden by the treaty partner; such a non-application would only serve the aim of the treaty partner." Further, "[t]he Government still studies possibilities of having the International Court of Justice in The Hague rule on the consequences of unilateral treaty overrides".
54. IRC Sec. 7852(d)(1), as added by the Technical and Miscellaneous Revenue Act of 1988, Sec. 1012 (aa)(1)(A), P.L. 100-647.
55. Similarly, IRC Sec. 894(a)(1) requires that "[t]he provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer". However, prior to its 1988 revision, IRC Sec. 894(a)(1) specified that "[i]ncome of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle".
56. See "OECD Committee on Fiscal Affairs Report on Tax Treaty Overrides", 2 *Tax Notes International,* No. 1 (January 1990), at 25, producing the OECD paper on this subject, with the permission of the OECD.
57. This treaty came into force on 27 January 1980. See 8 *International Legal Materials* (ILM), at 679.

earnings stripping provision)[58] asserted, however, a differing perspective on treaty overrides, at least in that context.

V. CONCLUDING OBSERVATIONS

The decade of the 1980s has produced significant evolution on the road of the U.S. Government to the implementation of rules limiting treaty shopping or the availability of treaty benefits in conduit arrangements. The sophistication of the limitation on benefits provisions evolves as taxpayers have been innovative in responding to previously implemented limitations. But the current U.S.–Netherlands income tax treaty negotiations seem to present one of the largest challenges in this context. The outcome of these discussions is difficult to predict, but can be anticipated to produce a roadmap for dealing with limitation on benefits conflicts during the decade of the 1990s. However, the other imponderable, that is, U.S. Congressional participation in this process (particularly through the use of the treaty override technique), remains murky and particularly hard to predict.

58. Report, at 66.

RECENT DEVELOPMENTS IN U.S. TAXATION OF FOREIGN DIRECT INVESTMENT

Carl Estes, II

I. BRANCH TAXES

A. *Branch profits tax*

The branch profits tax is a tax at the rate of 30 percent (or, in certain limited circumstances, at a lower treaty rate) on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the taxable year, or are disinvested in a later taxable year. The purpose is to treat the foreign corporation's U.S. business as being operated by a hypothetical U.S. subsidiary, and to apply the branch profits tax to a base that is equivalent to the amount that could have been distributed as a dividend by that hypothetical subsidiary.

The statutory term for this base is "dividend equivalent amount", and it is the foreign corporation's "effectively connected earnings and profits" for the taxable year with two adjustments:

(1) if the U.S. net equity of the foreign corporation as of the close of the taxable year exceeds its U.S. net equity as of the close of the preceding taxable year, the effectively connected earnings and profits for the taxable year are reduced (but not below zero) by the amount of such excess;

(2) if the U.S. net equity of the foreign corporation as of the close of the preceding taxable year exceeds its U.S. net equity as of the close of the taxable year, the effectively connected earnings and profits for the taxable year are increased by the amount of such excess (but limited to the non-previously taxed accumulated effectively connected earnings and profits).

Mr. Estes is a partner in the law firm of Vinson & Elkins, Houston, Texas. He is Vice-President of the U.S. branch of IFA and past Chairman, Tax Section Committee on Foreign Tax Problems of the American Bar Association.

The net effect of these adjustments is to reduce the dividend equivalent amount by earnings which are reinvested in the business and to increase the dividend equivalent amount for assets which are disinvested in the U.S. business.

The operation of these adjustments can be illustrated by the following example:

FC, a calendar-year foreign corporation, had US$ 1,000 net equity as of the close of 1988 and $ 100 of effectively connected earnings and profits for 1989. FC acquires $ 40 of additional U.S. assets during 1989 and its U.S. net equity at the close of 1989 is $ 1,040. In computing FC's dividend equivalent amount for 1989, FC's effectively connected earnings and profits of $ 100 are reduced by the $ 40 increase in U.S. net equity between the close of 1988 and the close of 1989. FC has a dividend equivalent amount of $ 60 for 1989.

For 1990, FC has $ 125 of effectively connected earnings and profits and its U.S. net equity decreases by $ 50. FC's U.S. net equity as of the close of 1990 is $ 990 ($ 1,040 – $ 50). In computing FC's dividend equivalent amount for 1990, the $ 125 of effectively connected earnings and profits is not increased by the full amount of the $ 50 decrease in U.S. equity during 1990, because the increase is limited to FC's non-previously taxed accumulated effectively connected earnings and profits as of the close of 1989. FC had $ 100 of effectively connected earnings and profits for 1989 and a dividend equivalent amount of $ 60 for that year, so FC has $ 40 of non-previously taxed accumulated effectively connected earnings and profits as of the close of 1989. The increase in effectively connected earnings and profits resulting from a decrease in U.S. net equity is thus limited to $ 40, and the dividend equivalent amount for 1990 is $ 165 ($ 125 effectively connected earnings and profits plus $ 40 decrease in U.S. net equity).

A prior year's deficit in effectively connected earnings and profits affects the computation of non-previously taxed accumulated effectively connected earnings and profits, and hence the limit for the upward adjustment. A prior year's deficit in effectively connected earnings and profits does not, however, reduce the amount of the current year's effectively connected earnings and profits.

FC, a calendar year foreign corporation, has $ 150 of non-previously taxed accumulated effectively connected earnings and profits as of the close of 1990, and has a $ 90 deficit in effectively connected earnings and profits for 1991. FC has U.S. net equity of $ 450 as of the close of 1990 and U.S. net equity of $ 350 as of the close of 1991 (i.e. a $ 100 decrease in U.S. net equity). FC has a dividend equivalent amount of $ 10 for 1991, resulting from FC's deficit of $ 90 in effectively connected earnings and profits for 1991 increased by $ 100, the decrease in FC's U.S. net equity in 1991.

For 1992, FC has no effectively connected earnings and profits and its U.S. net equity decreases by $ 150 (to $ 200) during the year. Because FC has no effectively connected earnings and profits for 1992, its dividend equivalent amount for the year is equal to the decrease in U.S. net equity during the year ($ 150) limited to the amount of its non-previously taxed accumulated effectively connected earnings and profits as of the close of the preceding taxable year. FC has $ 50 of non-previously taxed accumulated effectively connected earnings and profits as of the close of 1991 (i.e. its non-previously taxed accumulated effectively connected earnings and profits of $ 150 as of the close of 1990 less its $ 90 deficit in earnings and profits for 1991 less its dividend equivalent amount of $ 10 for 1991) and therefore has a dividend equivalent amount of $ 50 for 1992.

The term *U.S. net equity* means the U.S. assets (money and total adjusted bases for earnings and profits purposes of the foreign corporation's property which is treated as connected with the conduct of the U.S. trade or business), less U.S. liabilities (the liabilities connected with the conduct of that U.S. trade or business).

In general, U.S. assets are the following items:

(1) *Depreciable personal property and amortizable property*
This is generally treated as a U.S. asset in the same proportion that the amount of the depreciation or amortization with respect to the property that is allowable as a deduction, or is includable in cost of goods sold, for the taxable year in computing the taxable income of the foreign corporation that is effectively connected with the U.S. trade or business bears to the total amount of depreciation or amortization computed for the taxable year with respect to the property.

(2) *Inventory property*
Inventory property is treated as a U.S. asset in the same proportion that the anticipated amount of gross sales from the sale or exchange of the property that is reasonably anticipated to be effectively connected with the U.S. trade or business bears to the anticipated total amount of gross sales from the sale or exchange of the property.

(3) *Accounts or notes receivable*
An account or note receivable with a maturity not exceeding six months (whether or not bearing stated interest) arising from the sale of inventory, performance of services or lease of property, is treated as a U.S. asset in the same proportion that the amount of gross income represented by the receivable that is effectively connected with the U.S. trade or business bears to the total amount of gross income represented by the receivable.

(4) *U.S. real property interests*
U.S. real property interests described in Section 897(c)(1)(A)(i) are treated as U.S. assets.

(5) *Money*
Money is treated as a U.S. asset if it is held for the present needs of the U.S. business and not its anticipated needs. Thus, funds for future business contingencies will not be a U.S. asset.

(6) *Instalment sales*
An obligation received in connection with the instalment sale of a U.S. asset is treated as a U.S. asset in an amount equal to the sum of the amount of income that would be effectively connected (or treated as effectively connected) with the U.S. trade or business if the obligation were satisfied in full on the determination date; and the basis of the obligation on such date attributable to the amounts that would be treated as income that is effectively connected with the U.S. trade or business, if the obligation were satisfied in full on the determination date.

(7) *Marketable securities*
A marketable security is generally treated as a U.S. asset only if all of the income derived from such security during the taxable year is effectively connected with the U.S. trade or business, and either (a) any gain or loss from the sale or exchange of the security on the determination date would be effectively connected with the U.S. trade or business, or (b) such security had a yield for the taxable year (or for the portion of the taxable year during which the security was held) of at least 50 percent of the average of the monthly Federal short-term rates (as determined under Section 1247(d)(1)(C)(i))[1] during such period.

A foreign corporation may elect, subject to certain conditions, to treat as U.S. assets marketable securities that are not otherwise U.S. assets provided that the adjusted basis of such marketable securities does not exceed 25 percent of the sum of the foreign corporation's effectively connected earnings and profits for the taxable year and the non-previously taxed accumulated effectively connected earnings and profits attributable to the two preceding taxable years. This is generally called the *expansion capital* rule. The income or gain or loss from such marketable securities will be treated as effectively connected with the U.S. trade or business.

(8) *Partnerships*
A foreign corporation that is a partner in a partnership is generally treated as having a U.S. asset in an amount equal to the product of the foreign corporation's adjusted basis in the partnership interest and the ratio of its distributive share of partnership gross income for the taxable year that is effectively connected with the conduct of a trade or business in the United States to its distributive share of all partnership gross income for the taxable year.

U.S liabilities means the product of (a) the U.S. assets of a foreign corporation as of the close of the taxable year, and either (b) the ratio of the foreign corporation's world-wide liabilities as of the close of the taxable year or, (c) if the foreign corporation computes its interest deduction using a fixed ratio of liabilities to assets (as determined under § 1.882-5(b)(2)(i)), such fixed ratio. If a foreign corporation is a partner in a partnership, the world-wide liabilities of the foreign corporation include the foreign corporation's share of the liabilities of the partnership.

There are anti-abuse rules to prevent altering the computation of U.S. net equity by artificially adding assets or de-

1. Unless otherwise specified, all references are to the Internal Revenue Code and the regulations issued thereunder.

creasing liabilities. U.S. assets do not include money or property acquired or used by a foreign corporation if one of the principal purposes of such acquisition or use is to increase artificially the U.S. assets. If a foreign corporation repays or otherwise decreases its U.S. liabilities and one of the principal purposes of such decrease is to decrease artificially its U.S. liabilities on the determination date, then such decrease is not taken into account for purposes of computing the foreign corporation's U.S. net equity. To be one of the principal purposes, a purpose must be important, but it is not necessary that it be the primary purpose.

Section 884(e) generally provides that no income tax treaty between the United States and a foreign country will exempt any foreign corporation from the branch profits tax or reduce the amount thereof, unless the foreign corporation is a *qualified resident* of such foreign country. Consequently the branch profits tax will apply to Dutch corporations unless they are qualified residents of the Netherlands. Generally, a Dutch company must meet one of three tests to be a "qualified resident" of the Netherlands:

(1) more than 50 percent of its stock is owned by individuals who are either residents of the Netherlands or U.S. citizens or resident aliens (the so-called *stock ownership* test) and 50 percent or more of its income is not used directly or indirectly to meet liabilities to persons who are not residents of the Netherlands or the United States (the so-called *base-erosion* rule);
(2) it is publicly traded; or
(3) it is engaged in the active conduct of a trade or business in the Netherlands.

If a Dutch corporation is a qualified resident of the Netherlands, the branch profits tax will not apply because the U.S.–Netherlands income tax treaty has been interpreted to prohibit its application.[2]

A Dutch company meets the "stock ownership" test if 50 percent or more of its stock (by value) is beneficially owned, or is treated as beneficially owned, during at least half of the number of days in the Dutch corporation's taxable year by individuals who are either Dutch residents or citizens or individual residents of the United States, and it obtains and retains certain documentation to show that the stock ownership requirements have been met.

Generally, stock owned by a corporation, partnership, trust or estate is treated as owned proportionately by its shareholders, partners or beneficiaries. A Dutch corporation whose stock is primarily and regularly traded on an established securities market in the Netherlands is treated as an individual resident of the Netherlands for purposes of determining the ownership of stock in another Dutch corporation.

In order to satisfy the documentation requirement, a Dutch corporation must obtain the following written documentation from a sufficient number of its direct or indirect individual shareholders (including a corporation treated as an individual shareholder) to show that it has satisfied the 50 percent ownership test:

(1) The individual shareholder (or a corporation treated as an individual shareholder) must provide a statement under penalty of perjury stating that the shareholder is a direct or indirect beneficial owner of an interest in the Dutch corporation and that the shareholder does not own such interest on behalf of another person. In addition, the statement must include the following information:
(a) the number of shares owned directly or indirectly by the shareholder in each class of stock of the foreign corporation;
(b) the period of time during the taxable year during which the shareholder owned the stock;
(c) the name and permanent address of the shareholder;
(d) the country of residence of the shareholder; and
(e) if the stock in the Dutch corporation is held indirectly by the shareholder through one or more intermediaries, whether acting as nominees or beneficial interest holders, then the name and address of each such intermediary and a description of the chain of ownership through which the shareholder holds stock in the Dutch corporation, to the extent known to the shareholder.

(2) If any intermediary is identified in (1)(e) above, an intermediary ownership statement must be obtained from each intermediary in the relevant chain of ownership. The intermediary ownership statement must contain the following information:
(a) the number of shares owned directly or indirectly by the intermediary in each class of stock of the foreign corporation;
(b) the period of time during the taxable year during which the intermediary owned the stock, directly or indirectly;
(c) the name and principal place of business of the intermediary;
(d) the country of residence of the intermediary;
(e) if the stock is held as nominee for an individual or another intermediary, the name and permanent address of the individual, or the name and principal place of business of such other intermediary;
(f) if the stock is not held as nominee for an individual or another intermediary, the amount and nature of the interest owned in the intermediary issuing the statement by its direct shareholder, partner or beneficiary which indirectly owns an interest in the foreign corporation, and the period of time during the taxable year for which the interest in the intermediary was owned by such stockholder, partner or beneficiary; and
(g) if the intermediary owns stock in the Dutch corporation indirectly through one or more other intermediaries as nominees or beneficial interest holders, the name and principal place of business of each such intermediary and a description of the chain of ownership through which the intermediary holds the stock to the extent known by the intermediary.

(3) If the individual shareholder is not a citizen or resident of the United States, he or she must also supply a certificate of residency, signed by the authorities of the country of residence of the individual shareholder, stating that the individual is a resident of that country for purposes of its income tax laws.

(4) A statement from a corporation that is treated as an individual shareholder must also indicate that the corporation's stock is primarily and regularly traded on an established securities exchange in the United States or the Netherlands.

A Dutch corporation satisfies the "base erosion" test for a taxable year (or a portion of a taxable year) if it establishes that less than 50 percent of its income for the taxable year (or for the portion of the taxable year) is used directly or indirectly to meet liabilities (such as liabilities to pay interest, rents, royalties or reinsurance premiums) to persons who are not residents (or, in the case of foreign corporations, qualified residents) of the Netherlands and who are not citizens or residents (or, in the case of domestic corporations, qualified residents) of the United States. The meeting

2. IRS Notice 87-56, 1987-2 C.B. 367.

of a liability does not include a repayment of the principal amount of an obligation.

A Dutch corporation is publicly traded if five tests are met (trades between related persons and trades conducted in order to meet these tests are disregarded):

(1) one or more classes of its stock that in the aggregate represent more than 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote and of the total value of the stock of such corporation are listed on one or more *established securities markets* in the Netherlands or in the United States;
(2) the number of shares in each such class of stock that are traded during the taxable year on all established securities markets in the Netherlands or in the United States exceeds the number of shares in each such class that are traded during that year on established securities markets in any other single foreign country;
(3) trades in such class are effected, other than in *de minimis* quantities, on such market or markets on at least 60 days during the taxable year;
(4) the aggregate number of shares of that class traded on such market or markets during the taxable year is at least 30 percent of the average number of shares outstanding in that class during the taxable year (or at least ten percent in the case of a Dutch corporation that establishes that it has at least 2,500 shareholders of record during the taxable year); and
(5) if, at any time during the taxable year, 100 or fewer persons own 50 percent or more of the outstanding shares of a class of stock, then such class of stock cannot be treated as regularly traded for that year. Persons related within the meaning of Section 267(b) are treated as one person for this purpose.

The term "established securities market" means, for any taxable year:

(1) a foreign securities exchange that is officially recognized, sanctioned or supervised by a governmental authority of the country in which the market is located, is the principal exchange in that country, and has an annual value of shares traded on the exchange exceeding $ 1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;
(2) a national securities exchange that is registered under Section 6 of the Securities Act of 1934;[3] and
(3) a domestic over-the-counter market. If a principal exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier is to be treated as a separate exchange.

A Dutch corporation meets the active trade or business test (and is therefore a qualified resident of the Netherlands) if it meets all of the following conditions:

(1) It is engaged in the active conduct of a trade or business within the meaning of Section 367(a)(3) and the regulations thereunder or it qualifies as a banking, financing or credit institution under the laws of the Netherlands and it is engaged in the active conduct of a banking, financing or similar business within the meaning of § 1.864-4(c)(5)(i).

(2) It has a substantial presence in the Netherlands. This requires that the average of the following three ratios exceeds 25 percent and each ratio is at least equal to 20 percent:
(a) the ratio of assets used or held for use in the active conduct of the Dutch corporation's trade or business in the Netherlands to the world-wide assets of the Dutch corporation;
(b) the ratio of the gross income from the active conduct of the Dutch corporation's trade or business in the Netherlands that is derived from sources within the Netherlands to the world-wide gross income of the Dutch corporation; and
(c) the ratio of the payroll expenses of the Dutch corporation in the Netherlands to the Dutch corporation's world-wide payroll expenses.

(3) The activities that give rise to the income for which a treaty exemption or rate reduction is claimed constitute part of a U.S. trade or business in which the Dutch corporation is engaged (or is deemed to be engaged) and such U.S. trade or business is an integral part of an active trade or business conducted by the Dutch corporation in the Netherlands. A U.S. trade or business of a Dutch corporation is an integral part of an active trade or business conducted by a Dutch corporation in the Netherlands if an active trade or business conducted by the Dutch corporation in both the Netherlands and in the United States comprises, in principal part, complementary and mutually interdependent steps in the United States and the Netherlands in the production and sale or lease of goods or in the provision of services. A U.S. trade or business of a Dutch corporation will be treated as an integral part of an active trade or business of a Dutch corporation in the Netherlands with respect to the sale or lease of property (or the performance of services) if at least 50 percent of the Dutch corporation's world-wide gross income from the sale or lease of property of the type sold in the United States (or from the performance of services of the type performed in the United States) is derived from the sale or lease of such property for consumption, use or disposition in the Netherlands (or from the performance of such services in the Netherlands). If a U.S. trade or business of a Dutch corporation sells goods that are not, in principal part, manufactured, produced, grown or extracted by the Netherlands, such business shall in no event be treated as an integral part of an active trade or business conducted in the Netherlands if the Dutch corporation does not take physical possession of the goods in a warehouse or other storage facility that is located in the Netherlands and in which goods of such type are normally stored prior to sale to customers in the Netherlands.

B. *Branch interest tax*

Section 884(f) provides that in the case of a foreign corporation engaged in a U.S. trade or business, for purposes of the withholding tax provisions, any interest paid by such trade or business in the United States will be treated as if it were paid by a domestic corporation, and if the amount of interest allowable as a deduction in computing the effectively connected taxable income of a foreign corporation exceeds the amount of interest actually paid, the excess is treated as interest paid to the foreign corporation by a wholly-owned U.S. corporation on the last day of the foreign corporation's taxable year.

The effect of this provision is to treat interest as U.S. source to the extent it is deducted in the United States. Thus, any interest paid by a foreign corporation's U.S. branch in its U.S. trade or business is treated as from sources within the United States and thus subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision.

Relief is available under an income tax treaty between the United States and the foreign corporation's country of resi-

3. 15 U.S.C. Section 78f.

dence relating to interest actually paid by the foreign corporation only if the corporation is a *qualified resident* of that foreign country, or the foreign corporation meets, with respect to the interest payment, the requirements of a limitation on benefits or similar article in the treaty and such article entered into force after 31 December 1986.

A foreign person (other than a foreign corporation) who derives interest paid by a U.S. trade or business can claim benefits under provisions of an income tax treaty between the United States and its country of residence relating to interest derived by the foreign person. A foreign corporation can generally claim such benefits only if it is a *qualified resident* of the foreign country or meets, with respect to the interest payment, the requirements of a limitation on benefits or similar article in the treaty and such article entered into force after 31 December 1986.

The rate of tax imposed on the excess interest of a foreign corporation that is a qualified resident of a country with which the United States has an income tax treaty is limited to the rate provided under such treaty that would apply with respect to interest paid by a domestic corporation to that foreign corporation. In effect, any provision in an income tax treaty that exempts or reduces the rate of tax on interest paid by a foreign corporation does not prevent imposition of the tax on excess interest or reduce the rate of such tax.

These rules can be illustrated by the following example:

FC, a calendar year foreign corporation, is allowed an interest deduction of $ 115 under § 1.882-5 for 1991. The interest actually paid by FC's U.S. trade or business during 1991 is as follows: $ 55 of portfolio interest to B, a non-resident alien; $ 25 of interest to foreign corporation C, which owns 15 percent of the combined voting power of FC's stock, with respect to bonds issued by FC; and $ 20 to D, a domestic corporation. Neither B nor C is engaged in a U.S. trade or business. FC, B and C are resident in countries with which the United States does not have an income tax treaty. The interest payments made to B and D are not subject to tax under Sections 871(a) or 881 and are not subject to withholding under Sections 1441 or 1442. The payment to C is subject to withholding of $ 7.5 ($ 25 × 30%) under Section 881 on the amount of the excess. In addition, because FC's interest deduction ($ 15) exceeded the amount actually paid by FC's U.S. trade or business ($ 100), FC is subject to a tax of $ 4.50 ($ 15 × 30%) on the amount of the excess.

If C were a qualified resident of a country with which the United States had an income tax treaty reducing the rate of withholding tax on interest to zero, no U.S. withholding tax would be due on the payment of interest to C by FC. If FC were a qualified resident of a country with which the United States had an income tax treaty reducing the rate of withholding tax to zero on interest paid by U.S. payers to the foreign corporation, FC would not be subject to the tax on excess interest.

II. REPEAL OF THE GENERAL UTILITIES CASE[4]

The Tax Reform Act of 1986 repealed the provisions generally according non-recognition of gain or loss to a corporation distributing property in a complete liquidation. Gain or loss is thus to be recognized by a corporation on liquidating distributions of its property as if the property had been sold at its fair market value to the distributee. Exceptions are provided for distributions in which an 80 percent corporate shareholder receives property with a carry-over basis under Section 332, and certain distributions and exchanges involving property that may be received tax-free by the shareholder under Subchapter C.

The exception for 80 percent corporate shareholders does not generally apply where the parent is a foreign corporation. Section 367(e)(2) overrides the non-recognition provisions of Sections 332 and 337 where the 80 percent distributee (as defined in Section 337(c)) is a foreign corporation, except as provided in regulations. The legislative history indicates that the IRS regulations may permit non-recognition if the potential gain on the distributed property at the time of the distribution is not being removed from the U.S. taxing jurisdiction prior to recognition.

III. WITHHOLDING ON FOREIGN PARTNERS

The Technical and Miscellaneous Revenue Act of 1988 revised Section 1446 to require a U.S. *withholding tax* on partnerships in an amount equal to the U.S. tax on the foreign partners' distributive shares of effectively connected income. The statutory term ("withholding tax") is a misnomer because the tax is generally due to the foreign partner whether or not any distribution is actually made. Publicly traded partnerships can in effect elect a different tax regime: withholding on actual distributions (at a 28 percent rate).

If a partnership, whether domestic or foreign, has *effectively connected taxable income* for any taxable year, and any of this income is allocable to a foreign partner under Section 704, the partnership is required to pay a tax with respect to such foreign partner equal to the *applicable percentage* (the highest marginal rate of U.S. tax to which the foreign partner is subject) of the *effectively connected taxable income* of the partnership that is allocable to the foreign partner.

"Effectively connected taxable income" is the partnership's taxable income, as computed under Subchapter K, that is effectively connected with a U.S. trade or business, with the following adjustments: (1) items that normally are separately stated for Subchapter K purposes under Section 702(a) are included if they give rise to income that is effectively connected; (2) the partnership is allowed a cost depletion deduction rather than a percentage depletion deduction; and (3) any other item of income, gain, loss or deduction is not taken into account to the extent the item is allocable under Section 704 to any U.S. partner.

Since the withholding tax is a partnership-level computation, it does not affect the actual amounts of income on which a foreign partner is subject to U.S. tax. Thus, for example, any deduction, such as percentage depletion, that is not taken into account in arriving at effectively connected taxable income can still be claimed by the foreign partner.

Each foreign partner is to treat its share of the tax paid by the partnership as a credit against its tax liability for the partner's taxable year in which (or with which) the partnership's taxable year ends. Moreover, the amount of credit allocable to a foreign partner is treated as distributed to the partner on the last day of the partnership's taxable year for which the tax was paid, thus reducing the partner's basis in its partnership interest.

The IRS is given authority to prescribe regulations necessary to carry out the purposes of the provision. For example, special rules may be necessary in identifying a publicly traded partnership's partners as U.S. or foreign. In addi-

4. *General Utilities & Operating Co. v. Helvering,* 296 United States (U.S.) 200 (1935).

tion, rules may be necessary in the case of tiered partnerships to prevent the imposition of more tax than will be properly due (for example, rules to prevent the tax from being imposed on more than one partnership and rules to determine the applicable percentages). Procedures and general guidance for complying with Section 1446, as amended by the 1988 Act, were provided by Rev. Proc. 89-31, 1989-1 C.B. 895.

IV. EARNINGS STRIPPING

The Revenue Reconciliation Act of 1989 added new Section 163(j) to the Code which generally disallows a corporation's deductions for interest paid to related parties (determined under Sections 267(b) or 707(b)(1)) that are exempt from U.S. tax on the interest received. Interest recipients that are subject to a reduced rate of taxation (e.g. under a tax treaty) are treated as partially subject to U.S. tax and partially exempt from U.S. tax.

This related payee interest disallowance rule applies to a payor corporation if it has *excess interest expense* for the taxable year, and its ratio of debt to equity as of the close of the taxable year (and on such other days during the taxable year as the IRS may prescribe by regulations) exceeds 1.5 to 1. The amount of the disallowance is limited to the corporation's excess interest expense.

The term "excess interest expense" means the excess, if any, of the corporation's net interest expense over the sum of 50 percent of the adjusted taxable income plus any excess limitation carry-forward.

"Adjusted taxable income" means the taxable income computed without regard to net interest expense, net operating loss carry-overs, or any deduction allowable for depreciation, amortization or depletion.

The term "excess limitation" means the excess (if any) of 50 percent of the adjusted taxable income of the corporation over the corporation's net interest expense. If a corporation has an excess limitation for a taxable year, that amount becomes an excess limitation carry-forward to the first succeeding taxable year; to the extent not taken into account for that first year, it is carried forward to the second succeeding taxable year, and, to the extent not taken into account for that second year, to the third succeeding taxable year. The amount of carry-forwards taken into account for a year following the excess limitation year, however, cannot exceed the excess interest expense for that succeeding year (determined without regard to carry-forwards from taxable years that had excess limitation). In the case of a year following two or three prior years with respect to which excess limitations potentially may be carried forward, the excess limitation available from the earlier of the prior years will be used first.

The operation of the provision may be illustrated by the following example:

For 1990 a corporation has $ 150 of adjusted taxable income and $ 60 of net interest expense. This corporation is not subject to any disallowance of interest deductions for 1990 because 50 percent of its adjusted taxable income is $ 75. Moreover, it has an excess limitation for 1990 of $ 15 ($ 75 – $ 60).

For 1991 the corporation has $ 100 of adjusted taxable income and $ 60 of net interest expense. The sum of 50 percent of adjusted taxable income ($ 50), plus the excess limitation carry-forward from 1990 that is taken into account (i.e. used) for 1991, equals $ 60 ($ 50 plus $ 10). Therefore the corporation is not subject to disallowance of interest deductions for 1991.

For 1992 the corporation again has $ 100 of adjusted taxable income and $ 60 of net interest expense. The sum of 50 percent of adjusted taxable income plus the excess limitation carry-forward from 1990 that remains to be used in 1992 equals $ 55 ($ 50 plus $ 5). Therefore, the corporation will be subject to disallowance of up to $ 5 of interest deductions for 1992 if it has paid (or incurred) interest for 1992 to exempt recipients and its debt to equity ratio for that year exceeds 1.5 to 1.

The ratio of debt to equity means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets less such total indebtedness. For this purpose, the amount taken into account with respect to any asset is that asset's adjusted basis for purposes of determining gain. Where a debt obligation has original issue discount, the amount taken into account is its issue price plus the portion of the original issue discount previously accrued as determined under the rules of Section 1272.

Under a special exception, payments of interest to a partnership which would otherwise be a related person will generally not be treated as payments to a related person if partners with respect to whom no U.S. tax is imposed on their distributive shares of interest income of the partnership from the payor own in the aggregate less than ten percent of the profits and capital interests in the partnership. As an exception to this general rule, payments to such a partnership will be treated as payments to a related person to the extent such interest is allocable to any partner who is a related person to the payor of the interest. For these purposes, partnership interests owned by partners with respect to whom, under a treaty, reduced U.S. tax is imposed on their distributive shares of interest income of the partnership from the payor are treated as held in part by a tax-exempt person and in part by a taxable person. The division will be made under rules similar to the rules for determining the portion of each interest payment from a U.S. corporation to such a person that would be deemed to be exempt from tax. Interest expense which is disallowed as a deduction under this provision can be carried forward indefinitely.

Example:

For 1991 DC, a U.S. corporation with a debt to equity ratio exceeding 1.5 to 1, has adjusted taxable income of $ 60 and net interest expense of $ 50, and actually pays $ 100 in interest to a related foreign corporation which is exempt from U.S. withholding tax under a tax treaty. DC's interest deduction is limited to $ 30 (50 percent of its adjusted taxable income). Of DC's $ 50 of net interest expense, $ 20 is non-deductible, leaving it with taxable income of $ 30.

In 1992 DC earns $ 400 of adjusted taxable income, has $ 50 of current net interest expense and pays $ 100 of interest to the related foreign corporation. DC may carry forward the disallowed $ 20 deduction from 1991. Therefore, in 1992 DC's taxable income is $ 330 ($ 400 – $ 50 – $ 20). The total amount of net interest expense deducted is $ 70 ($ 50 + $ 20), which does not exceed 50 percent of adjusted taxable income in 1992, so no interest (either amounts incurred in 1992 or amounts carried over from 1991) is disallowed as a deduction.

The interaction of the related party interest disallowance rule and the branch level taxes is complex. The legislative history indicates that IRS regulations may provide that the payment of disallowed interest will not be treated as a decrease in the foreign corporation's U.S. net equity, for the purposes of the branch profits tax, until such time as the deduction for such interest payment is allowed. The regulations may also provide that, when a disallowed interest deduction is carried over and eventually used, the amount of interest represented by that deduction will not be treated as a deemed payment of interest by a domestic subsidiary under Section 884(f)(1)(b) in the year deducted to the extent that it is attributable to interest that had been treated as U.S.-source interest under Section 884(f)(1)(A) in the year the interest was paid or incurred.

This provision is generally effective for interest paid or accrued after 10 July 1989 in taxable years beginning after that date, except on debt instruments with fixed terms that were outstanding on that date, and until 1 September 1989 on demand loans that were outstanding on 10 July 1989.

V. INFORMATION REPORTING

A. *Section 6038A*

1. The Revenue Reconciliation Act of 1989 amended Section 6038A to provide that any corporation that is 25 percent owned by a foreign person and is either a foreign corporation that conducts a U.S. trade or business or a domestic corporation (a *reporting corporation)* must furnish the IRS with such information as regulations may prescribe regarding transactions carried out directly or indirectly with certain foreign persons treated as related to the reporting corporation (*reportable transactions*). A related person for this purpose includes a 25 percent shareholder as well as any person that is treated as related within the meaning of Sections 267(b), 707(b)(1) or 482.

Current Treasury regulations under the old version of Section 6038A require the annual filing of an information return reporting all related party transactions. As now amended, Section 6038A requires a reporting corporation to maintain (or cause another person to maintain), at the location, in the manner, and to the extent prescribed by regulations, any records deemed appropriate to determine the correct tax treatment of reportable transactions. While no new regulations have yet been issued, the legislative history of the amendment indicates that a principal purpose would be to "improve enforceability of Section 482 [intercompany pricing] with respect to U.S. subsidiaries and branches of foreign corporation".

In order to avoid the consequences of the non-compliance rule (discussed below) with respect to certain reportable transactions, each foreign person that is a related party of a reporting corporation must agree to authorize the latter to accept service of process as its agent in connection with any request or summons by the IRS to examine books, records or other materials, to produce such materials, or to take testimony related to any reportable transaction, solely for the purpose of determining the tax liability of the reporting corporation. Thus, assuming such authorization is given, IRS examination requests and summonses with respect to related-party transactions involving U.S. taxpayers can be served on related foreign persons through those U.S. taxpayers.

Failure of a foreign related party to designate a reporting corporation as its agent for accepting service of process in connection with reportable transactions (as discussed above), or, under certain circumstances, non-compliance with IRS summonses in connection with reportable transactions, can result in the application of the non-compliance rule in computing the reporting corporation's tax liability. This rule permits the IRS to use its sole discretion in determining the amount of the deduction for any amounts paid or incurred to the related party in connection with reportable transactions, and the cost (including costs of goods sold) to the reporting corporation of any property acquired from or transferred to the related party in connection with reportable transactions.

That discretion is to be exercised on the basis of any information in the knowledge or possession of the IRS or any information that the IRS may obtain through testimony or otherwise.

Failure to furnish the IRS with information or to maintain records as required under Section 6038A is sanctioned by a monetary penalty of $ 10,000, and additional $ 10,000 penalties are imposed if the failure continues more than 90 days after the IRS notifies the taxpayer of the failure. The penalty may be waived if the taxpayer demonstrates to the satisfaction of the IRS that reasonable cause exists for the failure to furnish required information or maintain required records.

B. *Section 6114*

Generally, if a taxpayer takes a return position that any treaty of the United States (including, but not limited to, an income tax treaty, estate and gift tax treaty, or friendship, commerce and navigation treaty) overrules or modifies any provision of the Code and thereby effects (or potentially effects) a reduction of any tax incurred at any time, the taxpayer is required to disclose such return position on a statement attached to such return. If a return of tax would not otherwise be required to be filed, a return must, nevertheless, be filed for purposes of making the disclosure required by this section.

To determine whether a return position is a *treaty-based return position* so that reporting is required, the taxpayer must compare the tax liability (including credits, carry-backs, carry-overs, and other tax consequences or attributes for the current year as well as for any other affected tax years) to be reported on a return of the taxpayer; and the tax liability (including such credits, carry-backs, carry-overs, and other tax consequences or attributes) that would be reported if the relevant treaty provision did not exist. If there is a difference (or potential difference) in these two amounts, the position taken on a return is a treaty-based return position that must be reported.

Reporting is specifically required with respect to the following positions:

(1) that a non-discrimination provision of a treaty precludes the application of any otherwise applicable Code provision, other than with respect to the making of or the effect of an election under Section 897(i);
(2) that a treaty reduces or modifies the taxation of gain or loss from the disposition of a U.S. real property interest;
(3) that a treaty exempts a foreign corporation from (or reduces the amount of tax with respect to) the branch profits tax (Section 884(a)) or the branch tax on excess interest (Section 884(f)(1)(B));
(4) that a treaty exempts from tax, or reduces the rate of tax on, interest or dividends paid by a foreign corporation that are from sources within the United States by reason of Section 861(a)(2)(B) or Section 884(f)(1)(A);
(5) that under a treaty, income that is effectively connected with a U.S. trade or business of a foreign corporation or a non-resident alien is not attributable to a permanent estab-

lishment or a fixed base of operations in the United States and, thus, is not subject to taxation on a net basis, or that expenses are allowable in determining net business income so attributable, notwithstanding an inconsistent provision of the Code;
(6) that a treaty alters the source of any item of income or deduction; or
(7) that a treaty grants a credit for a specific foreign tax for which a foreign tax credit would not be allowed by the Code.

Reporting is waived with respect to any of the following return positions taken by the taxpayer:

(1) that a treaty has reduced the rate of withholding tax otherwise applicable to a particular type of fixed or determinable annual or periodic income subject to withholding under Sections 1441 or 1442, such as dividends, interest, rents or royalties;
(2) that residency of an individual is determined under a treaty and apart from the Code;
(3) that a treaty reduces or modifies the taxation of income derived from dependent personal services, pensions, annuities, social security and other public pensions, or income derived by artistes, athletes, students, trainees or teachers;
(4) that income of an individual is resourced (for purposes of applying the foreign tax credit limitation) under a treaty provision relating to elimination of double taxation; or
(5) that a non-discrimination provision of a treaty allows the making of an election under Section 897(i).

Failure to file the statements required under Section 6114 is sanctioned by a monetary penalty of $ 10,000 for each separate payment for which a treaty-based return position was taken (Section 6712). The penalty may be waived if the taxpayer demonstrates to the satisfaction of the IRS that the failure was not due to wilful neglect.

VI. 1990 LEGISLATION

The Foreign Tax Equity Bill of 1990 would impose additional burdens on the foreign direct investor.[5]

A. *Capital gains*

The 1990 Bill provides in general that where a foreign corporation or non-resident alien individual owns or has owned, at any time during the previous five years, ten percent or more of the stock in a U.S. corporation, gain or loss from the disposition of the stock is treated as income effectively connected with the conduct of a U.S. trade or business and attributable to a U.S. permanent establishment. However, where the period beginning 20 March 1990 and ending on the date of disposition is shorter than five years, the relevant testing period is that shorter period only.

A person who meets the ownership criteria for imposition of the tax is termed a *ten percent shareholder* in the corporation under the 1990 Bill. For purposes of determining whether a person is a "ten percent shareholder", the attribution rules of Section 318(a) generally apply, with certain modifications. In addition, if a partnership is a ten percent shareholder in a U.S. corporation, its partners would generally be treated as ten percent shareholders in the corporation as well. An exception is provided under which the determination whether a partner is a ten percent shareholder in the corporation is determined on a *look-through* basis. The exception applies in the case of a disposition where at all times during the five-year period ending when the disposition occurred, the partnership owned less than 50 percent of the stock of the corporation, and the basis of the stock of the corporation held by the partnership was less than 25 percent of the partnership's costs of its total non-cash assets, less its liabilities.

The 1990 Bill suspends certain non-recognition provisions that would otherwise apply to disposition of stock in a U.S. corporation, and allows the Treasury to prescribe regulations providing the extent to which non-recognition provisions will, and will not, apply for purposes of the provision. The 1990 Bill contemplates that because it imposes shareholder-level tax on a disposition by a foreign corporation of stock of a wholly-owned U.S. subsidiary, the branch tax regulations would be amended to provide that branch tax would be imposed upon termination of a U.S. branch.

Under the 1990 Bill the tax would be collected, in the first instance, by withholding, generally at the rate of ten percent of the gross proceeds of the disposition giving rise to the tax liability. Amounts withheld in excess of the tax imposed on the foreign person would be refundable. The 1990 Bill also gives the Treasury the authority to prescribe reduced rates of withholding in particular circumstances where collection of the tax imposed on the foreign person would not be jeopardized thereby.

The 1990 Bill purports not to override any existing treaty to the extent the treaty would prevent imposition of the tax on a person who is a *qualified resident* of a treaty country. The definition of "qualified resident" for this purpose generally follows the definition used for purposes of the branch tax. In cases where a treaty prevents imposition of U.S. tax on stock gains of a qualified resident of a treaty country, the 1990 Bill recharacterizes amounts received by that person in any distribution in liquidation or redemption, to the extent of the earnings and profits of the distributing corporation which are attributable to the stock with respect to which the distribution is made, as dividends for all purposes. Dividend treatment would only apply to the gain, however.

The provision generally would be effective for dispositions after 19 March 1990, except that the withholding provisions would apply only to dispositions occurring six months or more after the date of enactment.

B. *Statute of limitations*

Under the 1990 Bill, the period for assessment may be extended by the IRS for a period not to exceed three years beyond the close of the period provided under present law, including extensions thereof, in certain cases involving deficiencies of either (a) a domestic corporation, 25 percent or more of the combined voting power or of the total value of the stock which is owned (directly or indirectly) at any time during the taxable year by a single foreign person (referred to as a "25 percent foreign shareholder"), or (b) a foreign corporation.

In the case of the 25 percent foreign-owned domestic corporation, the assessment period may be extended only with respect to a deficiency which relates to a transaction undertaken by the taxpayer directly or indirectly with a related foreign person. For this purpose, a related foreign person includes a 25 percent foreign shareholder, any foreign person related to such a 25 percent foreign shareholder under the rules of either Section 267(b) or 707(b)(1), or any other person who is considered related to the domestic corpora-

5. H.R. 4308, as introduced in the House of Representatives on 20 March 1990 (the "1990 Bill").

tion under the rules of Section 482. Thus, for example, if a 25 percent foreign-owned domestic corporation undertook transactions during a taxable year with both unrelated persons and its 25 percent foreign shareholder, any deficiency assessment with respect to the transactions involving unrelated persons must, as is the case under present law, generally be made within the three-year period (or within any extended period which is mutually agreed upon by the taxpayer and the IRS). With respect to the other transactions, however, the assessment period could be increased for a period of up to three additional years under the 1990 Bill.

In the case of a foreign corporation, the assessment period could be increased for up to three additional years under the Bill for any deficiency arising with respect to tax on income effectively connected with a trade or business in the United States (or income that is treated as effectively connected), the branch profits tax or the branch-level interest tax.

The 1990 Bill does not prescribe an automatic extension of the assessment period in the cases described above. Rather, the extension of up to three additional years would be permitted in cases where the IRS determines that the deficiency cannot be accurately assessed before the expiration of the otherwise applicable period by reason of delay or other actions of the taxpayer which prevented the timely assessment of such deficiency.

C. *Information reporting*

Under the 1990 Bill foreign corporations engaged in a U.S. trade or business would be removed from the reporting requirements of Section 6038A (which requires reporting with respect to related foreign party transactions), but a new Section 6038C would impose a similar reporting and record-maintenance regime on *all* foreign corporations engaged in a U.S. trade or business. Moreover, the foreign corporation would be required to maintain records that were in existence at any time on or after 20 March 1990, irrespective of the tax year involved. In effect, this is a retroactive maintenance requirement with respect to records now existing.

VII. TREATY INTERACTION

A. *Non-discrimination provisions*

The United States is becoming more adept at explaining why its new tax rules do not violate non-discrimination clauses in its treaties, as is indicated by the following passage from the Statement of Managers with respect to the earnings stripping provision:

> [T]he conferees believe that because the provision treats similarly situated persons similarly, there is no discrimination under treaties. For this purpose the conferees believe that the determination of which persons are similarly situated is properly made by reference to the U.S. tax those persons do or do not bear on interest income from U.S. corporations. This is consistent with the view that payments leaving U.S. taxing jurisdiction may in appropriate circumstances, consistent with treaties, be subjected by the United States to tax that would not be imposed on a payment to a U.S. person.
>
> The conferees believe that for these purposes related and unrelated lenders need not be treated as similarly situated. Allowance of unlimited deductions for related party interest permits an economic unit that consists of more than one legal entity to contract with itself at the expense of the government.[6]

The explanation in the description of the 1990 Bill is similar:

> It is further understood that application of the Bill's dividend definition rule only to liquidating and redemption gains realized by certain foreign persons does not violate a typical treaty non-discrimination provision. Among other things, it is believed that a U.S. shareholder and a foreign shareholder are not similarly situated for this purpose. A liquidating distribution or redemption distribution by a foreign-owned corporation may permanently remove U.S. corporate earnings from U.S. shareholder-level taxing jurisdiction (which all U.S. treaties retain to some extent), while in the liquidation of (or redemption of shares in) the U.S.-owned corporation the earnings will remain in U.S. taxing jurisdiction, assuring U.S. shareholder-level taxation.

B. *Capital gains*

Direct treaty overriding may be avoided by changing the source country's definition of undefined terms. However, when the change is applicable only in the case of treaties, as is the capital gain recharacterization rule proposed in the 1990 Bill, it can fairly be termed disingenuous:

> It is believed that the treatment of liquidating gains and redemption gains as dividends to the extent of earnings will be permitted under U.S. treaties in general. Typically, treaties do not define gains or dividends (or define dividends broadly as including income from shares), and provide that for purposes of applying the treaty, each party generally may treat any term not defined therein as having the meaning which it has under the laws of that country. Thus, if a U.S. treaty prohibits each party from taxing stock gains realized by residents of the other country, and the other treaty country treats a liquidating distribution as a dividend under its internal tax laws, typically that country may tax as a dividend, some portion of a liquidating distribution received by a U.S. resident from a company resident in the treaty country. It is understood that such treatment is often accorded by treaty countries to amounts received by U.S. persons, consistent with U.S. treaty language prohibiting tax on gains. It is believed that though the laws is enacted after the treaty enters into force, is also consistent with existing treaty language prohibiting tax on gains.

6. Statement of the Managers with respect to the Revenue Reconciliation Act of 1989 (H.R. 3249), at 67-69 (CCH-ed).

FOREIGN INVESTMENT IN THE UNITED STATES: PORTFOLIO INVESTMENT, TRADE OR BUSINESS AND WITHHOLDING TAX ISSUES

Robert I. Stricof

Tax Partner, Arthur Andersen & Co., New York

I. TAXATION OF NON-RESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS

A. *General rule*

Non-resident alien individuals and foreign corporations *not* engaged in a U.S. trade or business are generally subject to a 30 percent U.S. tax on U.S.-source interest, dividends, rents and other fixed or determinable annual or periodic gains, profits and income.[1] These amounts are subject to U.S. withholding tax under Sections 1441 and 1442.

Interest on U.S. bank deposits, if such interest is not effectively connected with a U.S. trade or business, is not subject to U.S. tax.[2] Discount on an obligation payable 183 days or less from the date of original issue is generally not subject to U.S. tax if received by a foreign person.[3] Interest on portfolio debt obligations issued after 18 July 1984 is exempt from U.S. withholding tax (see below).[4]

B. *Exceptions to 30 percent tax*

The IRC permits two exceptions to the 30 percent tax rate on non-resident alien individuals and foreign corporations. First, income that is effectively connected with a U.S. trade or business is taxed at ordinary graduated rates.[5] Deductions and credits are permitted if the foreign taxpayer files a U.S. tax return.[6]

Second, capital gains realized by a foreign investor are exempt from U.S. tax unless the gains are effectively connected with a U.S. trade or business or, in the case of a non-resident individual, such individual is present in the United States for a period or periods aggregating 183 days or more during the taxable year.

C. *Proposed legislation*

H.R. 4308, introduced in the House of Representatives on 19 March 1990, would tax certain foreign investors on gains from the sale of stock in U.S. corporations. Under the Bill, any foreign individual or corporation that is a "ten percent shareholder" in any U.S. corporation and that recognizes gain or loss on the disposition of stock would be taxed in the United States as if the income were effectively connected with a U.S. business, i.e. at graduated rates.

Recent U.S. tax legislation did not include the proposed tax on gains from the sale of stock by foreign investors. Nevertheless, the proposal might appear in future tax legislation due to its revenue-generating potential.

Treaties would override this proposed tax on a permanent basis, but only if treaty shopping is not involved. This would benefit residents of treaty countries that prohibit the United States from taxing capital gains. However, investors from such countries as Australia, Austria, Denmark, Greece, Luxembourg, Switzerland and the United Kingdom would be subject to the tax because their treaties permit the United States to tax capital gains.

Third country residents using treaty country corporations (for instance, a Dutch BV) to hold their U.S. stock investments would also be adversely affected because their holding companies will not be entitled to treaty benefits. Investors that are treaty protected from U.S. tax on their stock sale gains could still be subject to some U.S. tax if the company is liquidated or their shares are redeemed. The investor's gain from this type of disposition would be treated as a dividend, subject to the 30 percent U.S. withholding tax, to the extent of the company's earnings and profits.

D. *Tax treaties*

Interest and dividends are subject to reduced withholding tax rates under bilateral income tax treaties. For portfolio investors from the Netherlands, the ratios are zero percent and 15 percent, respectively.

II. PORTFOLIO INTEREST

A. *General*

Portfolio interest refers to qualified bearer obligations that meet the requirements of Section 163(f)(2)(B) and registered obligations that are either targeted for foreign markets or the owner of the bond certifies his or her non-U.S. taxpayer status.

B. *Historical background*

1. *Introduction*

Prior to the passage of the Tax Reform Act of 1984, interest payments by U.S. obligers to foreign debt holders were subject to a 30 percent U.S. income tax. As a result, U.S. borrowers were handicapped in their efforts to obtain access to foreign capital markets. In the Eurodollar bond market,

1. Internal Revenue Code (IRC), Secs. 871(a) and 881(a). All references, unless otherwise specified, are to the IRC.
2. Sec. 871(i)(1).
3. Sec. 871(g)(1)(B)(i).
4. Secs. 871(h) and 881(c).
5. Secs. 871(b) and 882.
6. Sec. 882(c)(2).

for example, debt obligations of U.S. issuers subject to the 30 percent U.S. tax had to compete with securities that were not subject to tax at their source. U.S. borrowers could compete only by bearing the economic cost of the U.S. tax by increasing their interest payments to include any U.S. tax withheld at the source. The increased interest cost made Eurodollar bond transactions too costly for U.S. borrowers.

2. *Treaties*
Several U.S. bilateral treaties exempt interest derived from U.S. sources from U.S. taxation. These treaties were not effective in eliminating the U.S. withholding tax, however, because Eurodollar bond financings were often issued as bearer obligations and non-residents of those treaty countries were ineligible for exemption from U.S. withholding.

3. *Finance subsidiaries*
To avoid the 30 percent U.S. withholding tax on interest payments to non-resident aliens and foreign corporations, U.S. corporations borrowed outside the United States through finance subsidiaries that were usually formed in the Netherlands Antilles. The U.S. parent guaranteed the payment of interest and principal on the obligations issued by the Antilles subsidiary. The subsidiary in turn loaned the proceeds back to the U.S. parent. The maximum allowable debt to equity ratio of the subsidiary was 5:1. Although the finance subsidiary structure avoided the 30 percent withholding tax on interest payments to non-U.S. recipients, the structure was costly to maintain and subject to increasing IRS scrutiny.

C. *The portfolio interest exemption*

Effective 18 July 1984, Congress enacted Sections 871(h) and 881(c) which repealed the withholding tax on portfolio interest. The repeal applies to obligations issued by U.S. corporations, partnerships, resident individuals, estates and trusts, and the United States and its political subdivisions after 18 July 1984. Portfolio interest paid on obligations issued prior to 18 July 1984 is still subject to U.S. withholding tax.

The portfolio interest exemption applies to two types of obligations: bearer obligations described in Section 163(f)(2)(B) and registered obligations with respect to which the U.S. withholding agent receives a statement that the beneficial owner of the obligation is not a U.S. person.[7]

1. *Bearer obligations*
Bearer obligations are obligations on which interest is payable to the person who has physical possession of the instrument. Interest on bearer obligations qualifies as portfolio interest and is exempt from withholding if it meets the requirements of Section 163(f)(2)(B). These requirements are met if (1) there are arrangements reasonably designed to ensure that the obligation will be sold only to a person who is not a U.S. person; (2) interest on the obligations is payable only outside the United States; and (3) there is a legend on the face of the obligation that any U.S. holder of the obligation will be subject to limitations under the U.S. income tax laws.

On 7 May 1990, Treasury issued final regulations, effective 10 May 1990, defining "arrangements reasonably designed to ensure sale to non-United States persons". These final regulations contain three requirements: (1) restrictions on offers and sales, (2) restrictions on delivery and (3) certification.

With respect to offers and sales, the issuer and distributor must not offer or sell the obligation during the restricted period (generally, the 40-day period following the closing date) to a person within the United States or its possessions or to a U.S. person. The obligation may, however, be sold to a U.S. person in certain circumstances if the person is a foreign branch of a U.S. financial institution or if the obligation is acquired and held through a foreign branch of a U.S. financial institution.

The distributor of the obligation will be deemed to satisfy this requirement if it covenants that it will not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a U.S. person. In addition, the distributor must maintain procedures reasonably designed to insure that its employees or other agents who are directly engaged in selling the obligation, are aware that the obligation cannot be offered or sold during the restricted period to a person who is within the United States or its possessions or to a U.S. person. With respect to delivery of obligations sold during the restricted period, neither the issuer nor any distributor may deliver the obligation in definitive form within the United States or its possessions.

Certification is required on the earlier of the date of the first payment of interest on the obligation or the date of delivery by the issuer of the obligation in definitive form. The certification may be signed or sent either by the owner of the obligation or by a financial institution or clearing organization through which the owner holds the obligation.

The final regulations alter the exception from certification contained in the proposed regulations for "targeted offshore offerings". The changes are in response to comments concerning offers and sales, under the exception, of obligations within or without the targeted foreign country.

The preamble to the proposed regulations solicited comments on several issues, including whether registered obligations convertible into bearer form should be treated as registered rather than bearer obligations at the time of issuance. Because of general tax compliance concerns, Treasury decided to maintain current law, which treats such convertible obligations as being in bearer form at the time of issuance.

The final regulations will apply to obligations originally issued after 7 September 1990. The issuer of an obligation may choose to apply either the rules of Reg. Section 1.163-5(c)(2)(i)(A) or Reg. Section 1.163-5(c)(2)(i)(B) or the rules of these final regulations, to an obligation that is originally issued after 10 May 1990 and on or before 7 September 1990.

2. *Registered obligations*
Portfolio interest includes interest paid on an obligation which is in registered form and with respect to which the U.S. withholding agent has received a statement that the beneficial owner is not a U.S. person.

An obligation is in registered form if (1) the obligation is registered as to both principal and any stated interest and any transfer of the obligation may be accomplished only through the surrender of the old instrument and the reissuance by the issuer of the old instrument to the new holder or the issuance of a new instrument to the new holder by the issuer; or (2) the right to the principal of, and stated interest on, the obligation may be transferred only through a book-entry system.[8]

7. Secs. 871(h)(2)(B) and 881(C)(2)(B).
8. Temp. Reg. Sec. 5f.163-1(a); Temp. Reg. Sec. 5f.103-1(c).

The statement that the beneficial owner of the registered obligation is not a U.S. person may be made on Form W-8 or a substituted form that is substantially similar to Form W-8.[9] The withholding agent is required to file Form 1040S, Foreign Person's U.S. Source Income Subject to Withholding, and attach the Form W-8.

Obligations required to be registered
Two kinds of obligations must be registered. A pass-through or participation certificate is an obligation backed by a pool of mortgage loans which is treated as a trust of which the grantor is the owner. Reg. Section 1.163-5T(d)(1) requires pass-throughs to be registered. A regular interest in a Real Estate Mortgage Investment Conduit, as defined in Section 860(D) and (G) and the regulations thereunder, requires registration.[10] Temp. Reg. Section 1.163-5T(e)(4) authorizes the Commissioner to collapse any transactions where the purpose is to avoid the registration statement.

3. *Exceptions to the portfolio interest exemption*

(a) *Ten percent shareholder exception*
Portfolio interest does not include interest received by a ten percent shareholder.[11] The term "ten percent shareholder" means (1) in the case of an obligation issued by a corporation, any person who owns ten percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) in the case of an obligation issued by a partnership, any person who owns ten percent or more of the capital or profits interest in such partnership.[12]

Generally, the full attribution rules of Section 318(a) apply, except Section 318(a)(2)(C) and (3)(C) applies without regard to the 50 percent limitation. Stock owned by a subsidiary is therefore attributed to its parent and vice versa. Without the ten percent shareholder exception, foreign investors could withdraw income from their U.S. subsidiaries on a tax-free basis and the U.S. borrower could benefit from a tax deduction for the interest expense.

(b) *Interest received by foreign banks*
Interest received by foreign banks is not considered portfolio interest.[13] Because banks are in the business of loaning money, the interest they receive is not considered portfolio interest, but rather business income. Interest received by foreign banks on U.S. government obligations is not subject to this exception, and therefore is considered portfolio interest.

(c) *Interest received by a controlled foreign corporation*
Interest received by a controlled foreign corporation from a related person (within the meaning of Section 864(d)(4)) is not considered portfolio interest.[14]

(d) *Inadequate exchange of information*
If the Secretary of the Treasury determines that a country lacks adequate exchange of information procedures, he can issue a statement declaring that future interest payments will not qualify for the portfolio interest exemption.

(e) *Back-to-back loans*
In Rev. Rul. 87-89, the IRS examined whether typical back-to-back loans scenarios, whereby funds are deposited with an intermediary that subsequently lends money to a party related to the depositor, should be ignored.[15] If the intermediary would not have made a loan to the U.S. person but for the related person's deposit, the related person will be treated as the true lender. Rev. Rul. 87-89 prevents, among other things, circumvention of the ten percent shareholder exception to the portfolio interest exemption through the use of back-to-back loans.[16]

III. OFFSHORE INVESTORS IN U.S. VENTURE CAPITAL FUNDS

A. *General*

Foreign persons are generally not subject to U.S. tax on gain realized on the disposition of stock in a U.S. corporation (other than a U.S. real property holding corporation), unless the gain is effectively connected with the conduct of a trade or business in the United States.

The gain could be effectively connected with a trade or business in the United States if the foreign person is a partner in a U.S. partnership. Partnerships are flow-through entities, and a foreign partner will be considered to be engaged in a U.S. trade or business if the partnership is so engaged;[17] similarly, a non-resident alien individual or foreign corporation which is a beneficiary of an estate or trust which is engaged in any trade or business within the United States.[18]

If an investment in a venture capital partnership is deemed to be a participation in a U.S. trade or business rather than a security, the foreign investor's capital gains from the enterprise will be subject to U.S. tax. In addition, a foreign partner's partnership income that is effectively connected to a U.S. trade or business is subject to U.S. withholding tax under Section 1446.

A number of court cases have distinguished the management of stock and securities investments from carrying on the trade or business of investing and trading in stocks and securities. The distinguishing factors appear to be the nature of the portfolio and how often it is traded or churned.[19] To the extent there is little trading in the portfolio of a venture capital fund, the foreign investors should not be deemed to be carrying on a U.S. trade or business.

B. *Trading in stocks or securities*

Trading in stocks or securities through a resident broker or other independent agent does not constitute a trade or business within the United States.[20] Similarly, the term "engaged in a trade or business within the United States" does not include trading in stocks or securities for the taxpayer's own account, unless (1) the taxpayer is a dealer in stocks or securities or a corporation, (2) the principal business of which is trading in stocks or securities and (3) the *principal office* is in the United States.[21]

9. Temp. Reg. Sec. 35a.999-5(b), Q&A 9.
10. Temp. Reg. Sec. 1.163-5T(e)(1).
11. Secs. 871(h)(3)(A) and 881(c)(3)(B).
12. Sec. 871(h)(3)(B).
13. Sec. 881(c)(3)(A).
14. Sec. 881(c)(3)(C).
15. 1987-2 C.B. 195.
16. See also Rev. Rul. 84-152, 1984-2 C.B. 381; and Rev. Rul. 84-153, 1984-2 C.B. 383.
17. Sec. 875(1).
18. Sec. 875(2).
19. *Higgins v. Commissioner of Internal Revenue*, 312 U.S. 212 (1941); *Yaeger v. Commissioner*, 55 Tax Court Memorandum (TCM) 1101 (1988), aff'd 889 F.2d 29 (1989).
20. Sec. 864(b)(2)(A)(i).
21. Sec. 864(b)(2)(A)(ii).

For example, a foreign corporation which carries on most or all of its investment activities in the United States but maintains a general business office or offices outside the United States in which its management is located will not be considered as having its principal office in the United States if all or a substantial portion of the following functions are carried on at or from an office or offices located outside the United States:

(1) communicating with its shareholders (including the furnishing of financial reports);
(2) communicating with the general public;
(3) soliciting sales of its own stock;
(4) accepting the subscriptions of new stockholders;
(5) maintaining its principal corporate records and books of account;
(6) auditing its books of account;
(7) disbursing payments of dividends, legal fees, accounting fees, and officers' and directors' salaries;
(8) publishing or furnishing the offering and redemption price of the shares of stock issued by it;
(9) conducting meetings of its shareholders and board of directors; and
(10) making redemptions of its own stock.[22]

Where the foreign corporations carry on other activities with respect to the investor companies, there is a risk that such other activities will constitute a trade or business with the result that all the income or gains recognized by the foreign corporation from its investments will be subject to tax.

IV. PARTNERSHIP ISSUES

A. *Withholding requirements for partnerships with foreign partners*

When a domestic partnership earns fixed or determinable, annual or periodic income that is not connected to a U.S. trade or business, withholding is only required to the extent it is allocable to a foreign person. This applies whether or not the income is actually distributed.[23]

This withholding is calculated each time distributions of fixed or determinable, annual or periodic income are actually made to the foreign partner. If the partnership does not distribute all fixed or determinable, annual or periodic income, it must withhold at the time the Schedule K or K-1 is sent to the partner. However, withholding must be paid over no later than the fifteenth day of the third month following the partnership's year-end.[24] Withholdings are deposited by the partnership with an authorized financial institution or a federal reserve branch using Form 8109. The time for paying over withholdings for most partnerships with any sizable distributions of such income will be within three banking days of the 7th, 15th, 22nd and last day of any month following a distribution.[25]

At the end of the year, Forms 1042 and 1042S are used to summarize all fixed or determinable, annual or periodic income of the entity for the year. They are used to reconcile the total withholdings for the partnership to the withholdings for each foreign partner. These forms are also used to provide information to the partners and the IRS.[26] These forms must be filed on or before 15 March of each year.

22. Reg. Sec. 1.864-2(c)(2)(iii).
23. Reg. Sec. 1.1441-3(f).
24. Rev. Rul. 89-17, I.R.B. 1989-6, 11.
25. Reg. Sec. 1.6302-2.
26. Reg. Sec. 1.1461-2.
27. Sec. 1446(a).
28. Sec. 1446(b).

B. *Effectively connected income – Section 1446*

1. *History*

The Tax Reform Act of 1986 required that foreign and domestic partnerships engaged in a U.S. trade or business withhold a 20 percent gross withholding tax on certain distributions made after 31 December 1987, to their foreign partners.[27] If less than 80 percent of the gross income of a partnership during the previous three years was effectively connected with a U.S. trade or business, the withholding tax would only apply to each foreign partner's pro rata share of effectively connected income distributed.[28]

The Tax Reform Act of 1986 did provide three exceptions to the 20 percent withholding on distributions of effectively connected income:

(a) the 20 percent withholding tax was not to apply to that portion of any distribution which was subject to Sections 1441 or 1442 withholding on non-effectively connected income;
(b) if income from sources within the United States and effectively connected income were properly allocated to U.S. persons, the 20 percent obligation was not to apply;
(c) authority was granted to issue regulations which would coordinate Section 1446 with Section 1445 (regarding FIRPTA).

2. *Rev. Proc. 88-21, 1988-1 C.B. 777*

Rev. Proc 88-21 provided guidance for Section 1446 and established 15 June 1988 as the first date for payment of withholding on foreign partners' effectively connected income. Rev. Proc. 88-21 also introduced an alternative to Section 1446 withholding, the Effectively Connected Income (ECI) election. This required quarterly tax payments on behalf of foreign partners based on their share of partnership effectively connected income, instead of withholding on distributions. The ECI election eliminated the problem of over-withholding when a partnership made distributions to its foreign partners at a time when the partnership had no effectively connected income.

Rev. Proc. 88-21 excluded from the term "Section 1446 distribution" any amounts attributable to the disposition of a U.S. real property interest which were subject to the withholding requirements of Section 1445. However, if the partnership made the ECI election, it would no longer be subject to the Section 1445 rules. It also provided that a Section 1446 distribution included the fair market value of a U.S. real property interest distributed to a partner which was potentially subject to withholding under Section 1445(e)(4).

3. *The Technical and Miscellaneous Revenue Act of 1988 ("1988 Act")*

The 1988 Act retroactively modified the withholding requirements imposed on partnerships with foreign partners. It is effective for tax years beginning after 31 December 1987.

The 1988 Act provided that no amount of tax shall be required to be deducted and withheld under Section 1446 of the 1986 Code as in effect prior to its amendment by the 1988 Act. In addition, affected partnerships are no longer required to withhold on distributions to foreign partners. Instead, they are now required to pay a withholding tax equal to the applicable percentage of the effectively connected taxable income allocable to foreign partners under Section 704. The applicable percentage is equal to the highest appropriate tax rate – 28 percent for individuals and 34 percent for corporate partners. The new withholding structure was enacted to avoid withholding on distributions that include little or no income potentially subject to U.S. tax.

IRS Announcement 89-60 retroactively eliminates, as of 1 January 1988, prior law requirements reflected in Rev. Proc. 88-21, above. It also states that Rev. Proc. 89-31 (discussed below) has replaced Rev. Proc. 88-21 for purposes of providing guidance with respect to Section 1446 as amended by the 1988 Act.

4. *Rev. Proc. 89-31, 1989-1 C.B. 895*

Rev. Proc. 89-31 includes procedures for computing, paying and reporting the new withholding tax based upon effectively connected taxable income allocable to foreign partners. It provides transition rules applicable to the payment of the withholding tax beginning in 1988. It also provides separate withholding procedures for publicly traded partnerships. Under these rules, the Section 1446 withholding tax is to be withheld from partnership distributions to foreign persons.

Rev. Proc. 89-31 also established new rules determining whether a partner is a foreign person. A foreign person is a non-resident alien individual, foreign corporation, foreign partnership, or foreign trust or estate.

For partnership taxable years *beginning before 1 July 1989,* if a partner has obtained a certification of non-foreign status under Section 1445, the partnership may rely upon it to determine that the partner is not subject to withholding. This only holds true if the partnership does not have actual knowledge that the certification is false. A partnership may not rely upon a certification of non-foreign status based on a Section 897(i) election to treat certain foreign corporations as U.S. corporations.

A partnership may rely on a partner's certification of non-foreign status until the earliest of:
(a) the end of the third year after the taxable year of the partnership during which the certification was obtained;
(b) the date the partnership receives notice from the partner that it has become a foreign person; or
(c) the date the partnership has actual knowledge that the partner has become a foreign person.

A certification that satisfies the requirements of Rev. Proc. 89-31 will also satisfy the requirements for a certificate of non-foreign status under Section 1445. No particular form is required for a certification of non-foreign status.[29] The certification must contain the following:
(a) statement that the partner is not a foreign person;
(b) the partner's name, U.S. identifying number and home address or office;
(c) provision that the partner will notify the partnership within 60 days of change to a foreign status; and
(d) signature under penalties of perjury.

5. *Effectively connected taxable income*

The partnership's gross income that is effectively connected under Section 864 (or treated as effectively connected with the conduct of a trade or business in the United States), less the allowable deductions, is subject to withholding. Such withholding only applies to amounts allocable to foreign partners.

In determining income subject to withholding, the partnership shall not take into account net operating loss carryovers or charitable contributions. Separately stated partnership items are included if they generate effectively connected income. The partnership is allowed a cost but not percentage depletion deduction. A foreign partners's distributive share of partnership deductions attributable to that partner's effectively connected income is determined under Section 873 for individuals, Section 882(c)(1) for corporations and Section 704 for partnerships. Income subject to withholding includes partnership income subject to a partner's election under Sections 871(d) or 882(d) to treat real property income as effectively connected income. It also includes partnership income treated as effectively connected income under Section 897 and other provisions of the IRC.

6. *Amount of withholding tax*

For corporate partners the rate of withholding is the highest rate of tax specified in Section 11(b) – currently 34 percent. For all other partners (e.g. partnerships, trusts, individuals), the rate is the highest rate of tax specified in Section 1 for income derived during the taxable year of the partnership – currently 28 percent. The tax is paid in four instalments.

A foreign partner's share of effectively connected income and deductions is annualized for purposes of determining the instalment payment amount. This is done by applying the principles set forth in Section 6655(e)(2). The withholding tax is computed by applying the Section 1446 applicable percentage to the partner's annualized effectively connected taxable income. Section 1446 withholding does not include a foreign partner's liability imposed under Section 884 (branch profits tax). It also does not take into account the partners's distributive share of the partnership's tax credits.

A partnership that fails to withhold may be held liable for the tax. Penalties and interest could apply. Officers or responsible persons of any withholding agent may be subject to a Section 6672 penalty equal to the tax withheld.

No penalty will be imposed if:
(a) the amount of each instalment equals 25 percent of the withholding tax that would have been payable on the partnership's effectively connected taxable income allocable to foreign partners for the prior year;
(b) the prior taxable year consisted of 12 months;
(c) the partnership filed a Section 6031 information return (Form 1065) for the prior year; and
(d) the amount of effectively connected income for the prior year was not less than 50 percent of the *actual* effectively connected income for the current year.

Partnerships must generally pay the Section 1446 payment for each foreign partner on or before the 15th day of the *fourth, sixth, ninth* and *twelfth* months of the partnership's taxable year. Only information of the partnership has to be reported at this time. This is a simplification of the prior rules which required quarterly reporting of detailed information on each foreign partner.

Each foreign partner is to treat its share of the tax paid by the partnership as a credit against its tax liability. The partner's credit is allowable in its taxable year in which the partnership's taxable year (for which the tax was paid) ends. The amount paid by the partnership allocable to a foreign

29. Sample certifications of non-foreign status are provided in Section 4.04 of Rev. Proc. 89-31.

partner is treated as distributed to the partner on the last day of the partnership's taxable year.

C. *Interaction with other withholding rules*

Fixed or determinable, annual or periodic income subject to tax under Sections 871(a) or 881 is not effectively connected income.

Such amounts are independently subject to the Sections 1441 and 1442 withholding requirements.

If a partnership is subject to the Section 1446 withholding requirements, it shall not also be subject to the Section 1445(e)(1) payment and reporting requirements with respect to income from the disposition of a U.S. real property interest. A partnership's compliance with the Section 1446 withholding requirements satisfies the requirements under Section 1445.

Any amounts withheld and paid over a partnership under Section 1445(e)(1) with respect to transactions occurring during taxable years beginning after 31 December 1987, but prior to the filing of the annual Section 1446 return, shall be allowed as a credit against the partnership's Section 1446 tax liability. A foreign partnership which is subject to the Section 1445(a) withholding requirements may credit that amount against its Section 1446 withholding tax liability for the year.

D. *Annual return requirement*

Every partnership with a foreign partner and effectively connected income is required to file an annual return under Section 1446. This annual return is similar to Form 1042 and 1042S. Form 8804, Annual Return for Partnership Withholding Tax, is used to report the total tax liability under Section 1446. It is also a transmittal form for Form 8805. Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, is used to show the amount of effectively connected taxable income and the tax payments allocable to the foreign partner.

V. TREATY-BASED RETURN POSITIONS

A. *T.D. 8292, 1990-1 C.B. 180*

On 14 March 1990 IRS issued final regulations (T.D. 8292) under Sections 6114 and 5712 covering the disclosure of treaty-based return positions and related penalties. The final regulations incorporate the rules contained in the temporary regulations issued in September 1989, with a few significant changes.

The most significant change is that a foreign corporation that is not engaged in a U.S. business does not have to file a U.S. income tax return to disclose a treaty-reduced withholding tax rate on dividends, interest, rents, royalties or other passive income received from a U.S.-related party, *provided* the U.S.-related payor has properly reported these payments to the IRS on Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding. This change will significantly reduce the reporting burden created by temporary regulations. For persons still required to disclose treaty-based return positions, the final regulations extended the due date for filing disclosure statements relating to returns due on or before 10 March 1990 to 12 June 1990.

The final regulations include numerous changes and clarifications to the temporary regulations, including instances where treaty-based return position disclosure is specifically waived, situations where disclosure is specifically required, and the information that needs to be disclosed.

Under the final regulations, U.S. persons, as well as foreign persons engaged in a U.S. business, that claim treaty benefits have to disclose treaty-based return positions on their returns. Foreign persons not engaged in a U.S. business, receiving only fixed and determinable annual or periodic U.S.-source income from *unrelated* U.S. payees, are generally not required to file returns disclosing treaty-based return positions.

Reporting is specifically required, however, if the U.S. payor has not properly reported the payment to the IRS on Form 1042S and the foreign recipient of passive non-effectively connected income is any of the following: (1) a CFC; (2) a foreign corporation controlled by U.S. persons; or (3) a shareholder of a U.S. corporation (or a foreign corporation engaged in a U.S. business) that is foreign-controlled under Section 6038A (for tax years beginning after 10 July 1989, the 25 percent test under Section 6038A applies). Thus, if Form 1042S is properly filed, *none* of the three foreign recipients described above would have to file a U.S. income tax return solely to disclose treaty-reduced rates on such income. Each person paying U.S.-source passive non-effectively connected income to a foreign person is required to report such payments annually to the IRS on Forms 1042 and 1042S.[30]

B. *Penalties for non-compliance*

The final regulations have also clarified that the penalty for failure to disclose (US$ 10,000 for corporations) is imposed on each *separate payment of separate income item* even if received from the same payor. Therefore, if monthly interest payments are received by a foreign corporation from a single payor and treaty-based return position disclosures are required under the regulation, the penalty for failure to disclose could be $ 120,000 (i.e. $ 10,000 × 12).

C. *Effective dates*

The final regulations are effective for tax years for which the due date of the return (without extensions) occurs after 31 December 1988. IRS Notice 90-19 delayed reporting on returns due on or before 10 March 1990 until 90 days after publication of final regulation in the Federal Register. With the publication of final regulations, the due date for disclosure was 12 June 1990. Notice 90-19 did not extend reporting for returns due after 10 March 1990. Therefore, reporting on returns due after that date must be made with the return.

VI. HYBRID ENTITIES

A. *Corporation vs. partnership*

Under Reg. Section 301.7701-2, in order for an organization to be classified for U.S. tax purposes as a corporation rather than a partnership, it must have a preponderance of the corporate characteristics of centralization of management, continuity of life, free transferability of interests and limited liability. Although an entity organized under foreign law is

30. Sec. 1461 and the regulations thereunder.

classified for federal tax purposes solely on the basis of the characteristics presented in Reg. Section 301.7701-2, the determination of the legal relationships affecting these characteristics depends on the local law of the foreign jurisdiction.[31]

For example, in Letter Ruling 9010028, the IRS found that a GmbH possessing the characteristics of centralization of management and limited liability could nevertheless qualify as a partnership for U.S. tax purposes because it lacked the characteristics of free transferability of interests and continuity of life. This ruling was later revoked, but apparently not for reasons affecting the logic of its conclusion.

An organization has the corporate characteristic of free transferability of interests if each of its members, or those members owning substantially all of the interests in the organization, have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization.[32] In Letter Ruling 9010028, the GmbH lacked the characteristic of free transferability of interests because its articles of association provided that shareholders could not transfer their shares in the GmbH to a non-affiliated company without first offering the shares to the other owners or obtaining their consent at a shareholders' meeting.

An organization does not have continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause the dissolution of the organization.[33] The articles of association of the GmbH in Letter Ruling 9010028 provided that the company would terminate upon the bankruptcy of any owner unless the other shareholders elected to assume the interests of the bankrupt owner, or the GmbH, upon an 85 percent majority vote, purchased the interest. The IRS found that the GmbH lacked the continuity of life characteristic because of the potential dissolution of the company upon a shareholder's bankruptcy.

The shareholders of the GmbH in Letter Ruling 9010028 were not directly or indirectly affiliated. If the owners had been related, the GmbH would not have been classified as a partnership. If related parties own all of the interests in a foreign corporation, limits on the free transferability of shares do not have substantive value.[34] Similarly, a statement in the articles of association that death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause a dissolution of the organization has significance only if there exist separate interests that could compel dissolution of the organization upon the occurrence of one of the listed events.[35]

An organization has centralized management if any person or group of persons has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. There is no centralization of continuing exclusive authority to make management decisions unless the mangers have sole authority to make such decisions.[36]

An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization.[37]

B. *Use of Dutch limited partnerships*

A typical plan implemented to benefit from using a Dutch "Commanditaire Vennootschap" (CV) involves a non-resident alien or foreign corporation forming a corporation in a no-tax or low-tax jurisdiction (e.g. the Cayman Islands). This corporation becomes a general partner in an "open" Dutch CV with an unrelated foreign company as a limited partner. The general partner receives a 90 to 95 percent distributive share of the CV's profits, with the limited partner receiving the remaining five to ten percent. The CV is structured to have the corporate attributes of continuity of life, centralized management and limited liability.[38] The CV invests its capital in the United States. If a CV is treated as an association taxable as a corporation for U.S. tax purposes, it may enjoy the reduced U.S. withholding tax rates provided in the treaty (zero percent for interest and royalties, and five percent or 15 percent for dividends).

For Dutch tax purposes, a CV is considered an entity similar to a limited partnership. A CV can either be *open* or *closed*. For Dutch tax purposes, a closed CV is treated as a pass-through entity, subjecting the partners directly to Dutch taxation. The Netherlands taxes an open CV as a corporation. However, an open CV may deduct distributions of profits to its general partner.

If a general partner does not have a permanent establishment in the Netherlands, distributions it receives from a CV are not subject to tax in the Netherlands. (For Dutch tax purposes, the trade or business and the permanent establishment of a CV are *not* attributed to the partners.) Assuming a general partner is incorporated in a jurisdiction that does not have an income tax, the overall effective tax rate on interest or royalties flowing out of the United States to a third-country resident would be nominal.

There is a significant risk that the IRS will not consider a Dutch CV an association taxable as a corporation under the structure described above. Although Letter Ruling 8103092 supports the fact that a Dutch CV can be taxed as a corporation (thus enjoying reduced treaty withholding rates for the partners), the facts in the ruling can be distinguished from the CV structures proposed.

The general partners in the ruling were Dutch corporations receiving small distributive shares of the profits. These distributions to the general partners were also subject to Dutch corporate tax. The limited partners in the ruling received most of the income so that, in effect, all of the income of the CV was subject to Dutch corporate tax. Also, the ruling stated that the general partners did not have significant assets and had only a small percentage interest in the partnership itself.

If a CV is considered, for U.S. tax purposes, to be a partnership rather than a corporation, the U.S. partnership pass-through rules should apply. Therefore, a general partner would be subject to the statutory 30 percent U.S. withholding tax on its distributive share of gross U.S.-source interest, dividends and royalties.

The Dutch tax authorities are reviewing the use of CVs. Furthermore, the IRS has stated it will not ordinarily rule on whether a foreign partnership will be classified as an association taxable as a corporation for U.S. tax purposes.[39]

31. Rev. Rul. 73-254, 1973-1 C.B. 613; Rev. Rul. 88-8, 1988-1 C.B. 403.
32. Reg. Sec. 301.7701-2(e)(1).
33. Reg. Sec. 301.7701-2(b)(1).
34. Rev. Rul. 77-214, 1977-1 C.B. 408.
35. *Id.*
36. Reg. Sec. 301.7701-2(c).
37. Reg. Sec. 301.7701-2(d).
38. See Letter Ruling 8103092.
39. See Rev. Proc. 90-3.

The IRS is also aggressively pursuing back-to-back loan and royalty arrangements (conduit principle).[40]

VII. CONCLUSION

The maze of tax rules affecting foreign investors in the United States continues to grow more complex. Congress' belief that foreign-owned entities pay too little U.S. tax indicates that this trend is likely to continue. As a result, portfolio investors, foreign partners and partnerships, and other foreign entities must pay particular attention to potential withholding tax issues when planning to invest in the United States.

40. Rev. Rul. 87-89, 1987-2 C.B. 195; Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.

EUROPE 1992: A U.S. TAX PERSPECTIVE

Nicolaas T. van der Kloot

I. BACKGROUND

There continue to be significant developments within the European Community. In the area of corporate taxation, several far-reaching directives have recently been ratified, their provisions generally taking effect from 1 January 1992. More directives in the direct tax area are expected in the not too distant future. At the same time, on a more general level, there is increasing awareness in the United States of the concept of an integrated Europe. A recent poll indicated that 47 percent of Americans have heard or read about the European Community as opposed to only 29 percent in 1987.[1] Generally, Americans have a positive attitude (the poll showed that 50 percent of those aware of the single European Community market regard it as good for U.S. consumers), combined with awareness that detailed planning, both commercial and tax-oriented, is necessary to ensure that the European operations of U.S. businesses are successful throughout the 1990s. As a complement to the process of analyzing the recent developments in Europe, attention is also being directed to whether U.S. domestic (tax) legislation adequately reflects those developments.

Part I of this article considers how domestic tax laws affect U.S. business operations in Europe in comparison with their European competitors in the post-1992 era. It also focuses on the amendments which might (or should) be made to U.S. tax legislation in order to remove or mitigate some of the potential tax disadvantages facing U.S. corporations operating in Europe. On a more positive note, Part II of the article reviews the specific changes in European tax laws which will come into effect post-1992 and considers how these might affect the tax planning strategy of U.S. corporations operating in the European Community.

II. U.S. TAX LAWS: A COMPETITIVE DISADVANTAGE?

Pressure from representatives of U.S. businesses is mounting in support of amendments to U.S. tax legislation which would reflect the current developments in Europe. It is felt that if these changes are not made U.S. corporations operating in Europe might be relatively disadvantaged compared with their European and perhaps Japanese counterparts. Specifically, many favour the suggestion of some form of legislative recognition that, as of 1992, the member states of the European Community should be treated as one country for U.S. tax purposes rather than as a collection of independent countries connected only by virtue of their geographical proximity. If such legislative recognition is not forthcoming it is feared that U.S. businesses in Europe may be placed at an additional competitive disadvantage. As is mentioned later in this article, however, it is unlikely that any legislation in this area will pass in the foreseeable future as a result of the U.S. budget deficit.

To illustrate the issue, let us consider, for example, the relative world-wide tax positions of a Dutch and a U.S. group operating in Europe pre and post-1992. Of particular interest is the potential impact of a cost-saving reorganization of the business operations on the post tax profitability of the European enterprises. Obviously, the following example is overly simplified to highlight the points to be made.

Drs. Nicolaas van der Kloot, CPA, is an international tax partner in the Parsippany, New Jersey office of Coopers & Lybrand. *This article is based on a presentation made by the author to the joint U.S.-Dutch IFA meeting in Amsterdam on 23 August 1990.* *It is with sincere gratitude that the author recognizes the significant contribution made by Annie Devoy, a member of the International Tax Consulting Group of Coopers & Lybrand in New York.*

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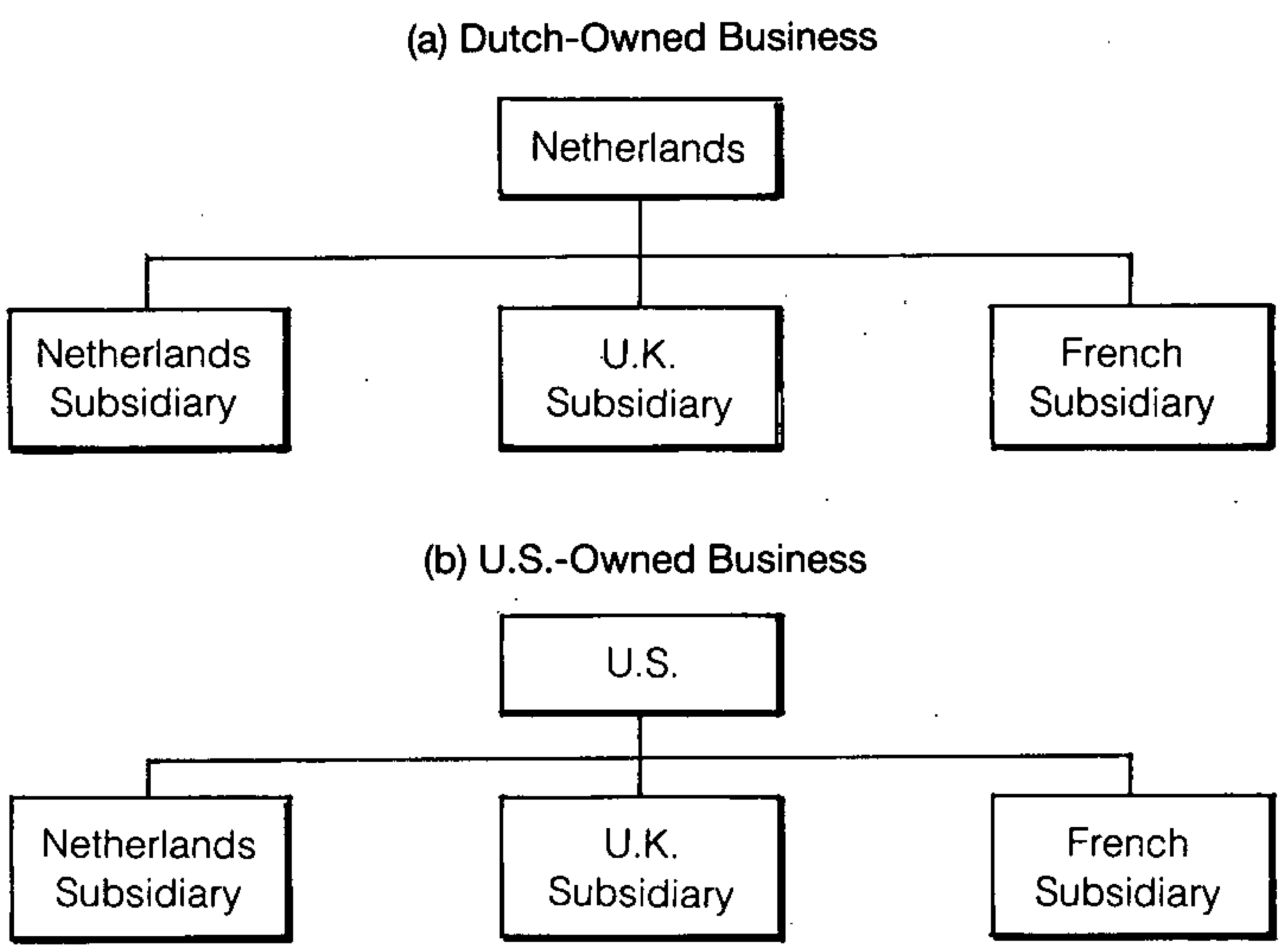
1. European Community-sponsored Gallup Poll – statistics quoted in the June 1990 issue of the *Eurocom Monthly Bulletin.*

Pre-1992

Under the pre-1992 scenario, let us assume that there exists a Dutch parent corporation and a U.S. parent corporation and that each corporation manufactures products only in its respective home country. Each of these parent corporations operates in the Netherlands, the United Kingdom and France through wholly owned distribution and sales subsidiary corporations. Each subsidiary has its own distribution network and holds inventory for distribution. Each subsidiary sells products only in its domestic market. Also, the subsidiaries have no immediate intention to remit dividends to the parent companies. Let us further assume that the effective rate of tax in each of the foreign countries is 30 percent. Even though the statutory tax rates in these countries may be higher, the effective rate may be reduced, for example, as a result of accelerated tax depreciation allowances. The corporate structure of both groups is illustrated in Figure 1 (a) and (b), respectively.

Figure 1



Assume that the operating and after-tax results for the year to 31 December 1991 are as follows:

Income for the Year
Ended 31 December 1991

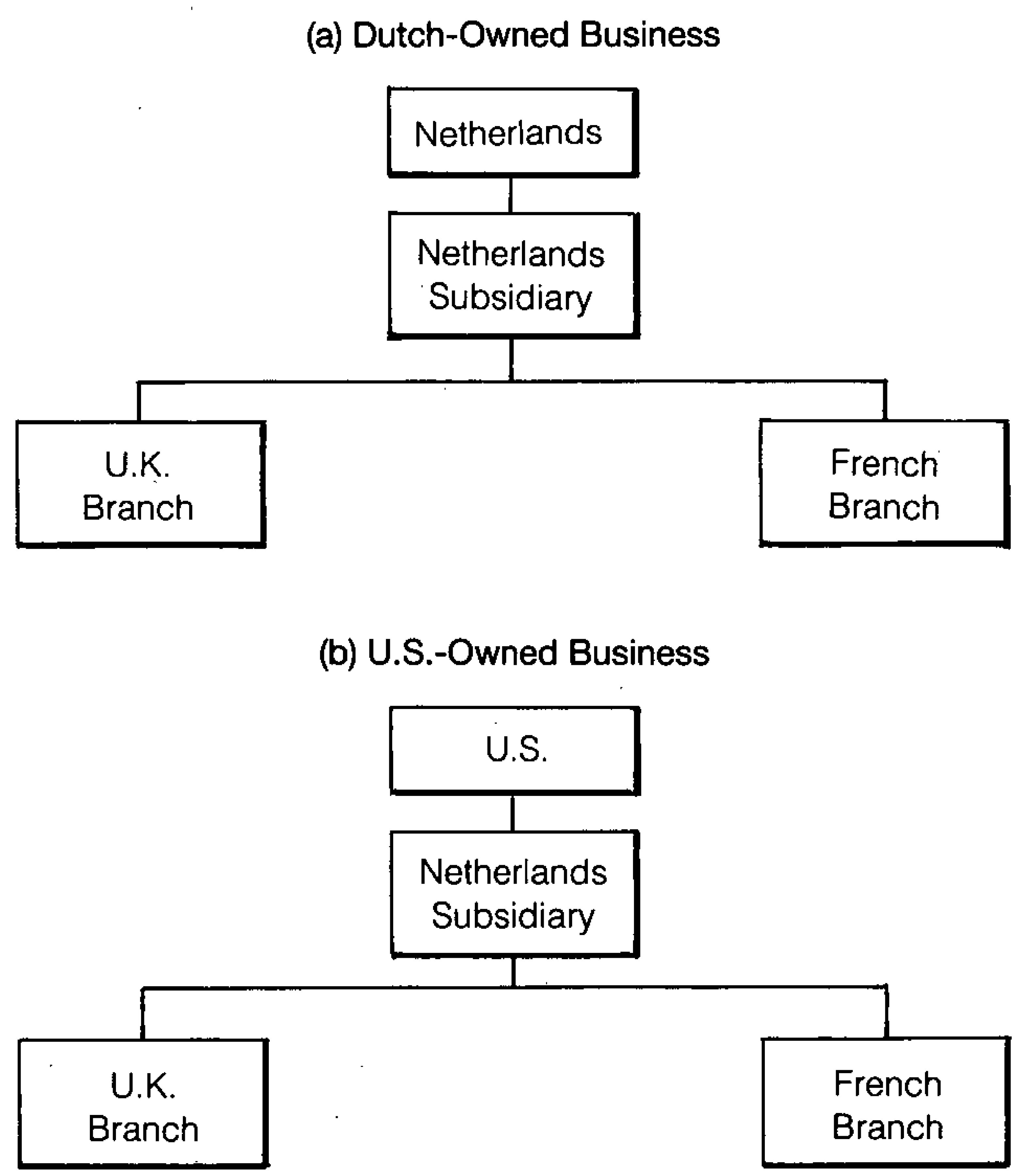
	Dutch Group m $	U.S. Group m $
Pre Tax Income:		
United Kingdom	100	100
France	100	100
Netherlands	100	100
	300	300
Taxation:		
United Kingdom	(30)	(30)
France	(30)	(30)
Netherlands	(30)	(30)
Net Income	210	210

Not surprisingly (or perhaps surprisingly) under this pre-1992 scenario, equal operating results for the U.S. group and the Dutch group translate into the same amount of after-tax net income. Taxation in each of the local countries is the same. The Dutch parent company, under Dutch tax law, does not pay Dutch taxes on unremitted subsidiary income. Similarly, the U.S. parent company does not pay taxes on the unremitted income of its subsidiaries under the general principle of U.S. tax law that unremitted income of foreign subsidiaries is not subject to U.S. taxes (although certain exceptions exist which, to the extent relevant, are discussed below).

Post-1992

Under the post-1992 scenario, we continue to assume that the U.S. and Dutch parent companies manufacture products only in their home countries. In response to the developments in Europe, the managements of both parent corporations conclude that significant cost savings may be achieved by centralizing the European distribution and inventory holding operations of their respective groups. Accordingly, both parent companies decide to utilize their existing Dutch sales subsidiary to operate the central distribution and inventory holding functions. Under this new structure the U.K. and French sales subsidiaries are liquidated and the sales activities in those countries are conducted through branches of the Dutch sales corporation. The resulting corporate structures are depicted in Figure 2 (a) and (b), respectively.

Figure 2



Cost savings resulting from the reorganization are as follows:

	million $
United Kingdom	9
France	9
Netherlands (due to additional expenses incurred by the Dutch sales subsidiary)	(4)
Net Savings (before tax)	14

For the purpose of this scenario, we continue to assume that the effective tax rate in the foreign countries remains at 30 percent and that there remains no intention to remit dividends. Assuming that the operating income before taking into account the cost savings described above remains the same, the results for the year ended 31 December 1992 are as follows:

Income for the Year
Ended 31 December 1992

	Dutch Group m$	U.S. Group m$
Pre Tax Income:		
United Kingdom	109	109
France	109	109
Netherlands	96	96
	314	314
Taxation:		
United Kingdom	(32.7)	(32.7)
France	(32.7)	(32.7)
Netherlands	(28.8)	(28.8)
United States ($ 218m @ 34% less foreign tax credits of $ 65.4m)	—	(8.7)
Net Income	219.8	211.1

As shown above, with the same pre-tax operating income ($ 314 million), the after-tax income of the U.S. group is now $ 8.7 million lower than that of its Dutch counterpart. The reason for the shortfall is that foreign branch income is not taxed in the Netherlands in this type of situation. On the other hand, income from sales of products (purchased from a related supplier) for consumption outside the Netherlands constitutes an exception to the general rule mentioned above, i.e. that undistributed income of a foreign subsidiary is not taxed to its U.S. shareholders.[2] This exception is found in Subpart F of the IRC and hence this type of income is referred to as Subpart F income. Subpart F income of a foreign subsidiary is currently includable in the income of its U.S. shareholders whether a distribution occurred or not. Accordingly, the income derived by the Dutch company from sales outside the Netherlands (e.g. the United Kingdom and France) is currently taxable in the United States. Subject to certain limitations beyond the scope of this discussion, foreign tax credits are allowed as an offset against the resulting U.S. tax.

Post-1922 – Increased cost savings

Ironically, if the cost savings resulting from the post-1992 reorganization are greater, the U.S. group may be further disadvantaged; even to a point where any cost savings are more than offset by increased taxation in the United States. Let us assume, for example, that the group structures remain as established under the post-1992 scenario described above and that all the post-1992 assumptions remain the same, except that the cost savings resulting from the reorganization are greater. Net savings are as follows:

	million $
United Kingdom	12
France	12
Netherlands	(7)
Net Savings	17

The results for the year ended 31 December 1992 are now as follows:

Income for the Year
Ended 31 December 1992

	Dutch Group m$	U.S. Group m$
Pre Tax Income:		
United Kingdom	112	112
France	112	112
Netherlands	93	93
	317	317
Taxation:		
United Kingdom	(33.6)	(33.6)
France	(33.6)	(33.6)
Netherlands	(27.9)	(27.9)
United States ($ 317m @ 34% less foreign tax credits of $ 95.1m)	—	(12.7)
Net Income	221.9	209.2

Compared to the original post-1992 scenario, the increased cost savings for the Dutch company result in a corresponding increase in after-tax profits. On the other hand, the greater cost savings under this scenario have made the U.S. group worse off, not only compared to the original post-1992 scenario but even to the point where the company's after-tax profits are now lower than before any cost savings were realized. This is because another provision of the IRC provides that if the *Subpart F* gross income of a foreign company (in this case income from sales outside the Netherlands) exceeds 70 percent of its total gross income, then all of the company's income is treated as Subpart F income.[3] Assuming equal operating margins in each of the countries, more than 70 percent of the Dutch company's gross income would be derived from sales outside the Netherlands. Accordingly, all of its income is treated as currently taxable in the United States under Subpart F.

Obviously, the above example is not intended to suggest that the European operations of U.S. corporations will inevitably be at a disadvantage compared with their non-U.S. competitors in the post-1992 era. However, it is clear that this may be the case in certain circumstances. Certainly, U.S. businesses will have to consider, very carefully, how to structure their European groups to take advantage of European Community developments without incurring additional U.S. taxes.

In addition to the example above, there are various other provisions of U.S. tax law pursuant to which the tax treatment of a certain transaction depends on whether it occurs within one particular country. Currently, the European Community is not treated as one country for this purpose. Rather, each of the individual member states is treated as a separate country. These provisions should be carefully considered when structuring operations within Europe. At best, they are potential pitfalls which should be avoided. At worst, they result in a competitive disadvantage for U.S. corporations operating in Europe. Some further examples of these types of provision are identified below. They broadly fall in three categories, i.e. rules regarding Subpart F income, sourcing of income and inbound investments.

2. Internal Revenue Code (IRC), Sec. 954(d). Unless otherwise mentioned, all references are to the IRC.
3. Sec. 954(b)(3)(B).

A. *Subpart F income*

Certain income, which otherwise would be includable as Subpart F income, will not constitute Subpart F income when elements of the underlying transaction occur in the same country and certain other conditions are met.

1. *Dividends and interest*
Dividends and interest received from a related person do not constitute Subpart F income if they are received from a corporation organized under the laws of the same foreign country as the recipient controlled foreign corporation (CFC) and the payor corporation has a substantial part of its assets used in a trade or business located in the same foreign country.[4]

2. *Rents and royalties*
Similarly, rents and royalties received from a related corporation in respect of property located in the same country as the recipient CFC does not constitute Subpart F income.[5]

3. *Income from sales*
Income from sales of products purchased from a related party (or involving certain other related party transactions), where the property is for use in the same country as that in which the recipient of the income is incorporated, does not constitute Subpart F income (as illustrated in the example above).[6]

4. *Income from services*
Income from services performed for or on behalf of a related person does not constitute Subpart F income as long as the services are performed inside the recipient CFC's country of incorporation.[7]

5. *Insurance/reinsurance income*
Insurance/reinsurance income comprising premiums covering risks in the same country as that in which the recipient insurer/reinsurer CFC is incorporated does not constitute Subpart F income.[8]

6. *Factoring income*
Factoring income is not treated as Subpart F income, where trade receivables are acquired from a related corporation incorporated in the same country as the purchasing CFC.[9]

B. *Sourcing of income*

Generally where a U.S. resident sells shares of a corporation, any gain is treated as U.S.-source income. However, where a U.S. shareholder sells stock in an affiliated foreign corporation (holding over 80 percent of the vote and value), any gain on the sale of the stock may be treated as foreign-source income if the affiliate is engaged in an active trade or business and more than 50 percent of the gross income of the affiliate, during the three taxable years ending prior to the period in which the sale occurs, was derived from the active conduct of a trade or business carried on in its country of incorporation.[10]

C. *Inbound investments*

Not treating the European Community as one country could also have an impact on foreign investors in the United States. For example, the United States imposes a branch profits tax where a foreign corporation conducts its U.S. operations through a branch.[11] In the absence of a favourable tax treaty, the rate of the branch profits tax is 30 percent. The tax is imposed on a foreign corporation's "dividend equivalent amount" which generally reflects the profit repatriation of the U.S. branch to its "home office". The branch profits tax cannot be eliminated (or reduced) by the provisions of a double taxation treaty with the United States unless certain tests are met.[12] These tests include:
- 50 percent or more of the stock of the foreign corporate taxpayer, seeking to rely on the relevant treaty provision, is owned by residents of that same treaty country and less than 50 percent of the corporate taxpayer's income is used to meet liabilities due to persons resident outside the treaty country; or
- the foreign corporate taxpayer is engaged in an active trade or business in its country of residence; or
- the stock of the foreign corporate taxpayer is primarily and regularly traded on an established securities market in its country of residence.

Most U.S. tax treaties, which have been negotiated or recently revised, contain an article limiting the benefits of the treaty to entities meeting similar requirements to those applied in the case of branch profits tax as discussed above.

D. *Other tax impediments to competitiveness of U.S. corporations in Europe*

Apart from the provisions considered above, other U.S. tax laws have been criticized on the basis that they are likely to restrict the success of U.S. businesses in a single European market. For example, changes to the foreign tax credit system have been suggested which, supposedly, would allow U.S. corporations to compete more effectively in the European market. In particular, many would like to see the removal of the separate basket for non-controlled Section 902 corporations (the "10/50" basket) which they claim might inhibit U.S. participation in European joint venture activity. Any discussion of these provisions is beyond the scope of this article.

E. *Proposed legislation*

A Bill (the "Bill") was introduced at the end of February 1990 to treat Europe as one country for the limited purpose of preventing intra-European Community sales and services income from being taxed under Subpart F (as illustrated in the above example).[13] In other words, the Bill does not apply to the other "same country" provisions listed above with respect to dividends, interest, rents, etc. The Bill's relieving provisions are restricted to European countries with statutory tax rates in excess of 90 percent of the maximum U.S. corporate rate and which do not exempt corporations from taxation pursuant to any form of tax holiday. For obvious reasons the Bill has attracted strong support from U.S. industry representatives. The general consensus, however, is that this Bill has a fairly slim chance of being enacted. Although many view the Bill's provisions as reasonable and likely to promote the success of U.S. business in Europe, the cost, in terms of revenue, of such legislation is considered to be prohibitive in light of current

4. Sec. 954(c)(3)(A)(1).
5. Sec. 954(c)(3)(A)(ii).
6. Sec. 954(d) (see Example 1).
7. Sec. 954(e).
8. Sec. 953.
9. Sec. 864(d).
10. Sec. 865(f).
11. Sec. 884.
12. Sec. 884(d)(4).
13. H.R. 4136, 101st Cong., 2nd Sess. (1990).

concern over the size of the U.S. deficit. To date no legislation has been proposed to change any of the other U.S. tax provisions mentioned above.

III. CURRENT DEVELOPMENTS IN THE EUROPEAN COMMUNITY

For decades, the European Community has been making efforts to achieve some degree of harmonization of the tax laws of its member states. However, progress has been very limited because of the divergence of the existing tax systems and the difficulty of getting all the member states to agree on standardized tax laws. The European Community has recently shifted its harmonization strategy to concentrate on the areas of tax law which cause relatively less conflict. Specifically, the reduction/elimination of double taxation on cross-border transactions within the European Community has become a high priority.

The following directives, relating to direct taxation in Europe, have been proposed/adopted:

Description	Date of Original Issue	Current Status
Directive on mergers, divisions and contributions	October 1973	Ratified – July 1990 Effective – 1 January 1992
Directive on parent/ subsidiary relationships	October 1973	Ratified – July 1990 Effective – 1 January 1992
Proposed Directive on harmonization of company taxation	December 1975	Draft – unlikely to be adopted in the near future
Convention on the elimination of double taxation in connection with the adjustment of transfers of profits between associated undertakings	November 1976	Draft – most recent version, July 1990
Council Directive concerning mutual assistance in direct taxation	December 1977	In force – amended December 1979
Proposed Directive on application to collective investment institutions of Council Directive on harmonization of company taxation and of withholding taxes on dividends	July 1978	Draft – unlikely to be adopted in the near future
Amended proposed Directive on the harmonization of the laws of the Member States relating to tax arrangements for the carryover of losses of undertakings	June 1984	Draft

The adoption of the two directives and a draft convention in July 1990 is a hopeful sign for a further trend within the European Community in relation to the harmonization of direct taxes. For example, directives are expected to be issued shortly which would prohibit withholding taxes on interest and royalties paid and received within the European Community. Similarly, although perhaps less likely in the near future, it is hoped that provisions will be enacted to allow tax consolidation of profits and losses of branches (and perhaps even subsidiaries) situated in different member states. Below follows a brief description of the three measures that were adopted in July 1990. This description is not meant to be exhaustive. Rather, the intention is to highlight the major provisions and analyze their impact on U.S. corporations operating in Europe.

A. *Parent/subsidiary directive*

This directive makes significant changes in the tax laws affecting groups of companies operating within Europe. The directive abolishes withholding taxes on dividends remitted from a subsidiary corporation to its parent corporation within the European Community.[14] Furthermore, the directive provides that on receipt of dividends by a parent company established in a member state that member state may treat the receipt, for tax purposes, in one of two ways.[15] Either it may exempt dividends from member state subsidiaries from taxation entirely (e.g. as under the current system in the Netherlands) or it may subject the dividend to taxation but allow a foreign tax credit for taxes paid by the subsidiary which are attributable to the dividend received (e.g. as under the current system in the United Kingdom). Taxes paid by lower tier subsidiaries are not required to be creditable, although in the United Kingdom, for example, such taxes are creditable under current domestic law. In effect, the directive seeks to eliminate the double taxation of profits distributed by a subsidiary company established in one member state to its parent corporation in another member state.

The general prohibition on withholding taxes is subject to the following exceptions:[16]
- Germany: a five percent withholding tax is permitted on dividends distributed by a German corporation until 30 June 1996 so long as the rate of German tax on distributed profits is at least 11 points less than the rate on undistributed profits (currently there is a 14 percent difference);
- Portugal: a 15 percent withholding tax is permitted on dividends distributed by a Portuguese corporation until 31 December 1996; 10 percent until 31 December 1999;
- Greece: withholding tax is permitted up to the amount allowed by Greece's double taxation treaties so long as distributed profits are not taxable under Greek law.

A "parent company" is defined as one which owns at least 25 percent of the stock of another corporation.[17] Note that the member states may impose a two-year holding period requirement in addition to the percentage holding test.[18] The provisions only apply to corporations which are subject to the basic corporate taxes in the member states.[19] For example, a Luxembourg holding company is not subject to regular income tax and, therefore, is not eligible for benefits under the parent/subsidiary directive. It should be noted that the directive contains certain anti-avoidance provisions.[20] While it is still unclear how these provisions will be interpreted at the national level, it appears unlikely that they will deny benefits to a European holding company established by a U.S. corporation, particularly if such holding company also has active operations.

14. Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States ("Parent and Subsidiary" Directive), 90/435/EEC OJ No. L225/6, Art. 5(1).
15. *Id.*, Art. 4(1).
16. *Id.*, Art. 5(2)-(4).
17. *Id.*, Art. 3(1)(a).
18. *Id.*, Art. 3(2).
19. *Id.*, Art. 2(C).
20. *Id.*, Art. 1(2).

It is expressly provided that the term "withholding tax" does not include prepayments such as the United Kingdom advance corporation tax and the French précompte.[21] It is not entirely clear whether or not the provisions of the directive would prohibit the application of a withholding tax to a (partial) refund of such prepayments pursuant to a tax treaty. The U.K. Inland Revenue are apparently of the view that the directive does not apply to withholding taxes on refunds of advance corporation tax.

Impact on U.S. multinationals: a European holding company?

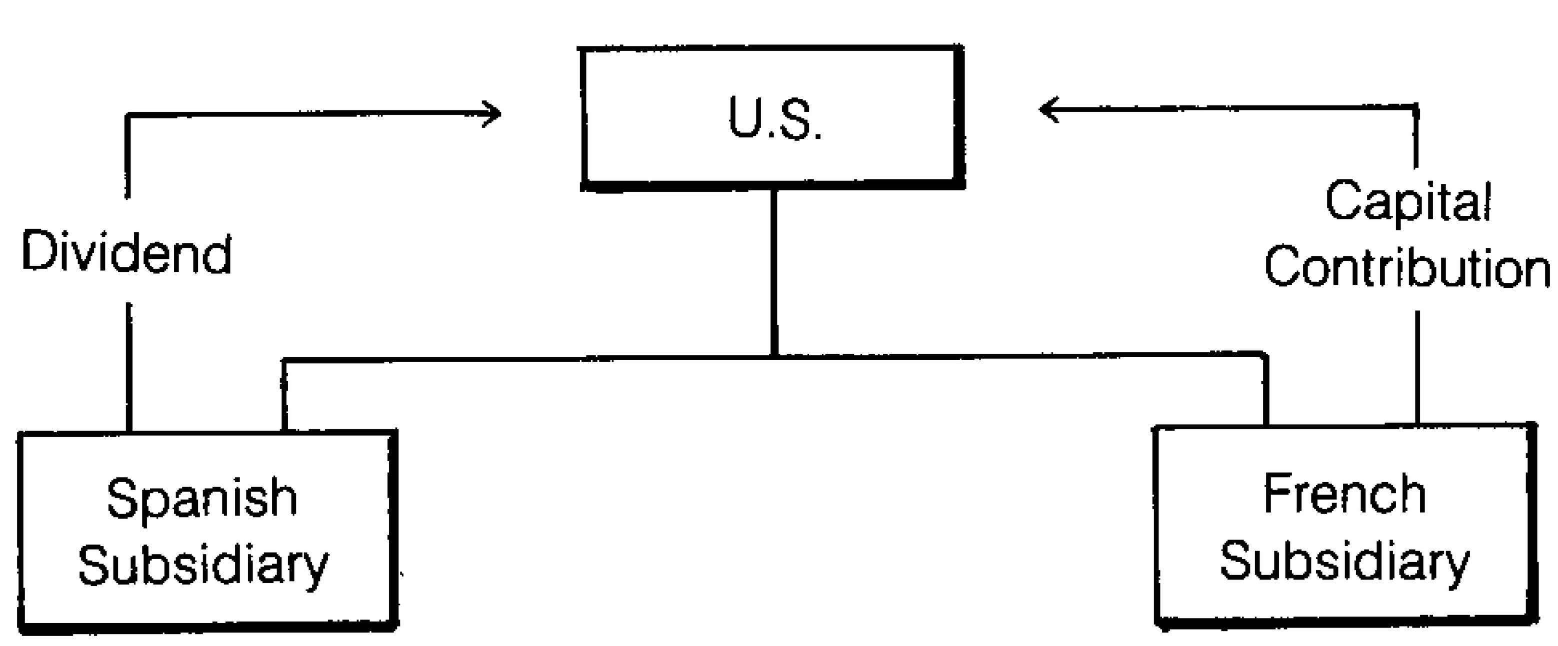
In the past, European holding companies were not regarded as particularly tax-efficient mainly because routing dividends through a holding company placed an additional layer of withholding tax on the dividend. After 1 January 1992 this particular argument should no longer apply in most cases since only one withholding tax will be payable on dividends remitted to a parent company outside the European Community via a European holding company (assuming that the local countries do not enact anti-avoidance provisions rendering U.S.-owned EC holding companies ineligible for the benefits of the directive).

European subsidiaries of U.S. corporations could be held under a holding company situated in a European Community country which has low dividend withholding rates on dividends paid to the United States and which does not tax dividend income. For example, with certain exceptions, a Netherlands holding company would allow dividends to be paid from European Community countries with the minimum charge for withholding tax (five percent).[22] In addition, a European holding company might allow more flexibility with respect to the movement of funds between subsidiaries in the European Community without incurring withholding taxes.

In order to illustrate the impact of the parent/subsidiary directive on business operations in Europe, let us assume a U.S. corporation owns subsidiaries in Spain and France. The Spanish subsidiary is profitable, while the French subsidiary is currently loss-making. As a result, the U.S. parent wishes to transfer funds from its Spanish subsidiary to its French subsidiary. Assume further that it is not feasible to do this by way of a loan, for example, because of local debt to equity ratio restrictions. Therefore, the transfer is made by paying a dividend from Spain to the United States and by subsequently making a capital contribution from the United States to the French subsidiary (as illustrated in Figure 3).

Figure 3

Existing Structure

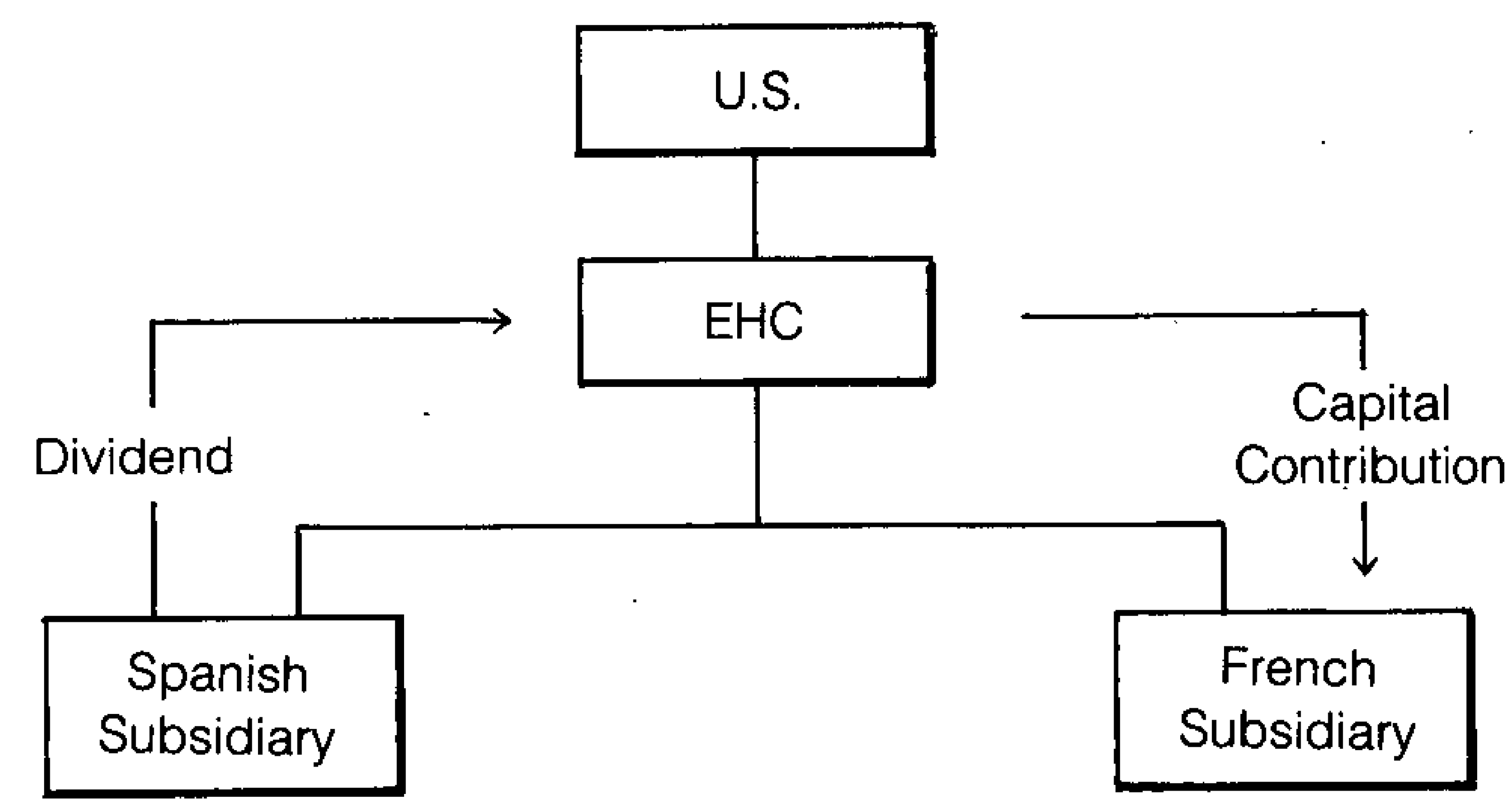


Under the existing structure, withholding tax of 25 percent (ten percent under the new U.S.–Spanish treaty which has not yet been ratified at the time of writing)[23] is payable on payment of the dividend. In addition, the dividend is taxable in the United States. Even though a foreign tax credit may be available to offset all or part of the U.S. tax, special conditions may exist which eliminate the benefit of a foreign tax credit. For example, the U.S. corporation might be in a net operating loss position. In this case, the dividend income would reduce the loss carry-over and the foreign tax credit would remain currently unutilized.

Alternatively, in a structure where a European holding company ("EHC") has been interposed (see Figure 4), no withholding tax is payable on a dividend distribution to the EHC. In addition to the elimination of withholding tax, it should be noted that the dividend (which otherwise would constitute Subpart F income) might qualify for the "high tax" exception to Subpart F income.[24] This exception is available where the dividend is subject to foreign income taxes at an effective rate greater than 90 percent of the U.S. rate. Taxes paid by the Spanish subsidiary can be taken into account for this purpose.[25] This could be beneficial to companies in an excess foreign tax credit position.

Figure 4

European Holding Company Structure



B. *Mergers directive*

Until the mergers directive takes effect, corporations seeking to merge, make acquisitions or otherwise realign operations across borders within the European Community face potentially burdensome tax costs. These tax costs result from the realization of taxable capital gains, even on share-to-share transactions. Although provisions exist on a national level allowing certain tax-free transactions, in most cases the tax-free treatment does not extend to cross border transactions. This is perceived as a major impediment to the free movement of capital within the European Community and the mergers directive has been adopted to counteract this impediment.

The mergers directive includes provisions designed to defer the taxation of capital gains resulting from certain transactions between residents of different member states. Where companies of two or more member states are involved in a merger, division or transfer of assets, the transaction should

21. *Id.*, Art. 7.
22. See Netherlands–U.S. Income Tax Treaty, signed 1 January 1947, Art. VII.
23. Proposed U.S.–Spain Double Taxation Convention, Art. 10(2)(a).
24. Sec. 954(b)(4).
25. Reg. Sec. 1.954-IT(d)(3).

not result in taxable capital gains so long as most of the consideration involved in the transaction is in the form of shares, and certain other requirements are satisfied.[26] If gain is to be avoided the transferred assets, generally, should be effectively connected with a permanent establishment of the recipient company in the country of the transferor company[27] and no step-up in the value of assets for tax purposes should result from the transaction.[28]

Where appropriate the transferee company should be able to utilize any tax losses or carry over any tax-exempt reserves of the transferror entity.[29] The provisions of the directive only apply to transactions between companies incorporated, resident and subject to tax in the European Community.

U.S. perspective
The provisions of the mergers directive could be of benefit to U.S. corporations wishing to restructure their European operations since more leeway is afforded to avoid foreign tax where entities in different member states are merged or liquidated. For example, where a U.S. corporation acquires the stock of another U.S. corporation and both have European subsidiaries, post-acquisition rationalization of the structure of European operations may be facilitated (obviously, there are U.S. tax implications which require consideration in the context of such a reorganization).

Moreover, in order to take full advantage of the relieving provisions of the mergers directive it may be advantageous for U.S. corporations to establish a European holding company. This would enable U.S. corporations to make a tax-free acquisition within the European Community by paying for a target company with the shares of the European holding company. Paying with the shares of a U.S. corporation would not qualify since the shares issued must be of an EC company.

C. *Transfer pricing directive*

This directive provides for binding independent arbitration on issues of double taxation resulting from transfer pricing adjustments made by member state revenue authorities. Under the directive, arbitration commissions will be established which will be made up of representatives of member state revenue authorities concerned with the case under dispute, an even number of "independent persons of standing" and a chairman who is also an "independent person of standing".[30]

These provisions might be helpful to U.S. businesses operating in Europe where transfer pricing disputes cannot be resolved and double taxation may result. However, the task, in practical terms, is not an easy one and it is still unclear how the negotiation and arbitration process will operate to allow a speedy and efficient resolution of a corporation's position. It will be interesting to see whether the directive leads, in the future, to similar agreements with revenue authorities outside Europe, perhaps within the framework of double taxation treaties. For example, the new U.S.–Germany treaty also provides for arbitration where the competent revenue authorities cannot resolve an issue.[31]

IV. CONCLUSION

The discussion contained in this article illustrates how the changes in the new Europe, even with careful tax planning, could have a negative effect on the competitiveness of U.S. business operations in Europe as a result of increased tax costs in the United States. On the other hand, if U.S. businesses consider revision of their European tax planning strategies it may well prove possible to take advantage of potential tax savings pursuant to the newly adopted measures in Europe.

It is clear that at this time U.S. corporations would be well advised to review the tax structure of their European operations and to continue to pay careful attention to future developments in European Community tax law in order to ensure that they are positioned to benefit maximally from the current and future provisions.

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26. Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States ("Mergers" Directive), 90/434/EEC OJ No. L225/1, Art. 2(a).
27. *Id.*, Title II, Art. 4(1).
28. *Id.*, Title II, Art. 4(3).
29. *Id.*, Title II, Art. 6.
30. Convention on the elimination of double taxation in connection with the adjustment of transfers of profits between associated undertakings ("Transfer Pricing Directive") 90/473/EEC OJ No. L225/10, FISC 81, Chap. II, Sec. III, Art. 7.
31. Convention for the Avoidance of Double Taxation of Income, United States–Germany, proposed and signed on 29 August 1989. The German Parliament ratified the treaty on 12 October 1990. The treaty had already been ratified by the United States.

IFA NEWS

INTERNATIONAL FISCAL ASSOCIATION

U.S. BRANCH

On 10 December 1990 the mid-Atlantic Committee sponsored an international tax seminar – a panel of experts discussed the international issues associated with investment in Eastern Europe, including the most recent developments in the tax treaty area.

DIRECT INVESTMENT IN THE NETHERLANDS
THE U.S. PERSPECTIVE

Erik J. Stapper

Stapper & Van Doren, New York, New York.

I. DIRECT U.S. INVESTMENT STATISTICS[1]

On 1 March 1990 the Netherlands Foreign Investment Agency released statistics concerning U.S. direct investment in the Netherlands from 1982 to 1987. Investments during these years more than doubled, increasing from US$ 6,760,000,000 in 1982 to $ 14,164,000,000 in 1987.[2] The most dramatic increase was in the classification of trade, non-banking finance companies, insurance and real estate, growing from $ 789,000,000 to $ 4,337,000,000, and thus accounting for 48 percent of the total increase. No decreases were reported.

Despite the increase in dollars invested, in 1988 the number of U.S. operations in the Netherlands decreased from 1,124 to either 1,097 or 1,104. The decrease was confined to the trade and services sector; increases, however, were noted in the manufacturing sector. In 1988 the manufacturing sector employed 96,398 Dutch or other foreigners and 139 Americans; the non-manufacturing and services sectors employed 42,264 and 399, respectively. Thus, manufacturing represents 37.5 percent of the dollar amount invested and 69.5 percent of the non-Americans employed in the Netherlands. U.S. corporations, represented by more than 1,000 employees, are exclusively in manufacturing enterprises, and include subsidiaries of General Electric, DuPont, Exxon, Honeywell, IBM, Philip Morris and Xerox. It is too early to predict whether there is a trend away from non-manufacturing direct investment by U.S. companies in the Netherlands. Nevertheless, the non-manufacturing sector is dramatically affected by the frequent changes in U.S. income tax laws relating to foreign investment. These amendments generally flow from the U.S. concern that U.S. income will escape the U.S. tax net. Consequently, any certainty that can be derived in the Netherlands through an advance income tax ruling is offset by uncertainty regarding U.S. income tax effects.

II. HISTORICAL PERSPECTIVE

U.S. income tax laws have been amended numerous times since 1960 in order to eliminate or restrict the tax-free accumulation of profits outside the United States. The sections of the Internal Revenue Code (the Code) that were of paramount concern 30 years ago were the following:

– *Section 367:* to prevent previously untaxed income or gain inherent in appreciated property from being removed from the United States, a U.S. taxpayer had to obtain Internal Revenue Service (IRS) approval in connection with a transaction which would have been tax-free if entered into with another U.S. corporation;

– *Section 1491:* a 27.5 percent excise tax had to be paid on the transfer of stock or securities to a foreign entity, based on the difference between the fair market value of the stock or securities and their cost unless prior approval had been obtained from the IRS. Approval could be obtained under Sections 367 and 1491 if the taxpayer demonstrated that the transaction did not have as one of its principal purposes the avoidance of federal income tax. The IRS issued guidelines delineating what did not constitute a forbidden purpose. The use of the transferred property in an actual trade or business and the transferee's need for a substantial investment in fixed assets constituted valid purposes;

– *Section 482* relating to the allocation of deductions and expenses between related taxpayers;

– *Section 901 and related sections* pertaining to the foreign tax credit;

– *Section 911* relating to the exclusion from U.S. tax of the earned income of U.S. aliens living abroad;

– *Section 861 and related sections* defining sources of income;

– *Section 551* relating to foreign personal holding companies where the income was taxed directly to the U.S. shareholders even if not remitted.

After 1960 each of these sections was significantly amended, and many new sections were added to the Code, in particular Subpart F. The rationale for these changes was the Treasury's perception that income had been earned in the United States, either through the taking of deductions against other U.S. income or in the form of exemptions from U.S. tax.

Section 367 was amended in 1967, 1975 and 1984, expanding from a section of 113 words to one with five subsections, each with at least two subsections and with as many as four paragraphs and five subparagraphs.

Section 1491 was amended in 1975 and 1984 to make technical amendments and increase the tax to 35 percent for property transferred after 2 October 1975.

Frequent technical changes were made to Section 901 and the foreign tax credit computation rules, particularly with regard to the use of the *per country* limitations and the *overall* limitation method. Between 1960 and 1975 taxpayers could elect between the two methods. From 1976 to 1986 the overall limitation was in effect subject to specific separate limitations for certain kinds of income. In 1986 a new system was introduced with multiple limitations and eight

1. The author gratefully acknowledges the assistance of Mr. Irwin de Jong, Executive Director of the Netherlands Investment Agency in New York in providing the statistical information.

2. No statistics are available in New York as to how much of the increase is attributable to inflation or currency exchange rate differentials.

different "baskets" of income. Baskets include passive income, high withholding tax interest income, non-controlled foreign corporation dividends, financial services income, shipping income, three types of special export company income and all other income not designated to be in any basket.

Section 482 was amended in 1986 to provide that the income with respect to the transfer of an intangible must be commensurate with the income attributable to the intangible, thereby abolishing the arm's length standard and creating a super royalty. Application of this rule will create double taxation problems that may not be resolved by those competent authorities following the arm's length standard of the OECD. A proposed advance ruling procedure does not now appear to permit the arm's length standard.

Section 911 was amended in 1962, restricted in 1976, repealed in 1978, and reinstated in 1981.

The source rules of Section 861 were changed significantly in 1986, with a temporary side effect of eliminating an estate tax exception for foreign-owned bank accounts.

The personal holding company rules were supplemented in 1962 by the Subpart F rules and Section 1248; these have also been amended several times. The Subpart F rules tax certain income of a controlled foreign corporation (CFC) directly to a U.S. shareholder even if the income is not distributed. Section 1248 treats as ordinary income (instead of capital gain) that portion of the profit on the sale of shares of a foreign corporation by a ten percent U.S. owner that are attributable to earnings and profits accumulated after 31 December 1962.

Subpart F was revised in 1969, 1975, 1976 and 1986. After the 1986 amendment of Section 957(a), a CFC is defined to mean "any foreign corporation if more than 50 percent of – (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation is owned (within the meaning of Section 958(a)), or is considered as owned... by United States shareholders". In order to be a U.S. shareholder, the U.S. person must own, directly or indirectly, ten percent of the total combined voting power of all classes of stock entitled to vote.

To encourage exports the Code was amended in 1971, adding Section 991 to provide special tax benefits for a domestic international sales corporation ("DISC").

In 1984 more sections were added to the tax law for foreign sales corporations (FSC) with special rules applying to small FSCs.

The reporting requirements were expanded with each change in the substantive tax laws affecting doing business outside the United States.

From 18 July 1963 to 30 June 1974 the Interest Equalization Tax was in effect to restrict U.S. loans to foreigners.

The significance of the historical perspective of U.S. tax rules is that the cost of planning and complying with U.S. tax laws for a U.S. business investing outside the country has become substantial. It can still be accomplished but only with the assistance of expensive expertise.

III. SOME TAX FACTORS AFFECTING THE DECISION TO DO BUSINESS OUTSIDE THE UNITED STATES

A. *Form of investment*

The purchase of a new or old foreign corporation with U.S. dollars does not necessarily avoid the transfer of property rules of Section 367, because the transfer of cash may be accompanied by the transfer of intangibles, such as the right to use the parent's name or goodwill and possibly going-concern value from already existing foreign operations.[3]

B. *Can foreign taxes paid be credited against U.S. taxes?*

In connection with dividends received from a ten percent owned foreign corporation, a proportional foreign tax credit is allowed for taxes paid by the first, second and third tier foreign corporation, provided the U.S. corporation owns directly or indirectly at least ten percent of the voting stock of the foreign corporation. No credit is available for taxes paid by a foreign corporation below the third tier even if it is 100 percent owned by the U.S. corporation.

Credit for foreign taxes paid is allowed only for an income, war profits and excess profits taxes or a tax paid in lieu of a tax on income, war profits or excess profits. The foreign tax must satisfy in its predominant character the U.S. concept of an income tax. As a result, a tax based on imputed rental value of property is not creditable. For example, the IRS concluded that the Belgian *précompte immobilier* is based on imputed annual net rental income from land, holdings and industrial equipment and is not an income tax and therefore not creditable.[4] A "soak up" tax is not creditable because it is imposed only when the tax or increased rates apply if the recipient is entitled to a credit in the home country.

The tax that has been paid, or the extent to which it has been paid, must be compulsory, including efforts to appeal its imposition, i.e. it cannot be a voluntary payment.

The taxpayer claiming the credit must in fact be the person legally obligated to pay the tax. The person required to withhold a tax on payments to others is not the taxpayer.

The source of income rules and the various baskets must be analysed and considered in order to calculate the limitations on the amount of a foreign tax. For instance, income from the sale of intangible property such as patents, copyrights and trade marks of a U.S. resident is sourced in the United States unless the payments are contingent on productivity in which case the source is the place of use. Moreover, the amount of the credit cannot exceed the U.S. tax attributable to the net income earned in the foreign country.

The amount of tax that is creditable must be offset by credits allowed, e.g. the Dutch WIR premium,[5] but only for investments made after 30 April 1986. In all other respects, Dutch income taxes qualify for the U.S. foreign tax credit.

IV. FISCAL AND NON-FISCAL ASPECTS AFFECTING THE DECISION TO INVEST IN THE NETHERLANDS

Since Dutch income tax is a creditable tax, the most important tax conclusion is in favour of making a Dutch investment. As demonstrated by the statistics many U.S. companies have concluded that the Netherlands offers a favourable climate for investments and access to the EEC.

3. See Rev. Rul. 79-288, 1979-2 C.B. 139.
4. See Technical Advice Memorandum 8524009.
5. See Rev. Rul. 86-134, 1986-2 C.B. 104.

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Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

The author should submit biographical data, including his or her current affiliation.

AUSTRALIA AND INDONESIA:
THE TIMOR GAP TREATY:
THE PETROLEUM (AUSTRALIA-INDONESIA ZONE OF COOPERATION) TREATY

Rick Krever

I. BACKGROUND TO THE TREATY

In December 1989 Australia and Indonesia signed a novel treaty to end 10 years of tense and sometimes heated negotiations over the exploitation of oil resources in the *Timor Gap*. The Gap, a 61,000 sq. km. area between Australia and Indonesia, arose as a unique geographic and political zone in 1972 when Australia and Indonesia reached agreement on the delimitation of seabed boundaries between the two countries apart from a 250 mile gap offshore of East Timor which, at the time, was a Portuguese colony.

The geographic location of East Timor on the edge of the Gap and the political events that arose in that country made it difficult for either side to advocate an early resumption of talks to settle the competing territorial claims. In 1974, Australia and Indonesia agreed that it would be appropriate for East Timor to join Indonesia when Portugal, which had ruled the territory for the previous 400 years, relinquished its claims over the colony. However, in August 1975, before Portugal quit the region, an independence movement within East Timor, *Fretilin,* took advantage of turmoil in metropolitan Portugal to seize control of the territory and declare its independence. Four months later Indonesian forces entered the territory and defeated the *Fretilin* forces, which withdrew from principal towns to conduct a guerrilla war against Indonesian armed forces.

Australia voted against subsequent UN resolutions calling upon Indonesia to withdraw from East Timor. In 1978 Australia announced *de facto* recognition of Indonesian sovereignty over East Timor and the next year extended *de jure* recognition to it. However, many international scholars, including some of Australia's leading international law experts, claimed the recognition was illegal as the Indonesian control of East Timor was obtained through a violation of the international law rule prohibiting the use of force.

Coincidental with de jure recognition of Indonesian sovereignty claims over East Timor, negotiations over the border delineation between Australia and Indonesia resumed in 1979. The competing territorial claims proved irreconcilable, however. Part of the reason the two nations were unable to reach agreement on boundaries through the Timor Gap is no doubt attributable to the fact that many analysts believe the region has significant potential for oil reserves, particularly in a geological structure known as *The Kelp*. Although the data relied upon is fairly old and somewhat incomplete, estimates of reserves of up to one billion barrels of oil have been articulated in some quarters.

The solution finally reached, and reflected in the 1989 treaty, was to adopt a treaty that facilitates cooperative economic exploitation of the Timor Gap area without formally settling the boundary dispute. The treaty is to operate for an initial period of 40 years, with provision for 20-year renewal periods should Australia and Indonesia not reach agreement on the border in the interim.

Although the treaty was welcomed by the Australian oil industry, it led to some protest amongst Australian groups who continue to oppose claims of Indonesian sovereignty over East Timor. It has also prompted formal protest by Portugal, which has threatened to take Australia to the World Court over the treaty. Portugal claims that adoption of the treaty is inconsistent with international law, in particular that it violates the right of the East Timorese people to self-determination. It was against the background of concerns such as these and inability to reach agreement on the delineation of the border that led to the unusual agreement to commercially exploit the region without settling its political and legal status.

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IV. Effect of the treaty

The Australia-Indonesia Timor Gap treaty represents a novel approach to the problems of exploiting natural resources in a region subject to competing sovereignty claims and enjoying no internationally recognized border delineation. While the treaty is in essence a double tax agreement, its form and provisions are unique, as are the legal structures it creates and the precedents it establishes. Some knowledge of the special historical and political forces that combined to give rise to this unusual treaty is important to understand its particular approach. Accordingly, in this article on the treaty I begin with a review of the background events that helped shape the development of the treaty and which will affect its future operation. The second part of the article looks at the details of the tax sharing arrangements incorporated into the treaty.

Rick Krever is a Reader in Taxation Law at Monash University in Melbourne, Australia.
The author would like to express his gratitude to Hilary Charlesworth who provided a useful criticism of an early version of this article.

The unique nature of the treaty was highlighted by the complicated and unusual signing arrangements. International law experts from the Australian Foreign Affairs and Trade Department said the treaty could not be signed in either country given unresolved international law questions and domestic sensitivities raised by the issue. Accordingly, arrangements were made for the Australian and Indonesian foreign ministers to sign the treaty in a jet circling over the disputed area in the Timor Sea. It was subsequently ratified by the Australian Parliament in May 1990. Australia is awaiting notification from Indonesia that its domestic law procedures necessary for the treaty to enter into force have been completed*. The treaty will enter into force 30 days after such notification.

While the treaty appears to resolve most of the commercial and revenue law aspects that have prevented exploitation of the region's resources until now, Australian oil industry spokespersons have suggested it may not achieve its purpose as long as underlying political issues remain undecided. Problems pointed out by the industry include the rights of three Australian-led consortia which spent AUS$ 50 million exploring the region before the territorial dispute became serious. The Australian oil industry, which has not previously been exposed to territorial disputes of this nature, also remains very concerned about what it feels are unresolved issues. In particular, industry spokespersons have pointed to the failure of the treaty to establish a mechanism to resolve disputes arising out of its application. Also unresolved is the potential effect of possible territorial challenges by Portugal, which claims the area belongs in part to East Timor, and the Portuguese threat of international legal action over the signing of the treaty. For all these reasons, it may be some time before the treaty has practical application. Sustained high world oil prices and dropping Australian reserves may overcome many of these inhibitions, however.

II. STRUCTURE OF THE TREATY

The treaty establishes a Zone of Cooperation in the disputed area comprising three areas: Area A, under the joint control of Australia and Indonesia, Area B, controlled by Australia and Area C, controlled by Indonesia. Area A, the largest of the three, is believed to contain most of the region's oil reserves.

Responsibility for all matters relating to petroleum operations in Area A is allocated to a Ministerial Council comprised of equal numbers of Ministers from both Australia and Indonesia. The Council, in turn, will control a "Joint Authority" that is responsible for the day-to-day management of Area A and for exercising the rights of the two countries in the Area. The use of the Joint Authority is intended to provide contractors with a security of tenure separated from the question of sovereignty. The theory is that since both nations have delegated the Joint Authority to act on their behalf, rights granted by the Joint Authority will be secure regardless of which country might ultimately prevail on the question of legal ownership.

The Joint Authority's administration is split between Australia and Indonesia. Its head office will be located in Jakarta, capital of Indonesia, while its Technical Directorate will operate from an office in Darwin, capital of Australia's Northern Territory and the Australian city closest to the Zone. The Joint Authority is exempt from income tax in both countries while official remuneration of the Authority's directors and officers is taxable only in their country of residence.

The Joint Authority's enumerated responsibilities include:
- releasing exploration acreage;
- entering into profit-sharing contracts with contractors who will search for and exploit oil in the Area;
- supervising environmental and safety aspects of operations in the Area; and
- distributing to each country 50 percent of the Joint Authority's share of profits from its production-sharing contracts.

The Joint Authority will only enter into production-sharing contracts with limited liability companies that have been established for the sole purpose of the contract.

There are four principal elements to the treaty in addition to the administrative framework for the establishment of the Joint Authority. They are:
- a petroleum mining code for Area A;
- a model production-sharing contract between the Zone Authority and exploration contractors;
- arrangements for information and limited revenue sharing in Areas B and C; and
- a Taxation Code for income derived by contractors operating in Area A.

The revenue-sharing arrangements in the exclusively controlled Areas B and C require Australia to pay Indonesia 10 percent of its gross resources rent tax revenues collected from corporations producing petroleum in Area B, while Indonesia must pay Australia 10 percent of its income tax collections from corporations producing petroleum in Area C.

The treaty precludes each country from applying any taxation law to the exploration for or exploitation of petroleum in Area A unless the other party has consented to the imposition of that tax. The taxes agreed to are set out in the Taxation Code itself.

Subject to three exceptions noted below, the Taxation Code applicable to Area A is intended to be an exclusive code for establishing tax liability and preventing double taxation of income related to operations in that zone.

III. THE TAXATION CODE

Although its form is somewhat unusual (it is appended to the general treaty as a separate annex), the Taxation Code applicable to profits derived by companies operating in Area A is similar in general form to an ordinary double tax agreement. It omits a definition of a *resident* of a contracting state because one is incorporated into the principal Treaty itself. The definition provision stipulates that it will apply to the Taxation Code.

The definition of "resident" simply incorporates the domestic law of each jurisdiction; a person (individual or corporate) is resident of Australia or Indonesia if he would be liable to tax in either country by reason of being a resident of that country under its domestic income tax law. The positive limb to the definition is supplemented by a negative limb excluding persons who would normally be treated as non-residents: a resident does not include any person liable to tax in one of the contracting states only in respect of income derived in that state. Special rules utilizing a hierarchy of tests allocate single country residency to persons who would be considered residents of both countries under their respective taxation laws.

* *Editor's note:* After this article went to press the Indonesian Parliament unanimously ratified the Timor Gap treaty.

Also excluded from the Taxation Code are the rules providing an exemption from taxation for the Joint Authority. These, too, are found in the principal treaty itself.

Finally, the principal treaty addresses the question of source and deems Area A to be part of each contracting state for the purpose of each country's taxation law, insofar as it might apply to the exploration for or exploitation of petroleum in Area A. The source provision also applies to any activities or ancillary matters in any way connected with such exploration or exploitation.

A. *Scope*

Indonesia has not agreed to the imposition of Australia's petroleum resource rent tax in the Area. As a result, the only taxes relevant to oil exploration or exploitation activities by companies operating in the zone are:
in Australia,
- the income tax;
- the fringe benefits tax (which is levied as a separate impost on employers in lieu of assessing employees on the fringe benefits they enjoy);
- the federal wholesale sales tax; and

in Indonesia,
- the income tax;
- the value added tax on goods and services; and
- the sales tax on luxury goods.

B. *Business profits*

The Taxation Code adopts a number of interesting measures to prevent double taxation of business profits attributable to Area A.

A corporate taxpayer deriving business profits in Area A can be taxed by both jurisdictions. If it is resident in one country, it will be taxed as a resident of that country and as a non-resident by the other. If it is resident of neither country, it will be taxed as a non-resident company by both jurisdictions. Whatever its residency status, the company's profits are halved for the purpose of each country's tax laws to prevent double taxation. Business losses are similarly halved for the purpose of each country's loss carryforward rules. Losses may be applied against taxable net profits only when determining tax liability under each country's tax legislation. In other words, they do not affect the determination of total business profits that are to be halved for inclusion in the taxpayer's taxable income.

An individual resident in Australia or Indonesia who derives business profits in Area A may only be taxed by his or her country of residence. There is, accordingly, no formula to reduce taxable profits for such taxpayers.

An individual who is resident in neither Australia nor Indonesia and who derives business profits in Area A may be taxed by both countries. Relief from double taxation is provided by a unique rebate system. The taxpayer's business profits are fully taxed in both countries. However, the taxpayer is then entitled to a non-refundable tax credit (called a tax rebate in the Code) that offsets 50 percent of the tax liability in each country. Business losses incurred by individuals resident in neither country are reduced by 50 percent for the purpose of each country's loss carryforward rules. Like corporate losses, these may be applied against taxable net profits only after total business profits from Area A have been calculated and apportioned.

C. *Dividends*

Special rules apply to dividends paid by a resident from one country to a shareholder in the other country where the dividends are attributable to profits from sources in Area A. Such dividends may only be assessed in the shareholder's country of residence; in other words, no withholding tax may be levied on the dividend.

From Australia's perspective, this provision was thought to be necessary to avoid difficulties with the Australian foreign tax credit system. The foreign tax credit system provides credits for foreign taxes imposed on foreign-source income. However, the principal treaty provides that Area A is deemed to be Australian territory for purposes of its domestic tax law. It could be argued, therefore, that dividends paid by an Indonesian company out of profits derived from operations in Area A are Australian-source income, in which case the foreign tax credit system would not apply.

Such fears may have been unfounded. While the profits may be attributable to Area A, the dividends are being paid by a resident of Indonesia. There is thus an argument that under Australian tax law the dividends would be treated as Indonesia-source income, although the case law on the source of dividends is not entirely clear.

Subsequent to signing the Timor Gap treaty, in 1990 Australia adopted a new foreign income tax system. Among other things, the new system provides an exemption from income taxation for dividends received from an Indonesian company by a non-portfolio corporate shareholder (i.e. a corporate shareholder with a 10 percent or greater voting interest in the Indonesian company).

From the perspective of an Indonesian shareholder in an Australian company, the treaty provision is only of relevance with regard to unfranked dividends. When Australia adopted an imputation system in 1986, it ceased to impose a withholding tax on franked dividends, that is, dividends paid from fully taxed profits. Only unfranked dividends, paid from untaxed profits, remain subject to a withholding tax. In the absence of the treaty, unfranked dividends paid to Indonesian shareholders by an Australian company from profits derived in Area A would have been subject to a 30 percent withholding tax.

D. *Interest*

Interest paid by a contractor operating in Area A to a resident of either country can be taxed in both countries. The lender's country of residence may tax the interest in full, while the other jurisdiction may impose via the contractor a 10 percent withholding tax on the interest. Interest subject to a 10 percent withholding tax is deemed to have a source in the country imposing the withholding tax to ensure the other country's foreign tax credit system will operate in relation to the withholding tax.

Interest paid by a contractor to a person not resident in either contracting state may be taxed in both Australia and Indonesia. Each country is allowed to tax only 50 percent of the interest paid, however. Australia's domestic law will limit Australian tax on such interest to a withholding tax of 10 percent of the gross taxable interest.

E. *Royalties*

Royalties paid by a contractor to a resident of either country can also be taxed in both countries. The recipient's country of residence may tax the royalty payment in full; the other jurisdiction may impose via the contractor a 10 percent withholding tax on the royalty. Once again, income subject to a 10 percent withholding tax is deemed to have a source in the country imposing the withholding tax to ensure the other country's foreign tax credit system will operate in relation to the withholding tax.

As was the case with interest, royalties paid by a contractor to a person not resident in either contracting state may be taxed in both Australia and Indonesia. Each country is allowed to tax only 50 percent of the royalties.

Australia has no blanket withholding tax rate applicable to royalties; there are provisions for withholding tax to be imposed but the amount withheld will depend on the taxpayer's total income and consequent tax liability. In all of its double tax treaties, Australia has agreed to flat rate maximum withholding taxes on royalties, which are usually set at 10 percent, although in some cases the withholding tax ranges up to 46 percent. The Timor Gap treaty addresses the question of withholding taxes on royalties paid to residents of the signatory jurisdictions, but does not, of course, deal with maximum tax rates applicable to royalties paid to non-residents of either country. Accordingly, the domestic legislation of each country will apply to the 50 percent of royalties each jurisdiction is entitled to tax.

F. *Alienation of property*

Capital gains and losses realized by an individual resident in Australia or Indonesia in respect of the sale of property situated in Area A will be recognized for tax purposes only in the vendor's country of residence. The recognition provision extends to the sale of shares in a company whose assets consist wholly or principally of property situated in Area A.

An apportionment rule applies to capital gains or losses in respect of the sale of property situated in Area A by an individual not resident in either Australia or Indonesia or by any corporate taxpayer, be it a resident or non-resident of the contracting states. In these cases, each country will recognize for tax purposes 50 percent of capital gains or losses. Once again, the recognition provision extends to the sale of shares in a company whose assets consist wholly or principally of property situated in Area A.

The Taxation Code contains no definition of *permanent establishment,* a provision commonly found in double tax agreements, or any measures specifying when a disposition of property will give rise to a capital gain and when it will give rise to ordinary business profits. As a result, the domestic law of each country will apply.

To the extent that taxpayers will be subject to Australian tax, the distinction between capital gains and ordinary business profits realized on the sale of property is of great importance. Unlike ordinary business profits, capital gains in Australia are indexed for tax purposes to eliminate the inflation component.

The Australian income tax legislation does not define the difference between ordinary business profits and capital gains; instead, the distinction is based on an array of complex, and often somewhat irrational, common law tests gleaned from the case law. Important factors considered by the courts when characterizing gains include the relationship between the disposition of an asset and the taxpayer's ordinary business activities, the frequency of similar dispositions by the taxpayer and the purpose for which property was originally acquired. In recent cases the trend has been to expand the concept of ordinary business profits to encompass most gains realized on the disposition of property in commercial ventures, even where these would previously have been considered capital gains.

From the perspective of potential Australian tax liability, the characterization of a gain from the disposition of property located in Area A as a capital gain or as an ordinary business profit may mean more than simply the difference between full inflation adjustment or no inflation adjustment. While Australian residents are subject to capital gains tax on the profits realized on the sale of any type of property, non-residents are taxed only if the property sold is a *taxable Australian asset.* Thus, if the gain is considered an ordinary business profit, it will be fully taxed in Australia, although the resulting tax liability will be reduced by 50 percent, while if it is considered a capital gain, it may escape Australian taxation completely provided the property does not fall into the definition of a "taxable Australian asset".

Taxable Australian assets whose disposition by non-residents gives rise to taxable capital gains include real property and buildings situated in Australia and assets that at any time have been used by the taxpayer in carrying on a business wholly or partly at or through a permanent establishment in Australia. As mentioned earlier, Area A is deemed to be Australian territory for the purposes of Australian income tax law. A permanent establishment is defined in the income tax legislation to include a place where the taxpayer has, is using or is installing substantial equipment or substantial machinery, a definition which presumably would apply to virtually all contractors operating in Area A. Thus, it would appear that non-resident contractors will be subject to Australia's capital gains tax provisions on the disposition of assets connected with their Area A operations, provided the disposition does not give rise to ordinary business profits or losses.

Persons other than contractors will most likely not be liable to Australian capital gains tax on the sale of property situated in Area A. For example, a person who sells equipment leased to a contractor operating in Area A will not be disposing of property connected with a permanent establishment of that person in Australia. On the other hand, they may be subject to taxation on any resulting gain as ordinary business profits if they satisfy the Australian common law test of business profits. This could be the case, for example, if there were evidence that in the ordinary course of its business, the taxpayer leased equipment in Australia and subsequently sold that equipment for a profit.

G. *Independent personal services*

Income derived by an individual who is resident in Australia or Indonesia in respect of professional services or similar independent personal services performed in Area A is taxable only in the taxpayer's country of residence. Income derived by a taxpayer resident in neither Australia nor Indonesia for the provision in Area A of professional services or independent personal services is taxable by both jurisdictions. However, the tax liability in each country is subject to a rebate of 50 percent of the tax payable.

H. *Wages and salaries*

Wage or salary income derived by an individual who is a resident of Australia or Indonesia in respect of employment in Area A is taxable only in the taxpayer's country of residence. Remuneration derived by a non-resident of either country in respect of employment in Area A is taxable in both Australia and Indonesia. Once again, however, the tax liability in each country is subject to a rebate of 50 percent of the tax payable.

I. *Other income*

Relatively few of Australia's double tax agreements contain an other income article applicable to income not covered by other, more specific, articles. The Taxation Code does, however. The Code provides that income of a type not specifically identified in other articles derived from a source in Area A by a resident of either Australia or Indonesia will be taxable only in the taxpayer's country of residence. If such income is derived by a non-resident of either country, it can be taxed by both states, subject to a rebate of 50 percent of the tax payable in each country.

J. *Fringe benefits*

In theory, Australia's income tax act taxes employees on the value of fringe benefits they derive in relation to their employment. For a number of political and administrative reasons, the applicable provision was rarely used, however. When it was invoked, taxpayers often successfully disputed their assessments by relying on interpretive arguments over the *value* of the benefit or technical arguments if, for example, the benefit was received by a spouse or related party rather than the employee.

To overcome these problems and to establish a fringe benefits tax system that would be more palatable to organized labour, the government introduced a separate fringe benefits tax. The tax is imposed on employers and is based either on the market value of benefits provided or a value computed by reference to a formula in the legislation. The tax is set at the highest personal marginal tax rate and is a non-deductible expense for ordinary company income tax purposes.

The fringe benefits tax is imposed on Australian employers only. It is, however, based on the value of fringe benefits provided to employees who are resident of any country. Accordingly, an Australian resident employer will be liable for fringe benefits tax on fringe benefits provided to any employees who derive the fringe benefits in relation to their employment in Area A. Where a fringe benefit is provided to an employee who is resident in Australia or Indonesia, the Australian employer will be assessed on the entire value of the fringe benefit. Where a fringe benefit is provided to an employee who is not resident in either country, the taxable value of the fringe benefit will be reduced by 50 percent.

K. *Competent authorities*

The Taxation Code provides a mechanism for appeal by taxpayers to the competent authorities that is similar in form and effect to analogous mechanisms provided in ordinary double tax treaties. Residents of one country who feel they have been taxed in a matter not in accordance with the provisions of the Taxation Code may, irrespective of the remedies provided by the domestic tax law of either country, present a case to the competent authority (i.e. revenue authorities) of the state of which they are resident. If the claim appears to be justified, the competent authority is directed to endeavour to resolve the case by agreement with the competent authority of the other state.

L. *Exchange of information*

An exchange of information provision, similar to that found in ordinary double tax treaties, directs tax authorities in Australia and Indonesia to exchange information needed for the application of the Taxation Code or domestic tax law concerning taxes covered by the Code.

IV. EFFECT OF THE TREATY

The Timor Gap treaty and accompanying Taxation Code is a unique attempt to enable Australian and Indonesian commercial enterprises to exploit resources in a disputed border region in the absence of a legal settlement of the border dispute. The unusual circumstances of the treaty's creation and signing and the distinctive provisions it contains are reflective of particular international law concerns and domestic political considerations. Factors of this sort have never previously impacted on treaties to which Australia is a partner. It remains to be seen whether these special circumstances will discourage Australian oil companies from exploiting the opportunity the government hoped the treaty would open up for them.

NEW ZEALAND:

THE IMPLICATIONS OF THE COMMISSIONER'S STATEMENT ON SECTION 99

Andrew M.C. Smith

Mr. Andrew M.C. Smith is Senior Lecturer in Accountancy, Faculty of Commerce and Administration, Victoria University of Wellington, Wellington, New Zealand. *The author would like to thank two anonymous reviewers for their comments in the preparation of this article.*

The ongoing conflict between taxpayers wishing to minimize their tax liabilities by every legal means available and the Commissioner of Taxes' desire to protect the revenue base is well known. The New Zealand Commissioner of Inland Revenue has a variety of options to prevent loss of revenue through tax avoidance, including a general anti-avoidance provision, Section 99, in the Income Tax Act 1976 [hereinafter referred to as ITA].

In February 1990, the Commissioner released a policy statement on the application of this general anti-avoidance provision of the ITA.[1] This statement breaks a long silence by the Commissioner on the application of Section 99. It was prompted by doubts as to how the section would be applied since the Privy Council's decision in *CIR v. Challenge Corporation Ltd.* (discussed below)[2] and pressures from the commercial community to dispel this uncertainty. There have also been indirect pressures for repeal of Section 99 on the ground that it is essentially redundant since the Government's tax reform programme has significantly reduced opportunities for tax avoidance.

This article addresses the significance of the Commissioner's statement, with particular reference to the historical development of the law surrounding the tax avoidance section in New Zealand and the likely direction of the Commissioner's use of Section 99 in the context of the recent income tax reform. The Commissioner's examples as provided in the statement will also be reviewed.

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I. THE ANTI-AVOIDANCE SECTION

Section 99 is a general anti-avoidance section designed to allow the Commissioner to treat as void for income tax purposes, arrangements entered into by taxpayers for the purpose(s) and/or with the effect(s) of tax avoidance.[3] The section represents a policy of the legislature to grant the Commissioner broad power to prevent revenue erosion through contrived tax avoidance arrangements by taxpayers without having to specifically legislate against each permutation of tax avoidance detected by the Commissioner. Such general anti-avoidance sections have also been present in Australian income tax statutes for a long time. Other countries too have similar provisions or judicial doctrines with similar objectives.

Section 99 has never been relied upon totally to negate the fiscal advantages sought from tax avoidance arrangements. The Commissioner's statement makes this point very clear. The ITA has always contained numerous specific anti-avoidance provisions; for example, restrictions on income splitting by payment of wages to relatives[4] and restrictions on short-term assignments of income.[5] The general anti-avoidance section is used as a last resort to negate advantages from arrangements that have been deliberately designed by tax planners to avoid the mine fields of specific restrictions.

Historical development of Section 99

Although the predecessors of Section 99 have been part of the scheme of New Zealand tax statutes since 1891, the Commissioner did not rely upon the general anti-avoidance provision extensively until the 1960s. This was after the Federal Commissioner of Taxes in Australia had succeeded at the Privy Council[6] in the 1950s with a similar provision in the Australian Income Tax Assessment Act [hereinafter referred to as ITAA].[7] In the 1960s the Commissioner argued over 50 different cases in New Zealand courts and four cases before the Privy Council using the predecessor of Section 99, Section 108 of the Land and Income Tax Act 1954.

1. The text of the Commissioner's statement is reproduced in the June 1990 issue of the *Bulletin*, at 288.
2. (1986) 8 New Zealand Tax Cases [NZTC] 5,219 PC [hereinafter referred to as *Challenge Corporation*].
3. See *supra* note 1.
4. ITA Secs. 97 and 190.
5. ITA Sec. 96.
6. See *Newton v. FC of T*, (1958) Appeals Court [AC] 450.
7. ITAA of 1936, Sec. 260.

The original Section 108, enacted in 1954, was substantially the same as its successor Section 99. Section 108 provided:

> every contract, agreement, or arrangement made or entered into, ... shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax.

Section 108 was amended in 1974 to its current form. This amendment answered some judicial criticisms of Section 108 that had surfaced during the 1960s and 1970s. The section was subsequently renumbered as Section 99 in the ITA 1976.

1. The *Newton predication test*

The judiciary has always recognized that the greatest difficulty with a general anti-avoidance section like Section 108 (and later Section 99) was the extent of its application. Did the section render void any genuine transaction that gave taxpayers some small, incidental tax reduction or any transaction that was merely undertaken in the most tax advantageous manner – or did it only apply to cases involving sterile and contrived arrangements motivated solely by tax avoidance considerations?

The issue was addressed by Lord Denning in an Australian case, *Newton v. FC of T,*[8] brought before the Privy Council in 1958, under the Australian ITAA Section 260. In *Newton,* Lord Denning set forth a judicial test for application of the anti-avoidance provision. This test, known as the "predication test", was stated as follows:

> In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business and family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.

In ascertaining what the purposes or effects of an arrangement were, Denning concurred with the approach of Williams J., that the purpose or effect must be ascertained from the arrangement's terms, not from the motives of the taxpayers involved. For over two decades this test was adopted by New Zealand courts in applying Section 108, and was widely accepted as being the appropriate test for application of the section.

In the 1960s, to counter a perceived increased aggressiveness on the part of taxpayers towards tax avoidance, the New Zealand Commissioner began to use Section 108 extensively. Almost invariably the section was applied to arrangements involving taxpayers, such as small businessmen, farmers or professionals who had attempted to avoid tax by using contrived income-splitting arrangements, commonly utilizing family trusts as an income-splitting device. In most of these cases the New Zealand courts upheld the Commissioner's application of Section 108. With one exception, the Commissioner brought no cases to court involving large corporate taxpayers.[9]

2. Revision of Section 108

While largely successful for the Commissioner, Section 108 was not without difficulty. For example, it was not clear whether, if multiple purposes or intentions were present, one of which was tax avoidance, Section 108 would be activated, nor did the section clearly specify the powers of the Commissioner to reconstruct an arrangement found void under Section 108.[10]

Some of these deficiencies were addressed when Parliament amended the section in 1974. In particular, the uncertainties, if multiple purposes or intentions flowed from an arrangement, were clarified and the Commissioner was given explicit power to reconstruct and impute income to taxpayers as if the arrangement had not been entered into.

Unfortunately, Parliament did not address the crucial issue of the relation of the anti-avoidance section to other provisions of the ITA, such as incentive provisions or the business deduction section.[11] For example, could a deduction meeting the deduction test for a business expense under Section 104 be subsequently disallowed under the anti-avoidance section? Or if a taxpayer arranged his affairs to utilize a tax incentive provided for in the ITA, could the advantage obtained be negated by Section 99? Case law in New Zealand on this issue was unclear – in most cases New Zealand courts had declared that Section 108 overrode other provisions in the ITA, while in several notable cases the opposite conclusion had been reached.[12] Australian Courts had developed a more consistent approach to this issue, generally holding that other sections of the ITAA could not be overridden by the anti-avoidance section. Ultimately this approach resulted in the Australian anti-avoidance provision (Section 260) being rendered ineffective,[13] and the Australian Parliament legislating radically new provisions to give their Federal Tax Commissioner greater power to counter tax avoidance arrangements.

(a) *The Challenge Corporation case*[14]

Despite having strengthened anti-avoidance powers in the form of the present wording of Section 99, the Commissioner appeared reluctant to test the amended section in court. It was not until 1984 that the opportunity presented itself, in a case involving a large New Zealand corporation, Challenge Corporation.[15]

The facts in the *Challenge Corporation* case are relatively simple. The company arranged to purchase the shares in a number of dormant companies from the liquidator of those companies. The only asset of the dormant companies was their large accumulated tax losses. The purchase agreement allowed the liquidators to share in any tax advantages obtained by Challenge Corporation from the purchase of the dormant companies. The New Zealand ITA allowed corporate taxpayers to offset losses of companies in a "company

8. See *supra* note 6.
9. This exception involved a large privately owned oil company (Europa Oil (NZ) Limited), which had avoided taxes by purchasing its trading stock via an offshore subsidiary located in the Bahamas.
10. This point was made very clear in *Gerard v. CIR,* (1974) 1 NZTC 61,151.
11. ITA Sec. 104(b).
12. See e.g. *Europa Oil (NZ) Limited v. CIR,* (No. 2) (1976) 2 NZTC 61,066.
13. By way of note, in an Australian case involving a similar principle, the taxpayer was able to retain the benefits of a tax incentive exploited in a contrived and artificial manner, based on the application of the doctrine of choice. In *Cridland v. FC of T,* (1977) 140 Commonwealth Law Review (Australia) [CLR] 330, a law student joined a unit trust scheme and engaged in farming for the consideration of AUS$ 1 in order to obtain the tax status of a "primary producer". Taxpayers with this status were able to spread income between fiscal years to mitigate the effects of progressive income tax rates on fluctuating income. It was held that this arrangement was valid for income tax purposes.
14. See *supra* note 2.
15. Challenge Corporation was one of the constituent corporations of New Zealand's largest company, Fletcher Challenge, formed by the merger of three companies in 1981.

group". The transactions were consummated in accordance with the law at that stage and indeed Challenge Corporation had actually obtained a ruling from the Commissioner that the transactions under review fell within the provisions concerning company loss offsets. In fact, shortly after the transactions were completed Parliament tightened the anti-avoidance subsections within the company loss-grouping provisions to prevent such transactions being repeated by other taxpayers.

The New Zealand Court of Appeal[16] found for the taxpayer. Richardson J. noted in his judgement the potential conflict between Section 99 and the other provisions of the ITA. He stated:

> clearly the Legislature could not have intended that [S]ection 99 should override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself.... On the other hand, [S]ection 99 would be a dead letter if it were subordinate to all the specific provisions of the legislation.[17]

Richardson J. held that the conflict must be resolved through careful statutory interpretation. He stated:

> ... the legal answer must turn on an overall assessment of the respective roles of the particular provision and [S]ection 99 under the Statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to Statutes mandated by [S]ection 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations.

Applying these principles to the facts in *Challenge Corporation,* Richardson J. noted that Parliament had allowed companies to offset losses in a group situation and that Challenge Corporation had meticulously complied with the technical requirements of those provisions, including a minor anti-avoidance subsection within the company loss-grouping provisions which allowed the Commissioner to disregard temporary transfers of shareholdings. Therefore to allow Section 99 to void the loss offsets would frustrate Parliament's intention in allowing loss offsets in the first place. Further observations included support for the *Keighery*[18] principle in that the taxpayers had adopted a specific course of action intended by Parliament and thus tax avoidance had not occurred in a statutory sense. Therefore Section 99 had no application. Cooke J. noted that when a section has its own anti-avoidance subsection (as mentioned earlier), that provision must be treated as being exhaustive in its own right and a taxpayer was entitled to take advantage of the benefits conferred within that section.

Challenge Corporation was subsequently appealed to the Privy Council by the Commissioner, and the Court of Appeal's decision was overturned.[19] A majority judgement held that Section 99 could void transactions otherwise within other sections of the ITA. The Privy Council made extensive note of the way the income tax legislation had developed and rejected the Court of Appeal's interpretation that Section 99 cannot overrule company loss-grouping provisions by virtue of those provisions having their own anti-avoidance subsection. The majority of the Judicial Committee concluded that the approach to determine whether transactions were subject to Section 99 was to distinguish between transactions which could be characterized as *tax avoidance* and those which could be characterized as *tax mitigation.*

"Tax mitigation" occurs when "a taxpayer ... reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability".[20] In such circumstances there is no tax avoidance (and hence Section 99 does not apply) because "the taxpayer's tax advantage is not derived from an 'arrangement' but from the reduction of income which he accepts or the expenditure which he incurs".[21] In support of this definition the Privy Council cited examples of companies who receive export incentives for certain export sales or a taxpayer who reduces his tax by making a settlement of an income-producing capital asset.

On the other hand *tax avoidance* was defined as where "income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had."[22] In support of this approach, the Privy Council cited a number of English authorities, such as *Black Nominees Limited v. Nicol,*[23] *Chinn v. Collins,*[24] *W.T. Ramsay v. CIR,*[25] and *CIR v. Burmah Oil Company Limited.*[26]

(b) *Comments on the Challenge Corporation case*

The rationale of the Privy Council in this decision is somewhat novel when compared with earlier decisions of the New Zealand Court of Appeal, Australian courts and the Privy Council itself. The changes made to the section in 1974 were not expected to have resulted in a significant departure from the way judicial authorities would approach the section, but rather to clarify some areas of doubt.

First, in *Challenge Corporation* the Privy Council made no reference to the earlier predication test, first formulated in 1958 in *Newton.* This was a surprising omission given the widespread reference to the test in subsequent Australian and New Zealand authorities and subsequent Privy Council decisions over a long period of time; nor was any reference made to doctrine of choice authorities (such as *W.P. Keighery Pty Limited)*[27] where the relationship between the anti-avoidance section and the rest of the ITAA was defined in Australia.

Indeed the wording in Section 99, making reference to "ordinary business or family dealings" in the section itself appears to suggest that Parliament anticipated that the section would continue to be applied with reference to the Newton predication test.

16. (1986) 8 NZTC 5,001.
17. *Id.,* at 5,019-5,020.
18. In *W.P. Keighery Pty Ltd. v. FC of T,* (1957) 100 CLR 66, it was held that the Australian ITAA prescribed two alternative taxing schemes for the taxation of companies – based on whether the taxpayer company was either a "private" or "public" company in terms of the Australian companies legislation. It was held that the Act offered a "choice" in this regard and it was up to taxpayers to "choose" which of the two options they wished to bring their affairs within.
19. *Challenge Corporation, supra* note 2, at 5,219.
20. *Id.,* at 5,225.
21. *Id.*
22. *Id.,* at 5,226.
23. (1975) 50 Tax Cases [TC] 229.
24. (1981) All England Reports [All ER] 189.
25. (1979) All ER 213.
26. (1980) 54 TC 200.
27. See *supra* note 18.

Without explicitly so stating, the Privy Council appears to have some empathy with the approach of Richardson J. towards statutory interpretation of the anti-avoidance provision. It is unfortunate that the Privy Council did not make more direct references to Richardson's judgement, as the Commissioner gives a prominent role to this approach in his statement. The Council's references to this approach can only be gleaned by their careful review of the scheme of the New Zealand legislation, in particular, the scheme of Section 191 for company loss offsets, the history of amendments and changes to the sections and the role of the minor anti-avoidance subsection. Their review of the legislative scheme is not that different to Richardson's at the Court of Appeal, except in one fundamental regard – the outcome.

More importantly, the Privy Council cited a number of U.K. authorities which were previously believed not to be applicable in New Zealand. These authorities, the best example being *CIR v. Burmah Oil Company Limited,*[28] introduced a judicial concept known as the "doctrine of fiscal nullity"[29] into U.K. law. This doctrine was previously believed to be applicable only in the United Kingdom as the U.K. income tax statutes had no general anti-avoidance provisions equivalent to Section 99. The doctrine had been expressly rejected in several Australian and Canadian cases.[30]

The Council's approach to the facts in *Challenge Corporation* and the tax mitigation/avoidance dichotomy as the test for application of Section 99 is easily applied to cases involving *abuses* of incentive-type provisions and probably to circular-type transactions. The Privy Council was less illuminating as to how this approach would apply to contrived income-splitting cases – nor is the fiscal nullity doctrine of much assistance. Many of the earlier Section 108 cases had concerned contrived income splitting.

Most income-splitting cases involve the alienation of income by the creation of an extra deduction to be claimed against a large income-earner's business income which will result in income being derived by another party – typically a family trust or close relative of the large income earner. Arguably in these circumstances the deduction that the taxpayer seeks to claim in order to reduce his income results in his incurring an actual loss which the Privy Council in *Challenge Corporation* held as falling within the umbrella of "tax mitigation". Clearly the taxpayer would not be an income tax avoider based on the definition of tax avoidance in *Challenge Corporation,* i.e. when "the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that deduction".[31] Such income splitting by the creation of contrived deductions was commonly held to be void under Section 108 by various New Zealand courts using the *Newton* predication test.

While the Privy Council did not expressly mention the *doctrine of choice* cases from Australia, their approach strongly rejects the Australian approach in respect to incentive-type provisions. They rejected the notion that there had been no tax avoidance in a statutory sense because the taxpayer's income had been determined strictly in accordance with the ITA. Their approach therefore reinforces earlier New Zealand cases[32] where doctrine of choice arguments were considered.

It is easy to see that the Privy Council's decision in *Challenge Corporation* gave rise to uncertainties as to how Section 99 would be applied in the future. While Section 99 was only a refined and strengthened form of the old Section 108, the Council's approach appeared to depart completely from earlier judicial approaches to the section. In particular, did the approach of the Privy Council herald a new test by which Section 99 would be applied to all cases brought before the courts, or was it an approach best suited to the specific type of situation presented in *Challenge Corportion,* with the long-standing *Newton* predication test still being applicable? The Commissioner's statement is therefore an important indication as to how he will interpret the section in light of this new approach and earlier decisions.

II. THE COMMISSIONER'S STATEMENT

First, it must be noted that the statement is not legally binding on the Commissioner in any way and he may alter his opinions at a later time.[33] Indeed the transactions that gave rise to the *Challenge Corporation* case may never have been entered into if it had not been for the Commissioner issuing a ruling, in response to a taxpayer request, that the proposed transactions were legally valid in terms of the specific company loss-offset sections.

The Commissioner's statement appears to suggest that he finds some difficulty with the approach of the Privy Council in *Challenge Corporation.* Explicitly, the Commissioner's statement provides support for the statutory interpretation approach taken by Richardson J. at the Court of Appeal as well as the earlier *Newton* predication-test approach to application of Section 99.

The Commissioner states that "the focus of [his] new policy will be to evaluate arrangements in terms of whether they frustrate the underlying scheme and purpose of the relevant provisions of the Act". The Commissioner lists four steps in the process he proposes to adopt in applying Section 99. Two steps involve "a careful and thorough analysis of – (a) the underlying scheme and purpose of the Act as a whole and of the specific provision under review;... (d) whether following this analysis it can be inferred that the arrangement frustrates the underlying scheme and purpose of the legislation". Clearly this supports the Richardson approach, implicitly adopted by their Lordships at the Privy Council.

Second, the Commissioner provides continued support for the *Newton* predication test: "the Newton predication test, for example, is regarded as fundamental to the process of Section 99 application". The Commissioner cites with approval Lord Denning from *Newton* on the method by which purpose or effect is to be ascertained when applying Section 99. Again in the statement on how he proposes to apply Section 99 he states that his approach "requires a careful

28. See *supra* note 26.
29. The fiscal nullity doctrine is similar in objective to the New Zealand Sec. 99. The doctrine entitles a court to look beyond the legal form of a transaction to its economic substance. Transactions which have no economic substance (i.e. fiscally null) are not effective for income tax purposes in the United Kingdom. The doctrine is easily applied to circular transactions which were common in the United Kingdom to avoid capital gains tax. The doctrine can be reconciled in some ways with the Newton predication test because a transaction that was fiscally null would probably not be able to be explained in terms of "ordinary business or family dealings" without being labelled as a means to avoid tax.
30. See, in Australia, *Oakey Abattoir Pty Ltd v. FC of T,* 84 Australian Tax Cases [ATC] 4718, and in Canada, *Stubart Investment Ltd v. The Queen,* 84 Dominion Tax Cases [DTC] 6305.
31. *Challenge Corporation, supra* note 2, at 5,226.
32. *McKay v. CIR,* (1972) 1 New Zealand Law Reports [NZLR] 592; *Wisheart MacNab & Kidd v. CIR,* (1972) NZLR 319.
33. The Commissioner is specifically authorized in the ITA 1976 to give binding determinations in respect of transactions affected by the interest accrual rules (Sec. 64B-M) pursuant to Sec. 64E and the Income Tax (Determinations) Regulations 1987 and in respect of the what constitutes a Foreign Investment Fund pursuant to Sec. 245S of the ITA.

and thorough analysis of – ... (b) the arrangement to ascertain its purpose or effect; (c) whether a fair and reasonable inference can be drawn that tax avoidance is one purpose of the arrangement (other than merely incidental) ..."

Later the Commissioner states: "[H]aving established the purpose of the arrangement as implemented by the taxpayer, it is necessary to effect a fair and balanced evaluation of that arrangement. The evaluation will be with a view to concluding whether one can predicate whether the arrangement was implemented in its particular way so as to achieve an income tax advantage." This provides further support that the *Newton* predication test is still perceived as relevant to application of Section 99.

The Commissioner only indirectly refers to the tax avoidance/tax mitigation dichotomy from *Challenge Corporation.* While making virtually no reference to it in his statement of how he proposes to apply Section 99, the approach does appear in several of the examples. In Example 3A he states, "the taxpayer has been involved in genuine commitments and expenditure". In Examples 4 and 5 a similar statement appears. This is perhaps the closest the Commissioner gets to the Privy Council's approach in *Challenge Corporation.* Example 3B contains a passing reference to the U.K. fiscal nullity doctrine when reference is made that the transaction is "economically neutral to all parties", which is virtually saying the transaction is fiscally null. Indeed the facts in Example 3B are ones that the fiscal nullity doctrine could easily apply to.

The Commissioner's emphasis on ascertaining the scheme and purpose of the particular provisions of the ITA is designed to answer criticism that strict application of Section 99 could deny taxpayers the advantages of any tax incentives enacted by Parliament. Such a view does, however, imply that there are boundaries to the manner in which incentives can be utilized by taxpayers and that utilization of an incentive per se does not remove the arrangement in question from potential application of Section 99. Ultimately it comes down to ascertaining the intent of Parliament when it enacted an incentive provision, and this is not necessarily easy. The key factor that led to opposite outcomes in *Challenge Corporation* at the New Zealand Court of Appeal and the Privy Council rested on the respective judges' differing conclusions regarding their interpretations of Parliament's intention in enacting the company loss-offset provisions.

It is also debatable whether the predication test would in fact deny taxpayers the advantages of tax incentives. Many incentives operate by the taxpayer incurring a certain type of expenditure or engaging in certain types of activities. To the extent that these activities or transactions are real, it is likely that the tax savings enjoyed would be deemed "incidental purposes or effects" of the transactions concerned. If the incentives were obtained using highly contrived and artificial means then arguably they could be caught by the predication test because it could be predicated that the arrangement was "implemented *in that particular way* so as to avoid tax ...."[34]

The only problem that arises is with the highly artificial provisions of the ITA, such as the company loss-offset provisions or the options for trading stock valuation,[35] where the advantages do not arise from incurring expenditures or undertaking certain activities by taxpayers; these provisions specify a particular manner in which a taxpayer's tax liability can be calculated in certain circumstances. It is at this stage that the interpretational approach of Richardson J. is particularly beneficial because the *Newton* approach is difficult to apply in these situations.

Of more interest are the examples of the tax avoidance schemes the Commissioner provides and his opinion as to how they would be interpreted in light of his statement. It is disappointing that the Commissioner did not indicate how some of the earlier income-splitting cases would be interpreted under this new approach, in particular car leasing schemes entered into by professionals.[36] This undoubtedly reflects the view that income splitting is less of a problem now given the reduction in marginal tax rates in New Zealand.

A. *The Commissioner's examples*

The Commissioner provides ten examples of how his approach would apply to a range of common tax avoidance transactions.

Example 1, involving an income-splitting arrangement by transferring income-producing investments to a family trust, was previously believed not to be caught under Section 108 and therefore one would expect the same under Section 99. The Commissioner indicates that in his opinion using the new approach such arrangements would continue to fall outside the ambit of Section 99. It is unlikely that any court would take a different view based on the facts given in this example.

However, income-splitting arrangements involving the sale and leaseback from a family trust of wasting assets by taxpayers carrying on a profession were previously held to be void under Section 108.[37] Unfortunately the Commissioner has not indicated whether these types of transactions would be viewed differently under his new approach.

Examples 7 and 9 are interesting because the scheme of the legislation is such that the tax advantages sought would be denied under other specific provisions of the ITA with little need for the Commissioner to rely on Section 99(2). In Example 7, involving a dividend-stripping arrangement, such arrangements have been specifically held void under a subsection of Section 99 and the Commissioner's example merely confirms what is widely understood to be the law since 1974.

Example 9, involving contrived deductions, is also easily dealt with by the Commissioner using specific sections of the ITA without relying on Section 99. A better example the Commissioner could have provided is one of a contrived deduction (such as the lease of a wasting asset by a taxpayer carrying on a profession) where the consideration was set at market rates. Such transactions were a common tax avoidance device and were previously held to be void under Section 108.[38]

34. *Newton, supra* note 6, at 8.
35. ITA Sec. 85.
36. Professional taxpayers (such as chartered accountants, medical practitioners, etc.) previously tried to overcome the difficulty of splitting professional income through the leasing of wasting assets (e.g. cars, computer equipment) from either trusts or other family members. This resulted in a deduction from their professional income and the derivation of income to the recipient to whom it would be taxed at a lower rate. The leasing of wasting assets by professional taxpayers in contrived situations had been held to be void under the old Sec. 108 in *Wisheart, supra* note 32 and in *Halliwell v. CIR,* (1977) 3 NZTC 61,208. In more recent cases brought under the new Sec. 99, the Taxation Review Authority found for the taxpayers (*Case L3* (1989) 11 NZTC 1,005; *Case L4* (1989) 11 NZTC 1,020; *Case L6* (1989) 11 NZTC 1,037). These cases are currently under appeal by the Commissioner.
37. *Halliwell, supra* note 36.
38. See *supra* note 18.

Example 2 reinforces the principle in *Challenge Corporation* that a specific anti-avoidance subsection within a provision is not exhaustive in itself. The new international tax provisions already incorporate specific anti-avoidance provisions in Section 249C(9). Taxpayers who arrange their affairs outside the provisions of Section 249C, and in particular subsection (9), are still liable to be caught by Section 99. The Commissioner is signalling that the enforcement of the new provisions brought about by the Government's tax reform programme will be backed up with his existing powers under Section 99. The *Challenge Corporation* decision provides the Commissioner with particular support in this regard. But the Commissioner does admit in this example that such an arrangement would not automatically be void under Section 99. The particular facts in such a case would be paramount and he concedes there could be good business reasons why such a structure would be adopted by a taxpayer.[39]

Examples 3A, 6 and 8 are interesting for several reasons. First, two of the transactions (in Examples 3A and 8) are no longer tax effective in the manner described because of recent legislative reforms. Second, one would have expected that the Commissioner would be prepared to assert that some of these examples were potentially void under Section 99.

Example 3A, involving an interest prepayment, is the least offensive in terms of tax avoidance criteria. The arrangement clearly can be explained in terms of a business purpose of raising debt capital. The only area of contention is that the interest is paid up front to ensure an early deduction for interest referable to the life of the loan. It is difficult to conclude that the scheme and purpose of the ITA has been frustrated in terms of the legislation prior to the interest accruals provisions, and arguably the tax saving is only an incidental purpose or effect that flows from having made an interest payment. In any case, the tax advantages of such a transaction have been subsequently negated through the accrual rules for interest income and expenditure.[40]

Examples 7 and 8 are ones where Section 99 could potentially have some application, especially if a pure *Newton* predication test is applied. In Newton the key words to the predication test are "that it [i.e. the arrangement] was implemented *in that particular way* so as to avoid tax". In other words, the test was designed to catch even ordinary business or family dealings if they were implemented in a convoluted or contrived manner to obtain a tax saving. The fiscal nullity doctrine cases, mentioned by their Lordships in support of their findings in *Challenge Corporation,* also make it clear that in cases of ordinary business transactions implemented with extra artificial steps which in themselves have no business purpose, the courts are entitled to ignore those extra steps.[41] Surely both of these approaches give the Commissioner some basis to assert that Examples 6 and 8 are potentially void under Section 99.

Example 6 is also remarkable in another respect. As the Commissioner notes, the trading stock valuation provision gives taxpayers an option as to how they value their trading stock. By changing the basis of valuation under the provision it is possible to transfer income between various income years. It is a well-known provision that has various applications – one is to overcome the provisions that restrict company loss offsets where there has been a change in company ownership – similar to the result the Challenge Corporation tried to achieve. Another is to shift income between fiscal years. The Commissioner readily admits that taxpayers may change their trading stock elections to solely to avoid tax but then asserts that such elections are not tax avoidance arrangements because Section 85 offers taxpayers an option! Surely this is exactly the same approach adopted in Australia in *W.P. Keighery*[42] which is acknowledged as the source of the choice principle, the very judicial concept that was rejected by the Privy Council in *Challenge Corporation.* Even at the New Zealand Court of Appeal, Richardson J. expressed some reservations about the potential effects of adopting the choice principle in terms of how this principle had developed in Australia.

Example 3B is another instance where the advantages sought have been specifically legislated against in the accrual rules for interest income and expense.[43] Quite clearly, whatever approach is used in the interpretation of Section 99 it is difficult to imagine any other conclusion being reached than that tax avoidance was being practiced. This example is a prime one of a sterile circular transaction with no business purpose other than tax avoidance. This type of example is also one that the fiscal nullity doctrine could easily be applied to.

Example 5, involving the use of redeemable preference shares by tax-loss companies, is an interesting example which has attracted much comment from the professional community since the release of the Commissioner's statement. The example was designed to illustrate a transaction whereby a company in a loss situation is unable to enjoy the cash flow advantages of an interest deduction, issues redeemable preference shares at a lower yield which is attractive to a corporate purchaser because the dividends received are tax exempt rather than interest which is assessable. The arrangement described also enables the purchasing company group to claim a large deduction for the interest incurred to finance the purchase of the redeemable preference shares. The purchasing group of companies would incur a deduction for interest without receiving any assessable income from the investment. Looking at the arrangement from the purchasing group's side it is possible to predicate that the redeemable preference shares were purchased in such a way as to avoid tax. To some commentators' surprise the Commissioner did not regard this transaction as potentially void under Section 99. The implications of this example led the Commissioner to state later that the example was not intended to endorse a form of tax-loss trading.

Instead the Commissioner's analysis emphasizes the scheme and purpose of the ITA, making particular note that the ITA prescribes different taxing regimes for debt and equity instruments. The Commissioner states: "The scheme of the Act contemplates that taxpayers may raise finance through either the debt or equity market. The scheme of the Act has not been frustrated when a taxpayer simply selects an option that the Act clearly contemplates that the taxpayer might choose." This again is the very basis of the doctrine of choice. A similar observation was made in the *Keighery*[44] case and in another case regarded by many as the ultimate example of the doctrine of choice.[45] Given the rejection of the doctrine of choice by the Privy Council in *Challenge*

39. By way of note to this example, if in fact the New Zealand resident in this arrangement effectively owned the additional one percent holding, then Sec. 245A(2) would apply and the arrangement in the example would potentially constitute tax evasion rather than avoidance.
40. ITA Sec. 64B-M.
41. The best example of this in the United Kingdom is *Furniss v. Dawson,* (1984) 55 TC 324.
42. See *supra* note 18.
43. ITA Sec. 64B-M.
44. See *supra* note 18.
45. *Slutzkin v. FC of T,* 77 ATC 4,076.

Corporation and by other New Zealand courts, this observation seems inappropriate.

Overall, the Commissioner's examples appear to have been chosen specifically to illustrate the statutory interpretation approach rather than their potential to illustrate the boundary between arrangements the Commissioner is likely to declare as void and those which are not void under Section 99. It is unfortunate that some of these examples have tended to create further uncertainty for professional advisers rather than diminish it.

B. *Future application of Section 99*

The Commissioner's statement is not designed to be a precursor to increased application of Section 99 but a response to uncertainty in the professional community about the section. The Commissioner has indicated in his statement and subsequently that he intends to use the provision sparingly. The primary policy towards countering tax avoidance is through specific legislative provisions with Section 99 as a backup if these provisions fail. This appears to be an accurate reflection of Parliament's intention given the scheme of the Government's tax reform programme over the last six years, even though the types of arrangements targeted by the reform were potentially void under Section 99 anyway.

The main parts of this tax reform programme are as follows:

(a) the taxation of fringe benefits provided to employees;

(b) detailed specification as to the timing of deductions and income for business taxpayers, particularly in respect of interest income from and expenditure in respect of debt instruments;

(c) revision of the tax treatment of distributions from corporations to their shareholders, including the introduction of the dividend imputation system;

(d) the taxation of offshore entities, such as companies, trusts and investment funds which are controlled directly or indirectly by New Zealand resident taxpayers;

(e) a significant reduction and compression of marginal tax rates to a maximum of 33 percent for both companies and individuals.

In enacting these reforms, the process by which legislative changes were made included extensive involvement by professional persons from the private sector, the issuing of consultative documents and setting up of committees to discuss submissions from the commercial community on proposed changes. Indirectly these consultative processes have publicly highlighted the types of tax avoidance arrangements previously in use, particularly by corporate taxpayers.

Legislative reforms additionally have required greater disclosure from taxpayers – especially with respect to offshore vehicles controlled by New Zealand taxpayers. Tax reforms have also resulted in taxpayers reporting increased income to revenue authorities since the enactment of the reforms. These factors have provided the Commissioner with evidence as to potential areas Section 99 could be applied to in respect of tax avoidance arrangements entered into before the tax reform. It is indeed a reinforcement of the principle enunciated in *Challenge Corporation* that legislation by Parliament to remove loopholes does not mean that transactions entered into prior to these legislative changes necessarily had implicit legislative approval and that the anti-avoidance section has no application. In fact, the same pattern occurred in *Challenge Corporation* – a taxpayer discovers a legislative loophole, exploits it, Parliament subsequently makes amendments that remove the loophole, only to have the advantages obtained by the taxpayer from the original arrangement subsequently negated under Section 99.

III. CONCLUSION

The issuance of a statement by the Commissioner to reduce uncertainty to taxpayers surrounding the application of Section 99 is commendable, particularly in light of shifting judicial attitudes to the application of the section. Whether or not the statement has met its objective, however, is questionable. The basic substance of the Commissioner's approach in interpreting Section 99 is likely to promote further uncertainty in practice. The *Challenge Corporation* case is a good example of the difficulties encountered in trying to ascertain the scheme, purpose and intent of legislation. In theory it is simple, in practice more difficult and uncertain. In *Challenge Corporation* the same approach applied by a skilled judiciary resulted in completely opposite conclusions. Attempting to marry this type of approach to the established *Newton* judicial test produces uncertainty as to how the section will be applied.

The Commissioner provided a number of examples to illustrate how this method of application of Section 99 would operate. Unfortunately some of these examples appear not to have been fully considered before being released. Several examples seem to support conclusions which are at variance with earlier authorities, including *Challenge Corporation* (particularly in respect of doctrine of choice arguments), and others appear to sanction arrangements which were widely thought to be potentially void under Section 99.

It remains to be seen how zealously the Commissioner plans to apply the section, particularly with respect to contrived transactions brought to his attention through the Government's tax reform programme. It appears that further statements may be forthcoming to reduce the uncertainty that the section and the Commissioner's statement have created.

HONG KONG'S SOURCE PRINCIPLE ESTABLISHED BY THE PRIVY COUNCIL

Ian W. Harris

Mr. Harris is Group Tax Adviser of the Hong Kong and Shanghai Banking Corporation.

Hong Kong, along with many other British Colonial jurisdictions, as well as many other countries where the tax law was developed by the British, only brings into charge for profits tax under Section 14 of the Inland Revenue Ordinance (IRO) income that *arises in or is derived from* Hong Kong. The term "arising in or derived from" has been the subject of much judicial determination not only in Hong Kong but in many other British Commonwealth jurisdictions as well. The development of this jurisprudence from all four corners of the globe provides a fascinating insight into one of the key features of Hong Kong tax legislation.

The earliest used of the Commonwealth cases was that of *Smidth & Co. v. Greenwood,*[1] where Lord Atkins stated: "I think that the question is where do the operations take place from which the profits in substance arise." Lord Atkins took this quotation a step further in the subsequent case of *Rhodesia Metals Ltd v. Commissioner of Taxes,*[2] where he said: "Source means not a legal concept but something that a practical man would regard as a real source of 'income'. The ascertaining of the actual source is a practical hard matter of fact." These two quotations, therefore, provide the substance as to what in Hong Kong has been described as the *operations test.*

Thus, by the time the IRO was introduced into Hong Kong in 1947 there was already a body of jurisprudence to assist in defining the term, "arising in or derived from". The concept was soon tested in *CIR v. The Hongkong and Whampoa Co Ltd,*[3] which concerned fees earned by a Hong Kong-based tugboat which was sent to an offshore island outside of Hong Kong's territorial waters to rescue a stricken vessel. On arrival at the site the master of the tug determined that the vessel was capable of being salvaged and signed the usual salvage form with the master of the vessel. The tug then towed the vessel back to Hong Kong. The case went to the Court of Appeal to determine whether the fees were earned in Hong Kong where all the preparatory work relating to the salvage operation was undertaken, or offshore where the decision to rescue the vessel was taken and the salvage work carried out. The court was referred to previously-decided cases from South Africa, the United Kingdom and Australia. It was this decision that gave rise to the "operations test" but which in more recent years appears to have caused considerable problems in the High Court of Hong Kong, because in the context of the Dock case, it was not the fact that the tug was based in Hong Kong nor that the initial negotiations with the owners of the vessel were undertaken in Hong Kong but rather that the action of the tug master in negotiation of the salvage contract gave rise to the income.

The Dock case was accepted in *CIR v. International Wood Products Ltd,*[4] but in the next case to reach the High Court, i.e. *Sinolink Overseas Ltd v. CIR,*[5] the well-established operations test used in the Dock case was rejected. The High Court produced a broader operations test relating not to the immediate acts that give rise to the profit but to the concept of operations being those of the taxpayer itself rather than the particular profit-earning activity. In reality this produced a management and control test. In 1990 even this broader operations concept was ignored entirely when the judgement in *CIR v. Hong Kong TVB International*[6] was handed down. *TVB* extended the management and control test. Under *TVB* if a taxpayer was carrying on business in Hong Kong all its income was subject to Hong Kong tax unless such income could be attributed to an offshore permanent establishment. Therefore, the *Sinolink* management and control test was extended to a residence concept.

However, while *Sinolink* and *TVB* were going through the judicial process in Hong Kong, a case concerning the Hang Seng Bank[7] was also proceeding through the system via the fact-finding body, the Board of Review, and the Court of Appeal (by agreement between the parties the case leapfrogged the High Court), producing decisions in favour of the taxpayer and based on the operations test.

The facts in *Hang Seng Bank* were as follows: the bank, which is managed and controlled in Hong Kong and which has virtually all its deposit base in Hong Kong purchased certificates of deposit (CDs) in offshore markets, mainly in London. The bank sold these CDs prior to maturity, thus realizing profits which the Commissioner of Inland Revenue sought to tax. It should perhaps be pointed out at this stage that the IRO was amended in 1978 to bring into the Hong Kong tax net offshore interest accruing to a financial institution carrying on business in Hong Kong. The bank contended that the profits did not arise in nor were derived from Hong Kong while the Revenue contended that the profits on the sale of the CDs arose from the carrying on of the bank's business in Hong Kong, or alternatively that the profits from the sale were in the nature of interest. However, the latter ground was not proceeded with before the Privy Council.

While the Court of Appeal in Hong Kong took what may be termed the traditional approach and sought to refer extensively to previously-decided cases, the Privy Council took a different approach.

In the Court of Appeal, Mr. Justice Cons (now Sir Derek

1. 8 *Tax Cases* [TC] 193.
2. [1940] Appeals Court [AC] 774.
3. *Hong Kong Tax Cases* [HKTC] 85.
4. 1 HKTC 551.
5. 2 HKTC 127.
6. Inland Revenue Appeal No. 9 of 1989.
7. *CIR v. Hang Seng Bank* (Privy Council Appeal No. 36 of 1989).

Cons), Vice President gave the leading judgment, and while accepting the statements made by Lord Atkins in *Smidth*[8] and *Rhodesia Metals*,[9] was of the view that those two statements did not go far enough. He said that the two cases offer no guidance as to how far the "practical man" may extend his vision in looking for the real source. The Court of Appeal, on the one hand, had to decide between the fact that the bank's capital and assets were in Hong Kong, their managerial and policy-making machinery were in Hong Kong, the foreign exchange department and the decisions regarding investments and specific deposits were taken in Hong Kong and the documentation leading to the acquisition of CDs was also in Hong Kong. On the other hand, the bank contended that in a practical man sense it was the purchase and resale of CDs alone in the United Kingdom and other centres that gave rise to the profits. In other words, the case for the Revenue was whether the employment of the funds garnered in Hong Kong gave rise to the profit in dispute or whether the investment in London was the true source of the profit.

In reaching its conclusion, the Court of Appeal said it was wrong of the Board of Review to completely ignore the fact that the funds which gave rise to the investment of the CDs were in fact garnered in Hong Kong. As Mr. Justice Cons stated: "As I see it now, the position in Hong Kong can be likened in physical terms to the damming of a river to form a reservoir for the production of hydroelectric power. If the practical man were then asked where electricity was derived from he would include, albeit to a limited extent, the upstream waters." However, the Court of Appeal took the view that under Hong Kong legislation the Board of Review was entitled only to look at one location in order to determine the source of profit as Hong Kong legislation makes no provision for the geographical apportionment of profit. Cons VP went on to state that "the locality where it [the profit] arises must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit". He continued: "If I might be allowed to return to the analogy I ventured to draw earlier and imagine that by some means the water that had been collected in bulk by the Hong Kong dam were transported to a reservoir somewhere else, that somewhere else would, I am sure, be where the practical man would say that the electricity was in substance derived from."

In a supporting judgment, Mr. Justice Clough commenced by saying that he concurred with the opinion of Mr. Justice Cons and spent some time discussing an Australian case used by Counsel for the Revenue, i.e. *Commissioner of Taxation v. Kirk*,[10] which he said dealt with a multi-source profit – the extracting and subsequent processing of ore which provided the true origin of the operations test.

Mr. Justice Clough said that "having regard to the manner in which the bank conducted its business operations involving the raising of working funds and investment of part of those funds offshore, it seems to me to be indisputable from the primary facts found by the Board (and to have been implicit from the Board's findings) that the purpose of raising the relevant part of the banks's funds which were invested offshore during the relevant period must have been to produce the profit which was achieved by that investment". Mr. Justice Clough continued that, in his opinion, "the business operations which were required to raise or purchase the relevant funds were the initial and a necessary stage in the process which eventually produced a sum of money in the form of the proceeds of sale of the certificates of deposit, bonds and gilt-edged securities. The net profit that arose was the amount of the proceeds of sale of the various instruments less expenses incurred at all stages. It is this net profit which is assessable and chargeable under Section 14 of the Ordinance if it is to be given a Hong Kong derivation." Clough J said that in his judgment this particular case was a "multi-source case" and "the Board of Review made an error of law by ignoring the fund-raising business operations of the bank in Hong Kong when determining the derivation of the profits which actually arose when the investment was sourced outside Hong Kong". In arriving at his final support to Cons VP, Clough J said that the derivation of the relevant profits of the bank was attributable to three basic stages, namely:

(1) acquisition of working funds by the bank's business operation in Hong Kong;
(2) investment of the funds in question outside of Hong Kong; and
(3) the sale of an investment outside of Hong Kong.

Mr. Justice Clough stated that whereas (1) indicated a Hong Kong source, (2) and (3) clearly indicated an offshore source and therefore, although it appeared that the Board of Review was wrong in law to ignore (1), Mr. Justice Clough was unable to conclude an error which required the Court of Appeal to set aside the Board's decision. Mr. Justice Clough, therefore, agreed with Counsel for the taxpayer when he contended that if this was a multi-source case, a view should tip in favour of an offshore derivation because the profits in question were investment profits and such profits cannot arise until after the investment was made. Mr. Justice Clough therefore agreed with Cons VP and dismissed the appeal by the Commissioner of Inland Revenue.

The Privy Council, on the other hand, looked to the construction of the IRO in its charging section and referred to only one of the traditional source cases, the Indian case of *Chunilal Mehta*.[11] The Privy Council first examined Section 14 which says:

> Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.

and then referred to the deeming section introduced in 1978 which in Section 15(1)(i) provides:

> sums, not otherwise chargeable to tax under this Part, received by or accrued to a financial institution by way of interest which arises through or from the carrying on by the financial institution of its business in Hong Kong, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside Hong Kong.

This needs to be related back to Section 15(1) which provides that:

> For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong.

The Privy Council accepted that it was probably the Bank's intention to avoid the charge under the 1978 amendment by rather than receiving interest, receiving something else in-

8. See *supra* note 1.
9. See *supra* note 2.
10. (1900) AC 587.
11. *Commissioner of Income Tax, Bombay Presidency and Aden v. Chunilal B. Mehta of Bombay (trading as Chunilal Mehta & Company)*, (1938) L R65 1A 332.

stead. The Privy Council defined a certificate of deposit:

> Certificates of deposit are issued by prime banks agreeing to repay a fixed sum of money on a fixed date at a fixed rate of interest but, unlike fixed deposits, are readily marketable at any time before maturity at a price which will fully reflect the anticipation of the interest element accrued up to the date of sale. At the material time there were markets for certificates of deposit in Singapore and London but not in Hong Kong.

The Bank's practice in dealing in CDs was for its foreign exchange department continually to monitor its foreign currency holdings and its future foreign currency requirements and to invest the relevant surpluses in CDs on the Singapore and London markets at the best rate obtainable and with a view to their resale shortly before maturity to meet obligations which would then arise. Instructions for purchase and sale were given through correspondent banks in Singapore and London. Sales were invariably effected before maturity. The funds used and accruing from these transactions were debited and credited to accounts of the respondent bank with other banks overseas.

Counsel for the Commissioner argued before the Privy Council that the business of the bank was one and indivisible in that it carried on its business in Hong Kong by obtaining deposits from customers in Hong Kong and lending out some of these funds to purchase CDs in Singapore and London, the operations for which were carried on in Hong Kong, the bank having no branches in either Singapore or London. The Commissioner argued that the overseas profits were the 'mere components' of the whole business whose profits arose in and were derived from Hong Kong.

Their Lordships refused to accept this argument and said that three conditions must exist before liability can arise under Section 14, namely:

(1) the taxpayer must carry on a trade, profession or business in Hong Kong;
(2) the profits to be charged must be 'from such trade, profession or business', which their Lordships construed to mean from the trade, profession or business carried on by the taxpayer in Hong Kong;
(3) the profits must be 'profits arising in or derived from Hong Kong'.

Thus, the Privy Council concluded the structure of Section 14 must accept that a Hong Kong business can earn profits from many sources, some within Hong Kong and some without and it was therefore impossible to construe Section 14 to require a Hong Kong business to have an offshore permanent establishment before such profits can escape tax in Hong Kong.

The Privy Council derived further support for their view from an examination of Rule 2A(1) of the IRO which states:

> No deduction shall be allowed for any outgoing or expense incurred in the production of profits not arising in or derived from Hong Kong, but where any outgoing or expense was incurred partly in the production of profits arising in or derived from within Hong Kong and partly in the production of profits arising or derived from outside Hong Kong then for the purpose of ascertaining the extent to which such outgoing or expense is deductible under Section 16 of the Ordinance, an apportionment thereof shall be made on such basis as is most appropriate to the activities of the trade, profession or business concerned.

The Privy Council stated that Rule 2A as read with Section 14 not only provided for exclusion of offshore profits from the charge to Hong Kong profits tax but further specifically provided for the disallowance of appropriate expenditure incurred in Hong Kong in respect of the offshore profit.

Although the Hong Kong Court of Appeal found in favour of the bank, the Privy Council disagreed with the route by which that Court arrived at this decision, which in some respects was similar to the reasoning of the High Court in *Sinolink*[12] and *TVB*,[13] i.e. to consider that all profits should be from a Hong Kong source if there was no offshore permanent establishment but to accept that there could be dominant fact or facts which lead the profits in question to fall on one side of the tax line or the other.

The final argument of the Commissioner and demolished by the Privy Council was as follows: because the management decisions relating to the CD operation were taken by management of the bank in Hong Kong and on a day-to-day basis by the bank's foreign exchange department that was sufficient to provide a Hong Kong nexus. However, the Privy Council concluded that the earlier Privy Council decision (that of *Chunilal Mehta)*[14] was persuasive. In that case, Mr. Mehta, a commodity broker carrying on business in Bombay, traded in commodity futures on exchanges in Liverpool, London and New York, giving buy and sell instructions to brokers operating on those exchanges. The issue was whether the profits of the trade were profits "accruing or arising in British India". Their Lordships found that the words "accruing or arising in British India" were synonymous with the words "arising in or derived from" [Hong Kong] in the IRO.

Although both counsel for the Revenue and for the bank quoted a number of authorities in support of their respective arguments, the Privy Council analyzed the issue by saying that if the profit was earned by exploitation of property assets, such as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or be derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.

In reaching this conclusion, the Privy Council stated that they could have reached their destination by a much shorter route. This was because Counsel for the Revenue had contended that the profits on the CDs would still have been liable to Hong Kong profits tax prior to 1978, and the introduction of Section 15(1)(i) which brought in the taxation of offshore interest was in reality clarifying an already-established position. Indeed, the Revenue contended that if the bank had held the CDs to maturity and derived interest therefrom, that interest would have been subject to tax even without Section 15(1)(i) because the funds available for investment would have been derived from the bank's Hong Kong activities and the investment decisions would have been made in Hong Kong. However, their Lordships were unable to accept this contention; otherwise the introduction of Section 15(1)(i) to deem income subject to Hong Kong profits which would not ordinarily have been subject to Hong Kong tax would have been totally unnecessary.

The Revenue asserted that the legislature cannot alter the meaning of a provision by an amendment to the existing legislation which proceeds upon a mistaken belief as to the effect of a provision in the original enactment. Their Lordships accepted that this argument was no doubt perfectly correct if the meaning of the original provision was clear and unambiguous, but it is otherwise if there is any ambiguity in the original provision. The Privy Council referred to *Attorney General v. Clarkson*[15] which supported this

12. See *supra* note 5.
13. See *supra* note 6.
14. See *supra* note 11.
15. (1900) 1 KB 56.

view and which had been quoted with approval in a number of subsequent cases heard by the House of Lords. In their Lordships' view, therefore, the meaning of Section 14 was at least ambiguous, and it follows that the introduction of Section 15(1)(i) was fatal to any contention that Section 14 was itself effective to bring into the charge for profits tax the earnings from the disposal of the CDs outside of Hong Kong in the absence of an applicable deeming provision. On this principle, the Privy Council dismissed the appeal by the Commissioner of Inland Revenue.

One aspect of the Privy Council judgment that has caused considerable comment amongst many commentators in Hong Kong was the reference to apportionment where Lord Bridge said:

> There may, of course, be cases where the gross profit deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.

Whether this statement does indeed give authority remains to be seen. While seen by many as a watershed, apportionment has been in existence for many years in respect of syndicated loans and similar activities of financial institutions. With Hong Kong continuing to be the crossroads of South East Asia, apportionment may well be the answer in many other circumstances, particularly in respect of manufacturing as much of Hong Kong's production takes place in the Pearl River delta in China.

While the highest appeal body for all tax cases in Hong Kong has now made a firm pronouncement on the source principle in Hong Kong – much to the satisfaction of the tax professionals in Hong Kong – it remains to be seen how far the Inland Revenue Department will accept the principles established in the Hang Seng case as being applicable to all outstanding and future source of profits cases in Hong Kong. However, it will be most difficult for the lower courts in Hong Kong to ignore the Privy Council decision unless the facts in a particular case are considerably different to those in *Hang Seng* and the principles established cannot be used. While as indicated above the Privy Council did not refer to the previously understood "operations test", it is obvious that a slightly amended version of the operations test has now been established; it might be called the "immediate profit earning" test. In other words, profits will fall to be charged to Hong Kong profits tax if the immediate action giving rise to those profits takes place in Hong Kong. Absent such immediate action the profits do not fall to be taxed in Hong Kong. To use the dam supplying hydroelectric power analogy used in the hearing before the Court of Appeal, while it would be true to say that all the streams and rivers leading into the dam contribute to the creation of the hydroelectric power, it is the dam itself that is the true source of the power.

One of the cornerstones of Hong Kong's success as a major financial and trading centre not only in Southeast Asia but in the world has been its low rate, simple sourced-base system of taxation. That one aspect of this particular cornerstone has been under a considerable degree of uncertainty over the past five or six years has not helped to attract new investment as advisers have been unable to state with any degree of certainty which profits of an enterprise would be subject to Hong Kong tax. It is hoped that this landmark decision by the Privy Council will remove this uncertainty and that once again Hong Kong's progress can be continued.

UNITED STATES:

CALIFORNIA UNITARY TAX UPDATE:

WORLDWIDE COMBINED REPORTING HELD UNCONSTITUTIONAL WITH RESPECT TO A FOREIGN PARENT CORPORATION

Leonard W. Rothschild, Jr.

In an opinion filed on 30 November 1990 a California Court of Appeal has held that California's unitary tax method of worldwide combined reporting[1] as applied to foreign unitary groups is unconstitutional under the foreign commerce clause of the U.S. Constitution.[2] The Franchise Tax Board filed a Petition for Rehearing with the Appellate Court that was denied on 27 December 1990. The decision is now subject to discretionary review by the California Supreme Court and the U.S. Supreme Court. While there is no assurance that either of these courts will grant a review of this case, it is possible that one of these courts will hear the case in the future. If the decision in *Barclays* becomes final the State of California has estimated it would be required to refund US$ 300 million to those taxpayers affected directly by the *Barclays* facts. This article discusses the *Barclays* decision and its importance for foreign-based taxpayers doing business in California.

Mr. Rothschild is a Certified Public Accountant and attorney, having graduated from the University of San Francisco (B.S. 1969, J.D. 1975).
Mr. Rothschild is the Bulletin *correspondent for the United States and has published several articles in* The Tax Advisor *and the* Journal of State Taxation. *He also lectures frequently on international tax subjects.*
Mr. Rothschild is a member of the U.S. branch of IFA, the California Council of International Trade and the San Francisco International Tax Group. He is co-founder of the San Francisco Foreign Tax Club. He is also a member of the American Institute of Certified Public Accountants, the California Society of Certified Public Accountants and the State Bar of California.
Mr. Rothschild is a partner in the San Francisco office of Deloitte Haskins & Sells, and is the Regional International Tax Partner for the Pacific Northwest Region.

This article also appeared in 50 Tax Notes *1 (7 January 1991), at 85.*

STATE METHODS OF APPORTIONING INCOME

All of the states which impose a corporate income tax use some type of formula to apportion business income among the various states in which the corporation operates. Most states use some variation of the three-factor formula based upon the separate ratios of sales, property and payroll in the particular state to the corporation's total sales, property and payroll.[3]

While most states only apportion business income of the corporation doing business within the state, California has adopted a "unitary" method of apportionment. Under this method the apportionment formula is applied not only to the income of the specific corporation doing business within California, but also to the income of any related corporation (parent corporation, subsidiaries and brother-sister companies, provided there is more than 50 percent control) where the related corporation's activities outside of California contribute to or are dependent upon the activities within California. The unitary method has been applied in California to domestic operations as well as to foreign operations.

The U.S. Supreme Court has upheld the constitutionality of the California unitary tax with respect to a U.S.-based parent corporation with foreign subsidiaries.[4] The U.S. Supreme Court, in footnote 26 to the *Container* decision, stated, "[w]e have no need to address in this opinion the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries". The issue presented in *Barclays* is precisely the issue left undecided by the U.S. Supreme Court, namely, is the California worldwide unitary tax constitutional as applied to a foreign-based parent company with a domestic subsidiary?

It should be noted that California has been under pressure in recent years by foreign governments and foreign-based corporations to eliminate worldwide combined reporting. In response to this pressure, beginning with the 1988 tax year California allowed multinational taxpayers the option to compute their California tax base on a "water's edge" basis, providing that electing corporations pay a special fee into the California Unitary Fund.[5]

1. California Revenue and Taxation Code, Sec. 25101.
2. *Barclays Bank International Limited v. Franchise Tax Board,* 90 Daily Journal D.A.R. 13727, 6 December 1990) ["*Barclays*"].
3. See L. Rothschild, Jr. and R. Anthony, "Worldwide Combined Reporting – Recent Legislative Developments", 37 *Bulletin for International Fiscal Documentation* (February 1983), at 59-64.
4. *Container Corporation of America v. Franchise Tax Board,* 463 United States [U.S.] 159 (1983) ["*Container*"]. For a discussion of *Container,* see L. Rothschild, Jr., "Worldwide Combined Reporting", 38 *Bulletin For International Fiscal Documentation* (April 1984), at 153-156.
5. For a discussion of the "water's edge" election, see B. Burgner, "International Aspects of State and Local Taxation", 44 *Bulletin for International Fiscal Documentation* (February 1990), at 112, 115, and P. Plant, et al, "California Unitary Taxation and Water's Edge Election", 29 *European Taxation* (July 1989), at 211.

THE APPELLATE COURT DECISION IN BARCLAYS

Background

The California Franchise Tax Board determined that Barclays Bank of California ("Barcal") and Barclays Bank International ("BBI"), and their ultimate corporate parent Barclays Bank Limited ("BBL"), as well as certain other subsidiaries of BBI and BBL constituted a unitary group (collectively referred to as "Barclays"). Barcal and BBI paid the additional tax under protest for 1977 and sued for a refund. Barclays challenged the federal constitutionality of these additional tax assessments on foreign commerce clause and due process grounds. The Appellate Court never considered the due process argument, as it decided the case based on the application of the foreign commerce clause.

The Appellate Court analyzed three important U.S. Supreme Court cases that have construed Article I, Section 8, Clause 3 of the U.S. Constitution that gives Congress the power "[t]o regulate commerce with foreign nations, and among the several states...."[6] *Japan Line* held that instrumentalities of commerce (in that case, cargo containers in seagoing ships) that are owned, based and registered abroad and that are used exclusively in international commerce may not be subjected to an apportioned ad valorem property tax by a state. The court found in *Japan Line* that there was actual international multiple taxation, since Los Angeles taxed the cargo containers at their full value. Also, the court found that this tax "may impair federal uniformity in an area where federal uniformity is essential" and prevents "the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause."

The next case analyzed by the United States Supreme Court was *Container*. This case, discussed above, upheld the California unitary tax since the Court did not find that this tax would "inevitably" lead to double taxation, and that the "speaking with one voice" standard in *Japan Line* did not apply to a domestic-based parent corporation "[a]bsent some explicit directive from Congress....that treatment of foreign income at the federal level mandates identical treatment by the States." It should be noted that the federal government did not file an amicus curiae brief opposing the tax and this inaction suggested that U.S. foreign policy was not seriously threatened by the California worldwide unitary tax.

The third case decided by the U.S. Supreme Court was *Wardair* in which it was found that it was "abundantly clear" that the federal government had affirmatively acted rather than remained silent with respect to the power of a state to tax all airline aviation fuel sold within the state regardless of the airliner's destination or the amount of interstate business it did. In *Wardair*, the United States filed an amicus curiae brief[7] in which it argued that there was a federal policy prohibiting such an unlimited tax. However, the court found that there was no such federal policy, and that the federal government had affirmatively acted to permit the tax. Therefore, the two tests in *Japan Line* that prohibited imposition of the ad valorem property tax, the risk of international multiple taxation and the federal government's role in regulating foreign commerce ("speaking with one voice"), were not present in this case.

Foreign Commerce Clause

Barclays contended that the worldwide combined reporting method is unconstitutional because it improperly interferes with the power of the executive branch of the federal government to conduct foreign affairs. Unlike in the Container case, the United States filed an amicus curiae brief in support of Barclays. Amici curiae briefs were also filed on behalf of the U.K. government and the Canadian government, and on behalf of two companies based in the United Kingdom (Thorn-EMI PLC and EMI PLC).

Enhanced risk of multiple taxation

The first argument raised by Barclays was the enhanced risk of multiple taxation. The appellate court could not distinguish any significant differences between domestic-based and foreign-based multinational corporations concerning the enhanced risk of multiple taxation. The court said that in neither case is double taxation inevitable. Therefore, the court followed *Container* and held that California's use of the worldwide combined reporting method as to foreign-based multinationals is not unconstitutional on this ground.

Federal uniformity ("speaking with one voice")

The second argument raised by Barclays is whether California's application of worldwide combined reporting to foreign-based unitary groups may impair federal uniformity in an area where federal uniformity is essential, so preventing the federal government from speaking with one voice in international trade. This argument involves two questions: (1) are there foreign policy implications that must be left to the federal government; and (2) has there been a clear federal directive?

Foreign policy implications

The Supreme Court in *Container* stated "[t]he most obvious foreign policy implication of a state tax is the threat it may impose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole". The Appellate Court in *Barclays* found that "every single nation in the industrialized western world has sent letters to the United States government protesting the use of worldwide combined reporting by American states". The Appellate Court also found that the seriousness of these protests has led the United Kingdom to enact retaliatory legislation and to cancel several trade missions to the United States.

The second foreign policy consideration identified in *Container* is whether the legal incidence of the tax falls on a domestic corporation or a foreign corporation. This issue was reserved in *Container*, as the *Container* decision expressly did not apply to foreign parent companies (see above). The court in *Container* noted that the tax there was imposed on a domestic corporation and not on a foreign entity, as was the case in *Japan Line*. In *Barclays* the tax fell both on Barcal, a domestic corporation with a foreign parent, and BBI, a foreign parent with foreign subsidiaries.

The third foreign policy factor identified in Container as bearing on the risk of foreign retaliation was whether the tax burden is more a function of California's worldwide combined reporting tax system or its allocation method.

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6. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) ["*Japan Line*"]; *Container*, supra note 3; and *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986) ["*Wardair*"].

7. *Editor's note:* Latin, "friend of the court". An amicus curiae brief may be filed by a person who is not a party to a case in order to protect his interests. An amicus brief is sometimes filed when the nature and significance of the issue before an (appeals) court would require such assistance.

There was a considerable amount of evidence introduced that demonstrated the additional administrative burden foreign-based taxpayers incur in complying with the California worldwide combined reporting tax system, as opposed to that incurred by domestic-based companies. For example, domestic-based companies keep their records in English, in U.S. currency and in accord with U.S. accounting principles. Evidence was presented that Barclays would incur a one-time cost of between $ 6.4 million and $ 7.7 million to establish a system of reporting to comply with the requirements of California's worldwide combined reporting, and an additional expense of from $ 2.0 million to $ 3.8 million each year to maintain the system. The court found that the primary reason of incurring these large expenses is California's allocation method, rather than its tax rate.

The court found that, unlike in the *Container* case, it is clear that foreign governments are offended by this method of taxation, and have in fact retaliated. In addition the amicus curiae brief filed by the federal government details the executive branch policy with respect to this tax.

Clear federal directive

The *Container* case held that a tax will violate the *one voice* standard if the tax violates a clear federal directive. As discussed above in *Container,* the court found no clear federal directive, as the federal government did not file an amicus curiae brief, and there was no clear congressional expression either way on the subject.

However, the appellate court in *Barclays* found that, in the years since the *Container* decision, a number of actions have taken place that demonstrate that the federal government has issued a clear directive in opposition to California's worldwide combined reporting. Examples of the actions included: the U.S.–U.K. income tax treaty debate with respect to the worldwide unitary tax, a letter written by President Carter's Secretary of the Treasury to the State of California with respect to the federal government's opposition to the worldwide unitary tax, President Reagan's directive to the Attorney General to pursue through litigation and treaty amendment a federal policy that foreign corporations be taxed by states only on income derived in the United States and the filing of an amicus curiae brief in the *Barclays* case. Therefore, the appellate court believed that the federal government had spoken clearly in opposition to worldwide combined reporting and had expressed its belief that foreign-based corporate groups should be taxed by the states only on income derived from within the United States.

Holding

The appellate court held that the trial court was correct in finding that the Executive Branch since 1975 has clearly and consistently opposed applying worldwide combined reporting to foreign based corporate groups. Also, the court held that the "one voice" standard of *Japan Line* and *Container* does not depend on the outcome of events for its application. As the trial court noted in this regard, "[t]his case factually demonstrates as extreme an example of predictable international consequences stemming from a local tax as can be conceived".

For these reasons the court, in a unanimous decision, found that application of worldwide combined reporting to foreign-based unitary groups is unconstitutional under the commerce clause of the federal constitution.

CONCLUSION

It is not clear if either the California Supreme Court or the U.S. Supreme Court will decide to hear an appeal of *Barclays.* If neither court hears an appeal then this decision will become final, and the California worldwide reporting method will no longer apply with respect to non-U.S. operations of foreign-based companies. Foreign-based companies will effectively be placed on the "water's edge" method, but since no election will be made, no fee will be payable to the California Unitary Fund.

If the California Supreme Court or U.S. Supreme Court decides to hear the *Barclays* case, then this issue will not be concluded until a final judgment is entered by one or both courts. In any event it is important for taxpayers that are affected by the *Barclays* decision to file a protective claim for refund with the California Franchise Tax Board for each year that is not already closed by the statute of limitations. The California statute of limitations is generally four years from the due date of the return, including extensions. For example, corporate tax returns for calendar year 1986 were due on 15 March 1987, and an automatic extension of time to file (if one was actually filed) would extend the due date until 15 October 1987. Therefore, the four-year statute of limitations for calendar year 1986 will expire on either 15 March 1991 or 15 October 1991, irrespective of the date the 1986 income tax return was actually filed. If the corporation's federal income tax return for any year is under audit by the Internal Revenue Service and the taxpayer has agreed to extend the statute of limitations for federal purposes by signing a waiver, the California statute of limitations is automatically extended until six months after the expiration date of the federal waiver. Many large multinational corporate taxpayers may find that the California statute of limitations is open for many years, as a result of waivers signed in connection with federal tax audits.

Relief for U.S. Based Multinational Companies?

There are judicial efforts in progress to reverse the *Container* decision that upheld worldwide combined reporting for U.S.-based parent corporations and their foreign subsidiaries. In *Colgate-Palmolive Co. v. Franchise Tax Board,*[8] a case that involved a U.S. parent corporation with foreign subsidiaries, a California District Court distinguished *Container* on the basis that the federal government had, subsequent to the *Container* decision, issued a clear directive in opposition to California's worldwide combined reporting. *Colgate* is now on appeal to the same court that has just ruled in *Barclays. Colgate* has been briefed, but no date for an oral hearing has yet been set.

Some observers believe that if the decision in *Barclays* becomes final, California may abandon worldwide combined reporting for U.S. based taxpayers, so that foreign based corporations will not enjoy a competitive advantage over domestic based taxpayers. In my view this is unlikely, as the revenue loss would be very substantial, and there are a number of California based taxpayers that prefer the worldwide unitary method.

8. Doc. No. 319175 ["*Colgate*"].

ARGENTINA:

TRANSFER PRICING AND THE NEW CRIMINAL TAX LAW

Ruben O. Asorey

I. INTRODUCTION

Transfer pricing issues have been largely neglected in Argentina, both in theory and in the legislation. In fact, the labyrinthine Argentine tax system contains no specific rules for transfer pricing, nor has any tax commentator thus far analyzed transfer pricing issues. Consequently, uncertainty shrouds any analysis of intercompany pricing operations.

A criminal tax law, introduced in 1990, provides for criminal sanctions in a wide variety of situations and may be applicable to transfer pricing practices.[1] This article provides an overview of the Argentine system with respect to intercompany transactions and examines the potential application of the new law to transfer pricing issues as well as the problems which may arise from application of the law.

Mr. Asorey is a partner at Marval & O'Farrell in Buenos Aires, and a professor of tax law at the Catholic University of Buenos Aires. He holds a Master's Degree in Comparative Jurisprudence from New York University and is a member of the Buenos Aires Bar. Mr. Asorey was president of the Argentine Association of Tax Law (1986-1989), the Latin American Tax Law Institute (1988-1990), and vice president of the Tax Committee of the International Bar Association (1988-1990). He has been a member of the General Counsel of IFA since 1985. Mr. Asorey has authored various articles on international tax.

For a more thorough discussion, see R. Asorey, "Transfer Pricing in Argentina", in The Treatment of Transfer Pricing (Amsterdam: International Bureau of Fiscal Documentation, 1990).

II. ARM'S LENGTH PRINCIPLE

Argentine tax law does not specifically address transfer pricing. Guidance must therefore be derived from various tax laws – primarily those relating to intercompany transactions – and case law on the subject.

The Income Tax Law contains provisions referring to the arm's length principle with respect to transactions between related parties. Article 14 provides:

> Those legal acts entered into between a local company of foreign capital and the individual or corporation domiciled abroad which directly or indirectly controls it, are to be regarded, for all purposes, as entered into between independent parties when the relevant consideration and conditions are in agreement with normal market practices between independent parties.

Under Article 14, branches of foreign corporations are considered independent from the foreign home office.[2] In accordance with this principle, any transaction entered into between related companies will be considered as if entered into by independent parties, provided the consideration and conditions under the transaction are in agreement with normal market practices between independent entities. This principle, however, is subject to certain limitations (discussed below).

Branches of foreign corporations must keep separate books and records and prepare separate tax returns reflecting the result of their activities in Argentina on the basis of an arm's length relationship with the home office or parent company. If the requirements of Article 14 are not fulfilled, the transaction is treated according to the rules governing capital contributions and profit distributions (the contribution and profit principle). In other words, if the intercompany transactions are not made at arm's length, the consideration paid will be viewed as an impermissible transfer of profit and therefore subject to a higher rate of income tax.

Article 8 applies in the particular case of import and export operations. Profits arising from the export of local goods are of Argentine source and, therefore, subject to tax in Argentina. Under this Article, exportation between a local seller and a foreign buyer are to be treated as if entered into between related parties if the price is not determined, or if the price agreed upon is less than the price which would be charged for the same goods in the wholesale market at the place of destination. In such a case an economic connection (vinculación económica) will be deemed to exist between the local seller and the foreign buyer. The Tax Board may then make a price adjustment to assess the correct tax due.

1. Law No. 23,771, in effect as of 8 March 1990.
2. Branches are taxed at a flat rate of 36 percent on their net taxable income, whether or not profits are remitted abroad.

Article 8 also provides that profits derived by foreign exporters from the importation of goods into Argentina are not subject to tax in Argentina because the goods are considered foreign sourced. However, if the price paid by a local buyer is higher than the wholesale price prevailing in the place of origin of the goods, an economic connection will be deemed to exist between the local importer and the foreign exporter if the parties cannot submit conclusive evidence to rebut this presumption. Any price difference will be considered to be a net profit of Argentine source for the exporter, and therefore subject to the income tax rate applicable to profits, i.e. 36 percent.

Income Tax Law Chapter V (Foreign Beneficiaries) provides special treatment for certain items of intangible property. Various percentages of net profits are presumed in the case of patents, copyrights, trade marks, transfer of technology, etc. The general withholding tax rate, i.e. 36 percent, is applied to these percentages, resulting in an effective withholding rate to which the payment to the foreign beneficiary will be subject. If these transactions are not made at arm's length, the income tax rate corresponding to profits will apply to the amount exceeding that found in normal market practices.

III. LIMITATIONS

The general rule of Article 14, i.e. that the consideration and conditions of the relevant transaction must be in accordance with normal market practices between independent parties, is subject to the following limitations.

A. *Loans*

Loans from associated companies must meet the requirements of Article 20 of Foreign Investment Law No. 21,382; that is, loans from a home office or related company to a local entity will be considered made by independent parties, provided that the Central Bank of Argentina does not object to the operation.

Under Article 20, the above requirements do not apply to credit balances originating from the price payable for the import of tangible assets, and any other debt claims of the controlling company other than those arising from loan agreements.

B. *Royalties regulated by Law No. 22,426 on the transfer of technology*

The general principle is that agreements stipulating royalties to be paid by a local company to its home office are subject to local government control. These transactions will generally be approved if made according to normal market practices, although no royalty payments for the use of trade marks are allowed and the amounts paid by the recipient of the technology must be in accordance with the technology transferred.

Lack of governmental approval will not affect the validity of the agreement, but payments to foreign beneficiaries resulting from non-approved agreements may not be deducted for tax purposes by the recipient of the technology transferred. Thus, the entire amount remitted to the foreign beneficiary will be taxed at an effective rate of 32.4 percent.[3]

However, if the agreement meets the requirements of Law No. 22,426, under the Income Tax Law it is presumed that only a certain percentage of the amount paid is taxable income. In addition, the local company can consider the amount paid as a deductible expense. In the case of technical assistance, engineering or consulting services, 60 percent of the amount paid is considered net profit, thus resulting in an effective rate of income tax of 21.6 percent. Eighty percent of the royalty payments made for the licensing of patents are considered net profit; thus they are subject to an effective rate of 28.8 percent.[4]

IV. CASE LAW

The Supreme Court has issued a judgement concerning the presumption of association of enterprises in import and export operations.[5] The Court has concluded that if it is proven that the local importer and the foreign exporter are not related companies, the importer is not obliged to justify the higher price paid to the exporter in comparison with the exporter's normal market prices. This case also established that it is not reasonable to consider any difference (even the slightest one) as evidence of an association of enterprises. In this respect the Supreme Court decided that although it is extremely difficult to make a list of the elements which may allow one to conclude that companies are related in terms of Article 8, the following aspects should be considered: common ownership of capital, organic subordination and integration agreements.

In another case,[6] the Supreme Court analyzed export operations in light of the provisions of the former profits tax law, Article 9, which is currently Income Tax Law, Article 8, partially amended. S.I.A. was a domestic corporation which exported horses to the United States and other South American countries. According to the corporate books, the price paid for the horses by the foreign purchasers was lower than the price S.I.A. originally paid. Consequently, the company reflected the result of the export operations as a tax loss in its income tax return. The Tax Board challenged the company's tax return, assessing the tax due according to the wholesale price in the place of destination of the goods exported. The company appealed and the Supreme Court held that the evidence submitted by the company regarding the lower price of the goods was insufficient to prove the facts alleged because such evidence existed only in the corporate books and in records of local sales made to employees of the corporation. The Court concluded that the Tax Board assessment was correct, as was the corresponding fine.

V. GENERAL PRINCIPLES OF NEW CRIMINAL TAX LAW NO. 23,771

Criminal tax aspects are governed by the law on fiscal procedure[7] and the recently promulgated criminal tax law.[8] Under Law No. 11,683, penalties range from fines to the temporary closing of the business for non-compliance with formal obli-

[continued on page 85]

3. Ninety percent of the payment made to the foreign beneficiary is presumed to be net profit. The 36 percent withholding tax rate is applied to that percentage, resulting in an effective withholding tax rate of 32.4 percent.
4. Again the 36 percent withholding tax rate is applied.
5. Supreme Court of Justice of the Nation (Corte Suprema de Justicia de la Nación (CSJN)), *Eduardo Loussinian,* of 20 September 1983, *Derecho fiscal* (D.F.) XXXV, 809.
6. *S.I.A.S.A.* D.F. XX, 176.
7. Law No. 11,683.
8. See *supra* note 1.

TRANSFER PRICING IN BRAZIL

Eduardo de Cerqueira Leite

I. INTRODUCTION

Brazilian income tax laws do not contain elaborate rules on transfer pricing. Apart from the cases discussed below, existing rules (which apply to both domestic and transnational cases) merely consist of brief descriptions of transactions. No special treatment is granted to non-Brazilian parties in tax havens or in tax treaty jurisdictions. In addition, Brazil does not have any legislation which allows the disregard of a legal entity or which emphasizes economic substance over legal form.[1]

The statute which lays the foundation for the current transfer pricing rules was enacted in 1964 and was designed to prevent specific tax avoidance schemes, primarily those devised by family-owned companies.[2] Because the statute did not encompass transactions between legal entities,[3] these rules were amended to conform to the law on corporations and to reach non-arm's length transactions between legal entities in cases where one entity was non-resident.[4] The provisions were again amended in 1983 to include any legal entities, regardless of their residence for tax purposes.[5] Despite efforts of Brazilian courts and the Treasury to simplify and clarify the rules on intercompany transactions, the final result is a cumbersome set of principles.

Mr. Eduardo de Cerqueira Leite is Partner, Baker & McKenzie, Miami, Florida and São Paulo, Brazil. Admitted to practice law in Brazil since 1979, Mr. de Cerqueira Leite started his law career at the Facultade de Derecho of the University of Uruguay and graduated from the Facultade de Direito of the University of São Paulo, Brazil, in 1978. He obtained a Masters Degree in Comparative Jurisprudence from New York University in 1980. Mr. de Cerqueira Leite has been a tax practitioner in Brazil for more than ten years and has also worked in the Chicago (1980-81) and Miami (1988-90) offices of Baker & McKenzie.

II. QUESTIONABLE TRANSACTIONS

The income tax law lists seven types of questionable transactions (six specific fact patterns and a general one); the transactions are described from the perspective of the controlled entity. The Brazilian Treasury may allocate income to the related party and/or penalize the controlled entity in the following circumstances:

(1) the controlled entity transfers assets to the related party, by sale or otherwise, for a price far below market price;
(2) the controlled entity purchases property from the related party for a price far in excess of market price;
(3) the controlled entity does not exercise a right of option to purchase assets, and waives, in favour of the related party, the amount deposited to secure the option;
(4) the controlled entity transfers to the related party without payment or for a price below market price, the right to subscribe to shares of a corporation;
(5) the controlled entity lends money to the related party even though the controlled entity's balance sheet shows retained earnings;
(6) the controlled entity pays to the related party rent, royalties or technical assistance fees far in excess of market price; and
(7) the controlled entity enters into any other transaction under conditions more favourable to the related party than those under which the controlled entity would contract with a non-related party.

When a transaction falls into one of these fact patterns, the Treasury may institute an action against the controlled entity or the related party, as the case may be, showing a comparable transaction which evidences the arm's length price. The burden of proof then shifts to the controlled entity or related party to show otherwise, i.e. that the transaction was in the best interest of the controlled entity and that the consideration was valuable and reasonable.[6]

Before discussing the seven types of transactions let us examine relevant legal definitions.

A chapter on Brazil for the IBFD's loose-leaf service, The Treatment of Transfer Pricing, is under preparation.

1. Art. 51 of Law 7450 of 23 December 1985 and Parecer Normativo 46, (Revenue Ruling) of 17 August 1987 illustrate recent attempts by the Brazilian legislator and the Treasury to adopt stricter standards for tax-motivated transactions. These rulings provide, in summary, that the use of corporate devices which lack any business substance in order to achieve a tax-free transaction constitutes a simulation. In such cases, the Brazilian Treasury has authority to demand the tax that would be due if the taxable event had not been so avoided.
2. Law 4506 of 30 November 1964, Arts. 72 and 73.
3. R. Sampaio Doria, *Distribuição Disfarçada de Lucros e Imposto de Renda,* 2d ed. (São Paulo: Resenha Tributária, 1977).
4. Decree Law 1598 of 26 December 1977, Arts. 60-62.
5. Decree Law 2065 of 26 October 1983, Arts. 20 and 21.
6. Decree Law 1598, Art. 60, para. 2.

A. Definitions

1. Market value

Market value is defined briefly as the cash price that the controlled entity could have obtained through a free negotiation in the relevant market.[7] Comparison with the corresponding cash price, however, may be onerous in a country with high indexes of inflation. For example, if the transaction is an instalment sale, the comparison must be made with the corresponding present cash value, a determination not easily made when inflation fluctuates significantly on a daily basis. If there is an active market for the property or right, the comparison should be made with similar property or rights, and under normal business conditions.[8] In the absence of an active or recognized market, courts have relied on the book value, the tax assessment value or opinions from independent experts.

2. Related party

A related party includes any shareholder of the controlled entity, regardless of whether the shareholder is an individual or a legal entity; an administrator; or the spouse and relatives (including the spouses of the relatives up to the third family degree, as defined in the Brazilian Civil Code)[9] of the shareholder or administrator. In addition, if the related party is a controlling shareholder of the legal entity, the Treasury may allocate income to the related party when the transactions described above are entered into by the controlled entity with a third party (individual or legal entity) under the direct or indirect control of the controlling shareholder.[10]

3. Controlling shareholder

A controlling shareholder is any person (individual or legal entity) that directly or indirectly holds decisive voting power in the controlled entity.[11] The term shareholder is used in a broad sense. It includes the quotaholder in a limited liability company (*Sociedade por Quotas de Responsabilidade Limitada*), the owner, partner or other equity holder in any legal entity.[12]

4. Administrator

Administrator is a concept that includes not only a shareholder who holds a management position but also a professional officer, manager, board member or other executive, provided such person is not a subordinate or employee. Treasury regulations define administrator as follows: "a person that carries out the day-to-day management and administration of the company pursuant to powers granted by the shareholders, the Board or the officers".[13] The definition excludes attorneys-in-fact with limited powers (e.g. customs brokers who represent an entity for specific purposes or tasks), temporary administrators and employees, or persons subject to rules of subordination within their area of work (e.g. salespersons who have limited authority to bind an entity).

B. Type of transactions

1. Transferring assets

The first type of transaction subject to scrutiny is one in which assets are transferred to a related party, by sale or otherwise, for a price far below market price. The term "assets" comprises all property (tangible or intangible) classifiable as assets for accounting purposes. The difference between fair market value and the transfer price must be excessive, evident or conspicuous. A relatively small difference is insufficient for the transaction to be treated as a distribution to the related party. When the property is traded in a well-known market, the comparable price is determined by reference to the market price under ordinary or normal conditions, for the same or similar property.

Determining a comparable price is easy for shares traded on a stock market. However, transfer pricing issues arise more frequently in close corporations where the shares lack a market value. Although it would be more reasonable to appraise the value of shares based on formulas generally accepted in corporate mergers or acquisitions, the courts have held that the value of shares in a close corporation must be determined by reference to the respective net asset (or net worth) value.[14]

Reliable market information is often unavailable in respect of transfers of real estate. Here the assessment value used by the city for purposes of the property tax or the value accepted by the State for purposes of state property transfer tax can be used.[15]

Administrative courts have held that the book value (which includes cost plus indexation) can be used as a parameter for assets without a clear comparable.[16] If the entity's assets are liquidated as a result of voluntary dissolution, the administrative courts have consistently held that the case should be scrutinized under the transfer pricing rules if the transfer is made at a price far below market value.[17]

2. Purchasing assets

This type of transaction is exactly the reverse of the above. Examples where income will be allocated for purchases of assets from related parties at prices far in excess of market value include the acquisition of assets by the controlled entity as a result of a capital contribution from the shareholder[18] and the purchase of raw materials imported from a

7. *Id.,* at para. 4.
8. *Id.,* at para. 5.
9. According to the Brazilian Civil Code, Law 3071, of 1 January 1916, Arts. 330 and 333, the family degrees are as follows: the first degree includes the parents and children of the related person; the second degree includes brothers and sisters as well as grandparents and grandchildren; and the third degree includes nephews, nieces, aunts and uncles.
10. Decree Law 1598, Art. 61, para. 1,b.
11. *Id.,* at para. 1,a.
12. Decree Law 1598, Art. 60, para. 3. See also N. Latorraca, *Legislaçao Tributária,* 11th ed. (São Paulo: Atlas, 1988). Unlike other countries, Brazil treats partnerships as legal entities separate from the partners for tax purposes.
13. Instrução Normativa 2/69, Secs. 130 and 131.
14. Federal Court of Appeals (Tribunal Federal de Recursos), 4th Section, Civil Appeal 46.865-SP, of 29 June 1983, and Taxpayers Court (*1st Conselho de Contribuintes*) Decision No. (Acórdão) 103-6.850/85.
15. Taxpayers Court Decision No. 103-02.007/77 in Centro de Estudos da Fiscalização do Imposto de Renda (CEFIR) 129. See also H. De Oliveira Coelho, *Distribuição Disfarçada de Lucros,* 1st ed. (São Paulo: Resenha Tributária, 1988), at 44.
16. Taxpayers Court Decision Nos. 101-74.505/83 and 101- 77.022/87, in *Diario Oficial da União* (DOU) of 10 February 1984 and 11 March 1987, respectively.
17. This position, adopted by the administrative courts, has not been accepted by most commentators.
See Superior Taxpayers Court (*Câmara Superior de Recursos Fiscais)* Decision 01-0.3561/83; Federal Court of Appeals, 4th Section, Appeal on Writ of Mandamus 105.605/85-SP; Federal Court of Appeals, 4th Section, Appeal 104.495-SP, in *Diario da Justiça da União* (DJU) of 8 August 1988.
18. Taxpayers Court Decision No. 101-72.350/81, in DOU of 31 August 1988.

foreign shareholder.[19] The penalty imposed on the controlled entity consists of disallowing the deduction of the additional cost via depreciation or disallowing the loss in the eventual resale of the assets.[20]

3. *Waiving deposit for an option*

Before the current transfer pricing rules were enacted it was common for controlled entities to place a certain amount of money in escrow to secure an option to purchase real property owned by a shareholder, and then waive its right to effect the purchase, thus forfeiting the deposit. The amount forfeited is now deemed a distribution to the related party and is not deductible for the controlled entity.

4. *Transferring the right of first refusal*

The legal definition of this type of transaction is rather narrow: to transfer to a related party the right to subscribe to the shares of a corporation, either for no charge or for a price below the market price of such a transfer.

According to the legal definition, the transaction requires the following:
(a) a corporation (therefore it does not apply to partnerships or limited liability quota companies);
(b) shares of stock traded on the stock market (close corporations are therefore excluded); and
(c) a negotiable value of the subscription right (i.e. not a theoretical value but rather a value that can be readily ascertained by third parties in the stock market).[21] For example, let us assume that a publicly-held corporation where the controlled entity has an equity interest contemplates increasing its capital, and that the controlled entity, rather than exercising its preferential right to subscribe to the increase, transfers the right to its controlling shareholder or related party for $ 10 – the same subscription right is traded on the market for $ 12. The difference between the market value of the right to subscribe to the stock and the transfer value will be treated as a dividend distributed to the beneficiary controlling shareholder or related party, and at the same time, will be added to the controlled entity's taxable income.[22]

5. *Lending money*

Loans, advances and other forms of making cash available to a related individual (including partners' draw and payments by the controlled entity of shareholders' personal expenses)[23] are subject to allocation even if made at arm's length (i.e. charging interest and monetary correction at market rates) whenever the controlled entity has retained earnings or profits during the period within which the amount of the loan or like transaction is outstanding.[24] If the controlled entity has no retained earnings or profits when the loan or advance is extended but accumulates earnings or profits during the period of the loan or advance, the Brazilian Treasury may allocate income up to the amount of the loan or advance, or of the retained earnings or profits, whichever is lower.[25] This rule applies only to loans or advances made to a related individual, not to a legal entity.

Surprisingly enough, if the controlled entity does not have retained earnings or profits and lends or advances cash to a related individual, charging no interest or charging interest below market rates, the transaction will not be subject to the allocation of income rules. The administrative courts have held that under such circumstances the transaction is not a transaction subject to scrutiny nor should it be treated as a transfer of assets for a price far below market value.[26] However, when the controlled entity borrows funds in the market to fund the loan to a related individual, deduction of the interest and monetary correction expenses may be disallowed as *unnecessary* to the operational activities of the controlled entity.[27]

If funds are lent to a related individual while the controlled entity has retained earnings or reserves of profits, any monetary correction and interest received by the controlled entity are subject to tax even if the loan was at market rates, and the amount lent must be deducted from the entity's retained earnings or profits for purposes of monetary correction of equity at year's end.[28] The effect of reducing the retained earnings is a lesser amount of deductible monetary correction as a result of applying the same index of monetary correction over the controlled entity's equity and fixed assets.[29]

When the loan or advance is extended to another legal entity directly or indirectly related to the lender, the transaction is not subject to allocation of income, provided the lender recognizes as income, and for tax purposes only, the monetary correction which would otherwise be charged to the borrowing entity.[30] The term *loan* is used in the broadest sense possible to include loans of any fungible property, such as raw materials and flows of cash within a group of companies using a centralized treasury system.[31] Advances made with the express and irrevocable purpose of increasing the capital of the borrower[32] and transactions between financial institutions in the ordinary course of business[33] are not subject to allocation of income or to the recognition of monetary correction requirement.

These rules and exceptions allow a great deal of flexibility in tax planning and are often used to shift income from one company to another, particularly when the investment of cash in the financial market generates a return greater than the use thereof in productive activities.

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19. Taxpayers Court Decision No. 101-71.580/80, in DOU of 7 April 1980.
20. Decree Law 1598, Art. 62, II.
21. Decree Law 1598, Art. 60, IV.
22. Decree Law 1598, Art. 62, I.
23. Taxpayers Court Decision Nos. 101-71.617/80 and 102-19.705/83 in CEFIR 156 and CEFIR 201, respectively.
24. Decree Law 1598, Art. 60, para. 8.
25. H. Higuchi, *Imposto de Renda das Empresas,* 13th ed. (São Paulo: Atlas, 1988), at 325.
26. Taxpayers Court Decision No. 101-77.033/87, in DOU of 11 March 1987.
27. Law 4506, Art. 47, para. 1, and Taxpayers Court Decision No. 101-75.558/84 in CEFIR 232.
28. Decree Law 1065, Art. 20, VII, and Revenue Ruling 24 of 5 December 1983.
29. For those not familiar with the Brazilian indexation system it is worth noting that corporate taxpayers must apply an annual index of monetary correction set by the government over the total fixed assets and total equity shown in the annual balance sheet. If the result of applying monetary correction over the fixed assets is greater than the result of monetary correction over the equity, then the difference is taxable as active monetary correction or gain. In the opposite case, that is, if monetary correction over equity is greater than monetary correction over fixed assets, the difference is deductible as passive monetary correction or loss. For the beneficiary of the loan, the difference between the monetary correction and interest charged and the market rates is deemed to be dividend income and taxable as such in the beneficiary's tax return, subject to penalties if not reported.
30. Decree Law 2065, Art. 21.
31. Revenue Ruling 10 of 13 September 1985.
32. Revenue Ruling 17 of 20 August 1984.
33. Decree Law 1598, Art. 60, para. 1.

6. *Rent, royalties or fees*

As in the other cases discussed above, the difference between the rent, royalties or fees and the respective market value must be excessive to be subject to the allocation of income rules. The market value of real property rentals may be easy to establish by expert opinion, based on comparable property. However, establishing the market value of royalties and fees is difficult because patents are differentiated and technical assistance can be distinguished from like services. In this connection, the Brazilian Treasury has used certain percentage limitations,[34] created more than 30 years ago to put a cap on deductibility of royalties by the licensee. These limitations, however, are outdated and not based on market indicators.[35]

With respect to licences between related companies, the deduction of royalty payments by the licensee is conditioned on approval of the contractual terms by the Brazilian Industrial Property Agency (*Instituto Nacional da Propriedade Industrial*), which, as a matter of policy, does not approve payments under a licence from a foreign parent to its Brazilian subsidiary.[36] When the beneficiary of the royalties is a related party, the expense may not be deductible regardless of the amount, if approval is not obtained. Application software licences, on the other hand, have been classified by the Brazilian Treasury as technology transfers for tax purposes, even though Brazil affords software the protection of copyright laws.[37]

Notwithstanding the practical obstacles above, the law provides that the difference between the rent, royalty or fee paid and the respective market value will be treated as dividend income for the beneficiary and will not be deductible for the controlled entity.[38]

7. *Other transactions*

The last category comprises "any transactions" other than the six listed above, in which the controlled entity accepts conditions more favourable to the related party than those under which the entity would have contracted with a non-related party. This imprecise definition was introduced in 1983,[39] and has not yet been tested in court. It is doubtful whether Brazilian tax principles would allow such a vague and broad description of conduct to be subject to penalties. If the underlying assumption in transfer pricing cases is that, unless otherwise shown by the parties, the transaction was an attempt to disguise the actual transaction between the controlled entity and the related person, then the system requires a minimum degree of certainty to guide taxpayer conduct. This broad legal mandate deviates significantly from the principle that the legal description of questionable transactions is to be construed strictly and that the list of transactions is exhaustive.[40]

III. CONCLUSION

The law provides that the consequence of entering into this broad type of transaction (described in 7 above) is the non-deductibility of the amounts paid or credited to the related person;[41] however, there is no reference to the consequences for the beneficiary of the non-arm's length transaction.

The transfer pricing rules of Brazil have not yet reached a technically satisfactory level of fiscal justice. They are too strict in some instances (e.g. lending to individuals) and too flexible in others (e.g. lending to legal entities). In addition, the rules are inconsistent with current business practices (e.g. royalties and fees) and inconsistent with legal principles of taxpayer security (as in the case of other transactions). The trend, however, is to enlarge the scope towards a more comprehensive and detailed description of the legal types of questionable transactions.

34. Portaria 436, issued by the Ministry of Finance on 30 December 1958, sets forth the maximum percentages allowed for deduction of expenses with royalties, fees and other payments in consideration for patents, trade marks and technology licences. It also provides that any excess paid by the licensee must be added to the licensee's taxable income.
35. See Higuchi, *supra* note 25.
36. Law 4131 of 3 September 1962, Art. 13, and Revenue Ruling 102 of 26 September 1975.
37. See Revenue Ruling 79 of 11 September 1975, and Law 7646 of 18 December 1987.
38. Decree Law 1598, Art. 62, V, and Law 4131, Art. 12.
39. Decree Law 2065, Art. 20, II. See also Revenue Ruling 24 of 5 December 1983.
40. Federal Court of Appeals, 4th Section, Civil Appeal 46.865-SP of 29 June 1983. See also N. Latorraca, *supra* note 12, at 365.
41. Decree Law 2065, Art. 20, VIII.

IFA NEWS

INTERNATIONAL FISCAL ASSOCIATION

BRITISH BRANCH

A meeting was held on 15 January 1991. The subject of the meeting was recent U.K. tax treaty developments.

The Manchester sub-branch has scheduled the following meetings:
16 January 1991 – International Remuneration Planning
20 February 1991 – U.S. tax update
24 April 1991 – Tax Cases Review
22 May 1991 – VAT and Europe.

INTERNATIONAL:

WHITHER TAXATION IN THE COMMONWEALTH?

S.I. Chelvathurai

This article is based on the Fifth S. Ambalavaner Memorial Lecture delivered by Mr. Chelvathurai on 6 September 1990.

Mr. Chelvathurai is Executive Secretary, Commonwealth Association of Tax Administrators. He was a Commissioner of Inland Revenue in Sri Lanka and served as Fiscal Officer at the Ministry of Finance and Planning, Sri Lanka, from 1980-84.

INTRODUCTION

Taxation in the Commonwealth has a somewhat chequered history. In medieval England, a table marked like a chess board was introduced, on which tax money was placed and counted. It was known as the Exchequer, and the Chancellor and other officials had places allocated around the tax table. Later the Poll Tax (or Head Tax) was introduced with a view to taxing both rich and poor. Because the poll tax was unfair, it generated considerable unrest, culminating in the Peasants' Revolt of 1381. Rebels beheaded the Chancellor, the Treasurer and two other Ministers of the King. More than 600 years later the Poll Tax has again been introduced in Britain and has, of course, caused widespread dissatisfaction. A tax which is too regressive and not based on ability to pay can easily become a harsh and iniquitous levy, particularly when the tax charged is high. It is indeed difficult to believe that a primitive tax such as the poll tax remains in vogue even in more enlightened times.

Another novel form of taxation introduced in England in medieval times was the Hearth Tax (or Fireplace Tax) which sent tax assessors into peoples' homes to count their fireplaces. This extremely unpopular tax was abandoned in 1691. The Window Tax was still another tax which engendered hostility. Many people objected to the tax so much that they had their windows bricked up to avoid paying. Over the years, a preponderance of indirect taxes were levied on all manner of things, often those which evidenced status or were fashionable – watches, racehorses, servants and even bachelors.

Income tax was first introduced in Britain in 1799 at progressive rates of 0.8 to 10 percent in order to recoup the losses incurred during the war across the Atlantic. Income tax was subsequently withdrawn and reintroduced at regular intervals and has been the central element in the British tax structure since 1842. Over the years, with the expansion of the British empire, Britain introduced income tax and other forms of taxation (e.g. excise duties) in most of the colonies which now form part of the Commonwealth. In the 1920s, a model income tax ordinance (drafted by Britain) was used in the colonies. A study of the tax codes of most Commonwealth countries reveals many similarities in basic structure.

The revenue function of taxation has long been regarded as its primary purpose. In more recent times, however, taxation has come increasingly to serve general social and economic policy objectives of government. A burgeoning social awareness in the latter half of the 19th century gave governments a social purpose – the establishment of social justice in a welfare state. With the dawning of the concept of social welfare, the tax structure was charged, for the first time in 1909 in Britain, with fulfilling an equity objective. The Keynesian revolution of the 1930s focused attention on the use of the tax structure to mitigate fluctuations in economic activity. In the 1960s and 1970s, taxation was seen as the ideal vehicle to accelerate the rate of capital formation and promote conditions for rapid economic growth. This led to a proliferation of tax incentives legislation in various countries to achieve the social and economic policy objectives of the governments in power.

The rise in the levels of taxation in this century is largely a consequence of the altered perception of the proper role of the government in allocating resources, redistributing income and stabilizing the economy. The growing importance of the redistributive function of government inevitably led to the growth of the public sector and consequently to the increase in the levels of taxation. This also contributed to the importance of income tax in the 1960s and 1970s.

Personal taxation and corporate taxation reached record levels during the 1970s and early 1980s. In the United Kingdom, for example, the effective rate of tax reached 92 percent in 1976/77. But the wheel has now turned full circle. There is a perception that the high tax rates encouraged a proliferation of tax expenditures which eroded the principle of equity upon which the entire structure of income tax was based. It became evident that the income tax was progressively becoming an inequitable tax. Led by economists like Arthur Laffer who popularized the view, the lower the tax rates, the more tax, attitudes of the industrialized nations took on a conservative cast.

This is the global scenario as far as taxation is concerned. I shall now deal with some of the taxation trends in Commonwealth countries in the context of these developments.

TAXATION TRENDS

Corporations or companies have evolved into institutions of major significance in modern society. The general advantages of the corporate form of organization over its non-corporate rivals are only too well known. In recent times, corporations, particularly the larger multinationals, have begun to wield immense economic power.

Various forms of tax are imposed on corporate profits. Corporations were originally taxed in Europe under a schedular system. From this emerged the classical system of treating a corporation as a separate legal entity. Under the classical model, shareholders are taxed separately on dividends. At the other extreme, the corporation is viewed merely as a conduit, with the corporation tax being treated as an advance payment of the tax due from the shareholders. The integration of the corporation tax with the income tax of shareholders is achieved under a variety of systems, the most common and most effective of which is the imputation system – so called because when dividends are paid it imputes or allocates to individual shareholders the profits and tax paid by the company, i.e. the tax paid at the company level is credited to shareholders.

An emphatic trend can be observed with regard to the corporate tax systems adopted by Commonwealth countries. Until 1987, 18 out of 35 Commonwealth countries followed the classical system of corporation tax, with 16 countries adopting the partial or full imputation system. However, in 1987 three more countries, (Australia, New Zealand and Sri Lanka) switched to the imputation system, thus aligning themselves with many other countries.

The imputation system is designed to improve horizontal and vertical equity. By avoiding economic double taxation of distributed earnings, tax on dividends is brought into alignment with tax on other returns to capital, thereby achieving complete neutrality in the taxation of corporate earnings. Drawbacks of the classical system include discrimination in favour of debt, retention of profits and the application of such retained profits towards socially less productive purposes, a higher tax burden and a shift towards unincorporated business organizations. The move to an imputation system can therefore have a definite impact on international income flows and can influence investment decisions.

Another noteworthy feature of the corporation tax reform programmes undertaken by Commonwealth countries over the last several years has been the bold reductions in the rate of corporation tax. For instance, Barbados, Jamaica and St. Lucia in the Caribbean region have reduced their rates from 45 percent to around 33 percent; Ghana, Mauritius, Malawi, Nigeria and Zambia in the African region have made reductions ranging from 50 to 60 percent to 35 to 45 percent; in Asia, India has announced a reduction of the rate from 40 percent to 35 percent for public companies, and Singapore has slashed its rate from 40 percent to 31 percent.

A study of the individual income tax system of the Commonwealth countries reveals a similar trend which is also evident worldwide. At the outset, most Commonwealth countries had a simple system of income taxation purely as a revenue measure.

But increasing demands on the Exchequer, prompted by the heavy capital costs of a developing economy, made it necessary to expand the scope of taxation by widening the tax net and raising the level of taxes through a progressive rate structure. In the United Kingdom, for example, the highest rate of income tax on investment income was 98 percent in 1979. Other Commonwealth countries which had a high marginal income tax rate of between 70 to 75 percent before the 1980s (and some even in the early 1980s) were Barbados, Botswana, Mauritius, Nigeria, Sierra Leone, Sri Lanka, Tanzania, Trinidad and Tobago, Uganda and Zambia.

The major changes in the U.K. tax incentives scheme announced in the 1984 Budget brought home the fact that here was a country which was moving away from the traditional tax incentives system. What were the reasons for this? What generated concern was the fact that these incentives provided fertile ground for sophisticated tax planners and had produced a multiplicity of tax shelter schemes and dodges. It was the U.K. experience that every tax incentive required additional legislation to prevent abuse. Special tax relief provisions were frequently called into question on the grounds that they distorted taxpayer decision-making and that in economic terms they produced a less than optimum allocation of resources. It became more widely recognized that tax incentives eroded the tax base and unnecessarily complicated the tax laws. After careful review the U.K. government opted to provide compensating reductions in the income tax by reducing the rates of tax.

The Canadian White Paper, "Tax Reform 1987", adopted a similar stance. According to the White Paper, an income tax with high rates relieved by an unfair patchwork of special incentives is not the solution: "[W]hat Canada needs is a fundamentally different approach: lower tax rates and a broader, fairer tax base." Under the new scheme – now in operation – there are only three rate bands (as against ten rate bands) for individuals, i.e. 17 percent, 26 percent and 29 percent.

This general trend of rate reductions, which was set by the United Kingdom and other developed countries, seems to have been followed by almost all Commonwealth countries. Out of 35 Commonwealth countries, 29 have effected rate reductions.

Another trend which has emerged in recent times is the increased reliance on sales tax, VAT and other forms of indirect taxes to meet revenue targets, particularly those of developing Commonwealth countries. In fact, Commonwealth countries like the Bahamas and Grenada have moved away from income tax. Grenada replaced income tax with a VAT in 1986 but, according to reports, the VAT system is not working satisfactorily and Grenada is in the process of reviewing its tax structure. New Zealand introduced a Goods and Services Tax (GST) in 1986, which is a simplified form of VAT with a single rate of 10 percent (increased to 12.5 percent in 1989) applied across the board with almost no exemptions. The New Zealand GST is working very well and has become a model for developing countries in the Commonwealth. Trinidad and Tobago introduced VAT last year, based on the New Zealand model, while Canada introduced a 7 percent Goods and Services Tax this year. In Sri Lanka, the turnover tax which now yields twice the revenue as income tax, has become the mainstay of government revenue. A switch to VAT, however, is being contemplated. Other Commonwealth countries contemplating the introduction of VAT are Cyprus, Jamaica and Malta.

Several advantages are inherent in the VAT system. Adoption of the VAT is generally viewed as a move towards an improved system of indirect taxation. Studies focusing on the economic effects of VAT on the level of prices, exports, investment and income distribution have shown, for instance, that introduction of VAT has a favourable influence on exports, with a lowering of investment costs and a lower burden on capital goods, as most countries provide for a full credit for the tax on the purchase of capital goods. Because VAT is levied only on value added, it prevents distortions in the pattern of goods produced. It also prevents any revenue distortion as the tax is not cumulative, with no cascade effect as in the case of turnover taxes. It is also possible to make accurate revenue forecasting.

There are, however, certain constraints, particularly in developing countries, which must be carefully considered before VAT is introduced. The administrative problems of a VAT system can be formidable. First, all taxable transactions must be fully recorded. Traders must be capable of maintaining proper records with fairly high bookkeeping standards. Second, detailed invoices must be issued for all transactions so that the trader can claim the input tax. Third, and most important, the tax administration must be efficient and fully equipped to tackle the problems under a VAT system. The invoicing system must be carefully monitored in order to control the illegal transfer of tax invoices to a third party and prevent introduction of fictitious invoices. All claims for tax credit on invoices will need to be scrutinized critically to ensure that credit is given only on taxable transactions and not, for instance, on exempt goods.

Countries contemplating the introduction of VAT should undertake an exhaustive study of the administrative implications of such a system and should take their time over it (for instance, Korea and Taiwan spent between five and ten years before introducing VAT and the system works well in both countries).

You may wonder why there has been this sudden upsurge of interest in tax reform. Perhaps politicians have discovered that tax reform can be a vote-winning issue. The OECD has identified three factors. The first is tax competition. Capital and certain categories of labour have become more geographically mobile as economies have become more integrated and trade barriers have been removed. In this new environment, governments may reason that the tax system must not get too much out of line with the systems of their major competitors (capital-exporting or capital-importing). The second reason is a new emphasis on structural adjustment. Many governments critically reviewed their existing tax systems when new research called attention to the distorting influence of tax systems, particularly during a period of sustained inflation and rapid price changes. The third factor, according to the OECD, is the fascination effect. With improved communications, we learn more rapidly, and when we see something we like, we quickly imitate. Politicians and even policymakers like to be trendy and follow fashion. The extent to which these tax reform measures achieve the goals of simplicity, fairness and efficiency will need to be evaluated by each individual government.

TAX ADMINISTRATION

How does the tax administrator fit into this vast upsurge of tax reform and change? It was Professor Carl Shoup (an eminent economist and public finance expert) who said that tax administration is the key to tax policy. To be effective any tax reform programme must be supported by sound and effective administrative machinery. Far-reaching and significant developments in tax administration have taken place in many Commonwealth countries in recent years. These developments have taken place concurrently with the general tax reform programmes.

Strategic planning, or corporate planning, has been a dramatic innovation in tax administration. Concepts of planning and control have been around for decades and have long been accepted as a *sine qua non* for efficient management, but until recently, only private sector organizations achieved the most progress in integrating these concepts into the organization. Public enterprises and government departments have belatedly evolved methodologies to apply these concepts effectively, having been accustomed to management by crisis.

New Zealand evolved a simple yet effective strategic plan in the mid-1980s. Some convincing answers have been provided to the question: Why plan? According to New Zealand, it is essential that public money be spent wisely and resources used efficiently. Top managers must ensure that the work and people under their command are properly directed, coordinated and motivated. Responsibility is assigned in relation to an entire business operation. Clear-cut targets are provided and performance is tested in each activity. It is encouraging to find that even smaller tax administrations like Papua New Guinea and Singapore have formulated both long- and short-term strategic plans.

The computer revolution has remoulded the face of society and man's overall behaviour pattern. It is now generally accepted that the computer can handle and integrate more data than any human being. It can store, collate and analyze information with unimaginable speed and perform complex calculations with startling precision. There is no gainsaying that computerization of tax administrations improves efficiency, makes them cost-effective, provides better public service, provides more up-to-date statistical data and an efficient information network. In addition to the developed countries in the Commonwealth, several tax administrations in the developing countries have also embarked on computerization programmes. This is the most far-reaching of the innovations introduced by the tax administrations of the Commonwealth countries in recent years.

A development related to computerization is the development of information systems in a number of tax administrations. It is interesting to discover that modern technology is being used through the information systems for activities like maintenance of a taxpayer master file, filing of returns, examination of returns, audit of files, collection and recovery, training of officials and taxpayer education, all of which are basic to a tax administration.

Another recent experiment has been the matching of a national identity number system with tax file numbers. Canada requires the social insurance number to be recorded on most transactions, whilst Australia has recently introduced the tax file number system under which a person entering into a specified transaction must quote his tax file number. This requirement extends to bank accounts and the purchase of shares; financial institutions and companies alike are required to report annually details of interest or dividends paid, together with the relevant tax file numbers. Jamaica, too, has introduced a similar system called the Business Enterprise Number System (BENO). In Sri Lanka the income tax file number must be quoted on several documents.

The self-assessment system is also gaining in popularity. Sri Lanka can take credit for popularizing this system, which was introduced as far back as 1972. The advantages of self-assessment are well known, so I shall not enumerate them. Australia, Canada and New Zealand, among the developed Commonwealth countries, are the other success stories as far as self-assessment is concerned. Four other Commonwealth countries, including India, have now introduced self-assessment, while 11 countries have a system of advance collection of tax from companies.

A radical departure from the traditional form of assessment in recent years has been the selective audit of income tax files, based either on random sampling techniques or on predetermined criteria. Some tax administrations like Canada have evolved a computerized selection based on a points system. No tax administration has either the staff or the resources to examine all files in detail. Selective audit is more cost-effective provided the selection or screening process is prudently deliberated. It is noteworthy that in two of the Commonwealth countries with extensive and long-standing systems of selective review, the ratio of accepted accounts to in-depth examination is strikingly similar. Only three percent of the files are audited. Countries which adopt a selective audit are satisfied that such a system maintains its credibility and deterrent value, and thus the general standard of taxpayer compliance, provided the tax administration has an effective system to deal with non-compliance. In essence, what really matters is how taxpayers perceive the tax administration. Do taxpayers feel that the tax administration is both efficient and effective? Such a visibility effect is crucial for improved tax compliance.

This brings me to the subject of voluntary compliance. What measures have tax administrators taken to improve voluntary compliance? Taxpayer education, which was given low priority some years back, has been gaining in importance in recent years and it is now felt that well-reasoned taxpayer education programmes can go a long way in improving voluntary compliance. Most Commonwealth countries now have some form of taxpayer education programme built into their systems.

Publications can be considered as basic to any taxpayer education programme and most Commonwealth countries have been providing these facilities. In Cyprus, for instance, forms design is undertaken by the Studies and Research Section of the Head Office, whilst Singapore has a Forms Design Committee whose members undergo a formal course on forms design. However, in most developing countries, there is no specialized training for officers engaged in forms design. In a recent publication on forms design by a senior official of the U.K. Inland Revenue, attention was drawn to the fact that the cost of producing a form is small in relation to the cost of using it. According to this publication, for every £ 1 spent on production, it costs £ 20 to use the form; the author concluded that more resources made available for forms design and publications will produce a handsome dividend in lower administrative costs. Tax administrators should ensure that resources are deployed for this all-important function.

Most Commonwealth countries now have some form of taxpayer assistance centre to handle routine enquiries from members of the public. An interesting trend in recent years has been the setting up of mobile units as part of the taxpayer assistance programmes. With the objective of getting tax out into the community, the Australian Taxation Office has set up shop-front information booths at major shopping centres across the country.

Sierra Leone has a novel but probably effective mode of taxpayer education. During return filing time, a department vehicle plies the streets of the country telling people why they should pay tax while simultaneously a team of revenue inspectors collects tax on standard assessments. Press, radio and television are widely employed by Commonwealth countries for publicity purposes and as a means of taxpayer education.

Developing countries, in particular, have been making extensive use of seminars and lectures to promote taxpayer education. Countries like Hong Kong, Malaysia, Singapore and Sri Lanka in the Asia region and the Gambia, Swaziland, Tanzania and Zimbabwe in the African region appear to be placing a great deal of importance on this mode of taxpayer education. These seminars and lectures are generally timed soon after the annual budget or near tax return filing dates. The volunteer programme has been a welcome innovation. The response to a pilot tax-help programme in Australia was so enthusiastic that the Department extended the programme. It is noteworthy that under Canada's volunteer programme during the 1988 filing season, the Department trained more than 3,800 volunteers, who, in turn, helped prepare the tax returns of 69,000 taxpayers. Trinidad and Tobago is one of the developing countries which has introduced a similar programme. Cannot more extensive use be made of this facility by other developing countries?

Quite a few Commonwealth countries have carefully planned taxpayer education programmes in their schools, which include the teaching of civics. Australia, Canada and the United Kingdom have elaborate school programmes which include school kits, videos, teacher guides and student guides. Of the developing countries, Trinidad & Tobago is again in the forefront, with a vibrant school tax programme. The Gambia, Tanzania and Zimbabwe have also tried to introduce some form of tax education programme in schools. As this has been identified as a vital area for taxpayer education, perhaps the time has come to introduce similar programmes in other Commonwealth countries. Must it be a political decision? How should the planning of the curriculum be done and what are some of the constraints? These are some of the questions which should be given special consideration by the planners.

It would appear that outside agencies, like professional bodies, Chambers of Commerce and trade associations have been assisting tax administrations in taxpayer education programmes, particularly in the developing countries. Can these outside agencies be called upon to play a more positive role in the future? Tax administrators could perhaps identify some of the areas or programmes in which they can make a more positive contribution.

Withholding tax at source is universally recognized as the most effective and inexpensive method of collecting tax. In recent years, several Commonwealth countries, both developed and developing, have increased the coverage of withholding tax even on non-investment income, so much so that withholding tax is fast becoming the cornerstone of most revenue systems. Withholding tax at source assists compliance, avoids the problem of inability to pay (or rather, makes taxes psychologically easier to bear) and puts the revenue into the government coffers more quickly. Withholding tax is now levied on a wide range of sources even in respect of resident recipients. For example, more countries now levy withholding tax on interest paid to residents. It is significant that as many as 15 Commonwealth countries impose such a withholding tax, while a few countries (e.g. Nigeria and Uganda) impose withholding tax on management and consultancy fees paid to residents. A withholding tax on payments made to resident contractors is now imposed in Australia (under the prescribed payments system), Ghana, Malawi, Nigeria, Sri Lanka (in the form of a turnover tax withholding) and the United Kingdom. Four Commonwealth countries have a withholding tax on the supply of certain goods (Bangladesh, Ghana, Malawi and New Zealand). It is not clear, however, whether the latter form of withholding tax works satisfactorily.

The late Professor Stanley Surrey (an eminent Harvard don) epitomized the importance of the collection function when he observed: "The final stage – in fact the goal of tax procedure – is the collection of tax. The sure sign of an ineffective tax administration is the presence of a very large delinquency in tax payments, for it indicates the lack of taxpayer respect for the tax system." Tax administrations have designed their collection systems, either by integrating or separating the assessment and collection functions. Whatever the system, however, it should ensure maximum effectiveness and speed. In recent years, tax administrations throughout the Commonwealth have focused more on the collection function. Computerized accounting and better planning techniques with regular statistical inputs have been introduced in several countries in an effort to improve collection. Administrators now feel that the recovery process could be made more effective if better use is made of the available administrative procedures and with more stringent penalty provisions for default. Staff motivation and upgrading the collection function are examples of other methods tried by Commonwealth countries.

When the 18th century philosopher statesman, Edmund Burke, made the chance remark "to tax and to please, no more than to love and to be wise, is not given to men", he probably did not realize that this would become a famous utterance, to be quoted by politicians the world over to berate the poor tax gatherer. The tax gatherer's lot has never been easy or popular. From time immemorial, tax gatherers have had to strive, often against tremendous odds, to keep the royal coffers full. Revenue was needed then, as it is now, to meet day-to-day governmental expenditure and to maintain law and order.

Relations between the politician and the taxman have always been thorny. As aptly put in a recent newspaper editorial, the former has to reflect something of the public's fear and suspicion of the latter, yet the taxman and his best efforts at assessment and collection are indispensable if the politician is to have the wherewithal for his projects.

This brings me to a critical issue: the role of the tax administrator and the assessor in the process of tax reform and change. The assessor is a professional, with a tough and unenviable job, shorn of all glamour and rarely in the limelight. He is frequently pitted against eminent lawyers and experienced accountants. He also must act as a judge. To this extent, a tax man is a lawyer, accountant and judge rolled into one. He must be adept at bookkeeping, master the intricacies of tax law and keep abreast of complex case law decisions.

Issues that arise for a decision by the tax official and later by the law lords can be very complex. I would like to refer to two interesting issues that recently arose. One was a claim made by an artist for tax relief for eye surgery. This artist had instructed his accountant to claim the cost of an eye operation against income tax. "A photographer claims for his cameras and his lenses. I claim for my paints, my brushes and my canvases, but the most important tool of my trade is my eyes. I cannot work without them, so I cannot earn any money", he said.

The second case concerned a lady of modest means with a large family; the taxpayer happened to have a rare blood type. For several years the taxpayer earned the bulk of her income by donating her blood to a commercial serum laboratory that paid her by the pint. Having extracted the plasma from the taxpayer's blood, the laboratory returned the red cells to her body, thus enabling her to make "donations" twice a week rather than the four or five times per year that a donor of whole blood might manage. To keep up the quality of her plasma, however, she had to spend extra money on food and medicine. The taxman allowed part of her claim for a deduction for the cost of medicine but rejected the claim for extra food, since there were grounds for suspecting that the woman's children had been helping to eat it. Pleading her own case, the taxpayer took the matter to the tax court. The court allowed a partial deduction for the taxpayer's share of the food. It rejected, however, the taxpayer's contention that, since her body was an appliance manufacturing saleable blood, she should be able to charge her medical insurance as a maintenance cost. The court also rejected her claim for depletion allowance in respect of the mineral content of the taxpayer's blood. The taxpayer fared better with respect to the modest travel allowance she had been receiving. Taxpayers may not deduct the cost of travelling to and from work. The government denied the taxpayer's entire claim for travel costs, arguing that she had merely been commuting to work. Not so, said the court. She had been transporting her blood to the centrifuge in the only way possible: "[P]etitioner was the container in which her product was transported to market", so the travel money went untaxed.

It is in this context that the role of the tax official assumes tremendous importance. A common problem faced by most tax administrations – in both developed and developing countries – is the difficulty recruiting and retaining high calibre staff. Apart from the need to have a close connection among the selection, training, development and leadership processes in order to make optimal use of resources, there should be motivation to stimulate trained officials to fulfill the objectives and functions of the administration. The low salaries for tax officials has been identified by most Commonwealth countries as a serious obstacle which impedes the efficiency and effectiveness of the administration. A number of countries, both within and outside the Commonwealth, have introduced special incentive schemes for tax officials which to a great extent have helped curb the exodus of trained staff.

CONCLUSION

Finally, what does the future hold, and whither taxation in the Commonwealth? What are the taxation trends of the 1990s? It is doubtful that the massive tax reform programmes of the 1980s will continue into the 1990s. According to an OECD forecast, one might expect a more selective approach, where countries may tie up any unfinished business on main tax issues but also turn their attention to other areas of taxation, where changes have been proposed but have been relatively rare (e.g. property and capital taxes). Some developed countries may endeavour to use taxation to redistribute wealth by a more effective use of net wealth tax, transfer taxes and death duties. It is unlikely that we will see governments returning to the view that progressive income taxes can redistribute income; the emphasis will be on horizontal, rather than vertical, equity. There is likely to be a change in the tax mix by relying more on consumption taxes, particularly the value added tax. Over the last ten years or so, we have moved from a scenario of uncritical acceptance of the effectiveness of tax incentives to one of total rejection. According to the OECD, the next stage in this cycle is, perhaps, an awareness that tax incentives, if carefully monitored and used selectively, can be a potent tool to effectuate certain policies. Double taxation treaties will assume greater importance for promoting international investment flows.

It is in the sphere of tax administration, however, that I can envisage a new emphasis being placed in the coming years, together with a change in the attitudes of taxpayers and tax officials towards each other. Tax administrations will rely more on voluntary compliance. A profound change that is gradually evolving is the approach to taxation itself – it brings into focus the social consciousness of the taxpayer by making him a partner in the process of taxation. Taxation will be increasingly viewed as a social necessity. The tax official will no longer be considered an outcast but a catalyst in this process for the ultimate benefit of society.

It will be increasingly obvious that an effective and efficient tax system will depend on the consent and voluntary cooperation of the general body of taxpayers, employers and tax consultants. This consent depends to a large extent on the belief that tax affairs are handled fairly, and that the tax official is helpful and courteous. Such a transformation in attitude can only take place if the tax official adopts a more humane and objective approach, so as to make the process less irksome and odious to the taxpayer. In other words, the tax official should change his approach. A taxpayer should be able to go to the tax official with full conviction that justice will be served and the tax official should approach the case objectively and judicially and not with distrust and suspicion. The tax official has an obligation to be candid and open with the taxpayer.

In this connection, I would like to mention some recent documents published by three Commonwealth countries – the Declaration of Taxpayers' Rights by Revenue Canada Taxation, the Statement of Purpose, Principles and Practice by the New Zealand Inland Revenue, and the U.K. Taxpayer's Charter. Each is a Bill of Rights which consolidates and sets forth for the first time in public the principles which should be adopted in handling taxpayers' affairs, along with the rights and obligations which apply where tax is concerned. It also describes the various avenues for redress which are open to a taxpayer who feels that his tax liability has not been correctly determined. I would commend these declarations for adoption by other Commonwealth countries. Certain taxpayer rights particularized in these declarations, i.e. the right to impartiality, the right to courtesy and consideration, the right to the presumption of honesty, the right to privacy and confidentiality and the right to every benefit allowed by law, should not remain as unattainable goals, but as ends which both the tax administration and the taxpayer should strive to achieve as partners in a common endeavour. These attitudes can be positively influenced by the "service" provided to the taxpayer, by stressing that the taxpayer is a client, rather than an opponent. This is not a Utopian ideal, but a practical possibility. These are challenges which face tax administrations and taxpayers alike in the 1990s.

ARGENTINA:
Transfer Pricing and the New Criminal Tax Law

[continued from page 75]

gations, failure to file tax returns, fraud, etc. Before the enactment of Law No. 23,771, fiscal fraud was punishable by fines and imprisonment under Law No. 11,683. In practice, however, imprisonment was never imposed. Criminal Tax Law No. 23,771 abrogates fiscal procedure law with respect to imprisonment but creates a much more severe punishment system, the effectiveness of which remains to be seen. Although the law does not contain any specific penalties for violation of transfer pricing rules on intercompany operations, some general provisions of Law No. 23,771 could be applicable to transfer pricing cases.

For example, Article 1 provides an illustrative list of manoeuvers, including the non-issuance of invoices or similar documents when required to do so, over- or under-invoicing the real price of goods, or over- or under-valuing the real price of goods. If a person responsible for his own debt or that of a third party hides, modifies, disguises or fails to reveal the real economic situation or wealth in order to obstruct the assessment or collection of taxes, he will be subject to one month to three years imprisonment, provided the act results in a loss to the Treasury. Although not specifically contemplated as a transfer-pricing issue, the Law 23,771 may well apply.

Article 2 establishes that those who, by means of the manoeuvres listed in Article 1, evade tax payment beyond certain minimum amounts or percentages shall be punished with imprisonment ranging from six months to six years.

In the particular case of imports and exports, Article 10 renders liable to imprisonment (from two years to six years) those who over- or under-invoice or over- or under-value with the object of obtaining tax benefits or exemptions.

The law also provides that imprisonment penalty will be applicable without prejudice to fiscal penalties, e.g. the fines of fiscal procedure law. Finally, it is worth noting that, according to Article 16, assessment of tax or the penalties adjudged by administrative bodies will not prejudice the Treasury in respect of the commencement of criminal proceedings or any judgement rendered in such proceedings.

VI. CONCLUSION

Far-reaching consequences may ensue from rote application of the criminal tax law to the bewildering – and as yet unexplored – area of transfer pricing in Argentina. Taking into consideration that intercompany operations are subject to the provisions of Criminal Tax Law No. 23,771, a detailed analysis of the transfer pricing rules and existing case law seems a foregone conclusion. An in-depth tax analysis should be made concerning all intercompany operations that any Argentine-related company may enter into in order to avoid any criminal consequences, which might easily derive from the ambiguous transfer pricing rules which now exist.

INDIA:

BUSINESS CONNECTION BETWEEN RESIDENT AND NON-RESIDENT TAXPAYERS

Har Govind

INTRODUCTION

To understand the concept of business connection in Indian tax law it is useful to compare it with the definition of permanent establishment in the OECD model tax treaty. The general operation and scope of business connection in Indian law is often regulated in tax treaties by the concept of permanent establishment which is defined in all bilateral tax treaties, usually in accordance with the OECD model treaty.

Mr. Govind holds a Masters Degree in science and a Bachelor's Degree in law. He is a former Chief Commissioner of Income Tax in New Delhi. Mr. Govind currently practices as an advocate at the Supreme Court of India, New Delhi. He was the U.N. Consultant on taxation to the government of Iraq. He was also Director of Investigation, Monopolies Commission. Mr. Govind contributes articles on a regular basis to various international tax journals.

SOURCE RULES

The Income Tax Act (ITA) provides that income accruing or arising "directly or indirectly, through or from any business connection in India" is deemed to accrue or arise in India.[1] This applies to residents and non-residents, to Indian nationals as well as to foreigners.

A company is said to be resident if it is an Indian company[2] or if the control and management of its affairs are situated exclusively in India during the year previous to the assessment year.[3] In practice, every foreign company falls under the category of non-resident since some part of the control and management of its affairs is always situated outside India.

The amount of a taxpayer's taxable income varies according to his residence status. A resident pays tax on his worldwide income regardless of the source. An individual not ordinarily resident is subject to tax only on Indian-source income.[4] Foreign-source income is exempt unless it is derived from a business controlled in India or a profession exercised there. A non-resident also pays tax only on Indian-source income. Foreign income is totally exempt.

All income which accrues or arises in India is liable to tax, regardless of the taxpayer's residence status. Income received indirectly in India is taxed as income no matter where it has accrued. Income which is received in the first instance outside India and subsequently remitted or otherwise transferred to India is not treated as income received in India for tax purposes. Remittances to India in any particular year from income earned or received abroad in earlier years are also not chargeable to tax in India in the year in which the remittances are made.[5]

A special feature of the source rules is that, apart from income actually accruing or arising in India, income deemed to accrue or arise in India is also taxable in India. Such deemed income is that which accrues or arises directly or indirectly through or from any property in India, any asset or source of income in India, a business connection in India, or through the transfer of a capital asset situated in India.

A business connection constitutes one of the statutorily specified sources of deemed accrual or arising of income.[6] The concept of deemed income assumes importance in business operations in cases of foreign investment and where royalties, fees for technical services and other similar payments are received under collaboration agreements.[7]

1. ITA Sec. 9(1).
2. An Indian company is defined in ITA Sec. 2(26). It denotes a company formed and registered under the Companies Act 1956 and includes any institution, association or body, whether incorporated or not, and whether Indian or non-Indian, which is declared to be a company by the Central Board of Direct Taxes (C.B.D.T.) for any particular assessment year.
3. A tax year or assessment year is the financial year which follows immediately after the accounting year or previous year. The income of the previous year is subject to tax in the tax year. A previous year is defined in ITA Sec. 3 to mean the financial year commencing on 1 April and ending on 31 March next.
4. Indian-source income means income arising or accruing in India or received in India. The provisions relating to the tax base or the scope of the total income are found in ITA Sec. 5.
5. See ITA Sec. 9 for source rules.
6. The following income is deemed to accrue or arise in India:
   - salary earned in India;
   - salary payable by the government to citizens for service outside India;
   - dividends paid by Indian companies outside India;
   - interest, royalties and technical service fees payable by the government, resident (except for businesses outside India) and non-resident businesses in India.
7. ITA Sec. 9(1)(i).

BUSINESS CONNECTION

The term business connection is not defined in the ITA, nor is the source of income derived by a non-resident through a business connection defined. There is a catena of case law which indicates on the facts of each case whether or not there is a business connection. It is not necessary to wade through the plethora of decided cases. The case, *Commissioner of Income Tax v. R.D. Aggarwal & Co.,*[8] will give sufficient idea of the concept of a business connection for tax purposes.

Aggarwal is the leading case on the subject of business connection. Aggarwal, a resident Indian company, carried on business as an importer and commission agent for two non-resident exporters, one Belgian and one Italian. He canvassed orders in Amritsar for the supply of worsted woollen yarn, communicated these orders to the Belgian and Italian companies and received commission on the sales made by them. Although Aggarwal had no authority to accept any orders on behalf of the non-residents, orders were accepted, payment was received and deliveries were made by the non-residents outside India. The Italian company described Aggarwal in a letter of appointment as the sole selling agent of its products in India. The Belgian company appointed Aggarwal as its representative for the whole of India on condition that Aggarwal promised not to represent any other Belgian mill or yarn producer and not to sell Belgian yarn in India on its own account.

The Supreme Court ruled that there was no business connection in India between the resident Aggarwal and the two non-resident companies. The Court held that a business connection "involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in [India] which contributes directly or indirectly to the earning of those profits and gains. It predicates an element of continuity between the business of non-resident and the activity in the taxable territories: a stray or isolated transaction is normally not to be regarded as a business connection. Business connection may take several forms: it may include carrying on a part of the main business or activity incidental to the main business of the non-resident through an agent or it may merely be a relation between the business of the non-resident and activity in [India] which facilitates or assists the carrying on of that business...."[9]

The Court added that the question of whether there is a business connection from or through which income, profits or gains arise or accrue to a non-resident must be determined upon the facts and circumstances of each case. Mere canvassing by a commission agent in India who has no authority to accept orders or to contract on behalf of the non-resident companies is not a sufficient "real and intimate relation" to constitute a business connection.[10]

From the case law it is clear that the concept of a business connection entails several elements. A business connection requires continuity of action between the person in India and the person outside India who receives the profit. Isolated transactions between a resident and a non-resident will not constitute a business connection. A business connection must be a commercial connection intimately linked with the business of the non-resident, contributing to the non-resident's profits.

A professional connection is also a business connection. In *Barenda Prasad Ray v. ITO,*[11] the Supreme Court concluded that the word *business* was one of wide impact and meant an activity carried on continuously and systematically by a person through the application of his labour or skill with a view to earning income.

Some examples of non-resident business connections in India include:

- maintaining a branch office in India for the purchase or sale of goods or transacting other business;
- building a factory in India where raw produce purchased locally is worked into a form suitable for export abroad;
- forming a subsidiary in India to sell the products of a non-resident parent company;
- appointing an agent in India for the systematic and regular purchase of raw materials or other goods, or for the sale of a non-resident's goods or for other business purposes;
- having a close financial or professional association between a resident and a non-resident company; and
- granting a continuing licence to a resident to exploit for profit an asset belonging to a non-resident.

PERMANENT ESTABLISHMENT

A tax treaty definition of permanent establishment corresponds to the concept of business connection discussed above. The main use of the concept permanent establishment is to determine the right of a contracting state to tax the profits of an enterprise of the other contracting state. Under Article 7 of the OECD model treaty, a contracting state cannot tax the profits of an enterprise of the other contracting state unless it carries on its business through a permanent establishment situated therein. Unlike the concept of business connection which is not defined in the Indian ITA but derives from case law, the concept of permanent establishment is expressly defined in the OECD model and other treaties based on this model.

The first paragraph of Article 5 of the OECD model treaty defines permanent establishment as a distinct situs, a fixed place of business through which the business of an enterprise is wholly or partly carried on. The second paragraph contains a list of examples of permanent establishments. The OECD definition of permanent establishment corresponds in a large part to the Indian tax law concept of intimate business connection. The most common intimate business connections are through management, control, supervision or the earning of profits. These in turn correspond to examples of permanent establishments listed in Article 5, paragraph 2 as do some of the examples of a non-resident business connection given above. A branch and a factory will generally constitute both a permanent establishment under the OECD model and a business connection under Indian income tax law.

Article 5, paragraphs 6 and 7 of the OECD model treaty exempt agents and subsidiaries from constituting permanent establishments. Under Indian law, however, agents and subsidiaries are often examples of business connections. As such, any income deemed to accrue or arise from agents or subsidiaries will make the non-resident liable to tax in India. A bilateral tax treaty based on the OECD model will limit India's right to tax these business connections as they now would fall under the permanent establishment article in the treaty which exempts agents and subsidiaries from permanent establishment status. The concepts of business connection and permanent establishment, while clearly not the

8. 56 Income Tax Reports (ITR) 20 (1965).
9. *Id.*, at 24.
10. *Id.*
11. 129 ITR 295 (1981).

same, are similar. The *Port Trust* case[12] illustrates this similarity.

The Andhra Pradesh High Court in India considered the scope of the concepts of permanent establishment and business connection in *C.I.T. v. Visakhapatnam Port Trust.*[13] The Port Trust signed an agreement with a German company under which the German company promised to supply equipment which was to be fixed to a steel plate manufactured and supplied by an independent Indian company. The equipment was to be assembled and installed at the Visakhapatnam Port at the expense of the Port Trust which also promised to provide the necessary labour for this purpose as well as to pay the salary and travel expenses of the German engineer.

The Court held that in the case of a sale of machinery abroad the fact that the foreign supplier agrees to render certain limited services in India which are incidental to the contract and are customarily provided would not make the foreign supplier liable to tax in India on the basis of a business connection. The German company's supervision of the installation of the equipment does not constitute a business connection in this case. The Court then went on to discuss whether the supervision of the equipment installation constituted a permanent establishment under the India–Germany tax treaty.

The India–Germany tax treaty defines a permanent establishment as a fixed place of business where the business of an enterprise is wholly or partially carried out. The Court noted that in cases of difference between the provisions of the Income Tax Law and of an international tax treaty, the provisions of the treaty prevail over the provisions of the Income Tax Act. In this case, the Court reasoned that the words "permanent establishment" postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country on to the soil of another country. The Court concluded that the German company did not have a fixed place of business in India as the supervision of equipment installation was insufficient to constitute a permanent establishment.[14]

Business connection complexities have given rise to much litigation in the past. Fortunately, the OECD model treaty and the international tax treaties made pursuant to it have clarified many of the ambiguities inherent in the case-by-case determination of a business connection in Indian tax law through the definition of permanent establishment. By giving clear guidelines for the source of income and its tax liability, the OECD model treaty definition of permanent establishment reduces litigation arising out of business connection confusion where international tax treaties are concerned. Understanding the similarities and differences between a business connection in Indian tax law and a permanent establishment under the OECD model is helpful when addressing tax problems in this area.

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13. *Id.*
14. *Id.*

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Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608888; Fax: 040-460405.

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Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41, Germany. Tel.: (0221) 40 30 28/29; Fax: (0221) 40 30 20.

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EHSAL-F.H.S. – Seminaries, Stormstraat 2, 1000 Brussels, Belgium. Tel.: 02/210.13.30 (81); Fax: 02/217.64.12.

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IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: 071-637 4393; Fax: 071-323 4298.

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Gerard Strahan, Director, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX. Tel.: 071-236 3288; Fax: 071-248 3350.

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Hilary McCann, Director-Europe, Euromoney Institute of Finance, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom. Tel.: (071) 779 8780; Fax: (071) 779 8799.

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The Conference Organiser, The Institute for Fiscal Studies, 7 Ridgmount Street, London WC1E 7AE, United Kingdom. Tel.: 071-636 3784.

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15 July 1991 – 16 August 1991

The Ninth Annual Summer Program in United States Law and Legal Institutions is intended to give lawyers and advanced law students from other countries intensive exposure to the basic structure of the United States legal system and to significant areas of U.S. law. The Program should give participants both a basic understanding of the United States legal system and the U.S. legal profession and an in-depth exposure to specific areas of U.S. law that affect a broad range of commercial, investment, and personal activities. It is designed to serve as a low-cost alternative to a full-year's program in U.S. law or as a preface to advanced formal training in the United States.

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For more detailed information regarding the program, write to:

Ms. Theresa Dougherty
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INTERNATIONAL:

A MODEL TAX TREATY FOR THE ASIAN-PACIFIC REGION? (Part I)

Prof. Richard J. Vann

SUMMARY

The publication of the OECD Model Double Taxation Convention on Income and on Capital in 1977 (hereinafter referred to as the "OECD Model" or simply the "Model") marked 50 years of development since the first models were produced by the League of Nations in 1928 in order to assist international trade by removing tax barriers. The Model has achieved considerable success far beyond the OECD membership in spawning a bilateral network of over 1,000 tax treaties. It seeks to remove international tax barriers by reconciliation at the interface of tax systems and has produced a bilateral network because it is generally considered that the diversity of tax systems around the world means that it is not possible to have a general multilateral treaty.

Despite its success, the Model is plagued by problems, particularly those arising from the taxation of transnational corporations and corporate groups. The major issue is whether separate taxation or consolidated group taxation should be applied to the members of a corporate group across national boundaries. The Model adopts separate taxation while the international tax system moves directly and indirectly towards consolidation.

The result is that the Model is increasingly inefficient as it creates biases in taxpayers' economic behaviour. The schedular structure of tax treaties with different tax regimes applied to different types of income encourages taxpayers to recharacterize income to obtain the best tax result. The problem is made worse by the requirement of reciprocity in tax treaties even where the tax systems of the treaty partners are quite different and effective reciprocity is not achieved by formal reciprocity. These difficulties are most acute in the corporate group, and similarly the practice of treaty shopping through the use of conduit corporations is caused by the separate taxation of the members of a group.

The arm's length standard adopted in tax treaties for transfer pricing adjustments between related parties may have been appropriate in the 1930s when it was formulated but the growth of transnational corporate groups and the increasing economic interdependence of their parts mean that both at the theoretical and administrative level the test is no longer workable. The alternative of formulary apportionment probably requires a multilateral framework since it is necessary for all countries to agree on an international tax base and formulas to allocate taxing rights to different countries. Hence the bilateral tax treaty network is reaching an impasse in the transfer pricing area.

International tax problems are also arising outside the OECD Model, that is, the Model fails to deal directly with or is inappropriate for them, as the issues were not significant when the Model originated. The practice of thin capitalization and the use of tax havens have produced legislative responses that adopt consolidation tax methods and contradict the basic structure of tax treaties. Foreign currency conversion and finance leases have raised acute international tax problems in recent years. Yet the Model has little or nothing to say directly on these matters and may even be an impediment to desirable development of national tax law. Failure to adopt the Model means that countries are explicitly or implicitly changing their domestic tax laws in ways that conflict with their tax treaty obligations.

Richard J. Vann is a consultant with the Legal Department of the International Monetary Fund in Washington, D.C. He is also a professor of law at the University of Sydney and an Associate Research Director of the Australian Tax Research Foundation.

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Failure to develop responses to emerging issues is largely to be explained by the converse relationship between the growth of and change to the bilateral tax treaty network – the larger the network the more difficult it is to change because of the increasing number of treaties that need to be renegotiated. Hence the OECD is resorting to change by reinterpretation but this has only marginal effects and leads to tortuous linguistic gymnastics. Judged from a trade perspective the network seems larger than is necessary. Moreover, individual nations, especially smaller ones, find their treaty policy choices restricted in negotiations by most favoured nation status protocols so that it is often not possible to produce the best solution in a particular bilateral negotiation. By contrast, the United States regularly breaches its treaties in pursuit of its policy goals.

The search for alternatives to the current bilateral network usually leads to suggestions for multilateral treaties, but as the diversity of tax systems that is the cause of bilateralism has not been directly addressed by the OECD Model, it is not possible for the bilateral network simply to evolve into a multilateral treaty. Such multilateral treaties as exist are regional and involve countries with similar economic and cultural backgrounds so that the necessary degree of uniformity is already present. Since the rest of the world remains in bilateral mode the multilateral treaties are likely to mimic the OECD Model and hence not address its problems.

It seems likely that the OECD may soon achieve success with a worldwide multilateral treaty network in the administrative assistance area but again this can be explained by the requisite degree of uniformity of tax administration laws and international problems. Hence the desire for a multilateral treaty often expressed by the drafters of model treaties can be regarded as a call for more uniformity in tax systems.

Such uniformity may be possible in the context of trade blocs which reconnect tax to trade issues. The European Community has, despite many difficulties and setbacks, made considerable progress in this area but more with sales taxes rather than the income tax which is the major concern of tax treaties. The existing bilateral network may be one reason why the income tax has not been given as much attention in Europe. One problem of regional moves to uniformity is that they may operate as barriers to rather than promoters of worldwide tax uniformity because of the political nature of the compromises involved.

A more flexible approach to international tax problems may be possible in the context of an international tax institution structured like the GATT. The minimum requirements for such an institution are a power to determine disputes among members and to act independently as a catalyst for promoting changes to international tax rules. The advantage of this approach is the flexibility that it offers. At the beginning it would only be necessary to have some minimal generally binding rules such as an obligation to relieve double taxation and the conferring of most favoured nation status on signatories. Nations could then adopt from a menu of options a greater range of undertakings such as tax rate ceilings (without reciprocity) and non-discrimination in much the same way as tariff undertakings and side agreements operate in the GATT.

It would be possible for rules to be more general than those in the OECD Model because of the interpretative role of the international institution. Within such a structure very different solutions could be adopted to the tax problems caused by transnational corporations such as an international tax base that would eliminate current income recharacterization, transfer pricing, treaty shopping, thin capitalization and controlled foreign corporations problems.

The world does not need another model bilateral tax treaty and this approach is not recommended for the Asian-Pacific region. What is needed is another mode for the development of international tax relations. Yet the success of the bilateral tax treaty network means that nations will not move on a worldwide basis to a GATT-style institutional alternative without some confidence that it will be an improvement. Hence such an initiative will need first to be undertaken on a regional basis. The Asian-Pacific region provides an ideal proving ground because it is not so preoccupied as Europe, Africa and the Americas with other issues such as trade blocs, the conversion of centrally planned to market economies and third world debt. Moreover, it is time that the region exerted an influence on world affairs as befits its economic status, and the need for another solution to international tax problems provides the opportunity to do so.

In this paper I wish to sketch a critical view of the current state of tax treaty policy and practice.[1] This will raise the issue whether some separate action should be taken by Asian-Pacific nations on tax treaties apart from the activities in the Organisation for Economic Co-operation and Development (OECD)[2] and the United Nations (UN)[3] and apart from the current practice of bilateral negotiation of tax treaties. My argument is that, despite the achievements of the 1977 OECD Model treaty, the Model is increasingly inefficient, irrelevant and inflexible, but a worldwide replacement regime is not yet on the horizon. The way forward is for an Asian-Pacific initiative in setting up a regional tax organization to take a different approach to international tax problems.

Although the strands in the argument are many and varied, one pervasive theme is the tax treatment of transnational corporations and corporate groups. The expansion of international trade is one of the arguments commonly offered for extension of the bilateral tax treaty network, but much of this expansion occurs in the context of corporate groups.[4] I hope to show that the OECD Model is at its weakest in this area. The Model is not alone in facing tax problems caused by corporate groups. Generally, tax law has proceeded on the basis that each corporation is a separate taxpayer and that transactions between related corporations in a domestic or international setting are to be characterized for tax purposes in accord with their general legal effect. In recent times this basic tenet of the tax system has increas-

1. This is a much revised and enlarged version of a paper presented to a conference on Anti-Avoidance and Tax Treaty Policies in the Asian-Pacific Region held at Wellington, New Zealand, 9-12 June 1989 and jointly sponsored by the Asian-Pacific Tax and Investment Research Centre, the Institute of Policy Studies, Victoria University of Wellington and the Australian Tax Research Foundation. The views expressed are those of the author and do not represent those of any organization with which the author is connected.
2. Principally in the *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1977). The OECD Committee on Fiscal Affairs is engaged in ongoing work on international taxation, including refinement of the Model.
3. *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* (New York, 1979), *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York, 1980).
4. Official statistics on this matter are hard to come by. In Australia it is likely that up to one half of imports represent trade within corporate groups.

ingly been contradicted in many countries[5] although the trend still represents the exception rather than the rule. By way of example consider the arm's length principle for transfer pricing adjustments and controlled foreign corporations ("CFC") legislation. The former represents separate taxation of corporations as adjustments are made separately to the income of various corporations, although it indirectly recognizes the relatedness of corporate groups. The latter is a consolidation approach to corporate groups since the income of one corporation is directly attributed to another member of a corporate group and transactions within the group are effectively eliminated.[6] They therefore represent quite different approaches to the taxation of corporate groups.

The link between the two areas is that they are dealing in part with common problems. One of the reasons commonly put forward for the introduction of CFC legislation is to prevent transfer pricing by residents.[7] It might therefore be expected that the different technique adopted to deal with the transfer pricing problem by CFC legislation might be generalized in countries with such legislation and thus used to supplant the arm's length principle. It has, however, been especially noteworthy in recent times how so many taxpayers, tax officials and governments have been in accord in stout defence of the arm's length principle, particularly in relation to two developments in the United States – unitary taxation by some states and the commensurate with income principle adopted for transfer pricing adjustments of royalties.[8] Yet more and more countries are adopting CFC legislation.

These trends in tax legislation reflect a fundamental discord in tax policy with respect to corporate groups. Should we tax corporate groups as a whole or as separate entities? It is not only in tax policy that this discord is evident. In corporation law, corporate groups are given legislative recognition in the requirements for group accounts for example, but the courts are loath to spell out any clear policy that will detract from the separate legal personality of each corporation so strongly established in the common law at the turn of the century.[9] Even in the accounting area where the need for corporate groups to be treated as a whole has the longest and strongest recognition, problems exist in the cases of equity accounting and off balance sheet companies.[10]

My argument about deficiencies in the OECD Model will thus not be that there are problems in its treatment of transnational corporate groups for these are pervasive difficulties, but rather that the solutions in the Model (where they exist) are bad, and that increasingly the Model simply fails to deal with more recent variants of the corporate group problem. When, however, one looks for alternatives to the OECD Model, a substitute is not easy to find. Regional multilateral treaties on similar lines to the current Model on their own offer only a modest advance. A worldwide multilateral treaty, though often suggested, shows few signs of becoming a reality.

A more fruitful source of inspiration is trade policy which for some not very cogent reasons seems generally to have been cut adrift from tax treaty policy. The development of regional trade blocs and, in the case of the European Community (EC), the resulting influence on tax policies suggest that a more organic development of international tax coordination may be possible. Equally, international trade law supplies the concept of an international organization that supervises the trade area under relatively flexible and continually developing rules. The General Agreement on Tariffs and Trade (the GATT) of course is not anyone's ideal – and strictly was not conceived as an international organization at all – but it is noteworthy that a specialist international tax institution does not exist as is the case in so many other areas of international concern.

Even if it were possible to get some kind of agreement on an alternative to the OECD Model and the current network of bilateral tax treaties, the method of moving from the current situation to the new order is, in the absence of a convenient world war that wipes the slate clean, not immediately obvious. For a worldwide approach it will be necessary for the United States and Europe to be involved. For the medium term other preoccupations such as 1992 and Eastern Europe for the EC and any number of issues for the United States will crowd out new initiatives in international taxation. The time is right for the Asian-Pacific region with its new-found economic strength and uncrowded international agenda to work on a new international tax approach at the regional level. Ironically, one way for this to occur may be for countries in the region (which are relatively

5. In Australia the most obvious example is the grouping provisions now found in the Income Tax Assessment Act 1936, Secs. 80G (losses), 160AFE (foreign tax credits) and 160ZP (net capital losses).

6. It is important to realize that the mere recognition of the relationship between the corporations in a group is very different from consolidation. In the one case transactions between corporations in a group are recognized but the pricing is adjusted to reflect that which would be charged between independent parties in determining the profits of each corporation in the group. In the other case the transactions are simply ignored in determining the profit of the group as a whole. The total of the profits of a group of corporations where profits are determined separately for each corporation will be greater than the consolidated profit for the group as a single entity by the amount of dividends paid between corporations in the group. In some cases the law may use a mixture of the two concepts and the characterization of the law in terms of the distinction may be difficult, as in the case of thin capitalization, discussed *infra* in note 35.

7. Suppose an Australian manufacturer sells a good to a subsidiary in Hong Kong for $ 100 which then sells the good to an unrelated party in the United Kingdom for $ 200 and that the good is shipped directly from Australia to the United Kingdom. If as is likely it can be shown that the Australian manufacturer would sell the good directly to the independent U.K. buyer for $ 200 then the arm's length transfer pricing adjustment would be to increase the sale price to the Hong Kong subsidiary by $ 100 and the profit of the Australian manufacturer by $ 100. The CFC approach would be to calculate the income of the subsidiary as $ 100 and to attribute that income to the Australian manufacturer.

8. Unitary taxation refers to the practice of taking the worldwide profit of a corporate group and assigning a proportion of that income to the taxing jurisdiction by application of a formula usually based on sales, payroll and property within the jurisdiction as a proportion of worldwide sales, payroll and property. The approach represents consolidation since the worldwide profit of the group is taken as the starting point and not the income of the corporation that happens to be operating in the jurisdiction in question. For the commensurate with income principle, see the Tax Reform Act of 1986, Sec. 1231(e)(1) as elaborated in the White Paper of 1988 and paragraphs of text following note 29 *infra*.

9. *Salomon v. Salomon & Co.*, (1897) Appeals Court [AC] 22; see *Walker v. Wimborne*, (1976) 137 Commonwealth Law Review [CLR] 1, *Industrial Equity Ltd v. Blackburn*, (1978) 137 CLR 567; compare *D.H.N. Food Distributors Ltd v. Tower Hamlets Borough Council*, (1976) 1 WLR 852; the issue is discussed in Ford, *Company Law*, 4th ed. (Sydney: Butterworths, 1986), at 131-139 and Gower, *Company Law*, 4th ed. (London: Stevens, 1979), at 117-133.

10. Consolidation of group accounts is generally required where one corporation controls another (with control defined in various ways such as holding more than half the voting shares in a corporation). Equity accounting refers to the practice of consolidating profits of a corporation where the formal control test for consolidation is not satisfied but an element of control is present. The effect is to boost profits as a corporation will not usually pay out all its current profits by way of dividend. Off balance sheet companies are corporations that are effectively controlled but are left out of consolidation because the formal control test is not satisfied. They are generally used for keeping substantial liabilities out of the group accounts. Together the practices amount to having your cake and eating it too.

unburdened by tax treaties) to consider carefully whether they should enter into new bilateral treaties.

The argument of much of the paper will be quite general in application (that is, not limited to the Asian-Pacific area). In the final section I shall address the significance of the argument for the region. Moreover, the contrast between the deficiencies of the OECD Model and the advantages of the preferred alternative are initially presented in stark contrast so that they seem to have little in common. Towards the end of the article where I address the many incremental steps that can lead from the current bilateral treaty network to a new international tax regime, the distance and differences between the status quo and the brave new world diminish: what initially is involved is a new mode of approaching international tax relations, rather than a revolution in international tax rules.

THE ACHIEVEMENT OF THE OECD MODEL TREATY

There can be no doubt that the OECD Model Treaty has achieved a great deal, if only for the impetus it has given to the enormous growth in the number of relatively uniform double tax treaties around the world. To that extent the Model has shown that it is possible to get coordinated activity at the international level in tax matters. What is at stake is the quality and current relevance of the achievement and I will be suggesting that adoption of the OECD Model as *the* solution to international tax problems is a concept whose time has come – and gone.

Origin and Development of the OECD Model

Although the earliest tax treaty is usually traced back to the last century, the direct source of the OECD Model can be attributed to the activities of the League of Nations. In 1920 the International Chamber of Commerce and other bodies sought the help of the League to overcome international double taxation and to promote the recovery of the world trading system. Thereafter there was considerable activity by the League that produced working draft models. A fairly comprehensive model (or rather models) which are clearly recognizable as the progenitor of the OECD Model had been devised by 1928 but the League's models did not reach their final form until after World War II in the so-called Mexico and London Models with the former generally regarded as favouring source (developing) countries and the latter residence (developed) countries.[11]

This work was in effect taken over by the predecessor of the OECD and led to a draft in 1963 that followed the London rather than the Mexico Model.[12] It was following the publication of this draft that the rapid development of the world tax treaty network occurred. By the time that the final OECD Model was published in 1977, the development of a comprehensive bilateral treaty network among the members was well advanced and by now for many members will be virtually complete.

From the very beginning the approach in structuring model treaties has been to seek to *reconcile* differences and overlaps of nations' tax systems through a combination of assignment of tax jurisdiction, sharing of revenue, relief of double taxation and provision of tie-breaker rules while preserving national sovereignty in tax matters by the least interference possible with national tax rules. The premises underlying this approach are that uniformity of tax systems around the world is not feasible because countries will not cede national tax sovereignty and that consequently diversity of nations' tax rules must be handled by special rules at the interface of tax systems. A corollary that has been found to apply in practice is that the different features of each interface of two tax systems mean that reconciliation is done on a case by case basis, that is, bilateral rather than multilateral tax treaties have become the rule.

Influence of the OECD Model

The 1963 and 1977 versions were also used in negotiations between OECD members and non-members, and among non-members so that the OECD Model has had an extensive influence far beyond its membership. As already noted the OECD Model is generally regarded as being geared to the interests of developed countries, and developing countries felt the need of their own model treaty.[13] This has been supplied through the 1979 UN Manual and 1980 UN Model which in a sense owe more to the Mexico Model than the London Model, but the starting point in the drafting of the UN Model was the OECD Model so there is significant similarity in language between these two models. Developing countries are thus now heavily committed to a bilateral tax treaty network that is effectively based on the OECD Model.

The OECD Model naturally enough has also been influential in particular nations' own model tax treaties (which form the basis of bilateral negotiations). Most nations with more than a few treaties are likely to have such models (both Australia and New Zealand do) but the models are not always public documents though their contents can readily be deduced. The most notable public nation model is probably that of the United States. The United States has a number of peculiarities in its treaty policy arising from features of domestic law such as the use of citizenship taxation and international policy such as the insistence on the treaty shopping clause. What is noteworthy is that in its successive published versions even the U.S. Model has become more closely aligned with the OECD Model.[14]

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11. The various League of Nations documents are conveniently collected in Joint Committee on Taxation, *Legislative History of United States Tax Conventions, Volume 4* (Washington: USGPO, 1962); see also Carroll, "The Historical Development of Income Tax Treaties", in Bischel ed., *Income Tax Treaties* (New York: PLI, 1978), at 51-74, Chrétien, "Le Rôle des Organisations Internationales dans le Règlement des Questions d'Impôts entre les Divers Etats", 86 *Recueil des Cours* (1954 II), at 5-116.
12. See Van den Tempel, *Relief from Double Taxation* (Amsterdam: IBFD, 1967).
13. There was a suggestion in the early 1960s by the Commonwealth Chambers of Commerce that a model should be developed for the Commonwealth of Nations to take account of the fact that both developed and developing countries would be parties to treaties. The proposal was for the removal of double taxation by exclusive allocation of taxing powers but the Committee appointed to consider the matter found this to be impractical and produced a model based on the 1963 OECD draft, though it incorporated elements of the credit and exemption systems for relief of double taxation depending on the type of income in question. The only real concession to developing countries was a provision for tax sparing. See 18 *Bulletin for International Fiscal Documentation* (October 1964), at 409-427.
14. See Van Raad, *Model Income Tax Treaties* (Deventer: Kluwer, 1983), which provides side by side for comparison, the 1963 OECD Draft, the 1977 OECD Model, the UN Model and the 1981 version of the U.S. Model. Changes in the U.S. Model and its relationship to the OECD Model are elaborated in Burke, "Report on Proposed United States Model Income Tax Treaty", 23 *Harvard International Law Journal* (1983), at 220-330 (a report of the Tax Section of the New York Bar Association).

Where to Now?

Although it is possible to refine the actual terms of the OECD Model and to elaborate the commentary so as to cover new cases as they arise, the time has passed for radical revision within the current bilateral framework. In a sense the opportunity to go in another direction was lost before the 1963 draft appeared. The failure to adopt any new approach to international tax after the Second World War (compared to trade law and the international monetary system) meant that effectively the solution adopted after the First World War continued by default. In other words the OECD Model is the culmination of 50 years of development, rather than a new departure.[15]

It should not be a matter of surprise then if the OECD Model is already beginning to show its age. Just to take one example, the replacement of fixed exchange rates and exchange controls with floating exchange rates and open exchange markets inevitably has created tax problems. The OECD Model says nothing about these and work recently done in the OECD concluded that there were no major issues in the area which called for solution by tax treaties.[16] The reluctance to make changes in the Model is understandable. As the number of bilateral treaties has proliferated, the prospect of getting any major change in the Model adopted in existing treaties within a reasonable time frame is remote. An extensive series of similar bilateral treaties is much more difficult to alter in fundamentals than a multilateral treaty – unless the alteration is pursued multilaterally – which in the tax context is a major advantage of multilateral treaties over bilateral treaties. There are three important ways in which the Model is showing its age. It is increasingly inefficient in the sense that it creates biases in economic decisions by firms and governments. It is increasingly irrelevant in the sense that it fails to deal with many emerging problems in the international tax area. And it is increasingly inflexible (for most but not all countries) because of the extensive bilateral treaty network that it has spawned.

THE OECD MODEL IS INCREASINGLY INEFFICIENT

Much of the thrust of tax reform around the world in the 1980s had to do with increasing the efficiency of tax systems in the economists' sense of eliminating distortions and biases of choice. The OECD Model is out of tune with these recent developments, though the fault for this lies more in the history of the Model treaty and trends in international tax laws than with the OECD itself.

Schedular Structure and Tax Rate Limits

Double tax treaties since their beginnings have been structured on a schedular basis, that is, different categories of income have been treated differently. Thus we find in treaties articles dealing with business profits, royalties, interest, dividends, personal services income, etc. To the extent that the treatment of the various categories is different, inefficiencies are bound to arise as taxpayers will seek to achieve the best tax result by manipulating the categories. For example, if a treaty contains a zero tax rate limit on royalties compared to complete freedom of taxation of business profits of a subsidiary incorporated in the country of source, then a non-resident taxpayer which is a parent corporation of the subsidiary will be encouraged to reduce business income of the subsidiary by payment of royalties to the parent (in effect converting business profits to royalties and lowering source-country tax accordingly).

The problem is the result not so much of the separation of income into separate categories (schedules) as the different source-country tax rates ranging from zero to unlimited applied to the income. It has long been recognized that in order to operate a progressive tax rate structure at the domestic tax level, it is necessary to operate on concepts of global income rather than types of income though there always have been and will continue to be special rules for particular types of income. Because of their relatively crude structure, however, tax treaties encourage the recharacterization of income.

When this feature is considered in the context of corporate groups it becomes a considerable problem. The OECD Model is premised on the separate taxation of a corporation on its own separate income. Hence recharacterization of income achieves the same results for related corporations as for unrelated taxpayers. Indeed we do not often contemplate recharacterization between unrelated taxpayers although it is quite possible; for example, a non-resident conferring patent rights on a resident might do so by a transfer of the patent in exchange for shares producing dividend income, or leave the purchase price outstanding as a loan producing interest income, or may instead license the patent in exchange for a royalty. In the corporate group, however, recharacterization is much easier to achieve since it is a matter of indifference from a commercial view how funds are shunted around groups (as the practice of eliminating intra-group transactions on consolidation of financial accounts recognizes). There is the possibility of transfer pricing adjustments being used to deal with this problem, but as we shall see below, where the payments, of interest say, are at market rates, the applicability of transfer pricing provisions is doubtful.

In view of the problems created by the schedular structure and differing tax rates of tax treaties, the obvious query is why was this basis adopted in lieu of global concepts of income and uniform rates. The answer is both historical and administrative. At the time the original Model treaty was developed by the League of Nations, schedular tax systems were more common and a number of reasons were suggested why the claim of the source country on various types of income should be different. The major variant of the first Model developed in 1928 indeed distinguished between impersonal income taxes (by which was meant schedular taxes generally collected by withholding) and personal income taxes by which was meant a global income tax

15. There is a curious lacuna in the evolution of model tax treaties from 1946 when the Mexico and London Models were published to 1956 when the Organisation for European Economic Cooperation, which became the OECD, resolved to take over the development of the models. The work of the League of Nations Fiscal Committee which produced the Mexico and London Models was inherited by the Fiscal Commission of the UN but this became bogged down in the problems of the East-West Cold War, the North-South divide and the fledgling UN's financial problems; it was "discontinued" in 1954. If the Commission had been effective, the history of international tax developments after World War II may have been very different; for detailed discussion of its work, see Chrétien, *supra* note 11. It might almost be said that the OECD became involved in the model treaty process by default and certainly the criticisms of the OECD Model in this article should not be regarded as criticism of the OECD itself which has carried out valuable work in circumstances where radical changes to the ground rules were not possible. The UN's re-entry into the field since the late 1960s has been very much on the coat tails of the OECD.
16. OECD Issues in International Taxation No. 3, *Tax Consequences of Foreign Exchange Gains and Losses* (Paris: OECD, 1988). By contrast the floating of exchange rates necessarily led to an extensive revision of the Articles of Agreement of the International Monetary Fund.

generally levied by way of a surcharge to introduce progressivity into the income tax system.[17] Although schedular elements remain in all income tax systems at the substantive law level (for example, the requirement that capital losses not be used against ordinary income), these hardly justify a schedular tax treaty structure, and policy considerations indicate that a single flat rate of tax should be applied to all non-resident income.[18]

In the modern context the justification for schedular tax treaty provisions must be found at the administrative level. In most tax systems collection of tax from non-residents on passive income occurs by withholding at source – once the income has left the country collection of tax is very difficult. It is not possible in most cases to calculate the taxpayer's net income for withholding purposes as the payer will not know what deductions the non-resident has incurred in relation to the income and so withholding is for practical reasons usually on a gross income basis. To allow in a rough and ready way for deductions the tax rate adopted for the gross basis is usually below the tax rates applied to income taxed on a net basis (or alternatively the power to tax is assigned exclusively to the residence nation). Business income on the other hand will be taxed in the international context at normal rates in the country of source on a net basis as the taxpayer will have a sufficient presence in the nation concerned for this to occur. The application of different tax rates and methods for withholding occurs in the domestic context as well to reflect the varying circumstances involved (for example, different collection mechanisms for wages and salaries, payments to contractors, business income and property income).

Tax treaties follow this common administrative collection practice and extend it to the substantive level for international purposes by specifying different maximum rates of tax for different types of income. It may be doubted whether administrative considerations continue to justify rate differentials in tax treaties. The collection of tax across national borders is being made easier through tax treaties, while the absolute nature of tax rate ceilings is being manipulated increasingly by recharacterizing income in international transactions.

Tax Rate Reciprocity

The problem of applying different rates of tax to different types of income is compounded by the implicit assumption in all model tax treaties, including the OECD Model, that tax rates will be reciprocal. That is, where one country agrees to limit its tax on a particular type of income sourced in that country to a particular rate, the other treaty partner will agree to the exact same limitation on its power to tax the same kind of income at source. Where the treaty partners operate very different tax systems with respect to the same type of income, reciprocity can cause inefficiency.

For example, if one treaty country has a classical system of corporation taxation, while the other treaty country operates an integration regime such as a split rate or imputation system, a reciprocal tax rate limit on dividends is meaningless. This arises for two reasons. First, the integration country may wish to change its withholding tax rate on dividends paid to non-residents to reflect the adoption of integration (typically to increase the rate under a split rate system and to decrease it under an imputation system). Second, the total tax on corporate income will usually be higher in the classical tax country than in the split rate or imputation country so that an apparently reciprocal tax rate is in fact not so. The result is that the tax system is biased in favour of certain types of investment.

The best known example of this problem is the debate that has occurred between Germany and the United States in relation to differences in their corporate tax systems. Germany has sought to introduce differential dividend tax rates in its treaty framework but this has been strenuously resisted by the United States even though the result has in the past been to bias the German tax system against firms which are owned by German residents in the case of reinvestment of profits, compared to foreign-owned firms.[19] It is noteworthy again that this problem is specifically one relating to corporate groups. The apparently reciprocal dividend rates were argued to favour investment by U.S. parent corporations in German subsidiaries, as compared to investment by German residents in German corporations and by German parent corporations in U.S. subsidiaries.

Arm's Length Pricing

Where tax rates are different between countries, strong incentives are created for shifting income and deductions in order to minimize overall taxation. The most apparent incentive is to shift income to the lower tax country and deductions to the higher tax country. There are more subtle factors also at work in particular cases. If a country has adopted an imputation system that grants imputation tax credits only in respect of domestic tax payments and not foreign tax payments (by far the most common practice), there is often an incentive to shift taxable income to the imputation country even if its tax rate is higher than the other country. These practices are easy for transnational firms especially where separate corporations are created within the firm (that is, a corporate group). Unless some objective standard can be established to combat the practices, the efficiency of the international tax system will be undermined.

One of the specific problems dealt with comprehensively by the League of Nations was the income tax treatment of transactions between related enterprises or different parts of the same enterprise.[20] The method devised for this purpose was arm's length separate accounting which is perpetuated in modern treaty practice. This method clearly

17. See League of Nations, *Double Taxation and Tax Evasion* (Geneva: 1928, League of Nations official number C.562.M.178.1928.II), at 7-15, Draft Convention No. 1a.

18. This point has been made in a number of contexts by Professor Peggy Musgrave, for example, "The Taxation of International Capital Income", in Head ed., *Taxation Issues of the 1980s* (Sydney: ATRF, 1984), at 279-294.

19. See Debatin & Walter, *Handbook on the United States–German Tax Convention* (Amsterdam: IBFD, looseleaf), BVI/15-BVI/25 for the history prior to the recently ratified 1989 treaty. Even where the United States has effectively conceded differential rates (as in the 1965 Protocol and 1989 treaty), the appearance of reciprocal rates is maintained. The basic rule is expressed in terms of reciprocity and then specific exceptions are created (even though they swallow up the basic rule). This type of problem is discussed generally by Sato & Bird, "International Aspects of the Taxation of Corporations and Shareholders", 22 *IMF Staff Papers* (1975), at 384-455.

20. Carroll, *Taxation of Foreign and National Enterprises* (Geneva: Vol. 1, 1932, Vol. 2-5, 1933, League of Nations official numbers, respectively C.73.M.38.1932.II.A.3, C.425.M.217.1933.II.A., C.425(a).M.217(a).1933.II.A., C.425(b).M.217(b).1933.II.A., C.425(c).M.217(c).1933.II.A.), conducted an exhaustive study of the problem which was considered in the League of Nations Fiscal Committee, *Report to the Council* for the fourth, fifth and sixth sessions (Geneva: 1933, 1935, 1936, League of Nations official numbers, respectively C.399.M.204.1933.II.A., C.252.M.124.1935.II.A. and C.450.M.266.1936.II.A.); see also Carroll, "Allocation of Business Income: The Draft Convention of the League of Nations", 34 *Columbia Law Review* (1934), at 473-498.

adopts the separate taxation of corporations in a group – it generally accepts a transaction between related corporations as to its existence and nature but substitutes the arm's length price where the price specified for the transaction deviates from that standard. Indeed separate taxation is carried even further so that a single corporation is broken up into separate parts where it has a permanent establishment (PE) in countries besides its residence and the arm's length criterion applied as between the parts of the corporation (more on which later). In this case it is effectively necessary to construct transactions that do not occur such as a sale of goods by head office to a PE in order to apply the arm's length test.

The competing method for dividing profits of a single corporation or corporate group among jurisdictions is the application of a formula to the consolidated profits of the corporation or group. The best known examples of this approach are the so-called unitary taxes applied by a number of states in the United States. It is not intended here to rehearse the recent unitary tax debate and the examples for and against arm's length pricing raised in that context. Rather I will deal briefly with the historical origins and theory of arm's length pricing to show why the standard is no longer appropriate from a policy or administrative viewpoint as the sole method of dealing with transfer pricing, while remaining the only viable method in a world of bilateral tax treaties.

At the time it was formulated the arm's length method was sensible and practical. Most transactions in question involved tangible goods, related enterprises in different countries (whether formally part of the same corporation or separate corporations) were relatively autonomous and the volume of trade within transnational corporations or groups was sufficiently limited and of a kind that made it possible to find genuine arm's length prices for comparable transactions.[21] Even so it is noteworthy that formulary methods of apportionment were seriously considered as an alternative, and although the outcome was described at the time as "a decided victory"[22] for the arm's length method, formulary apportionment was expressly adopted as a back-up where arm's length pricing was "found to be inapplicable".

The world is now a very different place. Transactions in intangibles are increasing and perhaps dominating over transactions in tangibles (especially as many transactions in goods are accompanied by related transactions in intangibles such as a licence to use patented or copyrighted features of the goods), communications are instantaneous so that control of the various parts of a transnational corporation or group around the world is feasible, and the volume of trade within transnational corporations or groups has grown to the extent where there are many transactions which are unique to that environment.

At the administrative level these changes mean that enforcement of the arm's length criterion has become a nightmare since actual arm's length comparable prices are frequently not available and various constructs often involving formulary elements of their own have to be adopted. From a theoretical perspective these changes mean that the arm's length formula has ceased to have any real meaning in many situations involving transnational corporations. Typical cases involve economies of scale and scope or other economic interdependence as explained by Musgrave:[23]

> The second situation arises when the structural linkage among the firms renders separation of their profits an arbitrary procedure. Such linkages might consist of economies of scale commonly found within horizontally integrated firms, as well as shared costs of management, research and development and a multiplicity of other cost items. In this case, important items of the firms' accounts are inextricably interrelated so that separable production functions cannot be assigned. The various firms have then to be treated as a single unit for purposes of profit attribution. It is to be noted that this second situation provides the more fundamental rationale for combination. In the absence of these structural interdependencies, the need for combination merely rests on the lack of administrative capability to enforce arm's length pricing.

These arguments seem to have been accepted by those who originally formulated the arm's length principle.[24] The accounting profession has long since realized that the only appropriate method of financial accounting for related enterprises is on a consolidated basis with elimination of transactions among the group. At first sight it is therefore a matter of surprise that most officials and practitioners involved in international taxation so vehemently defend arm's length pricing against formulary apportionment. The reason I think is that the debate is the hostage of the bilateral tax treaty network.[25] The problem goes beyond the general inflexibility produced by the growth of that network (which is taken up below).

In order to operate a formulary apportionment system it is necessary to agree on a greater range of issues than is involved in the arm's length pricing approach. Firstly, there is the definition of the necessary relationship among corporations to bring their profits within the formula. Secondly, there is the formula (or formulas) to be used in the allocation of profits among jurisdictions and the associated measurement of the elements in the formula. Thirdly, there is the definition of the worldwide tax base used in identifying group profits. Agreement on matters equivalent to the first two of these is necessary for the operation of the OECD Model – indeed the arm's length standard itself is the equivalent to the formula referred to in the second. The third, however, involves extensive additional issues.

It arises because the formulary approach takes as its starting point the worldwide profits of the corporations that fall within the defined relationship. Unless there is agreement among all the countries that have a tax claim in relation to a particular transaction on this matter, the same scope for double taxation will arise as occurs in the bilateral context where the treaty partners cannot agree on the transfer price

21. The exercise was also simplified by two principles which limit taxing power and are contained in the OECD Model, namely the exclusion of a simple purchasing office from the definition of a permanent establishment and the exclusion of profits on purchasing activities from the tax base of a permanent establishment, OECD Model Arts. 5(4)(d) and 7(5).
22. Carroll, "Allocation of Business Income: The Draft Convention of the League of Nations", *supra* note 20, at 473.
23. Musgrave, "Principles for Dividing the State Corporate Tax Base", in McLure ed., *The State Corporation Income Tax* (Stanford: Hoover Institution Press, 1984), at 228, 236. For a good example of both sources of difficulty in the context of financial instruments, see C. Plambeck, "The Implications of Global Trading", 44 *Bulletin for International Fiscal Documentation* (November 1990), at 527-537.
24. Carroll, "Allocation of Business Income: The Draft Convention of the League of Nations", *supra* note 20, at 489-494.
25. This point seems to me to underlie the differences of opinion between Kopits & Mutén, "The Relevance of the Unitary Approach for Developing Countries", in McLure ed., *The State Corporation Income Tax* (Stanford: Hoover Institution Press, 1984), at 269-280 and the "Comments on Kopits and Mutén", by Musgrave, at 281-285, and Bird, "Shaping a New International Tax Order", 42 *Bulletin for International Fiscal Documentation* (July 1988), at 292-303 and the comment by Mutén, "A New International Tax Order?", 42 *Bulletin for International Fiscal Documentation* (November 1988), at 471-472. A number of themes explored in this paper are also discussed by Mutén, "Some logical issues concerning international double taxation", in Cnossen ed., *Essays in Honor of Richard Goode* (Amsterdam: Noord-Holland, 1983), at 317-342.

and in the context of unilateral relief of double taxation where, for example, differing source or residence rules are adopted by the countries involved. As soon as contacts with more than two countries are involved in a particular transaction, agreement of three countries at least is involved.

In theory there is no reason why the general adoption of the same standard for measuring worldwide profits in a series of bilateral tax treaties should not be possible (as has occurred for the arm's length standard) but this outcome is very unlikely because the formulary process involves a much greater encroachment on national tax rules. Under the arm's length standard, each nation's tax system operates under its normal domestic tax rules subject to the relatively minor qualification of substituting arm's length prices in certain international transactions. In measuring worldwide income for formulary apportionment under a generally agreed standard, the great diversity of tax systems around the world means that many countries would have to apply rules for measuring their tax base in international transactions that are quite alien to the rules applied in the domestic context.

In practice it seems likely that formulary apportionment can only be achieved in a multilateral framework. Is this feasible in the context of the general bilateral tax treaty network? There is already in the customs area a multilateral treaty that deals with transactions between related parties and so serves a similar purpose as the arm's length test and formulary apportionment, namely the 1979 Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade (commonly referred to as the GATT Valuation Code).[26] The Code establishes the principles for determining the valuation of goods for customs purposes. There is a clear incentive in the customs area for understating the value of goods where ad valorem duties are applied and the GATT Valuation Code allows substitution of other values besides the transaction value where the buyer and seller are related.[27] This Code exists in the general multilateral environment of the GATT and the Customs Co-operation Council (CCC) (which also provide an organizational base) and hence is not strictly comparable for judging the feasibility of a multilateral treaty on formulary apportionment in the context of the general bilateral tax treaty network without an international tax institution to rule on interpretation issues and disputes among countries.

The idea of a combination of bilateral and multilateral treaties is not new in the international tax area. Indeed it was seriously contemplated by the League of Nations Fiscal Committee when the arm's length test was originally adopted that it be the subject of a separate multilateral treaty while tax treaties generally were developing bilaterally.[28] Moreover, the multilateral Convention on Mutual Administrative Assistance in Tax Matters is currently open for ratification and is likely to come into force after the recent U.S. ratification.[29] This Convention is a joint Council of Europe and OECD initiative, so that it is clear that the OECD regards a combination of multilateral and bilateral tax conventions as feasible. Nevertheless the antipathy to formulary apportionment so evident in recent times and the general wariness about multilateral tax treaties and cooperation do not make for optimism. The question of a multilateral approach generally to international tax questions is developed below.

Within the terms of the arm's length standard itself, there are signs of a shift in thinking and the style of reasoning based on economic interdependence is having an influence, even though fundamentally contrary to the standard. The opportunities for international tax manipulation among related corporations not only involve the use of arbitrary prices but also often involve conversion of returns on equity investment to royalties and interest, and so long as the prices charged are arm's length, there seems to be little in the current OECD Model to counter the problem, for the general premise seems to be to accept the nature of transactions among related parties and to adjust only their pricing. This conversion problem arises as we have seen from the schedular structure of tax treaties and tax rate limits. In order to counter this type of manipulation it is necessary to disregard the transaction in whole or in part (in addition to questions of pricing) on the basis that unrelated enterprises simply would not have entered into the transaction in the first place.

In 1988, the U.S. Treasury and Internal Revenue Service produced a draft *Section 482 White Paper on Intercompany Pricing,* a study mandated by the Tax Reform Act of 1986 which introduced the commensurate with income standard for "transfer pricing" adjustments of royalty payments between related corporations. The basic reasoning is that a corporation would not license newly-created intellectual property to an unrelated party until its income potential is known; hence royalties stipulated in licence agreements made with related parties can be ignored and higher levels of royalties (super-royalties) deemed to be paid on the basis of later knowledge of the income actually generated from the intellectual property concerned. The study maintains that this process is consistent with the traditional arm's length standard, a claim made plausible by the fact that the adjustments are made only to prices (royalty payments), but the basic reasoning effectively ignores the whole licence agreement and not just its pricing.

The study has been greeted with protests among OECD members on the basis that it contradicts the arm's length standard.[30] Yet in 1987, the OECD study on thin capitalization adopted the same reasoning.[31] The OECD considered that the current arm's length standard in its Model justified denial of interest deductions on related party borrowing on the basis that a non-related party would not have exposed itself to the risks implied by such high levels of lending, that is, the loans can be recharacterized for tax purposes as equity, whatever the interest rate being paid. It is noteworthy, however, that the OECD regarded it as possible to determine what is the arm's length amount of debt (as

26. (1980) *GATT Basic Instruments and Selected Documents,* 26 Supp 116, 151.
27. At first glance there is a similarity between the arm's length standard and the Code. Important differences can be distinguished, however. Firstly, it is necessary in the customs area to establish a particular value for each good in view of the way customs tariffs are constructed with differing ad valorem duty rates for different types of goods, that is, a general formulary apportionment simply cannot be used in the customs area. Secondly, the Code is more detailed and confined in the way that allegedly arm's length prices can be constructed; generally it is necessary to use actual prices to establish customs value.
28. League of Nations Fiscal Committee, *Report to the Council* for the fourth and fifth sessions (Geneva: 1933, 1935, League of Nations official numbers, respectively C.399.M.204.1933.II.A., at 2, C.252.M.124.1935.II.A., at 3).
29. The United States is the fourth of the required five ratifications for the treaty to become operative; it is believed a number of other countries were waiting to see whether the United States would ratify before taking action; see 2 *Tax Notes Int'l* (1990), at 1078.
30. For example, Boidman, "The Section 482 White Paper: A Canadian Perspective", 43 *Bulletin for International Fiscal Documentation* (November 1989), at 483-497.
31. OECD Issues in International Taxation No. 2, *Thin Capitalisation* (Paris: OECD, 1977).

opposed to the interest rate) in related party situations and preferred flexible rules rather than fixed debt/equity ratios for dealing with the problem, so that again consistency with the arm's length standard was claimed.

The more the arm's length standard is subject to this kind of reasoning and "flexible" (non) rules are advocated in determining when to disregard related party transactions on matters other than price (even if the resulting adjustment only affects the price), the more uncertain the standard will become in practice. In view of its incoherence in theory as the *sole* method of dealing with related party transactions, this development is to be expected and in itself should not concern us. What is disturbing at the official and institutional international level is the reluctance to face up to the implications of the recent trends and of the growing interdependence of the parts of transnational enterprises. While ongoing development of the arm's length standard may be necessary to cope with pressing problems of international taxation, even though the standard will be inevitably transformed in the process, serious work should commence on an alternative as there is so much to be settled before the alternative could become operational, such as the definition of the worldwide tax base, and the development of acceptable apportionment formula(s) and the necessary treaty and administrative framework.

The discussion should not be taken to suggest that the arm's length standard must be replaced entirely by formulary apportionment. Although the modern defenders of arm's length pricing seem to be entirely opposed to formulary apportionment, the proponents of the latter are not entirely opposed to arm's length pricing. Their arguments are based on economic interdependence and administrative difficulties. When neither of these are present the arm's length method still provides an appropriate adjustment. Clearly in modern conditions, its role is likely to be subsidiary to formulary apportionment just as the converse was the case in the 1930s when the standard was established. The relationship between the two methods is not determined by theoretical superiority, but by the nature of international trade. The more economically interdependent the various parts of transnational enterprises become, the greater should be the role of formulary apportionment.

Treaty Shopping

Another phenomenon which has arisen purely as a result of the bilateral tax treaty network and the separate tax treatment of related corporations is the practice of treaty shopping. That is, a taxpayer resident in one country who wishes to invest in another country will not necessarily make that investment directly, but will use a series of conduit entities located in various jurisdictions in order to make use of the tax treaties between the countries concerned. The Netherlands royalty route using the zero tax rate on royalties in most of the Netherlands treaties is a well-known example. This practice may also be accompanied by recharacterizing income to obtain taxation under the desired rubric. It thus involves the inefficiencies that arise not only from differing tax rates on differing income, but also from greatly increased complexities of corporate structures.

In this case the problem is not directly caused by the OECD Model but rather by the differing tax rates on the same type of income in the treaty network that it has spawned. If all countries adopted the actual tax rates in the OECD Model then treaty shopping would not be a problem (though recharacterizing income could be expected to be an even greater problem as taxpayers sought to gain the advantage of the zero tax rate on royalties in the Model in particular).

It is evident from the various reservations to the OECD Model and the failure of the UN Model to specify tax rates in some cases that agreement on tax rates in the current framework will be very difficult to achieve. Moving to a multilateral framework along OECD lines may assist in greater uniformity of rates, but the resistance to uniform rates then becomes an obstacle to the multilateral alternative. It will probably be necessary to preserve rate flexibility for multilateralism to be feasible if the GATT experience is to be taken as a guide.[32]

The main country to take this problem seriously is the United States. All that the OECD has been able to do is to produce a report on the topic encouraging members to pursue their efforts against improper use of tax conventions.[33] The dissatisfaction of the United States with the international situation and indeed with its own treaties in this area led it in 1986 to override many of its treaties even where treaty shopping articles had been inserted to limit the practice.[34] In an age when it is possible to buy very simple computer programmes outlining the routes to use on the basis of existing bilateral tax treaties in order to reduce source country taxation on the extraction of profits from that country, much more is required than the current neglect if tax treaties are not to become counter-productive.

THE OECD MODEL IS INCREASINGLY IRRELEVANT

The problems set out above are primarily matters arising within the current OECD Model tax treaty and the bilateral framework in which that treaty is used. What is also happening is that the treaty is simply irrelevant to emerging tax issues as (not surprisingly) those issues were not anticipated in the original drafting of the Model 30 years ago. Once again the main problem area is the transnational corporate group. The OECD tries to deal with this problem by "interpreting" the Model and suggesting modifications to it to cover new cases but for reasons considered below in relation to the increasing inflexibility of the Model, these measures can only be palliatives. There are even cases where tax treaties seem clearly to apply but because this is inconvenient to achieving a particular tax policy of a particular nation, means are found by the nation effectively to ignore its treaties.

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32. In the various GATT rounds the contracting parties agree to make differing tariff reductions; it does not seem to be an objective of the GATT to get uniform tariff rates (except of zero). The GATT rules of origin in the Kyoto Convention Annex D:2 (conveniently reproduced by the CCC, *Handbook: International Convention on the Simplification and Harmonization of Customs procedures* (Brussels: looseleaf)) deal with an analogous problem to treaty shopping of determining from which country goods actually originate (in the treaty shopping case the problem is to determine the country of which the ultimate taxpayer is a resident). Rules of origin are only necessary because uniform customs tariffs for the same goods often do not exist in particular countries, for example, the GATT allows countries to give customs concessions to imports from developing countries; see Jackson, *The World Trading System* (Cambridge, Mass: MIT Press, 1989), at 142-143, 278-279.

33. OECD Issues in International Taxation No. 1," Double Taxation Conventions and the Use of Conduit Companies", *International Tax Avoidance and Evasion, Four Related Studies* (Paris: OECD, 1987), at 87-106.

34. Internal Revenue Code of 1986, Sec. 884(e), which defines treaty shopping in terms of a stock ownership rule and a base erosion rule; many U.S. treaties, including the Australian treaty Art. 16, do not include the base erosion rule and to that extent are overridden. Although the Technical and Miscellaneous Revenue Act of 1988 clarified many of the interactions of U.S. treaties and the 1986 Code, including amendment of Sec. 884(e), the basic override remained intact.

Thin Capitalization

The use of subsidiaries capitalized by debt to strip out profits by interest deductions is not new. Indeed the practice may explain why the continued very high taxation of business profits derived through a subsidiary (as compared to lower taxation of passive income) has been possible in the bilateral tax treaty network since thin capitalization has been a means of minimizing that tax. In other words the recharacterization of income involved from dividends to interest has served as a partial corrective to the differential tax rates adopted for business and interest income in the OECD Model (unlimited and ten percent, respectively). This problem is one that arises typically from the separate taxation of corporations in a transnational corporate group.

Countries around the world are increasingly moving against the practice by denying interest deductions to the corporation funded by debt advanced by non-resident related parties. This practice is arguably an application of group taxation concepts (through the elimination of transactions within the corporate group as occurs on consolidation of group accounts).[35] Nonetheless the OECD in a recent report has sanctioned the practice as being within the arm's length pricing principle and as not contrary to the non-discrimination article of the Model so long as the particular laws in question are structured in the right way using flexible standards and not fixed ratios.

In so doing the OECD has effectively rendered inapplicable one article of its Model treaty that seems to be applicable (the non-discrimination article) and rendered applicable another article that seems inapplicable (the associated enterprises article). The purpose of this quixotic approach is to prevent the OECD Model operating as a bar to thin capitalization laws. While the distaste for protection of tax avoidance practices by the Model is understandable, the practical result is to leave most countries at large in dealing with the problem and to create the potential for unrelieved double taxation all over again. It is noteworthy in particular that recent enactments in Australia and the United States use the fixed ratio approach to thin capitalization despite the OECD's views.[36]

Controlled Foreign Corporations ("CFC") Legislation

Australia is the eighth country in the world (after the United States, Germany, France, Canada, Japan, the United Kingdom and New Zealand) to adopt CFC legislation and there is little doubt that the regime will spread to more countries. Such legislation is accepted by the OECD as is evidenced by its analysis of tax havens in a recent report, yet the legislation contradicts once again the fundamental building blocks of the OECD Model.[37] Under CFC legislation a parent corporation is effectively taxed on the profits of a subsidiary resident and deriving profits in another country. The OECD Model recognizes the separate existence of subsidiaries and, as noted above, assumes the separate taxation of corporations in a group (see Articles 5(6) Permanent Establishment, 9 Associated Enterprises, 10 Dividends, 24(6) Non-Discrimination).

CFC legislation is effectively consolidation of corporation accounts in accounting terms. In this case the domestic tax legislation is seeking to bring the tax treatment back into line with the accounting treatment, but the effect is to render the associated enterprises article, and for that matter the dividend article, in the Model treaty irrelevant. The increasing use of more and more extensive legislation in the CFC area will also inevitably lead to economic double taxation of the same income. This problem is already recognized in the laws of some countries and an attempt is made to deal with it. In the case of most countries adopting such legislation, however, no such attempt to relieve economic double taxation occurs. Thus the basic assumptions and primary objects of tax treaties are being subverted by major members of the OECD.

Foreign Exchange Issues

The inevitable irrelevance of the OECD Model Treaty in this area has already been noted. Yet it is clear from recent changes to the tax laws of countries around the world (and changes in contemplation) that this is one of the crucial international tax problems of the time. Two major issues arise. First, there is the tax treatment of foreign exchange gains and losses in relation to borrowings. Second, there are the difficulties of converting foreign currencies in the calculation of income and tax liability. The former can arise both inside and outside the corporate group context, while the latter is primarily a problem in transnational corporations or corporate groups.

35. As noted *supra* in note 6, the characterization of thin capitalization measures can be difficult. Strictly, the consolidation approach requires the disallowance of the interest deduction and the non-levy of interest withholding tax on the outward payment (that is, the payment is effectively ignored, though see *infra* note 77 and text below as to interest withholding tax). If the interest is disallowed on the amount of debt that exceeds the arm's length amount (that is, how much an independent party would lend to the taxpayer), then this is separate treatment of the corporation and is argued to be consistent with arm's length treatment by the OECD. If, however, the disallowance of interest deductions is determined by fixed debt/equity ratios (as is the case in Australia, Canada and most recently the United States), it is difficult to argue that this is an application of the arm's length principle unless it is claimed to be a rule of thumb, though equally it is more separate treatment than consolidation, as some interest deductions are allowed. When ratios are used they are sometimes applied to all debt (the United States) which suggests a rule of thumb but when the ratios only apply to related-party debt (Australia and Canada), then partial consolidation seems the best explanation. (In either event the disallowance of interest only applies to related-party debt).
Where the outward payment of disallowed interest is characterized as a dividend, it cannot be argued that this is arm's length treatment as an independent taxpayer would hardly invest in equity where it would not lend. This treatment has to be justified as a secondary adjustment reflecting separate treatment of the corporations involved. In this regard the OECD discussion is very odd. It does not question the amount of the investment on arm's length principles but only its character. Normally the operation of the principles is the exact reverse, that is, the amount is adjusted but not its character.
In the light of these considerations how then is a system that disallows part of the interest deductions by reference to fixed ratios based on related party debt only yet treats the whole outgoing payment as interest to be characterized? (This is essentially the position in Australia.)

36. See *supra* note 31. The OECD rejects the application of fixed ratios to non-residents on non-discrimination grounds. Australia does not regard its law as a breach of its only non-discrimination provision in its U.S. treaty because of a saving for tax avoidance measures. The United States does not consider its law as a breach of non-discrimination as the disallowance applies to domestic tax-exempt related parties as well.

37. OECD Issues in International Taxation No. 1, "Tax Havens: Measures to Prevent Abuse by Taxpayers" and "Double Taxation Conventions and the Use of Base Companies", *supra* note 33, at 19-85. The problem that the legislation poses for tax treaties has been recognized since the United States first passed substantial legislation in the early 1960s (there is some earlier more limited U.S. legislation); see General Report, XLIXb *cahiers de droit fiscal international*, "The delimitation between the country of residence and other countries of the power to tax corporations and/or their shareholders" (1964).

Again the accounting profession has spent considerable time coming to grips with this issue and seeking to develop uniform international practice. Indeed the OECD through its arm dealing with accounting practice has actively sought to deal with the problem.[38] The tax issues have been discussed in a recent OECD document which concludes that the Model treaty has nothing to say on the topic of any note and that there are no current problems that require resolution by treaties.[39] The OECD Model treaty remains silent despite the enormous disparities (and double taxation) that can be produced depending on the basis on which exchange gains and losses on loans are taxed and foreign currencies are converted in the calculation of tax liabilities.

Tax treaties, as well as simply not touching the many tax avoidance situations possible in the foreign exchange area, can indeed be used to facilitate tax avoidance practices. In view of the functional equivalence of interest expense and hedging costs, it is possible to put many financial transactions within various articles of tax treaties at will as suits the parties by expressing the cost of funds as interest (covered by the interest article in treaties) or, in part at least, as hedging costs (covered by the business profits, capital gains or other income article of treaties depending on the circumstances and the terms of the treaty). Further, where it is possible to obtain a deduction for hedging costs under one nation's tax laws, it is often possible by a matching transaction in the context of a corporate group to generate an equivalent gain in another nation which the first nation will not be able to tax under the provisions of a tax treaty between the nations (because the treaty under the business profits, capital gains or other income article will reserve the taxing right to the second nation on the basis of the residence of the relevant corporation in that nation and the lack of a permanent establishment in the first nation).

Finance Leases

One of the growth areas in international financing has been the finance lease; operating leases are also increasingly used around the world. Leases are usually made between independent parties although they can also be used for moving profits around a corporate group. From the tax perspective of individual nations, the greatest difficulty has been with the finance lease. Once again the accounting profession has taken the lead and equated finance leases to loans and put them on the balance sheet accordingly (within corporate groups the normal consolidation occurs). This treatment has not been so widely adopted for tax purposes with the result that finance leases have been a major source of international tax avoidance and shifting of profits and losses. For example, a number of airlines based outside Australia used finance (leveraged) leases to gain Australian tax benefits until special legislation was passed to deal with the practice.[40]

The OECD discussion of the leasing problem to date has been confined to the operating lease context and has been concerned with the problem whether lease rentals should be characterized as royalties or business profits.[41] The much more difficult and (from an international tax avoidance perspective) important topic of finance leases has been deliberately left aside although the problems involved have been acknowledged.[42] OECD's views on the application of the Model to finance leases, on its interaction with domestic provisions characterizing such leases as loans and on what positive international steps need to be taken to deal with the problem remain a mystery.

Ignoring Tax Treaties

In areas where double tax treaties may be thought to bite in relation to new problems and developments in tax law, countries are becoming increasingly restive, and finding means which explicitly or implicitly ignore treaty obligations because the treaty outcome is regarded as undesirable. I have already noticed the U.S. legislative override of tax treaties in the treaty shopping area. This is not the first time that the United States has acted in such an apparently high-handed manner. In the Foreign Investment in Real Property Tax Act of 1980 and in many parts of the 1986 tax reform, override also occurred. Recently, the United States has sought to clarify its attitude to tax treaties and (perhaps) to give more respect to them.[43] Other countries complain of course but to little avail. The apparent ease with which the United States can act in this regard is a theme returned to below.

If a country does not have the "clout" of the United States, then it can always find surreptitious means to ignore its treaties. Just to take one example in the region, New Zealand in 1988 introduced a dividend withholding payment which negates the tax exemption in a number of its treaties (particularly its treaty with the United States!) for dividends received by New Zealand corporations from corporations resident in treaty partners.[44] The theory advanced for the withholding payment is that it is a collection in advance for tax that will be payable on the profits in question by New Zealand individual shareholders (because no New Zealand corporation tax is paid on the foreign profits, no imputation credits will arise for the individual shareholders). Yet the same argument could be made for profits distributed from one New Zealand resident corporation to another to the extent that tax concessions have brought about the result that the profits they represent are untaxed.

More recently New Zealand has introduced a domestic withholding tax on dividends paid by a New Zealand corporation to the extent that they do not carry imputation credits (that is, have no New Zealand corporate tax attributed to them under its full imputation system). While this was introduced in the context of general domestic withholding and applies to the corporation paying rather than receiving the dividend, the negation of New Zealand's treaties by the withholding payment system is less blatant in the new context and probably will not be challenged by its treaty partners.

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38. *Foreign Currency Translation* (Paris: OECD, 1986).
39. See *supra* note 16; a similar view is expressed by the General Report in LXXIb *cahiers de droit fiscal international,* "Currency fluctuations and international double taxation" (1986); a number of country reports, however, advocate dealing with problems through tax treaties.
40. Australia only recharacterizes finance leases where particularly abusive situations are involved, one category being international transactions, *Income Tax Assessment Act 1936,* Sec. 51AE and Pt III Div 16D.
41. Reports of the OECD Committee on Fiscal Affairs, *Trends in International Taxation* (Paris: OECD, 1985).
42. *Id.,* at 12. Compare General Report, LXXCVa *cahiers de droit fiscal international,* "Taxation of cross border leasing" (1990); the General Report identifies significant problems in current law and suggests harmonization of national tax laws as a means of solving them.
43. See Schadé, "Tax Treaty Overrides in the Technical and Miscellaneous Revenue Act of 1988", 43 *Bulletin for International Fiscal Documentation* (May 1989), at 214-217.
44. See Vann, *Trans Tasman Taxation of Equity Investment* (Wellington: Victoria University Press, 1989), at 62-64, Vann, "The New Zealand Imputation System: A Comparison with Australia", 1 *CCH Journal of Taxation,* No. 3 (June/July 1989), at 60, 72-73.

THE OECD MODEL IS INCREASINGLY INFLEXIBLE

To add to this story of woe, the OECD Model – or rather the tax treaty network based on the Model – is less and less able to deal with its internal deficiencies and emerging international tax issues. This problem arises from the success of the Model in promoting bilateral tax treaties. As more treaties are negotiated, the more treaties there are to change if any new initiative is adopted in relation to terms of the actual Model. There are now in excess of 1,000 treaties and the number is still increasing rapidly.

An attempt is made to avoid this problem in part by resorting to "interpretation" rather than change of the Model. The difficulty here is that once an interpretation is accepted by a court in a particular country at a particular time, any subsequent reinterpretation or elaboration by the OECD is unlikely to be accepted by the courts of the country concerned, and given the propensity of common law courts in particular to take notice of decisions in other common law countries (even if the area of law involved is not common law), less likely to be accepted in other countries. The more adventurous the OECD Commentary becomes, the respect accorded to it will be the less. A number of recent creative interpretations by the OECD of its Model have already been noted in the thin capitalization area.

More Treaties than Trade Interests Require

Given that the original impetus for the development of model treaties lay in international trade issues, it is surprising how extensive the network of bilateral tax treaties has become. One would expect that a country would not enter into a treaty with another country unless it has significant trade contact with that country and unless there were something to gain in the larger trade policy sense. In reply it can be argued that if there are any trade or investment flows between countries then a tax treaty will be beneficial to trade because of the lowering of tax rates of the source country that will result. The benefit will, however, often flow to the Treasury of the residence country rather than the investor. Moreover many countries set their tax rates on non-residents higher than tax treaty norms simply to provide themselves with a bargaining chip in tax treaty negotiations that will always be conceded. In other words the tax treaty network has itself caused impediments to trade and investment (to the extent that the higher tax rates that apply in the absence of a treaty can be so characterized) and any argument that tax treaties are necessary for removal of these impediments is circular.[45]

Perusal of the literature on tax treaties demonstrates clearly that they have taken on a life of their own; they are usually written about in their own terms without any clear connection being made to trade policy. The same is generally true in practice. At least in the case of Australia, it seems that so long as another country writes and asks for a treaty, one will be negotiated. It is difficult, for instance, to see the trade justification for treaties with Malta or Finland (to take recent treaties negotiated).[46] It is surprising how little broader trade issues feature in tax treaty negotiations. The recent U.S.–Canada treaty is a case where non-tax trade questions were raised but this is the exception rather than the rule.

If we seek the reasons why tax treaties have become disconnected from trade policy between the nations concerned, at least three can be suggested. Firstly, the content of tax treaties goes beyond trade matters to issues of foreign policy and foreign aid. The current agenda for model tax treaties was set early in their history. Apart from royalties and the arm's length pricing principle, the 1928 drafts covered the same territory as the OECD Model, although it is noteworthy that administrative matters were the subject of separate draft conventions. The agenda does not seem really to have been reconsidered since, but there is some hope that the agenda may become refocused on trade by reason of recent events. Retirement income (pension) issues are more appropriately dealt with in special treaties covering public and private pensions and a treaty network is starting to develop in the pensions area. Similarly tax administration issues can be covered separately (which will occur if the multilateral treaty on this topic comes into effect with a large number of signatories). The redundant article on diplomats should simply be dropped.

Secondly, since the Second World War international trade policy has been largely a multilateral issue rather than a bilateral one, and the different mechanics of international tax and trade relations have, perhaps unconsciously, led to a separation of tax and trade policy issues, a matter returned to below. Thirdly, tax treaties have apparent symbolic significance in that the willingness of a country to enter into treaties indicates its preparedness to conform to the general international tax ground rules and sends positive signals to potential investors from all countries. It is not unreasonable, for example, for a developing country that wishes to foster its trade with the United States to enter into treaties with other nations of less significance to its trade in view of the difficulties that developing countries have experienced in having treaties ratified by the U.S. Senate. In this light also the practice of setting tax rates on non-residents at higher levels and reducing them more or less automatically in tax treaties makes some sense.

Most Favoured Nation Status and Lock In

Many bilateral tax treaties are accompanied by protocols which adopt the terms of bilateral trade treaties of the past (and the GATT) involving most favoured nation status. Under these protocols a treaty country undertakes that it will not grant more favourable terms typically in respect of tax rates on dividends, interest and royalties to other countries without granting the same concession to the treaty partner in question. The effect of such protocols is to lock particular countries into inflexible treaty positions as a concession in one bilateral treaty will be like the removal of a card from a house of cards. Even where there is no explicit protocol to this effect, it will usually be unwise for a country to adopt widely differing tax rates in its treaties as the matter is bound to be raised by nations that do not benefit from the lowest rate in any periodic treaty reviews.

Australia, for example, simply cannot depart from its dividends 15 percent, interest 10 percent, royalties 10 percent standard for minimum ceiling tax rates because of protocols

45. Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) Vol. 4, at 547, 575, explicitly recommended raising the tax rates levied on non-residents so that they could be lowered in treaties and this change was adopted in the 1970 reforms to the Canadian tax system.

46. In discussions following presentation of this paper, Mr Michael D'Ascenzo, the Australian competent authority under its tax treaties, noted that the negotiation of the tax treaty with Malta was headline news in that country presumably because of its effects on pensions (a significant number of Maltese have migrated to Australia in the past and retired to Malta). I regard this as supporting my approach, rather than undermining it (see the next paragraph of the text).

to various treaties. The effect of such protocols is moreover cumulative. If a protocol on tax rates with one country relates only to interest, with another country only to royalties and with a third country only to dividends, the protocols in combination mean that for any future treaty the minimum ceilings for interest, royalties and dividends have effectively been set. The result is that the more bilateral tax treaties a country already has, the less is likely to be its room for negotiation in relation to any proposed new treaty.

The OECD Model in a sense has nothing directly to say on this question. It would seem to be implicit, however, in the concept of the OECD Model as one to which member states adhere (subject to their specific reservations) that there will be consistency across the treaties of a particular country and this in fact usually happens. Such a requirement of consistency can be a disservice to a country in at least two respects.

Firstly, a country's treaty position is traditionally regarded as based on its status as a source country (capital importer) or residence country (capital exporter), the premise being that a net capital importer or exporter will be in this position generally with respect to all other countries. Again, in the modern world this simple view has been outmoded. Increasingly, all countries are capital importers and capital exporters. Moreover, although it will always turn out that a country is either a net capital importer or a net capital exporter, this relationship will usually not hold in relation to every other country with which the country in question deals. The effective requirement of consistency makes it difficult to adopt different treaty policies in relation to different countries even though this is a rational position to take.

Secondly, and more significantly, a country's position as net capital importer or exporter will change over time. Although historically this process has occurred slowly, nowadays changes in the relative positions of countries seem to match the hectic pace of the rest of modern life. Yet as the bilateral tax treaty network spreads, the pace with which it can adjust to such changes necessarily slows down.

The United States Plays by Different Rules

Lack of flexibility can usually be equated with stability, and stability of the law is regarded as a virtue especially in commercial matters. While the overall tax treaty network is clearly inflexible for reasons already developed, it in fact is not stable as the major player in the network keeps changing the rules for its treaties unilaterally. I have already noticed that the United States may be thought rather cavalier in its attitude to its tax treaties. The inflexibility of bilateral tax treaties hence tends to be felt most strongly by smaller players in the international tax game.

The concept of the Model Tax treaty may create a fool's paradise. Nations are encouraged to think that the Model will produce formal equality and will restrain more powerful countries in pursuing their self-interests. In fact international tax policy is no different from international policy generally. In the creation of the Model in the first place the policies of the more powerful countries are likely to be dominant, which is certainly the case with the OECD Model. While some restraining influence is no doubt exercised by treaties concluded pursuant to the Model, more powerful countries can still thumb their noses at treaty obligations where political imperatives so dictate. Small countries in particular need to consider whether there are any significant benefits in bilateral tax treaties that cannot be obtained in other ways.

The power of the United States in the international tax arena outside the bilateral tax treaty network has been demonstrated by the tidal waves sent around the world as a result of the 1986 tax reform. Whether this power is a bad thing or not depends very much on one's viewpoint. For critics of the bilateral tax treaty network, the power may be one catalyst for reshaping of the international tax order and with it the bilateral tax treaty network. Supporters of the current treaty system of course deplore treaty violations by the United States. Yet their complaints are not backed up by any effective retaliatory action. The bilateral nature of the tax treaty network in fact makes it easier for a country systematically to violate its treaties. The treaties concerned will not be all in the same terms and hence the violation may not affect all treaties or may impact on them differently, so that the complaint will not be voiced in uniform terms by affected parties. Moreover, it will not be easy for the complaining parties to take united action since there is not in place any multilateral framework or international organization to serve as a focus of complaint. Apart of course from the OECD, which has not been thus far an effective forum for changing U.S. ways.[47]

47. OECD Committee on Fiscal Affairs, "Report on Tax Treaty Overrides", 2 *Tax Notes Int'l* (1990), at 25-33 is obviously targeted at the United States despite the polite omission of any direct references. The efficacy of the report in restraining the United States may be doubted; compare McIntyre, "In Defense of Treaty Overrides", 1 *Tax Notes Int'l* (1989), at 611-614.

Part II of Prof. Vann's article will appear in the April 1991 issue.

NEW ZEALAND:
CONTROLLED FOREIGN COMPANY LEGISLATION

K. Jan Bebbington and D. John Hasseldine

I. INTRODUCTION

The problem of tax avoidance, tax deferral and tax base erosion effected by the use of controlled foreign entities resident in another tax jurisdiction is one which typically confronts many governments and revenue authorities at some time. This has been true for New Zealand, especially due to the absence of any comprehensive capital gains tax regime and was exacerbated by the removal of exchange controls in 1984.

The New Zealand Government first detailed its stated intention to review the taxation of foreign-source income in a Consultative Document on International Tax Reform issued in December 1987. This outlined the proposed system and called for public submissions to a Consultative Committee comprised of leading tax specialists, who released two reports, including draft legislation. The finalized provisions are now contained in Part IVA of the Income Tax Act 1976 (Sections 245-A to 245-Y).[1] The regime is now fully operative, having commenced in full from 1 April 1990, the first day of the 1991 tax year, although the commencement date may have been earlier depending on the foreign country concerned.

The objective of this article is to provide an overview of these reforms and to comment on practical implications affecting both New Zealand and foreign residents. The New Zealand provisions distinguish between foreign investments where New Zealand residents have control, controlled foreign companies which in essence are taxed as a branch, and passive investments where New Zealand residents do not have control, being foreign investment funds, which are taxed in a similar way as an accrual capital gains tax. Taken in its entirety, the regime involves a new set of strengthened residence rules (Hasseldine 1989a), a foreign dividend withholding payment system (Hasseldine 1989b), the controlled foreign company provisions (Part II below), the foreign investment fund regime (Part III below), and foreign trust provisions.

II. CONTROLLED FOREIGN COMPANY PROVISIONS (Sections 245-C to 245-Q)

A. *Background*

In a similar fashion to many countries, New Zealand domestic tax law operates on a source and residence principle. This provides that all income sourced in New Zealand is assessable for income tax and a resident's worldwide income is also assessable. This principle may be amended by the operation of a double tax agreement (Section 242).

The definition of corporate residence is of crucial significance in international tax. A company is resident in New Zealand if it is incorporated in New Zealand, has its head office in New Zealand, has its centre of management in New Zealand, or control of the company by its directors, acting in their capacity as directors, is exercised in New Zealand. The definition of a "foreign company" is any non-resident company or a company ordinarily resident in New Zealand, but not subject to New Zealand tax pursuant to being classified as non-resident under a double tax agreement.[2] Although the resolution of corporate residence is becoming more difficult, the strengthened residence rules may mean that a shareholding in a company, which although incorporated offshore, is actually a New Zealand resident and therefore not a foreign company, will be subject to New Zealand domestic tax law.

Companies resident in seven countries listed in the Act's fifteenth schedule are generally exempt from the international tax regime (Appendix A lists these countries). These grey list countries are exempted because they have international tax regimes similar to New Zealand's provisions. The Controlled Foreign Companies ("CFC") regime applies with effect from 1 April 1988 to a list of 61 low tax jurisdictions or territories and specified types of companies in nine other countries, known as the *black list* (Appendix B lists these countries).

K. Jan Bebbington and **D. John Hasseldine** are, respectively, Assistant Lecturer and Lecturer, Department of Accountancy, University of Canterbury.

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  B. Seventeenth Schedule (Black List) Countries
  C. Flowchart for CFC Application

1. All section references in this article are to the New Zealand Income Tax Act 1976.
2. Note that a treaty may provide relief from New Zealand tax on New Zealand-sourced income or income taxable in New Zealand, which under these international tax reforms would include foreign-source income.

B. *Control interests (Section 245-C)*

A CFC exists if at any time during any accounting period a group of five or fewer New Zealand residents control (directly or indirectly) 50 percent or more of a foreign company. A CFC also exists if New Zealand resident directors control 50 percent or more of a foreign company, regardless of the number of directors aggregated to constitute the 50 percent.

Control is determined by the calculation of control interests and involves an aggregation of direct and indirect control interests, including those of *associated persons.*[3]

Direct control interests are determined by reference to the percentages held (or entitled to be held)[4] in the following five classes:
(1) total paid-up capital;
(2) total nominal capital;
(3) entitlement to income (if the income were distributed at the end of the accounting period, provided the entitlement was the same at all other times during the period);
(4) entitlement to value of net assets (in the event of distribution of all the assets); and
(5) total rights to vote or participate in specified decisions. These decisions revolve around areas such as distributions, constitutional matters, variation of capital, and appointment or election of directors.

If the percentage voting rights differ over these types of decisions, then the highest voting right percentage applies. In determining direct control interests, the control class (out of the five categories) yielding the highest aggregate control interest is used. Control interests that a nominee holds or is entitled to hold are deemed to be held by the principal.

Indirect control interests arise where a first tier CFC, one directly controlled by New Zealand residents, holds or is entitled to hold direct control interests in another underlying foreign company. They are calculated by reference to the first tier company's *qualified control interests*[5] in the underlying foreign company, in each of the five control categories. It is important to note that the control interest in the next tier company is not multiplied by the holding in the first tier company, i.e. there is no dilution of interest purely due to a chain of shareholdings. Where an underlying foreign company controls another foreign company this method for determining indirect control interests is again used with the underlying foreign company being termed the first tier company and the third level foreign company then known as the underlying foreign company.

There are many possible, different ways to calculate the indirect control interests in a company, especially where the ownership structure is complex. In order to determine a unique value for indirect control interests the following rules have been adopted:

(1) Where there is more than one group of New Zealand residents that control the first tier CFC, the control interest will be deemed to be held by the group that is smallest in number.
(2) If there is more than one such group each being equal in number, the control interest will be deemed to be held by the group whose control interests in the first tier CFC is highest.
(3) If there is more than one such group each being equal in number and each having an equal control interest in the first CFC, the control interest shall be allocated in full to each group, but in deciding if there is a greater than 50 percent interest in the underlying foreign company each interest is counted once only.
(4) If there is more than one person in any of the above groups, the control interests of the first CFC shall be deemed to be held by each person in such a group pro rata to those persons' respective income interest in the first CFC.

Further, in the calculation of control interests to determine the existence of a CFC, direct and indirect control interests are only taken into account once. Section 245-C has its own anti-avoidance provision providing that where two or more New Zealand residents have entered into an arrangement which has the purpose or a purpose of preventing the foreign company from being a CFC, then control interests shall be deemed to be held by those persons divided equally among them.

C. *Income interests (Section 245-D)*

When it has been determined that a foreign company is a CFC, non-resident in a grey list country, it is necessary to calculate resident taxpayers' income interests in the CFC to determine whether a person must calculate his attributed foreign income or attributed foreign loss in that company. The calculation of income interests is determined by the aggregate of direct and indirect income interests. These differ from the calculation of control interests, in that the income interests of associated persons and entitlements to acquire an interest are generally not taken into account.

Direct income interests are calculated with reference to the same five classes used to calculate control interests and are the highest percentage of any category. Indirect income interests are calculated by multiplying the income interest of the person in the first tier CFC by the income interest of the first tier CFC in the underlying CFC. Where there are further CFCs held by other CFCs, the percentage held is correspondingly further multiplied by the preceding CFCs' income interest.

It is entirely possible that the calculated aggregate income interests of New Zealand residents in a CFC will exceed 100 percent (Section 245-H). This may occur as each person is attributed his highest percentage holding in the various control classes. If this occurs, a person's income interest is scaled down to the percentage held of the total income interests. If the scaled down income interest is under ten percent then the taxpayer in this specific case is not excused from the income/loss attribution process discussed under the next subheading.

The calculation of control and income interests at first sight appears to be done at any time within a foreign company's accounting year. However, to simplify matters these in-

3. The term "associated persons" principally includes relatives for individuals. Any two companies with substantially the same shareholders or under the control of the same persons, a company and any other person holding income interests that combined exceed 50 percent, are associated persons.
4. This covers the aspect of holding options to purchase shares that would give a shareholder effective control. In this way "warehousing" of shares is prevented. This constitutes an anti-avoidance provision of the legislation.
5. The term "qualified control interests" refers to the direct interests held by the first tier company in the underlying foreign company plus direct interests of persons associated to the first tier company in the underlying foreign company.

terests are actually calculated on specified measurement days; that is, the last day of every quarter (March, June, September and December). Once a CFC exists by virtue of greater than 50 percent control interests on any measurement day, it is a CFC for an entire tax year. With income interests, these must be calculated every quarter and are then subject to an averaging process to elicit an annualized figure. There is an election available for those taxpayers wishing to calculate their income interests on a daily basis. In the case of temporary changes to control interests made to ensure that a CFC never exists on a measurement day, these temporary changes are ignored (Section 245-E).

D. *Attribution of income and losses and grey list exemption (Sections 245-G and 245-P)*

Control interests are used to determine whether a CFC exists. Income interests are used to determine how much income of the CFC is attributable to the New Zealand resident taxpayer. Where a resident holds ten percent or more of the income interests in a CFC he must return his attributed foreign income (or possibly an attributed foreign loss).[6] If the holding is under the ten percent cut-off, the foreign investment fund regime may apply (see part III below).

An exemption to the attribution of CFC income (or loss) exists depending on the resident country of the CFC. If the CFC is resident in one of the seven grey list countries and receives no specified tax preference, it is exempt from the international regime. If the CFC does receive a specified tax preference, tax is based on net income or loss (calculated in accordance with foreign tax law) upwardly adjusted by the amount of the tax preference and by ignoring any prior year losses.

If the CFC is not exempt, the amount on attributed foreign income (or attributed foreign loss) is determined by the following formula:

$a \times b$ where:

a is the income interest of the person in the CFC AND

b is the branch equivalent income or loss of the CFC, as calculated pursuant to Section 245-J of the Act

Attribution of income (losses) of the CFC is done on a branch equivalent basis. The branch equivalent income (loss) equals the assessable income (loss) which would have been calculated in accordance with the provisions of the Act, had the company been a resident company over that time. Section 245-J governs the application of other sections of the Act to the calculation of branch equivalent income (loss) and this involves conversion of foreign accounts into New Zealand currency and the exclusion of provisions that do not apply to foreign companies. Dividends received by a CFC are taxable, unless the payer is another CFC in respect of which a New Zealand resident is already returning attributed foreign income.

E. *Tax credits and losses carried forward (Sections 245-K and 245-M)*

New Zealand tax to pay is calculated on the basis of a taxpayer's attributed foreign income. Credits for foreign income taxes paid or payable are allowed against the New Zealand tax liability. The amount of the credit allowed is the taxpayer's income interest multiplied by the income tax paid or payable by the CFC. Tax credits are allocated in the following order. Firstly, against domestic tax on attributed foreign income from that CFC. Secondly, against domestic tax payable of attributed foreign income of another company in the same jurisdiction and finally, credits are to be carried forward to the succeeding income year(s) to be offset in the same order as in the two preceding steps, provided a 40 percent shareholder continuity test is maintained. CFC tax credits are quarantined to the country of residence of the CFC, i.e. there is no global pooling, thus eliminating any possibility of sheltering income from tax havens against income from higher taxed countries. *Specified company groups* are able to offset credits in the same manner as indicated above although the quarantining of credits remains. This is subject to domestic law grouping requirements under which "specified groups" exist where two or more companies have identical proportions of shareholders. Although grouping is not restricted to resident companies only, there are controls on loss offsets where a lossmaking non-resident or dual resident company is involved (Section 191).

Losses carried forward are deemed to attach to the taxpayer to whom the loss is attributed. They do not attach to the foreign company. Losses are quarantined in the same manner as tax credits are. Prebble (1990) notes that this introduces an element of asymetry in that unlike losses, foreign-source income is aggregated. The reason for this quarantining is one of administrative difficulty in policing the accounts and transactions of foreign companies.

F. *Relationship with imputation regime*

If a dividend is paid by a CFC to a New Zealand resident from earnings already taxed as attributed foreign income, then double taxation would be a consequence. Accordingly, the CFC regime has been integrated with the dividend imputation regime so that credits for New Zealand tax paid on attributed foreign income are kept in a memorandum account called the branch equivalent tax account (BETA) – a sub-account of the imputation credit account. These credits are available for allocation to taxpayers when dividends are paid to the New Zealand company by the foreign company. In principle this is equivalent to the imputation regime. However, it differs from that regime in that only New Zealand tax is allowed as a credit. Therefore, there will be double taxation of the income which has foreign tax paid on it but no New Zealand tax paid on it.[7]

G. *Anti-avoidance provisions*

Some of the specific anti-avoidance provisions have already been identified under the sub-headings on control and income interests. There is also an overall anti-avoidance provision relating to attributed CFC losses. If a loss is calculated from application of the regime, but there is no economic or financial loss, or substantially no loss, then for the purposes of the Act there is no attributed foreign loss (Section 245-G).

The interpretation of avoidance provisions within New Zealand must be examined within the Commissioner of Inland Revenue's (1990) policy statement on Section 99.[8] This con-

6. Associates' income interests are considered when determining whether a taxpayer is above 10 percent, but if so, only that taxpayer's interest is used in determining the attributed foreign income or loss.

7. Further details on the operation of the BETA account and the withholding payment system on foreign dividends can be found in Hasseldine (1989b).

8. The text of this statement appeared in 44 *Bulletin for International Fiscal Documentation* (June 1990), at 288.

tained a specific example drawn from the CFC regime involving the holding of a 49.5 percent interest in a foreign company in a joint venture arrangement. It was stated:

> It cannot automatically be inferred that the structure like that outlined was designed to avoid the effect of the CFC regime. There may be a number of non tax-related reasons for adopting the arrangements, such as accommodating the commercial or tax needs of the non-resident joint venturer.
>
> However, having considered all the relevant factors it may be that the only proper inference which can be drawn from the arrangement and surrounding circumstances is that it was implemented in this particular way so as to avoid tax.

Accordingly there is no hard and fast rule on this particular issue even if the New Zealand shareholding is only just below the 50 percent CFC threshold.[9]

III. FOREIGN INVESTMENT FUND REGIME (Sections 245-R to 245-T)

A. *Background*

The purpose of this regime is to tax current income (including realized and unrealized capital gains) in the situation where a person does not control the foreign entity, but which may still be a tax avoidance vehicle. A foreign investment fund ("FIF") is a term used to describe a variety of foreign investment interests including a foreign company, a foreign unit trust, a foreign superannuation scheme or a life insurance policy issued by a foreign entity. The definition of a FIF is wide, although there are a number of exceptions. An investment will not be a FIF if:

- at all times during the period the entity was a resident in a grey list country; OR
- the foreign entity distributes by way of dividends 60 percent or more of its income, profits and gains (as measured in accordance with generally accepted accounting principles); OR
- no more than 40 percent, by market value of assets, of the entity is held directly or indirectly in assets of a certain type. Generally the assets specified are of the type that yield passive income;[10] OR
- foreign and New Zealand tax paid or payable by the entity amounts to 20 percent or more of the entity's income, profits and gains (calculated with reference to generally accepted accounting principles); OR
- the Commissioner of Inland Revenue determines that the investment is not an investment in a FIF; OR
- if the foreign entity is a CFC and the interest of that person is an income interest of ten percent or greater. Such a holding is governed by the CFC provisions.

A person is also deemed to hold an interest in a FIF where his rights would be deemed to constitute a direct income interest, were the entity a CFC. There is provision for a foreign entity or a person holding rights in such an entity to apply to the Commissioner for a determination as to whether or not those rights are FIF interests. The Commissioner has discretion as to whether to make a determination, and if one is made, it can be objected to under the normal objection procedures. Any change in a determination cannot be made on a retrospective basis unless fraud or wilful default was evident in the application.

Practical problems of significance may arise in the application of these listed exceptions, as published financial statements will generally use principles of income recognition different from the definitions of income, capital profits and capital gains specified in the exceptions. For instance, if assets are valued at historical cost and not market value, then there may be no information in annual reports for New Zealand investors to calculate if three of the exemptions apply.

B. *Foreign Investment Fund income or loss*

The income (or loss) associated with an investment in a FIF is determined by the following formula:

$(a + b) - (c + d)$

where:

a is the market value of the FIF at the end of the income year; AND

b is the market value of all consideration derived or deemed to have been derived or received or receivable by the person with respect to his interest held during that year; AND

c is the market value of the FIF as at the last day of the preceding income year; AND

d is the market value of all consideration payable or deemed to be payable by the person with respect to that interest during that income year.

In this way the net increase in the market value of a person's holding in a FIF is assessable income. Items b and d allow for profits and losses from the sale or purchase of FIFs to be calculated. Likewise, distributions from FIFs are taken into the overall calculation of profit or loss and need not be declared separately as assessable income. For many investments, just obtaining market price documentation for the above formula will involve some time and expense.

The FIF regime effectively is an implicit accrual capital gains tax. This is interesting as New Zealand currently has no comprehensive tax regime of this type and will probably not have one in the immediate future given that both major political parties are non-advocates of capital gains tax, despite many calls for its introduction and a 380 page Consultative Document on this topic issued in December 1989.

C. *Tax credits and losses*

There is no credit allowed for foreign tax paid by the FIF. The market value calculated by the preceding formula takes into account the fact that tax has been paid by the company. In this way the FIF regime is an implicit tax deduction system for accounting for foreign investment.

As under the CFC regime there is allowance for offset of losses. Losses can be offset against other FIF income from any jurisdiction. Once the preceding offset has taken place, losses may also be set off against other assessable income to the extent of FIF income already returned in prior years. Finally, losses can also be carried forward to future years, subject of course to the 40 percent shareholder commonality requirement being met by company taxpayers. There are also company grouping provisions whereby FIF losses can be offset within specified groups.

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9. For a detailed discussion on the policy statement, see A. Smith, "The Implications of the Commissioner's Statement on Section 99", 45 *Bulletin for International Fiscal Documentation* (February 1991), at 60.
10. For example, annuities, rights as a beneficiary of a trust or as a partner, rental properties, royalties, interests in other FIFs.

IV. OTHER ISSUES

A. *Disclosure, offences and penalties (Section 245-W)*

Taxpayers must disclose any income interest in any foreign company and any interest in a FIF. The comprehensive disclosure requirements also include "such other information as may be required by the Commissioner". It is an offence to knowingly not comply or to make a false disclosure in relation to these requirements. On conviction of such an offence, the maximum penalty is two years imprisonment and/or a fine not exceeding NZ$ 50,000. As many investors in FIFs may well be ignorant of their tax responsibilities, it is expected that these penalties will not be harshly applied. The penalties also apply to those who aid, abet or incite another to commit a non-disclosure offence. This may lead to tax advisers ceasing to act for clients who refuse to comply with their statutory obligations.

Prior to the operation of this regime, powers existed to attack tax avoidance/evasion using offshore entities through Section 21A which authorizes the Commissioner to request information on payments made to non-residents for which a deduction is claimed. In the absence of a satisfactory reply, the deduction can be disallowed with no appeal rights granted. Further, Section 22 also enables the Commissioner to combat transfer pricing arrangements. There is little published evidence that these powers have been extensively used but they have been retained as being complementary to the CFC provisions.

B. *Foreign trust regime*

As trusts can also be used as tax avoidance vehicles in lieu of companies, this area has also been reformed so that the CFC provisions cannot be bypassed in this manner. Brief coverage of the trust reforms is now given (for further details, see Prebble (1989)). Essentially the amendments removed a distinction between adult and infant beneficiaries, introduced specific rules in relation to foreign-source income and altered tax rates. "Non-qualifying trusts" include those that have been established overseas by a New Zealand settlor with non-resident trustees and which have therefore not paid New Zealand tax on all of their trustee income since inception. Beneficiaries of this type of trust are assessable on distributions of income and capital gains at 45 percent (higher than the top marginal rate of 33 percent). The only tax-free items are in respect of income derived by the trustee prior to April 1988 and the corpus of the trust. Current income not taxed via a beneficiary in that year is taxed primarily to the trustee, or failing this, to a New Zealand resident settlor as agent for the trustee and taxpayer of last resort. The "settlor regime" attracts identical disclosure requirements and penalties as detailed above and is complementary to the provisions outlined in parts II and III.

V. CONCLUSION

Professor Bird (1987) has stated that the effectiveness of international tax policy is dependent on properly formulated and implemented policy which detects and punishes non-compliers. The conclusions of his study into New Zealand's international tax area are largely incorporated into the legislation discussed in this article, although further research on interjurisdictional allocation rules and unitary taxation has yet to occur.

Primarily it is New Zealand residents who are affected; however foreign companies may be exposed to these provisions where non-residents "dog-leg" their shareholding through interposed New Zealand entities to reach a third foreign jurisdiction. No exposure should result if an overseas parent company has subsidiaries in New Zealand and other countries, providing there are no cross holdings between subsidiaries. Where CFCs derive New Zealand-source income, credit is of course given for any New Zealand tax paid. The interaction of differing foreign tax regimes with New Zealand's must be considered in computing branch equivalent income and should lead to stronger ties between tax specialists in New Zealand and elsewhere. The management of New Zealand CFCs will be aware of these reforms, but other companies not resident in grey list countries can also expect to receive enquiries from New Zealand shareholders or their advisers, in relation to the FIF regime.

The costs to the taxpayer to comply with the international tax regime may be substantial, as there will be significant information-gathering and reporting costs for liable taxpayers (both domestic investors and foreign investees). This is an unfavourable aspect of the international tax regime and the full burden will only be known after the end of the 1991 income year, being 31 March 1991. This has to be set against the current background of discontent with respect to the level of compliance costs for taxpayers. High compliance costs coupled with a low perceived probability of detection may encourage many taxpayers not to comply, so a final assessment of its effectiveness needs to be reserved until information concerning the costs of the regime, the level of taxpayer compliance and revenue collected is available.

New Zealand has formulated a comprehensive international tax regime. Further this regime is consistent with moves overseas to limit erosion of tax bases by residents accumulating income offshore. Specifically it reinforces the principle of tax harmonization with Australia.[11] Australia is New Zealand's major trading partner and the two countries have entered into a Closer Economic Relations (CER) agreement which so far has not had any real impact on their respective taxation regimes. This last comment should, however, be considered in light of the international tax election policy of the present National Government elected in October 1990. This states that they will seek to place tax on the agenda for the 1992 review of CER, they will seek to achieve better tax harmonization with Australia, in particular negotiating with Australia to allow residents in either country to receive imputation credits for company taxes paid in the other country, and they will also consider applying the CFC regime to nominated tax jurisdictions (the "black list") and then only to passive income.

11. See M. Friezer, "Draft Foreign-source Income Legislation", 44 *Bulletin for International Fiscal Documentation* (June 1990), at 285.

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APPENDICES

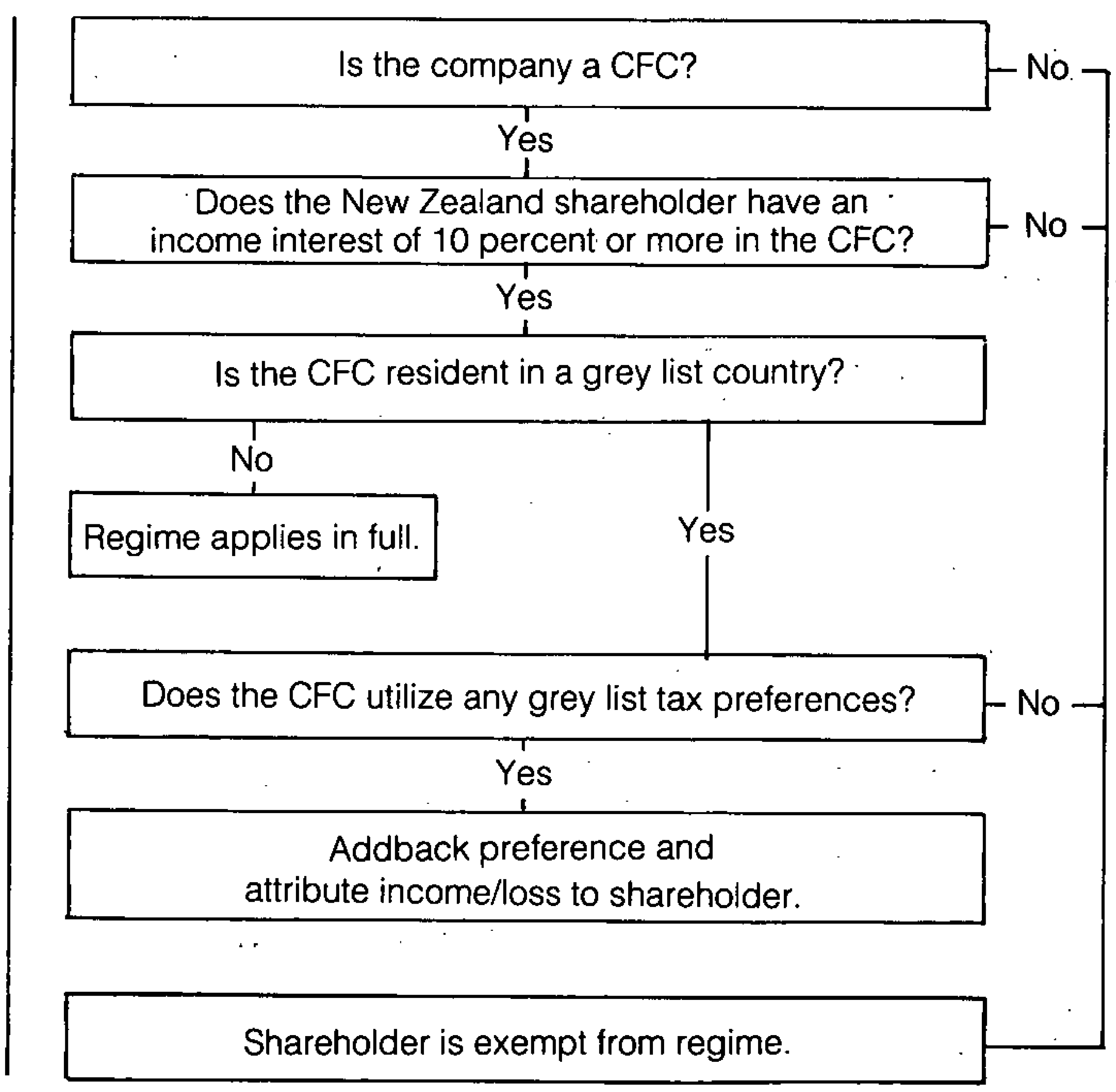
A. *Fifteenth Schedule Excluded (Grey List) Countries:*

Australia
Canada
Germany
France
Japan
United Kingdom
United States of America

B. *Seventeenth Schedule (Black List) Countries:*

Andorra
Angola
Anguilla
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
Palau
Panama
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

C. *Flowchart for CFC Application:*



TAX AND OTHER LAWS AFFECTING FOREIGN INVESTMENTS AND OPERATIONS IN THE USSR

Preston M. Torbert

I. INTRODUCTION

The Soviet Union today is undergoing two basic structural changes: the transition from a planned to a market economy and the devolution of power from the centre to the republics and to local areas. These changes profoundly affect the tax system and foreign investment.

A. *Recent tax legislation*

Legislation was passed in 1990 to promote the transition to a market economy. Included in this legislation is a new tax law that has substantially altered the tax system. The major legislation of interest to foreign corporations is the following:

- Law of the USSR on Taxation of Enterprises, Associations and Organizations (the "Enterprise Tax Law" or "ETL"), issued 14 June 1990;
- USSR Supreme Soviet Decision on the Procedure for Enforcing the Law of the USSR on Taxation of Enterprises, Associations and Organizations (the "USSR Supreme Soviet Decision"), issued 14 June 1990;
- USSR Council of Ministers Decree No. 815 on Establishing Rates for 1990 in Respect of Export and Import Taxes and Turnover Tax to Apply to Joint Ventures Set Up on the Territory of the USSR with the Participation of Soviet Legal Persons and Foreign Legal Persons and Individuals ("Decree No. 815"), issued 13 August 1990;
- RSFSR Supreme Soviet Resolution on the Creation of Free Enterprise Zones (the "RSFSR Resolution on Zones"), issued 14 July 1990; and
- RSFSR Supreme Soviet Resolution on Priority Measures for the Development of the Nakhodka Free Economic Zone in the Maritime Territory (the "RSFSR Resolution on the Nakhodka Zone"), issued 23 November 1990.

B. *Future tax legislation*

The USSR Council of Ministers is obligated by the USSR Supreme Soviet Decision to adopt the necessary measures to implement the Enterprise Tax Law by 1 January 1991.

C. *Recent corporate legislation*

The Soviet Union first issued joint venture legislation in 1987. This established a legal framework for these capitalist enterprises different from that for state enterprises.

Legislation passed in 1990 has provided a basis for new corporate forms (a joint stock company and a limited liability company) and for wholly foreign-owned enterprises.

The major legislation of interest to foreign corporations is the following:

- Regulations Governing Joint Stock and Limited Liability Companies (the "Companies Regulations") approved by the USSR Council of Ministers Decree No. 590 of 19 June 1990; and
- Decree of the President of the USSR on Foreign Investments in the USSR (the "Presidential Decree"), issued 26 October 1990.

The Companies Regulations state that terms of participation in the new corporate forms by foreign investors are to be determined by legislation of the USSR and the union and autonomous republics. The RSFSR has reportedly already taken a step in this direction. The Premier of the RSFSR recently signed a decision allowing foreign investors to establish wholly foreign-owned joint stock companies in the RSFSR. Now a foreign investor can establish a traditional joint venture under the prior legislation, or a joint venture or a wholly foreign-owned enterprise in the form of a joint stock company or a limited liability company under the new legislation.

Preston M. Torbert is a partner in the Chicago office of Baker & McKenzie. He has been involved in the firm's Soviet practice since 1974. He majored in Russian and Russian Studies at Princeton, received a Ph.D. in Russian and Chinese history from the University of Chicago and was graduated from Harvard Law School. In 1979, he conducted research at the Institute of State and Law of the USSR Academy of Sciences on Soviet law as a Senior Scholar under the official US/USSR research exchange programme. His practice has focused on advising U.S. clients on trade, licensing and investments abroad. He is a member of the firm's Soviet and East European Practice Group.

The USSR has undertaken the herculean task of transforming itself from a centrally planned to a market economy. Preston M. Torbert overviews recent developments in this process relating to tax and foreign investment.

D. *Future corporate legislation*

A proposed Law of the USSR on Foreign Investments in the USSR will probably be issued in the near future to implement the Presidential Decree and to coordinate the treatment of foreign investments. Reportedly, similar draft legislation is pending in the RSFSR and the Byelorussian Republic.

E. *Tax treaties*

Under the ETL, the provisions of international tax treaties prevail over conflicting provisions in the ETL. The USSR has entered into 19 double taxation treaties with non-socialist countries. Parties to these treaties include most of the major developed countries (the United States, Japan, the Federal Republic of Germany, the United Kingdom, Canada, France and Italy). These treaties (except the U.S. treaty) reflect, in general, the terms of the 1977 OECD model tax treaty. The U.S. treaty of 1973 is outdated, and the U.S. Treasury Department is reportedly close to completing the negotiations of a new U.S. treaty.

F. *Devolution of power*

The devolution of power from the centre (the union) to the union republics and autonomous republics and to local areas complicates the Soviet tax system and increases uncertainty.

1. *All-union taxes*

Currently, taxes and duties are imposed and administered at the national (all-union) level by the USSR Ministry of Finance. The ETL is an all-union law, but the tax revenues collected under it are split between national, union republic and local authorities as described below.

2. *Union republic taxes*

The union republics and autonomous republics impose and administer some taxes as well (e.g. land tax and dues on collective farm markets). Under the ETL, the union and autonomous republics receive tax revenues (see below).

Declarations of sovereignty by the union republics and the proposed treaty between the union republics and the union seem to portend greater taxing powers of the union republics.

3. *Local taxes*

As noted above, the ETL allows local areas to tax profits. A number of municipal governments, including those in Moscow and Leningrad, are reportedly considering imposing their own municipal taxes.

The ETL lays the foundation for a capitalist tax system over the long term. In the short term, however, it will create uncertainty and a lack of uniformity in taxation. This will require a careful examination of the all-union, republican and local tax aspects of any proposed project.

II. TAXES

The ETL provides for the following taxes affecting the operations and investments of foreign corporations: profit tax, turnover tax, export and import tax, and consumption tax.

A. *Profit tax*

This tax is called a "profit tax" rather than an "income tax" to distinguish it from other taxes imposed on gross income.

1. *Taxpayers*

The profit tax applies to any legal entity operating on a self-supporting basis and possessing independent accounts. The term "enterprises" is used to describe organizations subject to the profit tax. These include social organizations, cooperatives, joint ventures and foreign corporations.

2. *Determination of net taxable profits*

Taxable profits are reached by deducting allowable expenses from gross revenues to reach balance sheet profits. The balance sheet profits are then further reduced by adjustments for certain other tax exemptions and privileges (if applicable) to arrive at net taxable profits. In some cases, certain adjustments may lead to an increase in "balance sheet profits".

3. *Tax rates*

The profit tax is levied at two rates: an ordinary rate and an excess profits rate.

(a) *Ordinary tax rates*
The ordinary rate is a maximum of 45 percent. It is comprised of two components, an all-union 22 percent rate and a joint republic and local rate of up to 23 percent. A question arises regarding this rate. The 23 percent levied by local authorities also includes payments for labour resources and natural resources not otherwise deducted. Thus, in effect, the local tax burden *plus* payments for labour and natural resources not deducted cannot exceed 23 percent. It is not clear precisely what such non-deductible payments for natural resources and labour might be.

(b) *Excess profits tax rates*
Excess profits rates apply to profits exceeding a maximum established level. The maximum levels are to be set by the USSR Council of Ministers separately for each sector of industry. This has not yet been done. If profits exceed the maximum by 10 percent or less, a rate of 80 percent is applied to the excess. If the maximum level is exceeded by more than 10 percent, a rate of 90 percent is applied to the excess. The revenues from the excess profits tax are split equally between the all-union budget and the republican and local budgets.

4. *Effective date*

The effective date for the profits tax is 1 July 1990 for joint ventures with a 30 percent or less foreign share, and 1 January 1991 for other joint ventures and foreign entities.

B. *Turnover tax*

The turnover tax, the major Soviet tax since 1930, is a tax on the mark-up between the producer's and the wholesaler's prices or between the wholesaler's and retailer's prices.

1. *Taxpayers*

The turnover tax is imposed on enterprises, including joint ventures, but not on foreign legal entities. Previously, the turnover tax was *not* applied to joint ventures.

2. *Products subject to tax*

Which products are subject to the turnover tax is not yet clear. The USSR Council of Ministers is to determine this. It has not done so yet except in Decree No. 815 for joint ventures through the end of 1990; the tax is imposed on the products manufactured by joint ventures.

3. *Exemptions*

A number of privileges and exemptions are permitted. These include a two-year tax holiday, tax concessions of up to 50 percent and full exemptions (see below).

4. *Tax rates*

The tax rates are to be determined by the USSR Council of Ministers. It has not yet established the rates except for joint ventures for the last half of 1990: the basic rate for joint ventures under Decree No. 815 is 15 percent, but can go as high as 90 percent for hard liquor.

5. *Tax revenues*

The turnover tax revenues go to the all-union budget except for a part which goes to the budgets of the union and autonomous republics in accordance with norms established by the USSR Supreme Soviet and the Supreme Soviets of the union republics.

6. *Effective date*

The turnover tax is effective for all joint ventures on 1 July 1990.

C. *Export and import tax*

The export and import tax is a new tax, the purpose of which is to capture for the state budget the large profits gained by Soviet enterprises from importing foreign goods for resale in rubles within the Soviet Union.

1. *Taxpayers*

The tax is applicable to all taxpayers subject to the profit tax. The Decree lists the imported products to which the tax applies for joint ventures through the end of 1990. The USSR Council of Ministers is to issue regulations concerning the application of the export and import tax after the end of 1990 to joint ventures and other enterprises generally.

2. *Tax rates*

As in the case of the turnover tax, no rates have been established except in Decree No. 815 for joint ventures through the end of 1990 (generally between one to ten percent).

3. *Effective date*

The export and import tax is effective 1 July 1990 for foreign trade operations not provided for in the state plan for economic and social development of 1990.

4. *Tax revenues*

The tax revenues from the export and import tax go to the union budget.

D. *Consumption tax*

The consumption tax, an anti-inflationary measure, is imposed on any amounts in excess of minimum tax-exempt amounts that are used for consumption as a means of employee compensation. The tax is applied from 1 January 1991 to all enterprises except joint ventures in which the foreign share exceeds 30 percent, foreign enterprises and certain other entities.

III. TAX HOLIDAYS AND OTHER BENEFITS

Tax holidays and other benefits are granted by the ETL and the RSFSR Resolution on the Nakhodka Zone.

A. *ETL tax holidays*

Under the ETL, a joint venture may enjoy the following tax holidays:

1. A three-year tax holiday (except for ventures engaged in mining (including oil and gas extraction) and fishing) starting from the first profitable year if the venture meets all of the following criteria:
(a) the foreign share exceeds 30 percent;
(b) it is engaged in "material production", i.e. manufacturing, cultivation or significant value-added processing of industrial, consumer and agricultural products or materials; and
(c) it is located in the Soviet Far East.

2. A two-year tax holiday for a joint venture that is either:
(a) registered before 1 January 1991; or
(b) that has a foreign share exceeding 30 percent and is engaged in material production.

3. A joint venture not qualifying for the two or three-year holiday and established in the Soviet Far East or Far North enjoys a one-year tax holiday and the reduction of tax by one half for the second year (except mining (including oil and gas extraction) joint ventures).

Additional tax holidays may be granted with respect to the allocable portion of tax revenues by the USSR Council of Ministers, the legislatures of the union and autonomous republics and the local soviets of people's deputies.

B. *Other ETL benefits*

Under the ETL, joint ventures may enjoy a number of other benefits.

1. *Reduced tax rate*

Joint ventures with a foreign share exceeding 30 percent enjoy a profit tax rate of 30 percent (instead of 45 percent).

2. *Loss carryforward*

Joint ventures with a foreign share exceeding 30 percent enjoy a five-year loss carryforward.

3. *Reserve fund*

Joint ventures must place earnings in a non-taxable reserve fund until it reaches 25 percent of the charter fund. The rate of contribution to the fund may be determined by the joint venture agreement or charter.

4. *Exclusion from taxable profits for hiring retirees or invalids*

Joint ventures may exclude from taxable profits 30 percent of profits if at least 50 percent of employees are retired pensioners or invalids (or 20 percent of profits if between 30 and 50 percent of employees are such persons).

5. *Generally available deductions*

Under the ETL, expenditures on the production and sale of products are generally deductible. In addition, the following expenditures are deductible from balance sheet profits by all joint ventures and other enterprises:

(a) 30 percent of expenses (other than capital investments) on scientific research and experimental design work, training for and mastering of new advanced technologies and forms of production (including production of machinery for export against convertible currency) funded by the enterprise's disposable profits;

(b) the amount of profit used to repay loans granted to finance centralized state capital investments (for the term provided in the loan agreement) and not covered by accumulated profits;

(c) 30 percent of expenditures related to environmental protection projects funded by the enterprise's disposable profits;

(d) expenditures funded by the enterprise's disposable profits in accordance with the norms approved by local soviets of people's deputies for the maintenance of health facilities, homes for the aged and for the disabled, children's culture and sports facilities, public educational institutions and housing that are on their accounts;

(e) donations to specified charitable funds or cultural, educational, health and welfare, athletic and sports enterprises, institutions or organizations up to an amount equal to one percent of taxable profits; and

(f) expenditures funded from profits for extending aid to agricultural enterprises for construction projects in villages and on purchasing equipment for them up to an amount equal to one percent of taxable profits.

6. *Other benefits available only to certain enterprises*

Other tax benefits apply only to certain types of enterprises, such as small enterprises and certain consumer cooperatives. These are generally not relevant to joint ventures.

C. *Special enterprise zone tax holiday and benefits*

The RSFSR Resolution on the Nakhodka Zone grants the following incentives:
- an income tax exemption for five years starting from the first profitable year;
- an income tax exemption for up to five years for profits remitted abroad by foreign investors;
- a tax exemption for profits invested in development of the social sphere (e.g. housing and services) or formation of the Zone's infrastructure;
- after the expiration of the tax holiday, an income tax rate of ten percent and a withholding rate on remitted profits of ten percent;
- the Nakhodka Municipal Executive Committee and the Partizanskii District Executive Committee have the right to reduce local taxes for foreign invested enterprises or exempt them from such taxes.

Other RSFSR resolutions call for proposals for the establishment of Free Enterprise Zones or Free Economic Zones in Leningrad, Vyborg, Kaliningrad, Sakhalin, Chita, the Altai Territory, Kemerovo and Novgorod Regions, Zelenograd and the territory of the Jewish Autonomous Region.

D. *Tax holidays and benefits under joint venture legislation*

Under existing joint venture legislation, the Ministry of Finance is authorized to reduce the tax rate or to grant exemptions to individual joint ventures. The Supreme Soviet Decision provides that legislation effective before the adoption of the ETL is still to be applied to the extent it does not "contradict" the ETL. The authority of the Ministry of Finance to grant reductions and exemptions would seem to be in addition to, and not contradictory with, that granted to the USSR Council of Ministers and other foreign bodies noted above. It would appear therefore that investors could still apply to the Ministry for additional tax reductions or exemptions for joint ventures.

The same considerations apply to the Ministry's right under existing joint venture legislation to reduce or exempt from tax dividends paid to a foreign investor by a joint venture producing consumer goods, medical technology and medicine and scientific products of important domestic economic significance as well as to joint ventures located in the Soviet Far East.

IV. REPATRIATION OF PROFITS

The inconvertibility of the ruble poses an additional challenge for foreign corporations investing or doing business in the Soviet Union. The convertibility issue arises in the following two contexts.

A. *Remittances by unrelated Soviet entities*

In a sales or licensing transaction, the foreign party will want to ensure that the Soviet purchaser or licensee has convertible currency to enable it to effect payment in accordance with the contract terms. In the past, this has not been a major problem. In the last two years, however, considerable payment delays have been encountered due to shortages of convertible currency. As a result, foreign parties are seeking payment by confirmed letter of credit or even in goods.

B. *Remittances by joint ventures*

Soviet joint venture legislation provides that a joint venture, in principle, should be self-sustaining in regard to convertible currency, i.e. the joint venture should generate itself all the convertible currency it needs for payment of imported raw materials, royalties and dividends.

A joint venture may generate convertible currency through measures such as:

1. *Exports*

Exports of the products manufactured by the joint venture are the primary means by which a joint venture is supposed to generate the necessary convertible currency.

2. *Sales in convertible currency on the Soviet market*

Joint ventures may also sell their products or services on the Soviet domestic market for convertible currency, but for most joint ventures Soviet customers with convertible currency do not exist or are a very limited market.

3. *Foreign currency auctions*

In 1989 the Soviet Government began a programme of convertible currency auctions, but joint ventures were not allowed to participate. It is reported that starting in 1991, joint ventures will be able to participate in convertible currency auctions or a more permanent convertible currency exchange.

4. *Consortium agreements*

Consortium agreements that pool the convertible currency earnings of several joint ventures (some with a need for convertible currency, others with excess convertible currency) are another possible means of obtaining convertible currency. Examples are the American Trade Consortium and the European Trade Consortium.

5. *Barter and countertrade*

The opportunities for barter and countertrade are very restricted. Soviet legislation prohibits joint ventures from engaging in "intermediary" trading activities unless specific permission is received from the Ministry of Foreign Economic Relations.

V. APPLICATION OF THE ETL TO SPECIFIC ACTIVITIES

The ETL will primarily affect foreign corporations engaged in direct sales, licensing or capital investment activities in the Soviet Union. The specific application of the ETL to each of these forms of doing business is discussed below.

A. *Direct sales*

Under the ETL, a foreign corporation engaged in direct sales into the USSR will not generally be subject to the turnover tax, the export and import tax or the consumption tax, but it may be subject to the profit tax. Whether a foreign corporation is subject to the profit tax depends on whether it has a taxable presence in the USSR, and whether the profits are related to the taxable presence.

1. *Taxable presence*

The ETL defines a taxable presence as a "permanent representation" (a "PR"). The definition of a PR seems to follow general international tax principles, but it also raises several issues. It states that a PR includes "a bureau, office, agency, or other place for carrying out activities (connected with processing natural resources, performing in accordance with contracts construction, installation, assembly, fabrication, repair of equipment and analogous works) and also organizations and citizens which represent on the territory of the USSR foreign juridical persons".

This definition raises the following issues:
(a) Is a PR under the ETL synonymous with a "representative office" under Soviet legislation regulating the establishment and operations of offices in the Soviet Union by foreign corporations?
(b) To constitute a PR must an agent have authority to contract and regularly exercise such authority? Is there a distinction between dependent and independent agents?
(c) When will a construction, installation or assembly project trigger a PR, i.e. after 6 months, 12 months or longer?
(d) To what extent will Soviet tax authorities try to follow international tax practice (e.g. 1977 OECD model tax treaty) in interpreting this definition of a PR?

2. *Relation of profits to taxable presence*

The ETL does not clearly define the relation between profits and a PR. It states that profit tax is imposed on income "received by a foreign legal person conducting activities through a permanent representation on the territory of the USSR, on the continental shelf or in the economic zone of the U.S.S.R". (The economic zone of the USSR includes areas within 200 nautical miles from shore.)

This language says nothing about what the relationship between the profits and the PR must be before the profits are taxable. The silence of the ETL on the relation of profits to a PR raises the following issues:
(a) There is no mention of the concept of "effectively connected income" or "attributable income". Will such concepts be applied?
(b) Does the ETL language noted above mean that a "force of attraction" rule will be applied, i.e. all Soviet income of a foreign corporation will be allocated to its PR?

3. *Deductions and deemed profits*

The ETL provides that the calculation of income and composition of deductions are to be determined in the manner established by the USSR Council of Ministers.

The ETL also provides that, in cases where it is not possible to determine profits directly, a deemed profit of 15 percent based on gross income or expenses is permitted with the approval of the tax authorities of the union republic where the PR is located.

4. *Tax rate*

Under the ETL, the profit tax rate applicable to foreign corporations with a PR is 30 percent. This contrasts with a 40 percent rate under prior legislation.

5. *Registration*

The ETL provides that a foreign legal entity carrying out activities through a PR must register with the tax authorities where the PR is located within one month after commencing activities. Failure to register is considered the concealing of profits.

These provisions raise the following questions:
(a) How will foreign corporations know whether they have a PR and therefore be required to register? Will they have to seek advance advice from the tax authorities in each case?

(b) Under what circumstances would failure to register be considered the "intentional" concealing of profits that would be punishable under the ETL by fines and two years of corrective labour?

6. *Tax treaties*

Currently, the USSR has 19 tax treaties with the major developed countries with provisions relevant to direct sales to the USSR. These treaties can be divided into two groups: the U.S. treaty, and other treaties.

(a) *U.S. treaty*
The current U.S. tax treaty is a *sui generis* treaty reflecting the undeveloped state of tax and investment law in the Soviet Union in 1973.

The treaty states that income from commercial activity of a U.S. corporation will be taxable in the USSR only if it is "derived by a representation". A "representation" is defined as an office or representative bureau established in accordance with USSR law. The relevant Soviet law is that noted above regarding "representative offices". When the treaty was signed, a U.S. corporation could generally establish an office in the USSR only by complying with this legislation. Thus, a tax "representation" was almost always synonymous with a "representative office" under Soviet legislation. Therefore, determining whether a U.S. corporation had a representation in the Soviet Union under the treaty was relatively easy in most cases. Now, in practice a U.S. corporation may lease office space without first receiving approval from the Ministry of Foreign Economic Relations or other accrediting agency. Thus, it is now more difficult to determine whether a U.S. corporation has a representation for tax purposes.

Even where a U.S. corporation has a representation, the treaty provides exemptions that cover many activities (e.g. income from the sale of goods or supply of services through an agent of independent status acting in the ordinary course of its business; income from preparatory or auxiliary activities; and income from technical services in connection with an installation contract carried out in 36 months or less at one location).

(b) *Other treaties*
In Soviet tax treaties the definition of a "permanent establishment" generally follows that of the 1977 OECD model treaty. The treaties often use the basic definition from the OECD model, but not the specific illustrative examples (e.g. factory, workshop, etc.) and set a higher threshold for a building site or installation project that triggers a permanent establishment (commonly 24 months in Soviet treaties). They often use the "attributable" and "distinct and separate enterprise" tests in specifying what income is taxable to a permanent establishment.

B. *Licensing*

Under the ETL, foreign corporations are subject to 20 percent withholding tax on gross income received from dividends, interest, copyrights and licences, leaseholds and other income from sources in the USSR but not related to activities in the USSR through a PR. Prior legislation did not provide for any withholding tax on royalties. The U.S. tax treaty exempts royalties from taxation.

Other Soviet tax treaties often reduce the maximum withholding tax on royalties to zero; see, for example, the treaties with Austria, Belgium, Cyprus, France, West Germany, Italy, the Netherlands, Switzerland, and the United Kingdom. In other cases, the treaties reduce the rate to 10 percent; see, for example, the treaties with Canada and Japan.

The ETL prohibits tax "gross-up" clauses, i.e. contractual provisions imposing the tax burden on the Soviet party. This increases the importance of the exemptions or reductions offered by the tax treaties.

C. *Investment*

Joint ventures are generally subject to the same type of taxes as domestic enterprises (e.g. those discussed above), but they enjoy certain additional benefits. Further, joint ventures in which the foreign share exceeds 30 percent enjoy benefits not available to other joint ventures.

In regard to foreign-invested enterprises, the ETL specifically covers only joint ventures. It does not mention wholly foreign-owned enterprises because the Presidential Decree authorizing them postdates the ETL. It seems likely, however, that wholly foreign-owned enterprises will enjoy not only the same treatment as other Soviet Corporations under new legislation, but also, to the extent practical, the benefits available to joint ventures.

1. *Deductions*

Joint ventures enjoy the same deductions as other enterprises except as noted above.

Under Soviet joint venture legislation, joint ventures may determine in the joint venture agreement or charter the depreciation schedule to be applied to plant and equipment. Under the ETL, joint ventures may take depreciation deductions according to such a depreciation schedule.

2. *Profits exempt from tax*

Joint ventures enjoy the same exemptions and reductions available to other enterprises except as noted above.

3. *Tax rates*

Three different profit tax rates are applied to joint ventures:
(a) joint ventures with the foreign share exceeding 30 percent and located in the Soviet Far East are subject to a 10 percent profit tax rate;
(b) other joint ventures with the foreign share exceeding 30 percent are subject to a 30 percent profit tax rate; and
(c) for other joint ventures the ordinary 45 percent profit tax rate applies.

4. *Payment procedures*

Joint ventures pay tax in four equal advance payments calculated on the basis of their annual fiscal plans. Payments are due on the 15th day of the last month in each calendar quarter.

5. *Taxation of foreign investor*

The ETL imposes a 15 percent withholding tax on dividends remitted abroad.

The U.S. tax treaty has no provision on dividend withholding. Other Soviet tax treaties generally set the maximum withholding tax rate at 15 percent; see, for example, the treaties with Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, the Netherlands and Switzerland. Some treaties lower the rate to zero percent; see, for example, the treaties with Austria, Cyprus, Finland and the United Kingdom.

VI. TAX PLANNING OPPORTUNITIES

The Soviet Union's current domestic tax legislation and treaty network provide various opportunities for tax planning.

A. *Percentage ownership in joint ventures*

Foreign investors may wish to plan to keep their share in joint ventures above 30 percent. A joint venture in which the foreign share exceeds 30 percent will enjoy the following benefits:
- a two-year tax holiday;
- a profit tax rate of 30 percent;
- a five-year loss carryforward;
- no increase to balance sheet profits for amounts by which the joint venture's employee wages exceed certain norms;
- full deductions for expenditures on production development, interest on long-term bank loans (except for in-

terest on overdue or rescheduled loans), scientific research and experimental design and nature conservation projects;
- a later effective date for the ETL. The ETL is effective with respect to such joint ventures as of 1 January 1991 instead of 1 July 1990 for other joint ventures; and
- freedom from adjustments to tax rates and limitations to tax privileges that may be imposed under the ETL by the USSR Supreme Soviet. Other joint ventures are subject to such adjustments and limitations.

It appears that for purposes of calculating the foreign share percentage, the shares of two or more foreign investors will be aggregated. Further, the determination of a foreign party's percentage will reportedly be made for the relevant tax year, so commitments to contribute capital in the future will not affect the determination for the current year.

B. *Tax treaties*

U.S. corporations investing in the USSR do not enjoy at present the benefit of a tax treaty lowering the withholding tax on dividends, i.e. they pay the full 15 percent rate. It may be possible to route dividends through a country that has treaties with both the USSR and the United States. One alternative is Cyprus. Under the Cyprus treaty, dividends can be remitted to Cyprus from the Soviet Union at a zero percent tax rate. Cyprus imposes only a 4.5 percent tax on offshore profits. The withholding rate on dividends remitted from Cyprus to the United States under the U.S.–Cyprus treaty is zero percent. The effective tax rate on dividends remitted from a Soviet joint venture under this alternative, therefore, is 4.5 percent.

C. *Divergences in republic tax rates*

Foreign investors will want to examine the tax rates set by the various republics to determine which offer lower tax rates. For example, under a recent decision the RSFSR will offer a maximum combined union and federal profit tax rate of 38 percent for enterprises registered in the RSFSR instead of 45 percent for enterprises registered at the union level.

VII. CONCLUSION

A number of conclusions can be drawn from the above discussion.

A. *Market economy*

The USSR has taken the first step to reform its tax system to apply to a market economy. It is moving closer to international practice in its domestic tax system and in its international tax treaties.

B. *Impact on foreign investment generally*

The impact of the ETL on joint ventures is mixed. It restricts tax holidays and for the first time imposes withholding on royalties (at the rate of 20 percent), but it lowers dividend withholding from 20 percent to 15 percent. Its effect on wholly foreign-owned enterprises is not yet clear.

C. *Encouragement of certain joint ventures*

The ETL encourages joint ventures with more than a 30 percent foreign share. It also encourages manufacturing rather than service joint ventures.

D. *Clarification*

Clarification of many details will have to await implementing measures and other action by the Council of Ministers.

E. *New developments*

Soviet tax law has seen a number of developments at the national and the union republic level since this article was written in December 1990. The most dramatic is the RSFSR Law on the Procedure for Enforcement on the Territory of the RSFSR in 1991 of the Law of the USSR on Taxation of Enterprises, Associations and Organizations that was issued 1 December 1990. The primary effect of this Law is to change the allocation of revenues between the national, union republic and local authorities by purportedly eliminating the allocation to the national budget. The impact of this new Law on the taxation of joint ventures and foreign corporations would appear to be minimal: it clarifies the taxation of wholly foreign-owned subsidiaries by stating that they will be taxed at the rate of 30 percent (the same as for joint ventures), allows the deduction of expenses for the acquisition of patents and licences; and alters the calculation of the excess profits tax.

A second RSFSR law, the Law on the Formation of Budgets of Regions, Cities, Municipal Districts, Boroughs, Rural Settlements and Other Administrative and Territorial Units of the RSFSR in 1991, issued 22 December 1990, authorizes local Soviets to independently determine the rates of profit tax and to establish local taxes and duties.

Developments at the national level include the following USSR tax legislation:

1. The USSR Ministry of Finance's Instructions on the Method of Calculation and Payment of the Import Tax, issued 4 December 1990, which provides the rates of the import tax prior to 1 November 1990 and thereafter.

2. The USSR Council of Ministers Decree No. 1256 on the Procedure of Calculating Profitability in its Average Amounts by Branches of the National Economy, issued on 10 December 1990, which provides the average profitability rates for the various branches of the national economy.

3. The USSR Council of Ministers Decree No. 1307 on Establishing Coefficients of Increase of Expenditures for Labour Remuneration by Branches of the National Economy and Industries (Types of Main Activity) for 1991, issued on 18 December 1990, which provides the coefficients for calculating expenditures for labour to determine net taxable profits under the Enterprise Tax Law.

4. The USSR Ministry of Finance Instructions on the Procedure for Calculation and Payment to the Budget of the Profits Tax and Separate Types of Income, issued 29 December 1990, which detail the calculation of taxable profits, the profit tax rates and the taxation of income received by enterprises on stock, debentures, bonds and from their shares in joint ventures.

5. The USSR Presidential Decree on the Introduction of a Sales Tax, issued on 29 December 1990, which imposes a new sales tax of five percent.

USSR:

PERSONAL TAXATION FOR EXPATRIATES

Duncan McBride

I. INTRODUCTION

The USSR is undergoing dramatic change. After more than 70 years of communist rule the Soviets are moving towards a more market-orientated economy. Western firms are being allowed to open offices in the Soviet Union and are entering into joint ventures with Soviet partners. As a consequence there are an increasing number of expatriates on assignment in the USSR all of whom are potentially liable to Soviet tax.

Duncan McBride has specialized in the taxation of expatriates for 13 years; the last ten with Ernst & Young and its predecessor firms. He became a partner in 1988.

He has worked with multinational corporations running substantial expatriate programmes as well as servicing the needs of smaller companies with fewer expatriates and individuals.

Mr. McBride's primary experience was in the U.S. and U.K. tax consequences of employee transfers between those countries. Since the beginning of 1990 he has undertaken the responsibility for Ernst & Young's advice to companies and individuals seeking guidance on individual taxation systems in Eastern Europe and the USSR.

The author wishes to express his gratitude for the assistance of Ms. Rosemary Martin, Ernst & Young, London, in the preparation of this article.

II. RECENT LEGISLATIVE CHANGES

In April 1990 the Supreme Soviet passed comprehensive new personal tax legislation which came into effect on 1 July 1990. Some of the key features of the new law include:

(1) a definition of residency has been introduced for the first time;
(2) individuals who are considered to be permanent residents of the Soviet Union are taxable on their worldwide income;
(3) tax is assessed under six different schedules, five of which have a marginal rate of 60 percent, the sixth a marginal rate of 90 percent;
(4) regulations empowering the authorities to impose fines and penalties for non-compliance with the new law.

It is no longer possible for employers to ignore the personal tax liabilities of employees assigned to the USSR. The Soviet Union is no longer a tax haven where the top marginal rate was 13 percent and non-Soviet source income was ignored.

III. LIABILITY TO SOVIET TAXES

The tax year is the calendar year.

Income tax is levied on Soviet citizens, foreign citizens and stateless persons whether or not they have a permanent place of residence in the USSR.

For taxation purposes individuals who are present in the Soviet Union for more than 183 days in the calendar year are considered to have a permanent place of residence in the USSR. Such individuals are liable to Soviet tax on their worldwide income regardless of whether or not it is paid or received in, or remitted to, the Soviet Union. Income is taxable whether it is received in cash or in kind, in roubles or hard currency.

Individuals without a permanent place of residence in the USSR are liable to tax on their Soviet-source income only. Such liability to Soviet tax arises as for residents regardless of whether or not the income is paid or received in, or remitted to, the Soviet Union. The Soviet authorities have yet to issue written confirmation of what counts as a day of presence in the Soviet Union for domestic tax purposes. Nevertheless, if an individual arrives in the USSR on or after 2 July in any tax year then, provided he has not made any previous visits to the Soviet Union during the same tax year, he will not be considered to be a permanent resident of the USSR for the year of his arrival. This is regardless of how long he intends to stay in the Soviet Union and whether or not he will be considered to be resident for subsequent tax years.

As the Soviets move towards a market-oriented economy, more expatriates are being assigned to the USSR. Comprehensive legislation passed in 1990 will dramatically affect the personal tax liabilities of these employees.

The new Soviet personal tax regime as it applies to expatriates working in the USSR is considered in more detail below.

IV. TAX STATUS

Employees of foreign resident companies and Soviet joint ventures are liable to tax under one of the schedules in the new law; the self-employed and owners of "private companies" are liable to tax under a different schedule.

For Soviet tax purposes the income of private companies is considered to be the income of their owners. In this context the owner of a private company is considered to be a foreign individual who wholly owns a business unit the income of which is not liable to corporation tax in the country in which the business is registered or in which the individual is resident.

A. *Employees*

Individuals who are considered to be permanent residents of the USSR and who are employees of either foreign companies or Soviet joint ventures are, subjected to certain specific exemptions, liable to Soviet tax on the whole of their remuneration whether it is received in cash or in kind, in the USSR or elsewhere, in hard currency or in roubles.

B. *Salary, bonuses, commissions*

Salary, bonuses, commissions, etc. received by an individual while he is considered to be a permanent resident of the USSR will be liable to tax provided that it was earned during a period when the individual was resident in the Soviet Union or it relates to duties performed in the Soviet Union before he became a permanent resident of the USSR.

C. *Cost of living allowance*

Cost of living allowances and other allowances paid in connection with living in the USSR are liable to Soviet tax.

D. *Per diems*

Prior to 1 July 1990 the Ministry of Finance generally accepted that a daily allowance of 3.50 Rbs could be paid tax-free. Larger sums could be paid provided prior agreement was obtained from the authorities. The allowance could be paid tax-free regardless of whether or not it could be justified by expenses actually incurred. Since 1 July 1990 daily allowances have been fully taxable unless the amounts paid can be justified on the basis of the expenses actually incurred in travelling within the USSR or outside of it.

E. *Housing*

Amounts paid or reimbursed in respect of expenditure on renting living accommodation in the USSR are not taxable in the Soviet Union. Housing allowances will also be exempt from tax provided they do no more than cover the actual expenses incurred. Where there is a profit element the excess will be taxable.

F. *Cars*

Amounts paid or reimbursed in connection with the upkeep of a motor car used for business purposes are exempt from Soviet tax. The upkeep of a motor vehicle should be distinguished from its provision.

G. *School fees*

School fees paid or reimbursed by an individual's employer are liable to Soviet tax.

H. *Home leave*

Amounts paid or reimbursed in relation to the travel costs of an individual's family on vacation or for other similar purposes is fully liable to tax in the Soviet Union. Where the individual himself is able to combine business and vacation trips a proportion of the expenses paid or reimbursed may be allowable as business expenses.

I. *Expenses*

Amounts paid or reimbursed in respect of business expenses are exempt from Soviet tax. The exemption applies to travel and subsistence payments including accommodation expenses.

J. *Pension contributions*

State social security contributions deducted by an employer are not taxable regardless of whether the individual is liable to Soviet social security or he remains liable to State social security contributions in his home country.

Other pension contributions are not tax-deductible.

K. *Deferred compensation*

Compensation earned during a period of residence in the USSR but not paid until after the individual has finally left the USSR may escape Soviet tax. This is of particular significance when considering the Soviet tax treatment of stock options granted to or exercised by an expatriate during his assignment to the Soviet Union.

L. *Other benefits in kind*

The general rule is that where income is received in kind, the benefit is valued at the current retail price of goods received. In cases where the goods received are not generally available then the benefit is valued at the current retail price of a similar product.

M. *Tax equalization*

Most expatriates on assignment in the USSR will be covered by their employers' tax equalization programme.

Prior to 1 July 1990 the amount of tax paid to the Soviet authorities under a tax equalization policy was not generally included in calculating the individual's remuneration liable to Soviet tax, i.e. the tax paid on the individual's behalf was neither grossed-up and taxed in the year for which it was paid nor rolled over and taxed in the year in which it was paid.

The Soviet authorities are no longer prepared to accept this and have introduced a clause to the new legislation which provides that:

> It is forbidden to pay the tax on the earnings of citizens out of the funds of enterprises, institutions or organizations.

In order to formally comply with the new law it is now necessary to ensure that taxes paid under a tax equalization policy are included in the individual's remuneration.

V. TAX LIABILITY

A. *Employees*

Income received in foreign currency is translated into roubles at the official exchange rate of the State Bank of the USSR at the date on which the tax calculation is made. Amounts of income are rounded down to the nearest rouble. The amount of tax due is calculated to the nearest kopek.

For 1990 the year is treated on a split year basis. Income earned prior to 1 July 1990 is taxed at the following rates:

Amount of Monthly Income		Tax on	Tax Rate on
Lower Limit (Rbs.)	Upper Limit (Rbs.)	Lower Limit	Excess over Lower Limit
0	100	Flat rate of 8.2%	
100 and more		8.20	13%

Income earned during the period from 1 July 1990 to 31 December 1990 is taxed at the following rates:

Amount of Monthly Income		Tax on	Tax Rate on
Lower Limit (Rbs.)	Upper Limit (Rbs.)	Lower Limit	Excess over Lower Limit
0	150	Per tables	
151	700	14.70	13%
701	900	86.20	15%
901	1,100	116.20	20%
1,101	1,300	156.20	30%
1,301	1,500	216.20	40%
1,501	3,000	296.20	50%
3,000 and above		1,046.20	60%

Income received on or after 1 July 1990 but earned before 1 July 1990 is liable to tax at the old rates and in accordance with previous Soviet tax law and practice.

An individual's tax liability, calculated in accordance with the above, is reduced by 30 percent if he has three or more dependants. Dependants are considered in more detail below.

B. *The self-employed*

The self-employed are taxed under a different schedule to employees.

Soviet legislation refers to "individual labour activity", which is defined in the regulations as income from any socially useful activity, not prohibited by legislation, which is permanent in nature and does not involve the labour relations of the individual with an enterprise, institution, organization or other citizens. The activity in question does not have to fall within the scope of the law on Individual Labour Activity.

Generally speaking, foreign individuals who are regarded as self-employed in their home country will be treated as self-employed in the USSR and subject to Soviet tax under the provisions enacted in respect of individual labour activity.

Taxable income is considered to be gross income less expenses. Income received in cash or in kind is included in gross income. The regulations specifically include the following as allowable expenses:

(i) expenditure on materials;
(ii) depreciation;
(iii) rental payments;
(iv) compulsory property insurance;
(v) interest on short-term bank credits but *not* interest on delayed or deferred loans;
(vi) State social security contributions;
(vii) repair and maintenance costs.

Expenses will not be allowed unless the individual is able to produce documentary evidence to support his claim.

Example

An American citizen arrived in the Soviet Union on 1 April 1990. His remuneration for the period from 1 April 1990 to 31 December 1990 net of hypothetical U.S. taxes is as follows:

	US$
Base Salary	90,000
Cost of Living Allowance	9,000
Housing Allowance	9,000
Moving Premium (Paid April 1990)	5,000

The U.S. dollar : rouble exchange rate is assumed to be $ 2 : 1 Rb.

	$	Rbs.	Rbs.
1 April 1990 - 30 June 1990			
Salary ($ 90,000 × 3/9)	30,000		
COLA $ 9,000 × 3/9)	3,000		
Moving Premium	5,000		
	38,000		
Converted @ $ 2 : 1 Rb.		19,000	
Tax Thereon			
First 300 Rbs. @ 8.2%			24.60
Balance 18,700 Rbs. @ 13%			2,431.00
			2,455.60
1 July 1990 - 31 December 1990			
Salary ($ 90,000 × 6/9)	60,000		
COLA ($ 9,000 × 6/9)	6,000		
	66,000		
Converted @ $ 2 : 1 Rb.		33,000	
Plus			
Tax Equalization		38,193	
		71,193	
Tax Thereon			
First 18,000 Rbs.			6,277.20
Balance 53,193 Rbs. @ 60%			31,915.00
			38,193.00
Total Tax Due			
1 April 1990 - 30 June 1990:			2,455.60
1 July 1990 - 31 December 1990:			38,193.00
			40,648.60

Note

The housing allowance of US$ 9,000 (4,500 Rbs.) is exempt from Soviet tax under both the old and new legislation provided it does no more than cover the rental expenses incurred.

The payment of tax due is considered in more detail later.

Income received and expenses paid in foreign currency are translated into roubles at the official exchange rate of the State Bank of the USSR on the date the tax due is calculated.

The tax is calculated on an annual basis in accordance with the following:

Amount of Annual Income (Rbs.) Lower Limit	Upper Limit	Amount of Tax on Lower Limit	Rate of Tax on Excess over Lower Limit
0	3,000	In an amount equal to the amount paid for the corresponding number of months by employees	
3,001	4,000	332.40	20%
4,001	5,000	532.40	30%
5,001	6,000	832.40	50%
6,001 and over		1,332.40	60%

Example

An American citizen who acts as a self-employed consultant to Western firms wanting to expand their operations into the USSR receives gross consultancy fees of US$ 200,000 during 1991. His expenses total $ 40,000 plus 40,000 Rbs.

	$	Rbs.	Rbs.
Gross fees	200,000		
Less Expenses	(40,000)		
	160,000		
Converted @ $ 2 : 1 Rbs.		80,000	
Less Expenses		(40,000)	
		40,000	
Tax Thereon			
First 6,000 Rbs.			1,332.40
Balance 34,000 Rbs. @ 60%			20,400.00
			21,732.40

VI. TAX COMPLIANCE

A foreign individual who arrives in the USSR some time during the period from 1 January to 1 July inclusive and who intends to be present in the Soviet Union for more than 183 days during the calendar year is required to file a preliminary tax return within one month of the date of his arrival. Personal details and details of estimated income for the current year are entered on the return.

A final tax return needs to be filed before 1 March in the year following the end of the tax year for which the return is made. The return must include full details of all income actually received.

A return must also be filed one month before the date of final departure. The return should include full details of all income actually received.

Returns should be filed with the tax authority at the place where the foreign individual is permanently resident in the USSR or, if he is employed elsewhere, with the tax authority at the place where he works. They should be completed in Russian or the language of the Union Republic in which the return is filed. Foreign individuals should not file returns in their native language. Amounts shown on the return should be in either the currency in which the income was received or the currency stipulated in the relevant contract.

Individuals who are employed by a non-Soviet resident employer or who are paid outside of the USSR will receive a tax demand for, in effect, a payment on account. For new arrivals in the USSR this will be 75 percent of their estimated tax liability based on their preliminary tax return. For other individuals the tax demanded will be based on the final tax return for the previous year. It will be payable in three installments on 15 May, 15 August and 15 November.

The final tax due will be determined following the submission of the final tax return. Any overpayment will be either refunded or credited against future tax liabilities. Any further tax due will be payable within one month of the date of issue of the demand for the balance due.

Tax demands are either sent by post or handed to the individual personally.

VII. DEPENDANTS

As noted above, an individual's Soviet tax liability is reduced by 30 percent if he has three or more dependants. Dependants include any persons who subsist on the means of the individual and who do not have an independent source of income. It is not necessary for the dependant to be related to the claimant.

If a family has three or more dependant children both husband and wife will be granted relief. In any other case relief is granted to one spouse only. Only rarely will this be of significance to foreign individuals as other dependants will frequently have independent sources of income.

In order to claim relief, a foreign individual should attach the relevant documentation to his first Soviet tax return. The documents must be certified by the local authorities of the expatriate's home country. A separate certificate needs to be completed and authorized by the appropriate Soviet authority if the dependants are resident with the claimant in the USSR.

VIII. EMPLOYEES OF JOINT VENTURES

Foreign individuals employed and paid by a Soviet joint venture are subject to tax withholdings in the same way as Soviet citizens.

If remuneration is paid twice a month the tax is calculated on a monthly basis generally on the basis of payments made in the previous month. The tax so calculated is withheld from earnings paid for the first half of the month.

If remuneration is paid once a month the tax is calculated on, and withheld from, the remuneration paid for the same month. The Soviet tax authorities are empowered to carry out audits in order to check the accuracy of the withholdings made, the granting of reliefs and the promptness and completeness of payments into the State Budget.

IX. PAYING THE TAX DUE

As noted above, income received in foreign currency is translated into roubles at the official exchange rate of the State Bank of the USSR on the date the tax due is calculated. The tax due may be paid either in roubles or in foreign currency purchased by the State Bank of the USSR. When payment is made in foreign currency, the amount of tax which has been computed in roubles will be converted into the foreign currency at the official exchange rate.

Any repayment of tax due will only be made in foreign currency if the initial tax was paid in foreign currency purchased by the State Bank of the USSR.

X. PENALTIES

The Soviet tax authorities are empowered to impose penalties in the event that:
(1) a tax return is filed after the due date;
(2) the information shown on the return is incorrect or cannot be verified by appropriate documentation; or
(3) the amount of income received is under-reported.

The penalties are particularly severe if the income is received in foreign currency.

XI. NON-RESIDENTS

Persons without a permanent place of residence in the USSR are liable to Soviet income tax on their Soviet-source income only.

In this context Soviet-source income is regarded as any income paid by an enterprise, establishment or organization set up in accordance with the legislation of the USSR or received as a result of the use or the grant of a right of use of property present on the territory of the USSR.

In particular, such income includes income arising from work in Soviet enterprises, organizations and establishments; in joint ventures with foreign participation, and in foreign organizations. In such cases tax may be withheld at source in accordance with the provisions outlined above for individuals who have a permanent place of residence in the USSR.

However, provided that the individual is a permanent resident of a country with which the USSR has concluded a double tax treaty and the Soviet source income is liable to tax in the agreement country then the individual may claim exemption from Soviet withholding. A separate claim is necessary in cases when withholdings have been made but may be repaid under the provisions of a double tax treaty. The claim should be made within one year of the date on which the withholding was made.

XII. DOUBLE TAX TREATIES

The USSR has concluded double tax treaties with a number of countries including Austria, Canada, Italy, the United Kingdom and the United States.

Frequently there are provisions in a double tax treaty which may be utilized in designing a tax efficient expatriate compensation package. Such considerations are beyond the scope of the present article.

XIII. OTHER TAXES

A. *Income tax on non-employment income*

Foreign individuals are liable to Soviet income tax on their worldwide income regardless of whether or not it is paid or received in, or remitted to, the USSR. Therefore, they are liable to tax on interest, dividend income, rental profits, etc. received in their home country.

Taxable income is regarded as gross income less expenses. Documentary evidence is required to verify the expenses claimed. The net taxable amount is charged to tax at the following rates:

Amount of Annual Income		Tax on	Tax Rate on
Lower Limit (Rbs.)	Upper Limit (Rbs.)	Lower Limit	Excess over Lower Limit
0	300	Exempt	
301	360	0	10%
361	480	6.00	14%
481	600	22.80	19%
601	840	45.60	23.5%
841	1,200	102.00	29%
1,201	1,800	206.40	33.5%
1,801	2,400	407.40	40%
2,401	3,000	647.40	46.5%
3,001	5,000	926.40	52.5%
5,001 and above		1,976.40	60%

Any income which is assessable under this schedule will be taxed at the above rates if it is received on or after 1 July 1990. This will be the case even if the income accrued over a period prior to 1 July 1990.

B. *Capital taxes*

Currently, there are no capital taxes in the USSR. This can be expected to change as the rights of ownership are extended.

C. *Estate taxes*

Amounts received by way of inheritance or gift are generally not taxable in the USSR.

XIV. SUMMARY

Prior to 1 July 1990 the personal taxation of expatriates assigned to the USSR was of little importance in considering the overall costs associated with a company's expansion into the Soviet Union. This is no longer the case. The tax base has been extended to include previously non-taxable items of remuneration and non-Soviet source investment income; the top marginal rate of tax has been increased from 13 percent to 60 percent and legislation has been enacted which, if enforced, would result in the imposition of significant fines for non-compliance.

Nevertheless, both the domestic Soviet tax legislation and the provisions of the international agreements concluded with the USSR give scope for tax planning. Companies and their executives should give serious thought to the opportunities available.

Finally it should be noted that because the legislation is relatively recent there are many issues which have yet to be resolved.

UNITED STATES:

PROPOSED REGULATIONS UNDER SECTION 6038A ADDRESS REVISED RECORD KEEPING AND REPORTING OBLIGATIONS OF FOREIGN-BASED MULTINATIONAL GROUPS

Stanley C. Ruchelman

Mr. Ruchelman is a member of the bars of the State of New York and the District of Columbia and is a partner of Ruchelman & Felgoise, a law firm in New York City. He lectures on tax matters that are of special interest to multinational groups and is a frequent contributor to professional journals. Mr. Ruchelman received a B.A. Degree from Brooklyn College and a J.D. Degree from George Washington University.

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X. Proposed Effective Dates

On 5 December 1990, the Internal Revenue Service ("IRS") filed a notice of proposed rulemaking with the Federal Register regarding the reporting and record keeping obligations under Section 6038A of the Internal Revenue Code ("the Code") as modified by Section 7403 of the Revenue Reconciliation Act of 1989, P.L.101-239 ("the 1989 Act"). The proposed regulations are extensive and provide detailed rules for (1) identifying and reporting certain transactions with related parties, (2) the maintenance of records by certain foreign-owned U.S. corporations (and certain foreign corporations engaged in a U.S. trade or business) regarding operations of the foreign related parties with which they do business, (3) the mandatory appointment of the reporting corporation to be the agent for service of process of foreign related parties to facilitate the production of those records upon demand of the IRS and (4) penalties that can be imposed for compliance failures. For some purposes, the proposed regulations relate back to taxable years beginning after 10 July 1989, and a public hearing is scheduled for 22 February 1991.

This article summarizes the proposed regulations and highlights certain provisions of importance for the foreign-based multinational group.

I. BACKGROUND

The Code has imposed reporting obligations on certain corporations owned by foreign persons since 1983. Code Section 6038A was introduced into law by Section 339 of the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, with effect for taxable years beginning after 31 December 1982, and has remained essentially unchanged until the 1989 Act.[1] As originally enacted, Section 6038A required an annual filing of an information return[2] by a domestic corporation or foreign corporation that was engaged in a U.S. trade or business and was controlled by a foreign person.[3] For this purpose, the term "control" or "controlled" meant the ownership of at least 50 percent of the total voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.[4] Initially, Code Section 6038A called for reporting of transactions only with members of the same controlled group,[5] but this was eventually expanded to transactions with related parties.[6] Ownership attribution rules applied for purposes of determining whether (1) a corporation was controlled by a foreign corporation,[7] or (2) a person was related to a foreign controlled corporation.[8] The statute and the regulations were silent with regard to the reporting obligation of a domestic corporation that engaged in business only through a partnership where the latter engaged in a transaction with the foreign person that controlled the domestic corporation.

1. The scope of transactions covered by Code Sec. 6038 was broadened in a technical manner by the Tax Reform Act of 1986, P.L. 99-514, to require the reporting of transactions with related parties. Prior to that time reporting was required only for transactions with corporations that were members of the same controlled group of corporations, determined by reference to common ownership of at least 50 percent of voting power or value. The change extended the scope of reportable transactions to those involving related foreign individuals and partnerships.
2. The return was filed on Form 5472 (Information Return of a Foreign Owned Corporation).
3. Code Sec. 6038A(a) as in effect prior to the 1989 Act.
4. Code Sec. 6038A(c) as in effect prior to the 1989 Act.
5. Code Sec. 6038A(b) as in effect prior to the Tax Reform Act of 1986.
6. See *supra* note 1.
7. By reference in Code Sec. 6038A(c)(1) to Code Sec. 6038(e)(1), Code Sec. 318 was to be applied in modified form. The principal modification was that ownership of shares from a corporation to its shareholders would occur if the shareholder owned at least ten percent of the value of the corporation.
8. Code Sec. 267(c).

The failure to furnish the required information for a particular year caused the domestic corporation to face a penalty of US$ 1,000 and exposed the domestic corporation to additional penalties of $ 1,000 for each 30-day period during which the failure continued after 90-day notification by the IRS. The maximum additional penalty was $ 24,000 and, as a result, the aggregate penalties faced by a non-compliant domestic corporation were $ 25,000.[9]

The reporting rules for foreign-controlled corporations were modified significantly by the 1989 Act. In broad terms, the threshold for reporting was decreased. Reporting is now required if at least 25 percent of the corporation is owned by a foreign person. Hence, the term "foreign-controlled" was replaced by the term "25 percent foreign-owned".[10] Document retention obligations were placed on these corporations to maintain records regarding operations of related foreign entities with which the 25 percent foreign-owned corporation engages in business transactions. The stated reason is to allow the IRS to determine the true taxable income of the 25 percent foreign-owned corporation under U.S. law. In order to enforce the record maintenance and production rules, the foreign entity must appoint the 25 percent foreign-owned corporation in the United States to act as its agent for service of process under the provisions of the Code relating to compelled production of evidence.[11] This is a special appointment and does not make the appointee the agent for service of process for other matters.

Failure of the 25 percent foreign-owned corporation or the related foreign entity to comply with these rules can result in two types of penalties. The 1989 Act increased the dollar amounts of the penalties from $ 1,000 to $ 10,000 and eliminated the $ 25,000 ceiling. In addition, the 1989 Act contains a provision under which the price of items purchased from a related party, for purposes of determining cost of goods sold, or the amounts allowed as deductions arising from transactions with a related party can be computed unilaterally by the IRS on the basis of any probative information it may choose to obtain. The inherent risk for the reporting corporation is that the IRS will determine unilaterally that the item or the expense should be afforded little or no value.

The foregoing changes wrought by the 1989 Act were broad. The detail required for implementation is provided by the proposed regulations discussed below.

II. REPORTING OBLIGATION – DEFINITIONS AND MISCELLANEOUS RULES

The reporting obligation is set forth in proposed §1.6038A-2 of the regulations. Each reporting corporation is required to make a separate annual information return on Form 5472 with respect to each related party with which it engaged in a reportable transaction during the taxable year. The information must be furnished even if the particular item does not affect the amount of any tax that may be due. Key terms that are defined in the regulations are *reporting corporation, related party* and *reportable transaction.*

A. *Reporting corporation*

The term "reporting corporation" is defined in proposed §1.6038A-1(c) of the regulations. In general, it means either a domestic corporation that is 25 percent foreign-owned or a foreign corporation that is engaged in a trade or business in the United States.[12] Through 4 November 1990, a foreign corporation engaged in a trade or business in the United States was a reporting corporation only if it was at least 25 percent foreign-owned. However, that requirement was eliminated from the law with the enactment of Code Section 6038C.[13] As a result, if a foreign corporation is engaged in a trade or business in the United States at any time during its taxable year after 4 November 1990, it is a reporting corporation.

B. *25 percent foreign-owned*

For a corporation to be 25 percent foreign-owned, it must have at least one 25 percent foreign shareholder at some point during the taxable year.[14] The ownership threshold is met if a foreign person owns at least 25 percent of either (1) the total voting power of all classes of voting stock of the reporting corporation;[15] or (2) the total value of all classes of stock of the reporting corporation.[16] These tests are applied on the basis of facts and circumstances, and principles similar to §1.957-1(b)(2) of the regulations will be applied.[17] These principles are designed to prevent a foreign corporation from avoiding the status of a controlled foreign corporation ("CFC") by adopting a capital structure in which the class of shares retaining voting power is separated from the class of shares with value.[18] As a result, attempts to separate voting power from value will be closely examined to determine if a separation in form is also a separation in fact.

A person is adjudged to be a foreign person for purposes of Code Section 6038A under relatively straightforward tests.[19] In the case of individuals, a person is foreign if he is neither a citizen nor a resident of the United States.[20] An alien individual who is considered to be a U.S. resident solely because of an election to file a joint return is not considered to be a foreign person. However, a citizen of a possession of the United States is considered to be a foreign person in

9. Code Sec. 6038A(d) as in effect prior to the 1989 Act.
10. The rules discussed in the text were extended to all foreign corporations engaged in a U.S. trade or business by reason of Code Sec. 6038C, introduced by Sec. 11315(a) of the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 [the 1990 Act]. As a result, the percentage of foreign ownership in the foreign corporation became irrelevant. Thus, after 4 November 1990 any foreign corporation engaged in a U.S. trade or business is a "reporting corporation".
11. Code Secs. 7602 (relating to the examination of books and witnesses and the authority to issue a summons), 7603 (relating to the procedure for serving a summons) and 7604 (relating to the judicial enforcement of a summons).
12. Proposed §1.6038A-1(c)(1) of the regulations.
13. See *supra* note 9.
14. Proposed §1.6038A-1(c)(2) of the regulations.
15. Proposed §1.6038A-1(c)(3)(i)(A) of the regulations.
16. Proposed §1.6038A-1(c)(3)(i)(B) of the regulations.
17. Proposed §1.6038A-1(c)(3)(i) of the regulations.
18. The 1986 Tax Reform Act introduced a test based on value to the then-existing test based solely on voting power for purposes of determining whether a foreign corporation is a CFC. This put an end to many schemes that allocated shares with voting power to foreign persons and shares with value to U.S. persons. In the period since the enactment of the 1986 Tax Reform Act, §1.957-1(b)(2) of the regulations has been applied to circumstances where a foreign corporation is owned in small part by one foreign entity and in equal and principal shares by a U.S. person and by a foreign person that, itself, is not owned in substantial part by a U.S. person. If the first mentioned foreign entity informally agrees to vote its shares with the U.S. person, the U.S. person is deemed to possess the requisite voting power even though it may not possess shares having the requisite value. As a result, the foreign corporation may be deemed to be a CFC.
19. Proposed §1.6038A-1(f) of the regulations.
20. Proposed §1.6038A-1(f)(1) of the regulations.

the absence of other facts relating to his U.S. citizenship or residence.[21] A partnership, association, company or corporation is considered to be foreign if it is not created or organized in the United States or under the law of the United States or any of the States.[22] A foreign trust or foreign estate as defined in Code Section 7701(a)(31) is a foreign person.[23] Finally, a foreign government or foreign controlled commercial entity within the meaning of Code Section 892(a)(2)(B) is a foreign person to the extent that it is engaged directly or indirectly in a U.S. trade or business and receives income that is not exempt from tax under the Code.[24]

In determining whether a corporation is 25 percent foreign-owned, the rules of constructive ownership in Code Section 318 continue to be applied in modified form.[25] Under that section of the Code, the ownership of shares of stock by one person may be attributed to another. For example, stock owned by an individual may be attributed to a family member;[26] shares covered by an option may be attributed to the holder of the option;[27] shares may be attributed to a partnership, trust or corporation from partners,[28] beneficiaries or 50 percent shareholders of the corporation on a pro rata basis;[29] ownership of shares by a partnership, trust or corporation may be attributed respectively to a partner of the partnership, a beneficiary of a trust or to a shareholder owning at least 50 percent of the corporation;[30] and ownership through attribution is generally considered to be actual ownership except where specified.[31]

The modifications to Code Section 318 are those that appear in Code Section 6038(e)(1)[32] and which apply by reason of Code Section 6038A(c)(1).[33] Under the first modification, the threshold for attribution to a shareholder from a corporation is reduced to 10 percent from 50 percent. The ownership threshold has not been reduced for attribution from a shareholder to a corporation. Under the second modification, the rules attributing ownership to a corporation, partnership or trust from a shareholder, partner or beneficiary will not be applied if the effect is to cause a U.S. person to be deemed to own shares actually owned by a non-U.S. person. This standard seems to make greater sense in the context of Code Section 6038, which relates to U.S. ownership of foreign companies because its application prevents a U.S. subsidiary of a foreign parent from constructively owning all foreign subsidiaries of that parent.

If no single foreign person owns or is considered to own through attribution the required 25 percent of the voting power or value of the corporation, the corporation is not a reporting corporation even if foreign persons own 25 percent or more of the voting power or value of the corporation. The proposed regulations contain an example illustrating the point.[34] In the example, 20 percent of the voting power of a domestic corporation D is owned by each of two foreign corporations FC2 and FC3, neither of whom are engaged in a U.S. trade or business. In turn, 25 percent of the voting power of each of the foreign corporations is owned by a third foreign corporation, FC1. Although 40 percent of the voting power of domestic corporation D rests with foreign entities, no single foreign person owns sufficient shares to cause the domestic corporation to be a reporting corporation. FC1 is deemed to own only 10 percent of the shares of domestic corporation D (25% × 20% owned by FC2 and 25% of 20% owned by FC3), and because the attribution rules from shareholders to corporations continue to require at least 50 percent ownership, no attribution can exist from FC1 to FC2 or FC3.

C. *Related party*

The term "related party" means a person whose relationship to a reporting corporation meets any one of three tests.[35]

The first test is met if the other person is a 25 percent foreign shareholder of the reporting corporation after application of the attribution rules discussed above. A 25 percent foreign shareholder is deemed to be related to the reporting corporation.

The second test is met if the other person is related, within the meaning of Code Sections 267(b) or 707(b), to the reporting corporation or to a 25 percent foreign shareholder of the reporting corporation. Although these provisions describe various relationships, they address in substantial part relationships in which greater than 50 percent common ownership exists among various entities. Thus, for example, an individual is related to a corporation in which he owns more than 50 percent of the value of the outstanding stock;[36] two corporations are related if they are members of the same controlled group determined by reference to more than 50 percent common ownership;[37] and a corporation and a partnership are related if the same persons own more than 50 percent of the value of the outstanding stock of the corporation and more than 50 percent of the capital or profits interest in the partnership.[38]

For purposes of applying Section 267(b), a different set of attribution rules applies.[39] Under this set of rules, stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust is considered to be owned proportionately by or for its shareholders, partners or beneficiaries. In comparison to Code Section 318, attribution applies only upward along a corporate chain from corporation to its shareholders and no threshold exists. No attribution exists from shareholders to a corporation. An individual is considered to own the stock owned, directly or indirectly, by or for his family. For this purpose, the term "family" includes the persons designated in Code Section 318(a)(1) discussed above, and includes brothers and sisters. Finally, an individual owning any stock in a corporation other than through family attribution is considered to own the stock owned, directly or indirectly, by or for his partner.

21. Proposed §1.6038A-1(f)(2) of the regulations.
22. Proposed §1.6038A-1(f)(3) of the regulations.
23. Proposed §1.6038A-1(f)(4) of the regulations.
24. Proposed §1.6038A-1(f)(5) of the regulations.
25. Proposed §1.6038A-1(e)(1) of the regulations.
26. Code Sec. 318(a)(1). A family member is a spouse, grandparent, parent or child.
27. Code Sec. 318(a)(4).
28. Code Sec. 318(a)(3)(A).
29. Code Sec. 318(a)(3)(C).
30. Code Sec. 318(a)(2)(C).
31. Code Sec. 318(a)(5)(A). Proscribed reattribution involves shares attributed among family members or from shareholders to a corporation. In the first instance, once shares have been attributed to a family member, the shares cannot be reattributed a second time under the family attribution rules (Code Sec. 318(a)(5)(B)). In the second instance, once shares have been attributed to a corporation from a shareholder, the shares cannot be reattributed from the corporation to another shareholder (Code Sec. 318(a)(5)(C)).
32. See *supra* note 7. Code Sec. 6038 requires reporting of certain information by U.S. persons that control foreign corporations.
33. Proposed §1.6038A-1(e) of the regulations.
34. Proposed §1.6038A-1(j) *Example (3)* of the regulations.
35. Proposed §1.6038A-1(d) of the regulations.
36. Code Sec. 267(b)(2).
37. Code Sec. 267(b)(3).
38. Code Sec. 267(b)(10).
39. Code Sec. 267(c).

In applying these rules, stock constructively owned by a person under the entity-to-owner rules is considered to be actually owned for the purpose of reattribution. However, stock constructively owned by an individual by reason of the application of the family or partnership rules is not treated as owned for the purpose of another attribution under those provisions.

The third test is met if the other person is related to the reporting corporation within the meaning of Code Section 482. This test has certain technical difficulties in its application as Code Section 482 does not generally refer to related parties. Rather, the Code and the regulations[40] refer to two or more organizations, trades or businesses that are members of the same controlled group either because one controls the other or because both are controlled by the same interests. Control is given a broad definition that looks to facts and circumstances and it is the reality of the control that is important no matter how exercised. In this regard, the regulations provide that a presumption of control exists if income or deductions are arbitrarily shifted between taxpayers.[41] It is thought that the third test of the proposed regulations treats members of the same controlled group as related persons. Thus, if an adjustment to income may be made between an entity and a reporting corporation by virtue of Code Section 482, the entity is related to the reporting corporation.

Two administrative rules apply when determining whether another entity is related to a reporting corporation. First, as mentioned above, the modified ownership attribution rules discussed above apply when determining whether an entity is a 25 percent foreign shareholder and therefore related to a reporting corporation.[42] Thus, in a chain of corporations comprised of domestic reporting corporation C, foreign corporation B that owns 90 percent of the outstanding shares of C, and foreign corporation A that owns 10 percent of the shares of C and 20 percent of the shares of B, both A and B are considered to be related to C. B is related because it is a 25 percent foreign shareholder of the reporting corporation. A is related because it, too, is a 25 percent shareholder of C; A owns 10 percent of C's shares directly and 18 percent by attribution from B (20% × 90%).

Second, in order to avoid unnecessary duplication in reporting obligations, two domestic corporations that join in the filing of a consolidated return are not considered to be related.[43]

D. *Related party – attribution of partnership transactions*

In determining whether a reporting corporation has engaged in a transaction with a related person, the proposed regulations introduce a special rule that applies when the corporation is a member of a partnership.[44] Under the special rule, all transactions of the partnership may be attributed to a partner that is a reporting corporation on a pro rata basis, determined by reference to relative partnership interests. The rule applies if the reporting corporation directly or indirectly owns a capital or profits interest which by itself, or when added to the partnership interests owned by related parties, comprises 25 percent or more of the total interests in the partnership. The effect of this rule is to cause the reporting corporation to treat the partnership transactions as its own for purposes of the reporting, records maintenance, monetary penalty, agent for service of process and production of records rules of the regulations.

This rule of attribution may have broader implications than initially apparent, as illustrated by an example in the regulations.[45] In the example, partnership P is comprised of domestic corporation D, which owns 25 percent of the capital and profits interests, and foreign corporation FC1, which owns the balance of the capital and profits interests. FC1 and D are owned entirely by foreign corporations. In the case of FC1, the foreign shareholder is FC2, and in the case of D, the foreign shareholder is FC3. All of the partnership's transactions for the year are with FC2 and FC3. The example illustrates that D and FC1 are reporting corporations. In addition, the example states that the transactions of the partnership are attributed to each of its partners on a pro rata basis as they each meet the 25 percent threshold under which the partnership transactions are attributed to reporting corporations.

While not clearly mandated in the attribution rule, the example concludes that each partner must report its pro rata share of all transactions with each of FC2 and FC3. Presumably, each of D and FC1 is treated as related to FC2 and FC3. The basis for this treatment is far from clear. It would appear more appropriate for FC1 to report its pro rata (75 percent) share of P's transactions with FC2 and for D to report its pro rata (25 percent) share of P's transactions with FC3. Perhaps the unstated basis of the conclusion is that P, FC1, D, FC2 and FC3 are members of the same controlled group within the meaning of Code Section 482,[46] even though two separate and independent chains of companies are involved. Each of the chains comprised of (1) FC1 and FC2 and (2) D and FC3 have an inherent interest in not dealing at arm's length with P and the IRS may wish to review all transactions.

E. *Reportable transaction*

A reportable transaction is any transaction with a foreign related person involving any of the following items:[47]

- sales and purchases of stock in trade (inventory);
- sales and purchases of tangible property other than stock in trade;
- rents and royalties paid and received other than those relating to intangible property;
- sales, purchases and amounts paid and received as consideration for the use of intangible property, including copyrights, designs, formulas, inventions, models, patents, processes, trade marks and similar rights;
- the provision or receipt of technical, managerial, engineering, construction, scientific or similar services;
- commissions;
- amounts loaned and borrowed, excluding open accounts arising from sales made and collected in full in the ordinary course of business;
- interest;
- premiums for insurance and reinsurance; and
- any other transaction not specifically mentioned above.

A transaction is reportable even if monetary consideration is not required or is only part of the contemplated consideration.[48] Thus, for example, the provision of managerial services by a foreign related party for a start-up or troubled

40. §1.482-1(a)(3) of the regulations.
41. *Id.*
42. Proposed §1.6038A-1(e)(1) of the regulations.
43. *Id.*
44. Proposed §1.6038A-1(e)(2) of the regulations.
45. Proposed §1.6038A-1(j) *Example (1)* of the regulations.
46. See the discussion in the text *supra* at note 41.
47. Proposed §1.6038A-2(a)(2) and (b)(3) of the regulations.
48. Proposed §1.6038A-2(a)(2) and (b)(4) of the regulations.

operation in the United States is a reportable transaction even if the services are provided without a fee.

An exception is provided for completely foreign related items that have no direct or indirect connection to the United States.[49] If the reporting corporation and the related party are both foreign corporations, a transaction is not a reportable transaction if it gives rise, in the hands of the reporting corporation, to neither (1) currently recognized or deferred income or gain considered to be either from sources in the United States or effectively connected with the conduct of a trade or business within the United States, nor (2) an item that is deductible in a U.S. tax return.

III. REPORTING OBLIGATION – FORMAT

The proposed regulations provide for detailed identification of the reporting corporation, the related party and the reportable transaction.[50]

A. *Reporting corporation identification*

Form 5472 requires the reporting corporation to identify itself by providing its name, address and U.S. taxpayer identification number. In recognition of the existence of dual resident corporations, the Form requires a list of each country in which the corporation files an income tax return as a resident by reason of foreign tax law. Also, the country or countries in which the reporting corporation was organized and incorporated must be furnished. Information must be provided regarding the total assets of the reporting corporation, the locations where business is conducted and its principal business activity. Similar information must be provided for each 25 percent foreign shareholder. If the 25 percent foreign shareholder is an individual, the jurisdiction or jurisdictions of citizenship must be given rather than the jurisdiction of organization. Finally, the reporting corporation must list the total number of Forms 5472 that are filed for the taxable year and the aggregate value, denominated in terms of U.S. dollars, of gross payments made with respect to all foreign related party transactions.[51]

B. *Related party identification*

Information must be provided with regard to each related party, whether foreign or domestic, with which the reporting corporation has engaged in a reportable transaction.[52] The scope of the information is not identical with the information relating to the reporting corporation or the 25 percent foreign shareholder. Thus, although the proposed regulations state that the form requires information relating to the related party's name, taxpayer identification number, business location and jurisdiction in which a resident tax return is filed by reason of local law, the form also inquires into the nature of the related party's business and the relationship that exists with the reporting corporation. No information is requested regarding the jurisdiction of organization, incorporation or citizenship of the related party.

The proposed regulations are silent regarding the detail of the description that must be provided in identifying the relationship with the reporting corporation. Some advisers believe that the last requirement will be satisfied by identifying the particular test that causes the other party to be related. As discussed above, another person is related to a reporting corporation if it is (1) a 25 percent foreign shareholder; (2) if, with regard to the reporting corporation or a 25 percent foreign shareholder, it meets the standards set forth in Code Section 267(b) or 707(b); or (3) it is related under standards of Code Section 482.[53]

C. *Reportable transaction description*

The proposed regulations separate reporting transactions involving only monetary consideration,[54] whether denominated in terms of U.S. dollars or foreign funds, from those in which no consideration was paid or any part of the consideration paid or received was not monetary ("non-monetary consideration").[55] The regulations are silent as to the treatment of transactions for which the consideration is ultimately deemed to be less than arm's length in amount. Presumably, these transactions are covered in the former category if some consideration was paid and in the latter if no consideration was paid.

For reporting transactions involving only monetary consideration, the total amount of all such transactions and the separate amounts for each type of transaction must be reported. If the reportable transaction involves loans, the reportable balance may reflect either monthly averages or the average of the beginning and ending balances for the year. Items having a value not in excess of $ 50,000 may be reported broadly as "$ 50,000 or less".[56]

Where actual amounts are not determinable, a reasonable estimate is permitted. For this purpose, a reasonable estimate is one in which the deviation from the actual amount does not exceed 25 percent.[57] Where the deviation is greater, the taxpayer is permitted to make a showing of reasonableness on the basis of facts and circumstances submitted to the IRS[58] in a written statement made under penalties of perjury.[59] The ultimate decision is to be made by the IRS. A substantially incomplete Form 5472 exposes the reporting corporation to penalties (see discussion in the text below at note 141).

Reportable transactions that involve non-monetary consideration must be described in sufficient detail so that the nature and approximate monetary value can be determined. The description must cover all property (including the amount of any monetary consideration), rights, obligations or services involved and a reasonable estimate of the fair market value of the foregoing items other than money.[60] The same rules apply regarding reasonableness of estimates.

If the transaction involves the importation of goods from a foreign related party, the reporting corporation must state whether the costs taken into account in computing the basis or inventory cost differ from the costs computed in valuing the goods for customs purposes, adjusted as required pursuant to Code Section 1059A and the reasons for such difference.[61] The reporting corporation must also advise whether the underlying documents are in existence and available in the United States at the time of filing Form 5472.[62]

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49. Proposed §1.6038A-2(a)(2)(i) and (ii) of the regulations.
50. Proposed §1.6038A-2(b) of the regulations.
51. Proposed §1.6038A-2(b)(1) of the regulations.
52. Proposed §1.6038A-2(b)(2) of the regulations.
53. See the discussion in the text *supra* at note 35.
54. Proposed §1.6038A-2(b)(3) of the regulations.
55. *Id.*
56. Proposed §1.6038A-2(b)(7) of the regulations.
57. Proposed §1.6038A-2(b)(6)(i) of the regulations.
58. The statement is to be furnished to either the District Director or the Assistant Commissioner (International).
59. Proposed §1.6038A-2(b)(6)(ii) of the regulations.
60. Proposed §1.6038A-2(b)(4) of the regulations.
61. Proposed §1.6038A-2(b)(5)(i) of the regulations.
62. Proposed §1.6038A-2(b)(5)(ii) of the regulations.

D. *Exceptions to filing*

Three principal exceptions are provided to the filing requirement.[63] First, no reporting is required if a reporting corporation has no transactions during the year with any related parties.[64] This exception does not relieve the reporting corporation of its obligations to maintain records or to serve as agent of process for a foreign related party.

Second, if the reporting corporation is a foreign corporation for which all reportable transactions are with one or more related domestic corporations, the foreign corporation is excused from listing those transactions.[65] For this exception to apply, the related parties must be identified as required on Form 5472 and a full description of the transactions must be provided. This exception does not relieve the foreign corporation of its obligations to maintain records or to serve as agent of process for a foreign related party nor does it relieve the foreign corporation from the penalty provisions for failure to comply.

Finally, no reporting is required with regard to a reportable transaction with a related corporation if a U.S. person controls the reporting corporation and files Form 5471 that fully describes the reportable transaction.[66]

E. *Safe harbour exception for some obligations*

A safe harbour exception has been provided for a reporting corporation that has a *de minimis* amount of related party transactions.[67] The reporting corporation is subject to neither the records maintenance provisions of the proposed regulations nor the authorization provisions to serve as agent for service of process if (1) the aggregate value of gross payments made to or from a foreign related party is not more than $ 2 million; and (2) the aggregate value of those gross payments is less than 10 percent of the reporting corporation's gross income.

In determining whether the $ 2 million threshold has been reached, the value of transactions involving no monetary consideration or no consideration whatever must be added to the transactions for which monetary consideration has been paid. The threshold is applied on an aggregate basis with regard to all foreign related parties.[68] Thus, if a reporting corporation enters into transactions with three different foreign related parties, the $ 2 million is determined by reference to the aggregate of all payments made to or received from all three foreign entities. However, the threshold is computed separately for payments to and payments from foreign related entities.

Certain technical issues exist with this provision. First, as drafted, the *de minimis* rule seems to apply when the threshold is not met with regard to either payments or receipts. Presumably, if a reporting corporation has made $ 4 million in payments, but has received less than $ 2 million from foreign related parties, the exception applies. Second, if a reporting corporation has no gross income in a year because, for example, its cost of goods sold exceeds its sales, it cannot benefit from the provision. Because the company will have operated at a loss reported at the level of gross income, it can never demonstrate that the value of its gross payments to or receipts from a foreign related party is less than 10 percent of its gross income. In other portions of the proposed regulations, the IRS has recognized that a standard based on gross income has limitations and, accordingly, has based certain standards on gross revenue (i.e. receipts prior to offset for cost of goods sold)[69] or percentages of operating losses.[70] Consideration should be given to modifying the 10 percent standard so that it is based on gross receipts.

F. *Administrative requirements*

Form 5472 is to be filed with the reporting corporation's income tax return.[71] If the income tax return is not timely filed, Form 5472 is to be filed separately by the due date of the income tax return, as properly extended. A duplicate copy of the return is to be filed with the IRS Center, Philadelphia, PA 19255.[72]

All statements must be in English and all amounts must be expressed in terms of U.S. dollars, with an accompanying set of exchange rates used if transactions were actually denominated in terms of foreign funds.[73]

If reporting is required by reason of the partnership transaction attribution rules, the reporting corporation need only report its pro rata share of the transaction, determined by reference to its partnership interest.[74] Presumably, if the transaction is the subject of a special allocation, the reporting corporations's partnership interest with regard to that transaction will be affected.

G. *Consolidated reporting*

If an affiliated group of corporations joins in the filing of a consolidated tax return, the reporting obligations of the individual members of the group may be satisfied by filing a consolidated Form 5472.[75] However, the members of the group are not required to join in the filing of a consolidated Form 5472, and where one is filed, it need not cover all members. Indeed, the regulations contemplate that more than one consolidated Form 5472 may be filed. Where a consolidated Form 5472 is filed, the common parent and each reporting corporation that joins in the consolidated filing are jointly and severally liable for any penalties.[76]

In addition, the common parent may be authorized to act as the agent of all foreign related persons engaged in transactions with members of that group for purposes of the service of process provisions.[77] For this to occur, the various members must authorize the parent by submitting an authorization-of-agent statement attached to Form 5472 until such time as that form is revised to provide for such authorization. However, this authorization does not relieve the various members from their obligation to maintain appropriate records relating to related party transactions.

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63. Proposed §1.6038A-2(f) of the regulations.
64. Proposed §1.6038A-(f)(2) of the regulations.
65. *Id.*
66. Proposed §1.6038A-2(f)(3) of the regulations.
67. Proposed §1.6038A-1(h) of the regulations.
68. Proposed §1.6038A-1(h)(2) of the regulations.
69. Proposed §1.6038A-3(c)(5)(ii) of the regulations relating to the gross revenue test for material profits and loss statement.
70. Proposed §1.6038A-(c)(5)(iii) of the regulations relating to the industry segment test of the material profits and loss statement provisions.
71. Proposed §1.6038A-2(d) of the regulations.
72. Proposed §1.6038A-2(e) of the regulations.
73. Proposed §1.6038A-2(c) of the regulations.
74. Proposed §1.6038A-2(h) of the regulations.
75. Proposed §1.6038A-1(i) of the regulations.
76. Proposed §1.6038A-1(i)(3) of the regulations.
77. Proposed §1.6038A-1(i)(2) of the regulations.

IV. MAINTENANCE OF RECORDS – OBLIGATION

The records maintenance provisions appear in proposed §1.6038A-3 of the regulations. They begin[78] with the general rule that a reporting corporation must keep permanent books of account and other records that are required under Code Section 6001.[79] The proposed regulations go on to extend these record maintenance requirements to the records of any foreign related party that may be relevant to determine the correct treatment of transactions between the reporting corporation and its foreign related parties.[80] An exception is provided when the foreign related party is a foreign government or a controlled commercial entity. In such instances, the records maintenance requirements are inapplicable.[81] Records must be maintained in the United States except where an election is in effect to allow for maintenance outside the United States.[82] Moreover, records submitted to the IRS pursuant to a request must be in English or must be translated into English upon request.[83] Unless the period is extended, translation must be provided within 30 days of its request.

A. *Physical possession*

The obligation to maintain records falls on the reporting corporation. However, physical possession of the records can rest with the foreign related party or with a third party.[84] Moreover, where the foreign related party wishes to keep information secret from the reporting corporation, it or its representative may make arrangements with the IRS to directly furnish requested records.[85] Nonetheless, the penalties for the failure of a foreign related party or third party to maintain required records cannot be shifted from the reporting corporation.

B. *Integrated groups*

In illustrating the scope of these requirements, the proposed regulations specify that the record maintenance requirements apply not only to records directly related to a reportable transaction, but also to records that are indirectly related.[86] Thus, the obligation to maintain records in the United States applies not only to the records of the foreign related party, but also to those subsidiaries and affiliates of the foreign related party that participate in an integrated manufacturing or trading operation which culminates in the transfer of products or services in a reportable transaction (referred to in the regulations as "U.S. connected products or services"). The records of those entities must be maintained in the United States as they are indirectly related to transactions involving a reporting corporation. To illustrate, the records possessed by a foreign subsidiary of a foreign related party that document the raw material or component costs of a product manufactured by the subsidiary and sold as a finished product by the foreign related party to the reporting corporation are indirectly related and, accordingly, subject to this rule.

V. RECORDS TO BE MAINTAINED – DEFINITION

Proposed §1.6038A-3(c) of the regulations sets forth the records that must be kept. The provision is a safe harbour designed to advise the reporting corporation of the types of records that must exist in order to avoid the risk of penalty.[87] A corporation that maintains or causes another to maintain the specified records is deemed to have met the records maintenance requirements of Code Section 6038A. As this is a safe harbour, a reporting corporation presumably can avoid a penalty even if less than all the listed records are maintained in the United States, provided the records that are maintained allow the IRS adequate information to evaluate the accuracy of the reporting corporations's returns. The reporting corporation would risk penalty if the IRS were not satisfied as to the record maintenance levels.

A. *In general*

Only records that are directly or indirectly related to a transaction between a reporting corporation and a foreign related party must be maintained.[88] In determining whether a record actually exists, labels are disregarded. The record must contain the anticipated data. Functional equivalents to specified records are acceptable.[89]

The proposed regulations state that records which are not created in the course of business need not be created to meet the safe harbour of proposed §1.6038A-3(c) of the regulations. Moreover, if a specified record is not applicable to the industry or business of the reporting corporation and the foreign related party, it need not be created. However, once a specified record is created, it must be maintained as provided in the proposed regulations.

Nonetheless, certain records must be created and maintained even if they do not otherwise exist. Basic accounting records are included in this category of mandatory items. The proposed regulations caution that basic accounting records must be sufficient to document the U.S. tax effects of transactions between related parties. However, the proposed regulations provide no indication whether these records must be in greater detail than the accounting records maintained for third party transactions. "Material profits and loss statements" as discussed below must be created if they do not exist. In general, these are profits and loss statements that are actually maintained by a related party, or relate to a significant industry segment, or to high profit operations. Finally, all internal records storage and retrieval systems used for each taxable year must be retained.

B. *Original entry books and transaction records*

Original entry books and transaction records must be maintained if they are relevant to transactions between any foreign related party and the reporting corporation.[90] Com-

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78. Proposed §1.6038A-3(a)(1) of the regulations.
79. Under that section of the Code, every person liable for tax or for the collection of tax is required to keep such records, render such statements, make such returns and comply with such rules and regulations as may be prescribed by the IRS. In turn, this has been interpreted in the regulations to mean that a taxpayer must keep records that are sufficient to establish the amount of gross income, deductions, credits or other matters required to be shown in any return. See §1.6001-1(a) of the regulations.
80. Proposed §1.6038A-3(a)(1) of the regulations.
81. Proposed §1.6038A-3(b)(5) of the regulations.
82. Proposed §1.6038A-3(b)(1) of the regulations. This is discussed in the text *infra* at note 119.
83. Proposed §1.6038A-3(c)(4) of the regulations.
84. Proposed §1.6038A-3(b)(3) of the regulations.
85. This could lead to an anomalous situation in which the foreign-related corporation and the IRS share information that is kept secret from the reporting corporation.
86. Proposed §1.6038A-3(b)(2) of the regulations.
87. Proposed §1.6038A-3(a)(2) of the regulations.
88. See the discussion in the text *supra* at note 80.
89. Proposed §1.6038A-3(c)(1) of the regulations.
90. Proposed §1.6038A-3(c)(2)(i) of the regulations.

prised within this category are general ledgers, sales journals, purchase order books, cash receipts books, cash disbursement books, canceled checks and bank statements, workpapers, sales contracts and purchase invoices.

C. *Records relating to material profits and loss statements*

This category encompasses records from which the reporting corporation can compile and supply, within a reasonable time, material profits and loss statements for itself and related parties. These statements must reflect profits or losses of the group attributable to products or services imported to or exported from the United States in transactions involving the reporting corporation and a foreign related party.[91] The material profits and loss statements to be compiled from the retained records must take into account directly and indirectly related items. The proposed regulations contain an illustration of records that are indirectly related to a reportable transaction. As mentioned briefly in the text at note 86 above, documents must be retained which relate to the cost of raw material used by a foreign related party to manufacture finished goods that are sold by another foreign related party to the reporting corporation. Even though the first mentioned foreign related party never entered into a reportable transaction with the reporting corporation, it entered into a transaction with the second related party that was integrated into an overall series of transactions culminating in a reportable transaction. Records relating back to the operations of the first mentioned foreign related party must be retained, as they are required for purposes of compiling material profits and loss statements.

Only records that are ordinarily maintained under generally accepted accounting principles in the United States need be maintained in that manner.[92] For other records, an explanation must be available which explains the material differences between the accounting principles used and generally accepted accounting principles in the United States. Where items are allocated among various material profits and loss statements, an explanation must be available of the allocation method that has been adopted.

A profits and loss statement is deemed to be material if it is the subject of an agreement with the IRS[93] or if it meets one of three, separate objective standards.[94] These standards are referred to in the regulations as (1) the existing records test, (2) the significant industry segment test and (3) the high profit test.

1. *Existing records test*

Under this test, a profits and loss statement is material if any member of the group comprised of the reporting corporation and related parties creates or compiles the statement in the course of its business operations.[95] This includes statements prepared for internal accounting or management purposes or for disclosure to persons such as shareholders, financial institutions or government agencies. To the extent these statements or the underlying records reflect the profit or loss of a related party from a reportable transaction or an integrated series of transactions culminating in a reportable transaction, these records must be maintained.

2. *Significant industry segment test*

Under this test, a profits and loss statement is material if three conditions are met.[96] First, the statement must reflect the profits or losses of a related party group which is attributable to a single industry segment. For this purpose, an industry segment is a segment of the group's combined operations which is engaged in providing a product or service or a group of related products or services. A product is an item of property or a combination of component parts that results from a production process, performs a specific function and is primarily sold to unrelated parties.[97]

The grouping of products or services is to be made on the basis of reasonable accounting, marketing or other business practices within a particular industry.[98] Products are segregated into narrow classifications of models and aggregated into broad classification of product lines and product area groups. A model is a classification of a product that incorporates particular components, options, styles and other unique features resulting in product differentiation.[99] A product line is a group of products that are aggregated into a single classification for accounting, marketing or other business purposes.[100] Illustrations include functionally similar products, products marketed under the same trade name, brand name or trade mark, and products that are related economically by reference to rates of profitability, degrees of risk and opportunities for growth.

Second, the gross revenue from U.S. connected products or services that is attributable to the industry segment must be at least $ 25 million.[101] Gross revenue is not the same as gross income. Rather, it is defined to include receipts from sales without offset for cost of goods sold arising from sales to customers outside the related party group and from inter-segment sales within the related party group.[102] Also included is interest derived from sources outside the group and interest earned on inter-segment trade receivables if, in each such instance, the interest arises from an asset considered to be an identifiable asset of the industry segment. An asset – either tangible or intangible, including investments in goodwill – is an identifiable asset if it is used by the industry segment.[103] It may be used exclusively or may be shared by two or more segments. If shared, only a reasonably allocated portion of the asset is deemed to be an identifiable asset and the method of allocation must be available. Corporate overhead assets are not allocable.

Finally, the industry segment must be a significant contributor to the assets or operating results of the group.[104] This occurs if either (1) the gross revenue of the industry segment comprises at least ten percent of the combined gross revenue of all of the group's segments; or (2) the identifiable assets of the industry segment comprise at least ten percent of the combined identifiable assets of all of the group's segments; or (3) the absolute amount of the industry segment's operating profit or operating loss is at least ten percent of either (a) the combined operating profit of all

91. Proposed §1.6038A-3(c)(2)(ii) of the regulations.
92. *Id.*
93. Proposed §1.6038A-3(e) of the regulations authorizes the District Director or the Assistant Commissioner (International) to negotiate and enter into an agreement with a reporting corporation that identifies records which must be maintained, methods of maintenance and persons who assigned the task of maintenance. See also proposed §1.6038A-3(c)(3) of the regulations.
94. Proposed §1.6038A-3(c)(3) of the regulations.
95. Proposed §1.6038A-3(c)(4) of the regulations.
96. Proposed §1.6038A-3(c)(5)(i) of the regulations.
97. Proposed §1.6038A-3(c)(5)(iv)(D) of the regulations.
98. Proposed §1.6038A-3(c)(5)(iv)(E) of the regulations.
99. Proposed §1.6038A-3(c)(5)(iv)(F) of the regulations.
100. Proposed §1.6038A-3(c)(5)(iv)(G) of the regulations.
101. Proposed §1.6038A-3(c)(5)(ii) of the regulations.
102. Proposed §1.6038A-3(c)(5)(iv)(A) of the regulations.
103. Proposed §1.6038A-3(c)(5)(iv)(B) of the regulations.
104. Proposed §1.6038A-3(c)(5)(i)(C) of the regulations.

industry segments that reported an operating profit, or, if greater, (b) the combined operating loss of all industry segments that reported an operating loss.[105] Operating profit or loss is defined to mean gross revenue reduced by all operating expenses.[106] It is not clear whether this includes cost of goods sold which generally is not thought of as an operating expense. Presumably, no reason exists for not including cost of goods sold. On the other hand, the regulations are clear that, in computing operating profit or loss, no consideration is given to any of the following: (1) revenue derived at the corporate level that is not attributable to an industry segment, (2) general corporate expenses, (3) interest expense (except for banks, insurance companies, leasing companies, financing companies and other companies engaged in a financial trade or business), (4) income taxes and (5) extraordinary items.

In making the required computations to determine whether an industry segment is significant, groups of related products and services must be chosen to provide a reasonable level of specificity.[107] The grouping must result in the greatest number of separate significant industry segments in comparison to other possible classifications. The proposed regulations suggest that the grouping should be accomplished in steps. First, the group's operations that involve the provision of U.S. connected products should be grouped into product lines. A determination should be made whether any particular line is properly categorized as a significant industry segment when compared to the entire operations of the group. If any product line qualifies as a significant industry segment, its products should be segregated to determine whether a particular product, too, is a significant industry segment. Finally, if a significant industry segment exists at the product level, the models comprising the products should be segregated to determine whether a particular model is a significant industry segment. A similar analysis is to be applied in classifying and testing services.

The identification of significant industry segments with a reasonable level of specificity is illustrated by two examples in the regulations.[108] In one example, a related party group is engaged in the manufacture and worldwide sale of automobiles and aftermarket parts. Presumably, these are items such as replacement hub caps, bumpers, body parts and drive train parts.

(a) Automobiles made by the group are classified for marketing purposes by three separate trade names.

(b) Two separate models marketed under one of the trade names and one model sold under another of the trade names have substantial revenue (i.e. more than $ 25 million) and are substantial contributors to the gross revenue and assets of the group under the standards discussed above.[109]

(c) Assuming that the aftermarket parts and the three trade names also meet the foregoing tests, the example concludes that the foreign corporation has eight significant industry segments comprised of the broad categories of automobiles and aftermarket parts, three product lines comprised of each of the trade names and three products comprised of each of the models.[110] Classifications into trade names and car models are generally used in the industry and other types of classifications produce fewer significant industry segments.

In the second example,[111] a related party group manufactures electronic goods distributed at retail in the United States by a reporting corporation. The products are televisions, radios and video cassette recorders.

(a) Each of those broad product areas has sufficient revenue and contributes a sufficient amount to operating results to be a significant industry segment.

(b) The recorders can be segregated further into high-end and low-end product lines. Thus, assuming revenue and contribution standards are met, these two product lines are themselves significant industry segments.

(c) Of the various models within each product line, the example states that only one generates enough revenue to qualify as a significant industry segment.

(d) Televisions are classified by the industry on the basis of size, and three product lines exist comprised of portable, medium and console televisions. Assuming each product line has substantial revenue and contributes substantially under the gross revenue or assets standard mentioned above, each is a significant industry segment.

(e) Finally, only radios marketed under one of the trade names meets the standard of a significant industry segment; no further segregation of product lines or products produces a significant industry segment.

(f) The example concludes that the group has ten separate significant industry segments, comprised of four cassette recorder segments (the cassette recorder product area group, each of the of high-end and low-end product lines of cassette recorders and one widely sold model), four television segments (the television product area group, and each of the portable, medium and console televisions product lines) and two radio segments (the radio product area group and the product line marketed under the trade name).

3. *High profit test*

Under this test, a profits and loss statement of a single industry segment is material if the gross revenue from U.S. connected products or services attributable to the segment exceed $ 75 million and the return on assets of that segment is relatively high in comparison to other related operations.[112] The latter occurs where the return on assets within the particular industry segment (1) exceeds ten percent and (2) is at least 200 percent of the rate of return on assets earned by any other significant industry segment which incorporates those business operations.[113] The return on assets is computed by dividing the segment's operating profit by its identifiable assets. To be incorporated, all of the gross revenue attributable to the narrower component must be attributable to the broader segment.

For many companies, the return on assets will be applied at the level of a significant industry segment because of the $ 75 million threshold. However, it is conceivable that the segment might not be a sufficient contributor to operating results or a sufficient user of assets for large multinational conglomerates.

The facts in the second example, above, are helpful in placing this test in perspective. In that example, the video cassette recorder product area group, two product lines and a model were found to be separate significant industry segments. Assume that the recorders are manufactured by a

105. Proposed §1.6038A-3(c)(5)(iii) of the regulations.
106. Proposed §1.6038A-3(c)(5)(iv)(C) of the regulations.
107. Proposed §1.6038A-3(c)(5)(v) of the regulations.
108. Proposed §1.6038A-3(c)(5)(vi) *Examples* of the regulations.
109. See the discussion in the text *supra* beginning at note 105.
110. Proposed §1.6038A-3(c)(5)(vi), *Example* (1) of the regulations.
111. Proposed §1.6038A-3(c)(5)(vi), *Example* (2) of the regulations.
112. Proposed §1.6038A-3(c)(6)(i) of the regulations.
113. Proposed §1.6038A-3(c)(6)(ii) of the regulations.

foreign related party located in a Pacific Basin country under a grant of tax-free status pursuant to the local pioneer industry law. Assume further that the operations of the foreign related party qualify as a segment[114] and that gross revenue of this segment is $ 150 million, its identifiable assets are $ 200 million and that the operating profit is $ 50 million. Based on these facts, the return on assets of the segment is 25 percent. This industry segment is a narrower component of the significant industry segment comprised of the product area group of video cassette recorders in general. It cannot be allocated to each of the other significant industry segments related to video cassette recorders because its revenue is not entirely attributable to any of the other segments. If the rate of return on assets of the broader segment fails to reach 12.5 percent, the profits and loss statement of the foreign related party's segment will be material – 25% is 200% of 12.5%.

D. *Pricing documents*

This category comprises all documents relevant to establishing the appropriate price or rate for transactions between the reporting corporation and a foreign related party.[115] This category is a catch-all and covers virtually all documentation generally reviewed in the course of a transfer pricing examination. Thus, included in this category are:
- documents related to transactions involving the same or similar products or services with related and unrelated parties;
- shipping and export documents;
- commission agreements;
- documents relating to production or assembly facilities;
- third-party and inter-company purchase invoices;
- manuals, specifications and similar documents relating to the performance of functions conducted at a location;
- inter-company correspondence discussing any instructions or assistance relating to specific transactions;
- inter-company and internal correspondence regarding pricing of transactions;
- documents regarding the value of intangibles used or developed by the reporting corporation or a foreign related party;
- documents regarding the direct and indirect costs of material, labour, cost of goods sold and other expenses; and
- documents relating to direct and indirect selling, general and administrative expenses such as advertising, promotion or warranty.

E. *Filed documents*

This category of documents is comprised of financial and other documents filed with a foreign government, an independent commission or a financial institution relating to transactions between the reporting corporation and a foreign related party.[116] This category appears to be duplicative of the existing records category discussed above in the text at note 95 in connection with material profits and loss statements.

F. *Ownership and capital structure documents*

This category of documents is comprised of records or charts showing the relationship between the reporting corporation and foreign related parties.[117] In broad terms, it is a corporate organization chart with regard to the international corporate structure of members having operations relating directly or indirectly to the reporting corporation and its reportable transactions. Included in the material are the location, ownership and status of these entities as corporations, partnerships, branches, divisions or joint ventures. In addition, loan documents, agreements and documents relating to transfers of shares of the reporting corporation that, upon effect, could cause a change in the status of a foreign person as a related party. It is thought that the last category is illustrated by options, calls, puts, mandatory redemption instruments and self-executing agreements that go into effect automatically upon the happening of an event.

G. *Documents for non-sale transactions*

This category of documents relates to transactions other than sales.[118] Included are documents related to:
- loans, including third-party loans that are related to a reportable transaction;
- guarantees involving a reporting corporation and a foreign related party;
- hedging arrangements involving the reporting corporation and any foreign related party;
- security agreements between the reporting corporation and any foreign related party;
- research and development expense allocations;
- performance of services, such as management services, including supporting schedules of time charges and travel records;
- import and export transactions;
- registration of patents and copyrights relating to reportable transactions; and
- lawsuits in foreign countries, if any, such as product liability litigation relating to products involved in reportable transactions.

VI. EXCEPTION TO MAINTENANCE IN THE UNITED STATES

An exception is provided to the general requirement that records must be maintained in the United States by or at the direction of the reporting corporation. If the reporting corporation elects, records may be maintained outside the United States.[119] To make the election, the reporting corporation must undertake to have duplicates of all requested records delivered to the IRS or to a custodian in the United States within 60 days after the issuance of the request (120 days if the records relate to material profits and loss statements under the significant industry segment or the high profit return tests discussed above).[120] If the records are to be sent to a custodian, the IRS must be provided with an index to the records, the custodian must be identified and its address provided, and the documents must remain in the United States for as long as they may be relevant for the determination of income.[121] Unfortunately, that could be for a substantial period if the records relate to fixed asset acquisitions. Records of cost remain relevant to the determination of basis until the fixed asset is sold.

The obligations undertaken to maintain records outside the United States should not be taken lightly. The election may

114. See the discussion in the text *supra* beginning at note 104.
115. Proposed §1.6038A-3(c)(2)(iii) of the regulations.
116. Proposed §1.6038A-3(c)(2)(iv) of the regulations.
117. Proposed §1.6038A-3(c)(2)(v) of the regulations.
118. Proposed §1.6038A-3(c)(2)(vi) of the regulations.
119. Proposed §1.6038A-(3)(f)(1) of the regulations.
120. Proposed §1.6038A-3(f)(1)(i) and (ii) of the regulations.
121. Proposed §1.6038A-3(g) of the regulations.

be invalidated for cause by the District Director acting with the concurrence of the Assistant Commissioner (Examination) or by the Assistant Commissioner (International).[122] Cause exists if a clear pattern of failure to maintain or timely produce the required records is established. However, the assessment of penalties is not necessarily sufficient, of itself, to result in the invalidation of an election. To make the election, an annual agreement must be entered with the IRS (see Chart I).

If the volume of documents maintained outside the United States is great, the IRS is authorized to allow the reporting corporation a period of time for the orderly production of records.[123] The IRS is also authorized to extend the period for production or for translation upon the showing of good cause.[124] The request for delay is to be made within 30 days of the date of the IRS request for production of records.

CHART I

Until such time as Form 5472 is amended to provide for the agreement, the following format is to be used:

ELECTION TO MAINTAIN RECORDS OUTSIDE THE U.S.

[Name of reporting corporation] hereby elects to maintain outside the United States the records described in paragraph (b) of Section 1.6038A-3, relating to transactions between [name of reporting corporation] and [name of foreign related party] for its taxable year ending on [date]. [Name of reporting corporation] agrees to produce upon request of the Internal Revenue Service any [name of reporting corporation] or [name of related party] records covered by this election (and translations of specified records) within the time and in the manner prescribed by the regulations.

[Name of Reporting Corporation]

By:________________ ________________ ________________

Signature & Printed Name | Title | Date

CERTIFICATION

I certify that I have the authority to execute this agreement on behalf of [name of reporting corporation].

________________ ________________ ________________

Signature & Printed Name | Title | Date

VII. AUTHORIZATION OF REPORTING CORPORATION TO ACT AS AGENT

A foreign related party that engages in a transaction with a reporting corporation is required to authorize the reporting corporation to serve as its agent for purposes of the Code provisions applicable to compelled production of evidence.[125] Failure of such a foreign related party to make the authorization causes the penalties of proposed §1.6038A-7 relating to unilateral determinations of cost of goods sold and deductible expenses to apply.[126] By its literal terms, this requirement apparently does not extend to foreign related parties that have entered into a transaction which relates only indirectly to the reporting corporation, such as related suppliers to foreign parent corporations. In addition, this requirement does not apply to a foreign government or its controlled commercial entity.

The authorization is made annually and is effected in a straightforward appointment and acceptance by duly authorized personnel. It is contemplated that Form 5472 will be the vehicle for effecting the authorization (see Chart II).

CHART II

However, until such time as the Form is revised, the following format is to be used:

AUTHORIZATION OF AGENT

[Name of foreign related party] hereby expressly authorizes [name of reporting corporation] to act as its agent solely for purposes of sections 7602, 7603, and 7604 of the Internal Revenue Code with respect to any request to examine records or produce testimony related to any transaction between [name of the foreign related party] and [name of reporting corporation] or with respect to any summons for such records or testimony.

[Name of Foreign Related Party]

By:________________ ________________ ________________

Signature & Printed Name | Title | Date

CERTIFICATION

I certify that I have the authority to execute this authorization of agent to act on behalf of [name of foreign related party].

________________ ________________ ________________

Signature & Printed Name | Title | Date

ACCEPTANCE

[Name of reporting corporation] accepts this appointment to act as agent for [name of foreign related party] for the above purpose.

[Name of Reporting Corporation]

By:________________ ________________ ________________

Signature & Printed Name | Title | Date

CERTIFICATION

I certify that I have the authority to accept this appointment to act as agent on behalf of [name of foreign related party] and agree to accept service of process for the above purposes.

________________ ________________ ________________

Signature & Printed Name | Title | Date

The proposed regulations allow for a retroactive authorization to be made upon discovery that the foreign party is related to the reporting corporation.[127] However, a retroactive appointment requires permission of the IRS. The proposed regulations indicate that the permission will be granted if (1) the transaction is small or isolated and conducted on arm's length terms; and (2) the related party does not directly own shares of the reporting corporation. To obtain permission, a written request must be submitted to the IRS indicating the underlying facts and circumstances.[128] All responses of the IRS must be in writing to be effective. An authorization must be submitted to the IRS within 30 days from receipt of permission. If not, the monetary penalties of proposed §1.6038A-4 of the regulations will be applicable.

The appointment of the reporting corporation as agent allows the reporting corporation to file a petition to quash a summons or a petition to review an IRS determination of

122. Proposed §1.6038A-3(f)(4) of the regulations.
123. Proposed §1.6038A-3(f)(3) of the regulations.
124. *Id.*
125. Proposed §1.6038A-5(b)(1) of the regulations.
126. Proposed §1.6038A-5(a) of the regulations.
127. Proposed §1.6038A-5(e)(1) of the regulations.
128. Proposed §1.6038A-5(e)(2) of the regulations.

non-compliance.[129] It also allows the IRS to commence legal proceedings to enforce a summons under Code Section 7604.[130] The authorization does not, by itself, cause the foreign related party to be viewed to be engaged in a trade or business in the United States for corporate income tax purposes nor does it cause that party to have a permanent establishment or fixed base in the United States for purposes of an applicable income tax treaty.

Finally, an ameliorative procedure exists for a deemed appointment in exceptional circumstances where none has been made.[131] It applies when neither the reporting corporation nor the related party had reason to know that the parties were related and the IRS is satisfied that all transactions between the two entities were carried on at arm's length.

VIII. PENALTIES – UNILATERAL DETERMINATIONS

One of the main sanctions for non-compliance in Code Section 6038A is the provision allowing the IRS to unilaterally determine the cost of property acquired from a related party and the amount allowed as a deduction in a transaction with a related party. The grant of discretion is broad and the determination is to be made by the IRS (acting through either the District Director or the Assistant Commissioner (International)) on the basis of its own knowledge or from information it may choose to obtain.[132] In that regard, the IRS may disregard any information, documents or records that is deemed to have insufficient or insignificant value.

This penalty applies in three instances. First, it may apply if a foreign related corporation that has engaged in a reportable transaction with a reporting corporation fails to appoint the reporting corporation as its agent for service of process in matters pertaining to Code Sections 7602, 7603 and 7604.[133] Second, it may apply if a summons is issued to a reporting corporation to produce records or testimony for itself or for a related party with respect to a transaction between the two and the summons is neither quashed nor timely complied with.[134] Finally, it may apply if the reporting corporation fails to maintain, or fails to cause another to maintain, required records and by reason of that failure (1) a summons is quashed in a proceeding under Code Section 6038A(e)(4) or in a proceeding instituted under Code Section 7604; or (2) the records are not provided.[135] Accordingly, the IRS is not required to begin an enforcement proceeding to enforce a summons in order to apply the penalty if the records are not maintained and therefore not provided.[136]

The proposed regulations provide a *de minimis* rule applicable to small compliance failures. Under this rule, it is intended that such failures will not result in the application of the penalty.[137] However, the exception applies only at the discretion of the IRS and only if it determines that the requested documents have insufficient or insignificant value. As a result, the scope of this provision in practice is not anticipated to be great; it applies only when the IRS demands documents that it subsequently determines are immaterial to the matter under examination.

IX. PENALTIES – MONETARY

The other set of penalties called for in Code Section 6038A are monetary penalties. They may be imposed in three instances.[138] First, they may be applied if the reporting corporation fails to furnish required information timely on Form 5472 and in the manner required.[139] For this purpose, the filing of a substantially incomplete Form 5472 is the equivalent of a failure to file. Second, they may be applied if the reporting corporation fails to maintain or to cause another to maintain required records.[140] Finally, they may be applied if a reporting corporation fails to produce records maintained outside the United States within the time prescribed.[141]

In general, the monetary penalty is $ 10,000 for each taxable year with respect to which one of the foregoing failures occurs.[142] Members of a group that join in the filing of a consolidated Form 5472[143] are jointly and severally liable for the penalties. If a reporting corporation engages in reportable transactions with more than one related party, the corporation is subject to multiple $ 10,000 penalties arising from failures with regard to each such party.[144] The penalties are not increased, however, if more than one type of failure occurs with regard to a particular related party.

If a failure goes uncorrected for 90 days after notification by the IRS, an additional penalty of $ 10,000 is imposed with respect to each failure that continues uncorrected for 30 days or a fraction thereof.[145] Again, multiple penalties may be imposed if the reporting corporation engages in transactions with more than one related party. The additional penalty accrues until the failure is corrected. If the penalty relates to failure to maintain records, correction cannot occur before the reporting corporation demonstrates to the satisfaction of the IRS that compliance exists.[146]

The proposed regulations treat written notice of one failure as written notice of all potential failures. As a result, penalties may continue to accrue after the particular failure mentioned in the notice is cured. To illustrate, assume the IRS furnishes written notice to a reporting corporation directed at a failure to file Form 5472 with regard to a particular related party. The notice is silent with regard to other failures. Form 5472 is filed within the 90-day period. Assume further that the IRS subsequently determines that records were not maintained. The proposed regulations state that the additional penalty of $ 10,000 for each 30-day period (or part thereof) will continue to accrue from the 90th day following the original notification.

The regulations also contain provisions excusing the penalties in appropriate circumstances. Thus, the penalty may be excused if an affirmative showing is made that reasonable cause exists.[147] To demonstrate reasonable cause, a written declaration made under penalties of perjury must be submitted demonstrating the facts supporting the request. The

129. Proposed §1.6038A-5(c)(1)(i) of the regulations.
130. Proposed §1.6038A-5(c)(1)(ii) of the regulations.
131. Proposed §1.6038A-5(e)(4) of the regulations.
132. Proposed §1.6038A-7(b) of the regulations.
133. Proposed §1.6038A-5(a) of the regulations.
134. Proposed §1.6038A-6(a)(1) of the regulations.
135. Proposed §1.6038A-6(a)(2) of the regulations.
136. Proposed §1.6038A-6(b) of the regulations.
137. Proposed §1.6038A-6(c) of the regulations.
138. Proposed §1.6038A-4(a)(1) of the regulations.
139. See the discussion in the text *supra* beginning at note 71.
140. See the discussion in the text *supra* at note 87.
141. See the discussion in the text *supra* at note 120.
142. Proposed §1.6038A-4(a)(1) of the regulations.
143. See the discussion in the text *supra* at note 75.
144. Proposed §1.6038A-4(a)(2) of the regulations.
145. Proposed §1.6038A-4(d)(3) of the regulations.
146. Proposed §1.6038A-3(d)(3) and (f) *Example (2)* of the regulations.
147. Proposed §1.6038A-4(b)(1) of the regulations.

ultimate decision rests with the IRS as to the existence of reasonable cause and the period for which it exists.[148] In addition, concepts of substantial compliance specifically exist with regard to failures involving omissions or errors regarding the filing of Form 5472 or the maintenance of records.[149] Thus, compliance with records maintenance requirements is to be determined on a system-wide basis and not by reference to particular line-by-line items.[150] A reporting corporation may be in compliance even if a relatively small number of items – exclusive of essential documents – are not compiled and maintained.

X. PROPOSED EFFECTIVE DATES

The definition of a reporting corporation in proposed §1.6038A-1(c) of the regulations is effective for taxable years beginning after 10 July 1989. All other definitions and rules that appear in that section (such as the partnership transaction attribution rule, the definition of related party and the *de minimis* value rule) are effective as of 10 December 1990, without regard to the beginning of a taxable year.

The rule relating to the obligation to file Form 5472 and the data that must be provided, which appears in proposed §1.6038A-2 of the regulations, is generally effective for taxable years beginning after 10 July 1989. For a reporting corporation whose sole business in the U.S. involves banking, financing or similar activities, the effective date of this provision is 10 December 1990.

The records maintenance requirements of proposed §1.6038A-3 of the regulations are generally effective as of 10 December 1990, except that records in existence on or after 20 March 1990 must be maintained.

The monetary penalty provisions of proposed §1.6038A-4 of the regulations are generally effective for taxable years beginning after 10 July 1989 with regard to the obligation to file Form 5472. However, the provision is effective on 10 December 1990, with regard to the failure to maintain records or the failure to produce documents as agreed under an election to maintain records outside the United States.

Proposed §1.6038A-5 of the regulations, relating to the authorization of a reporting corporation to serve as agent of a foreign related party, is effective on 10 December 1990 without regard to the beginning of the taxable year to which the records relate.

The rules calling for the unilateral determination of cost of goods sold and deductible expenses arising from related party transactions which appears in proposed §1.6038A-6 of the regulations and which are triggered by the failure to provide information are effective after 5 November 1990 without regard to the beginning of the taxable year to which the summons relates.

Finally, the penalty of unilateral determination which appears in proposed §1.6038A-7 of the regulations is effective on 10 December 1990 without regard to the beginning of the taxable year.

148. Proposed §1.6038A-4(b)(2) of the regulations.
149. *Id.*
150. Proposed §1.6038A-4(c) of the regulations.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1991 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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A U.K. resident company is generally not entitled to repayment of the tax credit attaching to a dividend paid to it by another U.K. resident company, and losses, capital allowances, etc. which a U.K. resident company may set off against its mainstream corporation tax profits may generally not be relieved against income received in the form of dividends from other U.K. companies. This article examines Sections 242 and 243 of the Income and Corporation Taxes Act 1988 which, under certain circumstances, allow a U.K. company to make such a claim; the author tries to unravel the labyrinthine chain of consequences which invoking these sections initiates.

BARBADOS:
IFA BARBADOS BRANCH CONSIDERS CARICOM TAX TREATY AND TAX ISSUES 186

Bruce Zagaris

On 2-3 November 1990, the Barbados branch of IFA and the Caribbean Law Institute presented a seminar on the CARICOM tax treaty and tax issues within CARICOM. This article highlights a number of the talks given during the seminar.

INTERNATIONAL:
THE USE OF NON-TAX TREATIES FOR ENCOURAGING INVESTMENT AND ECONOMIC DEVELOPMENT 190

David A. Gantz

Bilateral investment treaties are useful mechanisms to attract investment, offering both tax and non-tax incentives to nationals of the treaty country, and in many cases, to third country nationals willing to establish joint ventures in one of the treaty countries with a view to further activities in the other treaty country. This article discusses past and current bilateral investment treaties, as well as the new possibilities raised in the U.S. "Enterprise for the Americas" Initiative, and how these arrangements can assist nations in encouraging U.S. and third country investment.

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We welcome the submission of articles which are of interest to tax professionals, executives and scholars to be considered for publication. The author should ensure that the significance of the contribution will also be apparent to an international readership.

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The author should submit biographical data, including his or her current affiliation.

INTERNATIONAL:

A MODEL TAX TREATY FOR THE ASIAN-PACIFIC REGION? (Part II)

Prof. Richard J. Vann

Richard J. Vann is a consultant with the Legal Department of the International Monetary Fund in Washington, D.C. He is also a professor of law at the University of Sydney and an Associate Research Director of the Australian Tax Research Foundation.

Part I of this article appeared in the March 1991 issue of the Bulletin.

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THE MULTILATERAL ALTERNATIVE

One panacea that is often advanced for the ills of the bilateral treaty is the multilateral tax treaty. The 1963 OECD draft was put forward as a model for both multilateral and bilateral negotiations within the OECD; the resolution adopting the 1977 Model encouraged groups of countries to use it as the basis of multilateral negotiations where feasible and the UN has expressed similar hopes for its Model. From the very beginnings of model treaties in the League of Nations, the possibility of a multilateral treaty was explored. Yet from then until today the general response of experts appointed to consider the possibility has been negative – and that response has been borne out in practice.

The history to date suggests that simple evolution will not lead to higher and better things for tax treaties (multilateralism). Evolution is as much about decay and disappearance as improvement. What is required (to continue the evolutionary metaphor) is that some fundamental shift in circumstances favourable to change must occur. In this section I will explore the prospects of simple evolutionary change to multilateralism. In succeeding sections I will look at some multilateral approaches that change the basic premises of the current system.

Existing Regional Multilateral Tax Treaties

There are a small number of regional multilateral tax treaties in existence, for example, the 1971 Andean treaty involving Bolivia, Chile, Colombia, Ecuador and Peru[48] and the Nordic treaty involving Denmark, Finland, Iceland, Norway and Sweden.[49] In the case of the Andean countries there is also a model for treaties with other countries. This is a logical outcome of the multilateral approach on a regional basis but the further step of joint Andean negotiation of treaties with third countries has not been taken.

The Nordic treaty is based on the OECD Model structure. The Andean treaty by contrast proceeds by assigning exclusive jurisdiction to tax for different categories of income and hence does not need any specific provisions for relieving double taxation or tax rate ceilings. Surprisingly neither involves much greater detail than the Model provides; moreover, each preserves the schedular structure common to all models to date. The Nordic treaty has specific rules for specific countries in the treatment of dividends and relief of double taxation and to that extent is similar to a series of bilateral treaties. In the dividend area the Nordic treaty at least takes account of the differences in the corporate tax systems of the various countries and departs from formal reciprocity in doing so.

The benefit of such treaties is that they establish a uniform position on such matters as definitions and assignment of taxing powers but this is also their weakness. As the many years of work on the UN Model show, it is precisely in the areas of important definitions, such as "permanent establishment" and ceilings on tax rates, that agreement is hardest to achieve. In particular the continued use of reciprocity in tax rate ceilings or exemptions (apart from dividends in the Nordic treaty) is likely to be an insuperable barrier at the worldwide level.

48. See A. Atchabahian, *Fiscal Harmonization in the Andean Countries* (Amsterdam: IBFD, 1975), which contains a translation of the treaty; Chile has since left and Venezuela joined the Andean Group.
49. H. Hamaekers, "Multilateral Instruments on the Avoidance of Double Taxation", 40 *Bulletin for International Fiscal Documentation* (February 1986), at 99-114, which contains a translation of the 1983 treaty; a supplementary agreement between Denmark and Sweden was made in 1986, see 41 *Bulletin for International Fiscal Documentation* (February 1987), at 74; the treaty was replaced in 1987 and again in 1989. The most recent version of the treaty is printed in 44 *Bulletin for International Fiscal Documentation* (August/September 1990), at 438-452.

Existing regional multilateral treaties can only be regarded as marginal to the international tax treaty network, and not likely to expand in the current international tax environment to include major trading nations. Moreover, they generally offer more of the same so far as the OECD Model is concerned. The Andean preference for exclusive assignment of taxing powers does represent some departure from current norms but the idea simply has not taken hold outside the region and in a practical sense may be regarded as stillborn. Why is it that multilateral treaties so often are conceived simply as extensions of current bilateral treaties?

The answer in the context of regional multilateral treaties is that the tax treaty world is essentially a bilateral one and any treaty with a third country by a regional group acting jointly would essentially be a bilateral exercise with the regional group on one side and the third country on the other. The adoption of bilateral norms in dealings by a regional group with outside countries then flows back to affect the tax relations within the grouping. Whether this is a necessary consequence is not clear. The route followed in the customs duty area where it is possible to abolish duties within a regional grouping and to apply uniform rates for goods entering the region from outside is not applicable to the taxation area. The critical difference is that the trade bloc is formed to abolish customs duties within it. There is no suggestion of abolishing the income tax within a regional group!

It is noteworthy that the external Andean model adopts the same approach as the internal treaty but that treaties that Andean countries outside the group adopt follow OECD Model lines (apart from treaties between Bolivia and Argentina and Ecuador and Sweden which are in the Andean mould even though the latter treaty predates the Andean model). Similarly there are some federations where the constituent parts levy income taxes as well as the central government. These federations may use different rules to assign taxing jurisdiction among the parts of the federation than those that apply between the central government and foreign countries. The controversy caused by unitary taxation for the U.S. federal government suggests that different assignment methods will create problems.

At least this is so if the unitary tax debate is viewed as a question of the simultaneous use of different methods of division of the international tax base by the United States and its constituent states, rather than of determining the theoretically correct method for taxing corporate groups. The latter issue has predominated in the debate but without successfully disentangling it from the former. Clearly the existence of the bilateral tax treaty network will place some constraints on regional experiments with alternatives, though whether it dictates close adherence to OECD norms in regional multilateral treaties is doubtful.

The Failure and Success of the OECD with Worldwide Multilateral Treaties

When we shift attention from regional to worldwide multilateral tax treaties the reasons that may apply in the regional case for the continuing use within the region of the structure of the OECD Model lose their force. Yet the same assumption is made that the OECD Model should be the starting point. Let us look once more at current experience and try to explain this assumption.

In a formal sense the OECD Model can only be described as a failure at promoting multilateral treaties generally among its members. The only example is the regional Nordic treaty referred to above. In a broader sense the OECD Model (and the UN Model) can be regarded as having multilateral elements in substance which may be more important than the formal bilateral nature of the tax treaty network. The Models are sponsored by international organizations set up under multilateral treaties. Members are encouraged in as strong terms as feasible to use the Models (by and large they do so) and are expected to abide by the official Commentaries – tax administrations and courts regularly have recourse to the Commentaries. Hence a large degree of effective multilateralism has been achieved which indeed may be thought to have neutralized any sustained push for a general multilateral treaty.

There is currently under way a test case for worldwide multilateralism in the form of the Convention on Mutual Administrative Assistance in Tax Matters referred to earlier. The drafting origins of this convention can be traced back to work of the League of Nations; the drafts produced in 1928 included two bilateral administrative assistance models.[50] In 1981 the OECD produced a bilateral model convention on the topic[51] and this subsequently evolved into the multilateral version. Interestingly, the Nordic countries referred to above already have multilateral treatment in this area; indeed the administrative assistance treaty preceded the more general treaty among the Nordic countries.[52] Although Australia and the United Kingdom have indicated that they will not be signatories to the Convention, the U.S. Senate has ratified the treaty in the area of exchange of information. This ratification is likely to get the Convention off the ground and may lead to its more widespread acceptance, in which event Australia and the United Kingdom may reconsider their position.

Assuming for a moment that the Convention is a success, we have an example of bilateral models evolving with little change into a general multilateral convention through the agency (at least in part) of the OECD. Why should this be possible in the administrative area and not more generally? First, there is no general network of existing bilateral treaties in the administrative area (apart from exchange of information and the mutual agreement procedure) and so it may not be accurate to consider the case as a multilateral treaty evolving out of a bilateral network (as opposed to bilateral models). Whatever obstacle a functioning bilateral network with multilateral elements puts in the way of a multilateral convention may thus not be present.[53] Secondly, a smaller part of the tax universe is being tackled in

50. See *supra* note 17, Bilateral Convention on Administrative Assistance in Matters of Taxation and Bilateral Convention on Assistance in the Collection of Taxes. In the Mexico and London Models these were amalgamated into one model. The provisions for exchange of information in these various models found their way into the 1977 OECD Model, but not the other administrative measures covered.

51. *Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims* (Paris: OECD, 1981). The resolution of the OECD Council recommending the model to its members referred back to the Fiscal Committee the possible future development of multilateral initiatives.

52. Convention between Denmark, Finland, Iceland, Norway and Sweden regarding Mutual Assistance in Tax Matters, 1972, as amended 1976, 1981 and 1987, is reproduced in *Supplementary Service to European Taxation*, Section C (Amsterdam: IBFD, looseleaf). The other three current signatories to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters besides the United States are, not surprisingly, Nordic countries (Sweden, Norway and Finland).

53. There is overlap in the case of exchange of information but the multilateral convention Art. 27 provides in effect that where this occurs, the more extensive provision will govern. The U.S. ratification, however, only relates to the exchange of information area and if this becomes the norm then the multilateral treaty will clearly be covering the same ground

the administrative Convention than in the current OECD Model. Thirdly, the laws governing tax administration around the world arguably have more common elements than tax systems overall. Finally, the obstacles facing tax administrations in the international enforcement of tax laws are common to most countries and fairly limited in scope – most notably, the existence of secrecy laws and the common private international law rule that one country will not assist in the enforcement of the revenue laws of another country.

While these factors may explain why the putative success in the administrative area will not be matched with the OECD Model, it should be noted that they do not address the question with which this section of the paper began, namely, why is the OECD Model assumed to be the obvious starting point for a worldwide multilateral treaty, especially when the thrust of the basic argument has been to suggest that the OECD Model is highly, perhaps irretrievably, defective.

The hopes for multilateralism expressed by the framers of model treaties reflect an unease with the efficacy of bilateral tax treaties for long-term solutions to international tax problems. Yet the many years of growth in the bilateral treaty network show both a robustness and success that cannot lightly be put aside in the absence of concrete alternatives. It is not surprising then that the path of development is often seen as simple evolution of bilateral treaties into a multilateral treaty of similar form. This approach seeks to preserve the success to date both in terms of the method (reconciliation at the interface of tax systems), the particular solutions adopted (the text of the models) and the administrative mechanism (preservation of national supremacy subject to an obligation to consult with and assist other nations). In this framework the benefits of a multilateral treaty are the ability to deal with new situations and the overcoming of rigidity. That is, my second and third criticisms of the OECD Model (increasing irrelevance and inflexibility) are answered and even the first to the extent that efficiency problems can be dealt with by additions and refinements rather than entire reworking.

It seems to me that there are two independent issues that need to be separated. One argument emerging from my criticism of the OECD Model is that bilateralism is a barrier to remedying some of the more important existing defects of the OECD Model and its operation in practice, such as the substitution of formulary apportionment for the arm's length pricing method, the increasing inflexibility of the treaty network and the prevention of breaches of existing treaties. The argument has not been that the defects of the OECD Model are preventing the shift to multilateralism. What is at work here is the enormous diversity of the details of tax systems around the world (especially the income tax). It is possible bilaterally to solve most of the conflicts between two tax systems; it is generally considered impossible to secure agreement multilaterally on the many specifics arising from tax systems' diversity that are raised in tax treaty negotiations.[54]

This is what distinguishes the administration area of the tax system and permits a multilateral approach – the greater uniformity of the systems and the common (fairly limited) international problems faced. No doubt the process has also been facilitated by the ability of the multilateral administrative treaty to live side-by-side with existing bilateral treaties between the same parties, which would not seem to be possible in the case of a general multilateral treaty. Similarly in the case of regional multilateral treaties it is likely that existing considerable uniformity in the tax systems concerned permits the transition from bilateralism to multilateralism. Hence the desire on the part of the drafters of model treaties to move to multilateralism is really a (disguised) call for more uniformity in tax systems.

Traces of recognition of this argument can be found in many recent OECD studies, and viewed in this light the studies are positive signs as well as the proof of the problems in the current OECD Model as they have been portrayed above. Thus in the area of foreign exchange gains and losses, the major part of the report is devoted to description and discussion of the various possible domestic tax regimes for dealing with the problems of fluctuation of exchange rates, and members are urged to adopt certain and uniform practices within each country. The report disclaims any intention to urge members to adopt internationally uniform measures but it is clear that the effect of the report is likely to produce more convergence in tax laws than has occurred to date.

Moreover, the OECD regularly produces reports on matters of interest in tax law outside the realm of international taxation and the Model, and the effect of such publicity and sharing of information is bound to be more uniformity in tax laws as a consensus in particular areas is very gradually built up (even if the consensus revolves around more than one way of dealing with the problem).[55] This type of activity was also conducted by the League of Nations and may be credited in part with the fact that it has been possible to produce a single model treaty for the prevention of double taxation rather than the three that the League originally drafted in 1928.[56]

On the other hand because the priority of the OECD is tax treaties rather than increasing uniformity of tax laws, domestic measures are generally expected to conform to the Model rather than the Model being changed to conform with domestic laws. In the case of thin capitalization the result is recommendation of flexible rules for domestic laws rather than fixed ratios (except as safe harbours) in order to conform with the OECD (tortuous) interpretation of the Model, even though it is conceded that countries with such rules end up not enforcing them.

The other benefits that would be possible in a multilateral framework along OECD Model lines compared to the current bilateral system, such as a different approach to transfer pricing, are not really recognized at all in the face of the much larger problem of how to achieve greater uniformity in tax systems. If greater uniformity is the goal it should be clear from the preceding discussion that a combination of bilateral treaty negotiations along with multilateral discussions on current international tax problems such as occur in the OECD and the UN are highly unlikely to achieve the necessary degree of uniformity in any realistic time frame. Yet we are hostage to this framework as the only worldwide multilateral tax cooperation currently in existence. In other words it is simply the history of where we are in the interna-

as bilateral treaties. Yet in an important sense the multilateral treaty will not have evolved out of the bilateral treaties as they will still be in place. For a pessimistic view of the likelihood of success (and effectiveness) of the Convention, see General Report, LXXVb *Cahiers de droit fiscal international,* "International Mutual Assistance through Exchange of Information (1990).

54. See references *supra* note 28, United Nations, *Tax Treaties between Developed and Developing Countries Seventh Report* (New York: 1978), at 60-61.

55. For some recent examples, see OECD, *Personal Income Tax Systems under Changing Economic Conditions* (Paris: OECD, 1986), *Taxation in Developed Countries* (Paris: OECD, 1987).

56. See *supra* note 17, Draft Conventions Nos. 1a, 1b and 1c. For work of this kind, see in particular League of Nations Fiscal Committee, *Report to the Council* for the ninth session (Geneva: 1939, League of Nations official number C.181.M.110.1939.II.A.).

tional tax field which explains why it is so often assumed that multilateral developments will evolve from the current OECD Model.

It seems likely, if any significant progress is to be made, that multilateralism requires a catalyst in the form of a different method from simple evolution. Two questions emerge from the previous discussion regarding the nature and objectives of such a method. First, by what method is greater uniformity of tax laws achievable? This way of posing the issue accepts the solution implied in previous discussions of a shift from bilateralism to multilateralism but seeks an alternative means. Secondly, can a method be devised that does not necessarily require greater uniformity of tax laws? This question attacks the problem more fundamentally. If 50 years of discussing multilateralism has not led to sufficient uniformity of tax systems for the multilateral approach to be feasible, it may be as well to seek a route to multilateralism in which increased uniformity may be a bonus but not a necessary condition to progress.

THE TRADE BLOC ALTERNATIVE

One area where there is already an increasing uniformity of tax laws is in regional trade blocs, most notably the EC. Their origin lies, as their name suggests, in trade issues and in particular their purpose is the removal of trade barriers. So far as taxes form barriers to trade, they are either removed or made more uniform, but the last major tax that tends to be tackled in this process is the income tax, which has been the focus of this article.

Internal Mechanics of Tax Uniformity

The trade bloc typically starts with the objective of removal of protective customs duties among the member states. The European Community has moved far beyond this problem but in the case of more recent formations, such as the Australia/New Zealand Closer Economic Relations (CER) Agreement and the Canada/U.S. Free Trade Agreement, the phasing down of protective customs barriers is still in progress. Here tax uniformity can be achieved simply by the removal of the taxes concerned within the trade bloc, but as already noted this solution is not generally available for other taxes.

If it is wished to advance to the point where all border tax adjustments are removed, the uniformity problem is much more difficult. Sales taxes are generally levied on the destination principle, that is, the tax falls on the final consumer of the goods or services and is levied in the state of consumption. Where the goods or services cross a state's borders it is therefore usual to refund any sales tax levied up to that point in the state of origin and correspondingly for the state of destination to collect tax at the point of import. Removal of border adjustments involves the development of elaborate rules for determining in which state or states sales taxes will be levied in particular cases and dealing with adjustments to the positions of taxpayers and states in cross border transactions, while dispensing with physical border controls.

The European Community is currently in the process of solving this problem in moving to the common market in 1992. The first step is for all countries to levy common sales taxes (the value added tax and excises on selected commodities) with more or less common bases and within an agreed band of tax rates. Although the levy of a VAT is a condition of membership of the EC, it has taken many years to achieve the levy of the tax in all member states.[57] Harmonization of the tax base is an ongoing enterprise and the application of the agreed band of tax rates is still some way off. When that point has been reached it is possible to move to an origin or combined origin and destination type tax where no actual adjustments take place at the border and taxable persons importing goods in one state can credit tax levied in the country of export. The relative tax position of member states is then to be maintained by the transfer of tax revenues between states through the medium of a clearing system. Final implementation of all these processes in the EC will occur some years after 1992.[58]

In addition to indirect taxes, non-tax barriers to trade are also tackled, particularly in harmonizing corporate and commercial laws. Here the objective is very much to level the playing field across countries. The European Community has now a long history of action in these areas, and even in the much more recent example of Australia and New Zealand, there is now agreement as part of CER on harmonizing company, securities and monopoly laws. Finally, removal of border barriers in capital and financial markets may require even greater abrogation of sovereignty by member states, as we are witnessing in the debate over European Monetary Union. These non-tax adjustments are mentioned at this point for the reason that in the EC income tax uniformity is grouped with them under the rubric "technical barriers". This classification means that progress in the income tax area is much slower than in the sales tax area and is a lower priority. The suggestions in this paper that international income tax issues should be considered as part of trade policy is not intended to imply this kind of downgrading. On the other hand harmonization in non-tax areas such as corporation law is likely to make harmonization of the income tax an easier process.

If we turn to the income tax in the context of the objective of removal of barriers at the border, the only border-specific problem that arises is where withholding tax is levied on international transactions that does not apply to domestic transactions, as indeed commonly occurs with passive income such as interest, dividends and royalties. The solution is either to remove the withholding tax or to generalize it to all transactions of the type in question, whether international or domestic. The EC has in fact proposed the levy of a general withholding tax on interest but this proposal has foundered for the time being.[59]

The taxation of dividends paid across borders raises the more general issue of coordination of corporate tax systems within a trade bloc. The argument is increasingly made that harmonization of the corporate tax base and tax rate will be necessary to prevent tax distortions within the EC, that is, to achieve a level playing field, although the arguments are not universally accepted.[60] In the 1970s a proposal was made to harmonize the corporate tax systems of EC members by

57. Puchala, *Fiscal Harmonization in the European Communities* (London: Frances Pinter, 1984), describes the history up to the time of entry of the United Kingdom.
58. For a recent description of EC proposals, see Terra & Kajus, "The Elimination of Tax Borders within the EC: Recent Developments Regarding VAT", 44 *Bulletin for International Fiscal Documentation* (July 1990), at 311-320.
59. Turro, "The Demise of the Unified European Community Withholding Tax", 1 *Tax Notes Int'l* (1989), at 3-4.
60. Tanzi & Bovenberg, "Is There a Need for Harmonizing Capital Income Taxes Within EC Countries", unpublished IMF Working Paper, (March 1990); compare Bird, "Corporate-Personal Tax Integration", in Cnossen, ed., *Tax Coordination in the EC* (Deventer: Kluwer, 1987), Devereux & Pearson, *Corporate Tax Harmonisation and Economic Efficiency* (London: IFS, 1989).

accepting a common tax rate band and degree of imputation. This proposal also has not been pursued by the EC though recently, after 20 years' stalling, important corporate tax directives have been adopted by the Commission, the original proposal has been withdrawn and further studies on the corporate tax question have commenced.[61]

In the income tax area then the EC experience offers only some hope that trade blocs will lead quickly to greater uniformity of tax systems even on a regional basis. However, the real test is yet to come with the completion of the internal market.[62] Similarly income tax was deliberately excluded from the Australia/New Zealand CER Agreement, apparently on the basis that each country desired to get its tax system in order before committing to some kind of international accord.

One reason why income tax uniformity may not have been given higher priority in the EC case is the network of existing bilateral tax treaties among members. Take, for example, the case of royalties. These currently do not pose significant border problems since most European states adhere to the OECD Model norm of taxing them only in the country of residence of the taxpayer, with the result that border withholding taxes are removed within the EC. Indeed the EC members are obliged to enter into bilateral treaties for elimination of double taxation.[63] The extent to which bilateral treaties between the members will be replaced by EC directives is thus a matter of conjecture, though there are signs such as the recent corporate tax directives that replacement will occur over a period of time.

External Tax Relations of Trade Blocs

Tax treaties take on a different dimension, however, if we turn to the external tax relations of regional trade blocs. The operation of tax treaties has the potential to be an obstacle to achieving the internal income tax objectives of a trade bloc where members of the bloc wish to adopt a different solution to border (international) tax problems in the bloc than applies outside the bloc. States outside the trade bloc may not be prepared to accept such differentiation and protocols to tax treaties embodying most favoured nation status principles may provide a means to prevent it. This may arise in relation to the EC directive that withholding taxes be removed from dividends paid by a subsidiary in one member country to a parent corporation in another member country.

It will also be difficult precisely because of the bilateral tax treaty network for Australia and New Zealand to achieve very much tax uniformity in the traditional areas covered by such treaties even if the income tax comes to be included in CER. Income tax coordination will have to be outside those areas involving such matters as similarity of rules and tax rates. This problem is similar to the one observed above in the case of regional multilateral tax treaties in a bilateral tax treaty world.

It is interesting to note that the development of the VAT within the EC has not been burdened by a tax treaty network. The lack of treaties is partly explained by the fact that the world has exhibited much less agreement on the method of taxing consumption than it has in the income tax area. Indeed the dominance of the VAT among sales taxes is only a recent phenomenon largely stemming from the EC adoption and refinement of the tax. More important, the use of the destination principle for sales taxes generally makes double taxation less likely than in the income tax area. At least this is so in the case of trade in goods. The increasing trade in services and increasing extension of the VAT tax base into the services area will inevitably produce cases of double taxation in the sales tax area in the future because it is much more difficult to apply the destination principle to services as a matter of both theory and practice.[64]

The EC has invested considerable effort in devising a VAT system to deal with international trade in services and may not take too kindly to suggestions that its system should be adjusted by sales tax treaties to avoid double taxation with countries outside the EC. This example highlights one of the dangers in regionalism generally and with particular reference to achieving uniformity of tax systems. The difficult and delicate political process of achieving an agreed position within a trade bloc may create the same kind of lock-in effect produced by the bilateral tax treaty network, that is, the members of the trade bloc having resolved an issue among themselves after protracted negotiation will be unwilling for it to be reopened. Examples in the non-tax area, such as the intransigence of the EC arising out of the Common Agricultural Policy over agricultural trade in the Uruguay Round of GATT negotiations, are well known.

Consideration of the external position of trade blocs thus presents a paradox. On the one hand, the existing bilateral tax treaty network may constrain the development of uniformity of income tax law within the bloc, while on the other hand, the development of such uniformity may itself be a constraint to achieving uniformity between the members of the trade bloc and other nations. This interaction of the internal and external tax positions of regional trade blocs suggests that a more broadly based international approach is appropriate. Moreover, the trade bloc model is one of uniformity around specific rules and, like the existing multilateral tax treaties, this approach may only be suitable for the purpose of countries with relatively similar economic conditions and interests. For the great diversity of nations, a more flexible model is probably necessary. Given the origin of tax treaties in trade issues, perhaps the international trade area may suggest alternative solutions in the tax area.

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61. Goldsworth, "EEC Commission Adopts a New Approach to Company Taxation", 2 *Tax Notes Int'l* (1990), at 550-551, "EC Finance Ministers Agree on Direct Tax Measures ... At Last!", 2 *Tax Notes Int'l* (1990), at 665-668; the proposals include the phasing out of withholding tax on dividends between subsidiary and parent corporations from 1992 (1996 in the case of Germany). Two further proposed directives were announced by the Commission late in 1990, one for the abolition of interest and royalty withholding taxes on payments by subsidiaries to parent companies and the other for income tax consolidation of profits and losses within corporate groups across national borders; see 3 *Tax Notes Int'l* (1991), at 16. The Commission's income tax activities are concentrated in the corporate group area and reinforce the theme of this article that the treatment of corporate groups is the pressing issue of international taxation.
62. Some commentators have seen this as the way ahead on a worldwide basis, Weiss & Molnar, "International Cooperation Is Possible", in Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley, 1988), at 101-117; the tax harmonization of the EC has certainly generated an extensive literature.
63. Treaty Establishing the European Economic Communities, 1957, Art. 220 provides that members "shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals ... the abolition of double taxation within the Community" (reprinted in *Sweet & Maxwell 's European Community Treaties* (London: 1980), at 125).
64. See Terra, "The Place of Supply of Services", paper presented to a conference on Administrative Aspects of a Value Added Tax, Washington D.C., on 11-12 October 1990.

THE GATT ALTERNATIVE

I have already noted how tax treaties seem to have outgrown trade policy concerns and suggested that it is time for them to return to their origin. This would be consistent with the tax reform of the 1980s. Prior to the 1980s, the tax system was seen as the domestic solution to many evils. Poverty could be eliminated, desirable activities could be encouraged and nations could grow wealthy under a benign tax system. The shocks to the international economic system during the 1970s undermined these fondly held beliefs with the result that the tax reforms of the 1980s may be characterized as giving priority to efficiency over equity in the structure of income tax systems.

Similarly in the international area, the coordination of tax systems should turn mainly on efficiency with equity subsidiary (the relevant equity being inter-nation rather than interpersonal). If we see international tax basically as part of trade (understood in a broad sense encompassing trade in goods and services, and capital and financial markets), one may ask why international tax should not be subsumed under the GATT (or something similar).[65] Both direct and indirect taxes are dealt with negatively in the GATT, though the greater impact is on the shape of indirect rather than direct tax systems.[66] One hesitates, of course, to hold up the GATT as an ideal. Indeed there are probably lessons for the GATT in bilateral tax treaties as there are for international tax in the GATT.[67] The GATT model suggests, however, two basic conditions which may be part of a new international tax order, an international tax institution and flexibility of ground rules.

International Tax Institution

We do not have an international tax institution of the GATT or International Monetary Fund (IMF) kind, that is, a specialist tax (or trade and tax) body which has authority and procedures to apply international tax rules to members. The major international (as opposed to regional) institutions dealing with tax matters, the OECD and the UN, use persuasion rather than legal powers and procedures to attempt to produce changes in international tax matters, and neither is a specialist tax institution. They may be characterized as the secretariat model where a small group of permanent international officials assists experts and national representatives in discussions of international tax matters, but without power to settle disputes or bind members. Moreover, their activities are similar to but less comprehensive than unification of law projects where an international organization draws a uniform law to be implemented through a multilateral treaty. The individual members retain the decision-making power as to whether each will bind itself to the treaty once it is drafted.

Both the GATT and the IMF were created after World War II to prevent the kind of events that led to the Depression from occurring again. The IMF may be considered the "strong" model of an international economic institution with powers to take action that binds members as well as settle differences between members, and with substantial staffing to carry out its functions. The EC institutions also may fit the strong model after the point has been reached where a directive on tax matters has been adopted by the relevant EC institutions. (The discussion of the EC under the preceding heading dealt with the prior stage leading up to the adoption of a directive.)

The GATT by contrast is a "weak" model of an international economic institution.[68] Formally, it is not an international institution at all and it has little power to take independent action that binds members, but it is empowered to decide disputes between members and is staffed on the secretariat scale. The UN Fiscal Commission was the post-War inheritor of the work of the League of Nations Fiscal Committee. It had the potential to develop as an international tax institution in strong or weak form and to change the course of international tax development, but the placement of it under the UN umbrella doomed it to failure.[69] The subsequent activity of the UN in the tax area has been firmly in the secretariat mould.

The ongoing efforts to establish a multilateral tax convention in the administrative area contain the seeds of such a tax institution of the "weak" form that may issue advisory opinions and recommend actions to achieve the aims of the Convention. It is noteworthy, however, that the institution has no power to make authoritative decisions in disputes between members.[70] The Nordic regional multilateral treaty similarly creates a mechanism for consultation but there is no body to make determinations among members.[71]

It seems likely that the "weak" form of institution is the most feasible in the international tax area. At a minimum this would require a power to determine disputes among members, even if only through appointing an arbitrator after negotiations have failed,[72] a power to initiate rule-making procedures even if unanimous assent of all members is required to make new rules binding, and some independent staffing. The advantages of an international institution over current arrangements is that a greater constraint arguably is

65. This idea has occurred to other commentators, for example, Slemrod, "Tax Principles in an International Economy", in Boskin & McLure, eds., *World Tax Reform* (San Francisco: ICS Press, 1990), at 11-23.
66. Jackson, *supra* note 32, at 194-197.
67. Compare Bryan, "Some Observations on the Relationships Between Tax and International Trade Law", 42 *Bulletin for International Fiscal Documentation* (March 1988), at 110-115, who seems to regard the current international tax position as superior to the international trade position.
68. See Jackson, *supra* note 32, chapters 2, 4.
69. See *supra* note 15.
70. Art. 24 provides:

> 3. A co-ordinating body composed of representatives of the competent authorities of the Parties shall monitor the implementation and development of this Convention under the aegis of the OECD. To that end, the co-ordinating body shall recommend any action likely to further the general aims of the Convention. In particular it shall act as a forum for the study of new methods and procedures to increase international cooperation in tax matters and, where appropriate, it may recommend revisions or amendments of the Convention.
> 4. A Party may ask the co-ordinating body to furnish opinions on the interpretation of the provisions of the Convention.

The Council of Europe and OECD, *Explanatory Report on the Convention on Mutual Administrative Assistance in Tax Matters* (Strasbourg: 1989), at 61-66, makes very clear that each signatory retains ultimate decision-making power for itself.
71. See *supra* note 49. Art. 28 of the 1989 version dealing with the mutual agreement procedure provides that where two members are using the procedure, they are to communicate with the other members before coming to an agreement and any member can then require consultation among all members.
72. Arbitration of international tax disputes seems to be the next step beyond the current mutual agreement procedure; see L. Maktouf, "Resolving International Tax Disputes through Arbitration", in *Anti-Avoidance and Tax Treaty Policies in the Asian-Pacific Region* (Singapore: APTIRC, 1990), at 231-265. The United States recently ratified a treaty with Germany which includes an arbitration procedure in Art. 25 and diplomatic notes were exchanged elaborating the procedure; see *Federal Taxes: Tax Treaties II* (Englewood Cliffs, New Jersey: Prentice Hall, looseleaf), ¶ 39,055, ¶ 39,065; the procedure still depends on the agreement of both parties, that is, it is not compulsory.

placed on strong nations to abide by international obligations and that the institution can act with some degree of independence in setting the agenda of development and bringing about change. In the case of the GATT, for example, change occurs through the negotiating rounds which have developed international trade rules enormously since World War II, and in the case of the IMF through formal amendments to its Articles of Agreement and by evolution of its policies (the role and functions of the IMF in particular have changed radically since its foundation).

If an international tax institution is based on the weak model, then it is unlikely to be able to build uniformity of tax systems directly, as has been attempted in the EC, and will need to follow a different route in the structuring of its rules. This brings us to the second characteristic of the GATT alternative.

Flexibility of Rules

As well as providing the focus of evolution of international tax rules, an international tax institution set up under a multilateral treaty would permit quite different approaches to international tax problems that simply are not feasible in the bilateral framework or in a multilateral framework without an international institution. The case of transfer pricing rules has already been mentioned as one where a bilateral or multilateral framework makes a considerable difference. If formulary apportionment was adopted as the primary method of profit adjustment in the international framework, then the international tax institution would be able to ensure that the agreed tax base and formula(s) are applied on a consistent basis. This would be a more satisfactory procedure than the resolution of differing views of the appropriate arm's length price by agreements between national tax authorities as occurs in the bilateral context and is the cause of taxpayer suspicions that such cases may be decided by reference to extraneous criteria. The crucial difference, however, is the amount of flexibility that is possible under the multilateral GATT model.

Thus the multilateral approach with an international tax institution would permit departure from the strict reciprocity that characterizes bilateral treaties. For example, parties to the Convention could specify different tax rate limits that would apply to income derived by non-residents from sources in their countries and those rates would automatically be extended to all parties to the treaty irrespective of whether other countries adopted the same or different rates. It could be expected that developing countries would specify higher and developed countries lower tax rate ceilings. This process is analogous to the tariff undertakings made in the context of the GATT negotiating rounds where different countries undertake to achieve different levels of tariff reductions as is appropriate in their circumstances.

It would also be possible to accommodate in this type of framework a greater variety of arrangements for individual nations (apart from the tax ceiling issue) both through permitting parties to specify which parts of the multilateral treaty bound them and through greater overall flexibility. The bilateral tax treaty network in theory allows this to happen and there are clear differences in nations' negotiating positions, but the effect of the OECD Model is to produce significant treaty uniformity; indeed from a bilateral perspective this is one of its great advantages. For example, under a multilateral treaty a nation may agree to be a party to non-discrimination but not to tax rate ceilings at all (and vice versa); or one nation may specify a single tax rate ceiling for all types of income (which would overcome the problems referred to above of differential tax rates) while another nation may continue with the schedular system.

There would of course need to be some generally binding rules such as the conferring of most favoured nation status by all parties to the treaty on other parties, but in the early stages these could be minimal and then progressively more binding undertakings could be added over the years. This does not necessarily mean less agreement than exists in the current bilateral tax treaty network, as most countries could be expected from the beginning to go beyond the minimal obligations for membership. The GATT once again demonstrates the possibilities of flexibility. The GATT binding commitments have become more embracing over the years but parties are still able to pick and choose, in particular in relation to the many side agreements that form part of the GATT framework such as the GATT Valuation Code and the Annexes to the Kyoto Convention. Further, the most favoured nation status conferred by membership of the GATT is not seen as preventing the grant of special tariff concessions to developing countries, which suggests a way of accommodating tax sparing in a multilateral international tax framework.

Such a model implies international tax rules which could take one or both of two forms. First, they could be of the relatively determinate and fixed kind which predominate in the OECD Model (although applied more flexibly through the mechanisms outlined above). Secondly, the rules themselves could be of a more general and flexible kind, akin to some of the trade rules found in the GATT (and a few rules in the OECD Model). Many would no doubt say that the virtue of the current OECD Model is the precise nature of most of the rules contained in it. Yet their precision is the cause of many of the problems with the current Model that have been noted above.[73]

It is likely that a multilateral alternative would adopt both kinds of rules. For example, it could contain both a specific and general undertaking in relation to the relief of double taxation. The specific undertaking would outline the procedure normally adopted by a nation to relieve double taxation (exemption or credit method) and may in fact be an optional part of the treaty; the general undertaking would apply to all parties and would simply be to eliminate double taxation (not dissimilar to the undertaking often found in the mutual agreement procedure, OECD Model Article 25(3)). If the controlled foreign corporation legislation of any jurisdiction arguably produced double taxation, then the general undertaking may or may not apply, depending on the interpretation of it by the international tax institution in the circumstances.

The major difference from the OECD Model in this regard would be the reversal of emphasis: currently bilateral tax treaties will contain the specific relief of double taxation provisions but will often omit the more general provision. As this example shows, the existence of an interpretative body that can develop an increasingly detailed jurisprudence around a generally expressed rule makes it possible to shift the emphasis in the multilateral context with an international tax institution. The use of rules in such general

73. It is not therefore surprising that the OECD in recent times has come to emphasize domestic flexible rules as in the thin capitalization and tax haven areas, *supra* notes 31, 39, and the OECD Model general requirement for relief of double taxation as opposed to the specific requirement. Flexibility applied on the domestic level, however, will lead to greater diversity and uncertainty in international taxation unless there is an international institution that can provide authoritative and binding determinations on the content of the rules.

terms would add another dimension of flexibility to the multilateral treaty to give as many means as possible to overcome difficulties arising from the diversity of tax systems around the world (which, it will be recalled, has generally been seen as the reason for not moving to a multilateral treaty in OECD-type terms).

Achieving Uniformity of Tax Systems

The trade bloc and GATT alternatives have in common that an attempt is made to build uniformity of tax systems after a specialist multilateral institution is put in place, though the emphasis is different particularly with respect to attempts by the institution to impose uniformity of tax systems on its members (which is clearly not feasible in the case of an institution of the weak form). The weak form of institution is more likely to operate through negative rules of what tax systems may not do (double tax, discriminate) and to build towards uniformity by increasing the number of negative rules to the stage where they more or less amount to positive prescriptions.[74]

Arguments can be made that now is a propitious time to seek such a multilateral institution as the end of the cold war and the adoption of market systems in place of central planning in communist or former communist nations has led to greater examination, influence and (possibly) effectiveness of multilateral institutions, not to mention to the creation of an important multilateral institution in the shape of the European Bank for Reconstruction and Development. This argument may be bolstered if the Uruguay round of GATT negotiations is successful but equally if the round fails, as daily seems more likely, it may be foolish to throw international tax relations into a state of flux when international trade rules are going backwards*. As always with proposals for change, nothing will happen unless some nation or multilateral institution takes the initiative and as yet such a volunteer has not been forthcoming (if we discount the EC activities and the administrative Convention as being likely to lead to this result).

Another alternative, especially for those pessimistic about multilateralism, is to seek to achieve greater uniformity of tax laws before moving to the multilateral level. In one sense this may seem to have been tried already in that it has been recognized ever since the first attempts to coordinate nations' tax systems that lack of uniformity has driven developments along the bilateral path. Yet it is a paradox of the history of international tax developments that while the diversity of tax systems has been recognized as the cause of bilateralism and an impediment to multilateralism, the development of bilateral models has not had as a major objective the uniformity of tax systems, nor has such uniformity been made independently a substantial goal of institutions concerned with international taxation.

Given the increasing difficulties with the bilateral network of treaties and the failure of multilateralism to date in the tax field, there is much to be said for a shift of priorities to achieving increased uniformity of tax systems rather than further pursuing bilateralism as a means to multilateralism (which seems to be the current order of priorities in the OECD and the UN). The same problem is confronted in this case as with achieving multilateralism outside an extension of bilateralism – which nation or institution will provide the means to the end. While this is an avenue certainly worth exploring, for example, what exactly does greater uniformity entail and what are the benefits, I shall leave it to another occasion. There is no reason why efforts directed to multilateralism and greater uniformity of tax systems should not proceed hand in hand, and given the difficulties (as well, it seems to me, as the inevitability) of moving from the status quo, the betting person will back as many horses as possible.

Transnational Corporations and Corporate Groups

A major theme of the previous discussion of the problems of the OECD Model is its inability to deal adequately with the tax problems raised by transnational corporations and corporate groups. The discussion of the alternatives has not, however, addressed the question of why they may be likely to be more successful in coping with the problems. If we think of transnational firms as multilateral private organizations (that is, a multiplicity of member businesses operating in many nations bound together by common goals effected through common ownership and management, accounting, financial, etc. practices), then it seems obvious that it is more effective to deal with them whether for regulatory or tax purposes through a multilateral public institution (without going to the utopian extremes of suggesting that the multilateral institution itself act as a tax gatherer).[75]

More specifically in the tax context, the solution to many of the problems arising under the OECD Model has been suggested to be consolidation of corporate group accounts for tax purposes. To take complete consolidation as the ultimate goal, transactions within the group would be eliminated, the international tax base so established would be divided by a formulary method, each country would apply a single tax rate to its portion of the tax base subject to any ceiling rate to which it had agreed multilaterally (but the rate could vary from country to country) and the residence country would then tax or not as it saw fit the foreign income, subject to rules against double taxation. Such a method can only be realistically approached at the multilateral level. These measures can deal simultaneously with the issues of recharacterization of income, transfer pricing, treaty shopping, thin capitalization and CFC regimes as well as simplifying the foreign exchange and finance leasing areas.

In the case of recharacterization of income, the effectiveness of this activity within the group is eliminated by consolidation and outside the group by the division of the tax base through an appropriate formula and application of a single source country tax rate. Transfer pricing is subjected to the consolidation and formulary apportionment rather than the arm's length approach as has been argued to be the theoretically correct method above where the various parts of a firm are interdependent (the arm's length approach may remain for a small minority of cases where consolidation does not occur). Consolidation equally does away with treaty shopping (which often involves recharacterization as well as diversion of income) since the portion of the international tax base that would be allocated to the country where the conduit company operates would be nil (absent any other "real" operations there) under an appropriate apportionment formula.

* *Editor's note:* Since the writing of this article the GATT talks have broken down. It is expected, however, that talks will resume in the near future.

74. Of course negative propositions can be expressed positively and vice versa but the difference that is being highlighted is that in the weak model member nations would maintain much greater control over their tax systems and there is much greater scope for the degree of diversity of tax systems that can be accommodated.

75. Such as Weiss & Molnar, *supra* note 62, at 113-115; this is asking too much for Bird, *supra* note 25, at 297.

Thin capitalization ceases to be a problem because interest payments within the corporate group are eliminated. All that matters are interest payments by the group to third parties and then only for establishing the total international tax base subject to division. Back-to-back loans involving third parties which have to be identified for effective thin capitalization rules in the current international tax environment would only create timing problems under the consolidation approach (that is, mismatches of the interest paid and the corresponding income received) and might well be disregarded. Similarly finance leasing and foreign exchange transactions within the corporate group would cease to be problems, and only such transactions outside the group would be of concern. It would be necessary to have rules for dealing with the various issues raised in that context but accounting theory has already substantially advanced towards the necessary solutions.[76] Moreover, the agreement on the international tax base would need to adopt a consistent rule for conversion of the currency of tax accounts for a corporate group into the currencies of the various countries sharing the tax base.

Finally, the need for CFC legislation would be removed since its consolidation function is performed by the definition of the corporate group's international tax base and the residence country would have a comprehensive tax base which to tax. In particular, the problem of deferral of taxing foreign income until its repatriation within corporate groups, which is one of the reasons for the adoption of CFC legislation, would be eliminated by the consolidation process. Whether and to what extent residence countries of ultimate parent corporations in corporate groups levied tax would depend on a number of factors – the uniformity of tax rates around the world or otherwise, the nature of corporate tax systems and their international treatment, the desire to give tax sparing relief, the residence of shareholders, etc. These matters raise a host of issues that already receive international attention but they will not be pursued here.

The consolidation approach would not be without its difficulties. It has the great benefit, however, of attacking the international tax problems arising under the OECD Model at their root and therefore the ongoing tinkering and interactions that second-best solutions to tax problems usually entail would be reduced if not eliminated (though no doubt along the way to development of the new system some second-best elements would be adopted in the details). Three problems can be noted at this point.

First, there would be an incentive for transnational corporate groups to manipulate the grouping rules to avoid or attract grouping as suited their circumstances. This kind of problem is present in domestic grouping rules but there would be the added difficulty in the international context of entities resident in countries which, by virtue of secrecy laws or other provisions, make it difficult to trace corporate relationships. This is not a new international problem but it would have to be tackled vigourously to prevent grouping rules being subverted.

Secondly, the collection of tax in international transactions would still pose difficulties even in the presence of mutual assistance provisions if the international tax institution does not act as a tax collector. There is no reason why a combination of international business and withholding tax collection regimes should not remain in place despite consolidation of the tax accounts of corporate groups. For example, interest withholding tax could be collected on interest payments within a corporate group even though they are eliminated on consolidation. Such withholding could not be regarded as final, however, as the amount of tax due to a country would be set by the international division of the tax base.[77]

Thirdly, there is the problem of countries remaining outside the system. Unless the system encompassed the major trading nations, it would not be possible to achieve the level of international consolidation just outlined and the coherence that it brings, for the world would still be a duality of multilateral and bilateral relationships with all the constraints that situation implies. Assuming the major trading nations are included, the problem becomes whether free riders like the current tax havens would threaten the integrity of the system. This seems less likely than under the present system because the international division of the tax base would allocate income outside the members only to the extent that substantial activities took place there. The real problem of tax havens currently is the artificial location of transactions; their attraction of substantial "real" activities is a function of convenience of location and other non-tax factors combined with tax competition among nations. It is not suggested that tax competition must necessarily be precluded among nations within the proposed system (though it is one possibility to consider) which means that the tax competition factor may not be a problem. Similarly, problems arising from attempts to locate the residence of a parent corporation of a group in a haven outside the system to avoid residence country taxes is a problem that can be dealt with by the definition of residence and the nature of the international corporate tax system.

It may be considered nonetheless that some incentive to join the system is appropriate. Depending on the extent of membership this could be achieved, for example, by tax ceilings applying only among the members, unrelieved double taxation for taxes levied outside the members, allocation of the whole international tax base among the members or other measures and would flow quite naturally from the GATT-type structure extending most favoured nation status only to members of the system. Even apart from the tax haven problem, such incentives fulfil a symbolic function of indicating the importance that each nation attaches to efforts to deal with international tax problems, and may be likened to the current practice of setting withholding tax rates at a high level mainly for the purpose of lowering them in bilateral tax treaty negotiations.

While consolidation and the other measures suggested provide a coherent goal for multilateral effort, they are not likely to be or necessarily achieved all at once. Outside of consolidation there are a number of advantages in the GATT Model, such as breaking down the formal reciprocity of tax rates and the schedular nature of bilateral tax treaties and most critically creating an institution that has as its mission the improvement of the international tax order and is endowed with some powers to assist in that process.

76. Indeed one of the attractions of the consolidated international tax base is the greater ability to rely on consolidated financial accounts for tax purposes.

77. As a sidelight, the solution to the problem of levying an appropriate international tax on interest that tackles the widespread tax evasion encouraged by the current erosion of interest withholding taxes without distorting international capital markets could be developed in a multilateral environment. For example, there might be no obligation to withhold on interest payments to financial institutions but an obligation for corporations and financial institutions to withhold on payments to taxpayers that are not financial institutions; this would meet most of the problems that a ten percent withholding tax is too high for payments to financial institutions but generally too low for payments to other taxpayers. The remaining problems would be met by the withholding tax not being a final tax, so that taxpayers can claim deductions against the interest income and a refund of tax where appropriate.

Hence it is possible to proceed gradually to full consolidation with various forms of partial consolidation and by discarding existing rules designed to deal with the corporate group problem only when the particular reason for the rule is overtaken by the progress of consolidation.

The fact that the international system would (temporarily) contain elements of consolidation and separation of corporate groups need not be of overriding concern. Domestic tax systems have increasingly displayed this kind of ambivalence as they move away from separate treatment and towards consolidation in international transactions. Inevitably, this movement has been indirect because the current bilateral treaty network is built on separate treatment and limits domestic choices to some degree. Nonetheless, the OECD Model itself (or at least as the OECD interprets it) contains a similar discordance in the arm's length pricing area.

Most nations which actually tax foreign branches of a resident corporation do so on a consolidated current basis, that is, the profits of the branch (PE in international tax jargon) are treated simply as part of the profits of the corporation when derived, whether or not they are repatriated. Under Article 7(2) of the OECD Model, where a PE of a corporation resident in one nation exists in one of its treaty partners, the profits attributable to the PE and subject to tax in the source nation are determined as if the PE "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". In turn, the residence country is obliged to give a foreign tax credit on the same basis for taxation in the source nation.

I have already noted how these words require the construction of artificial transactions that never legally occur. On their own they suggest that where, for example, the PE engages in manufacturing using a patent held by the corporation and developed through activities in the residence country, an arm's length royalty payment for that use from PE to the corporation should be constructed, for it is only in this way that the separation of the branch from the corporation for application of the arm's length principle can be recognized. Yet the Commentary does not permit the creation and deduction of artificial royalties; the only deduction the branch can claim is an appropriate share of actual royalty payments by the corporation to third parties. Conversely, artificial prices can be created for goods transferred from head office to the PE.[78] In the case of patents held by the corporation, it is apparently considered that the PE will effectively get a share of deductions for current research and development expenses, but this is not the same thing by any means as deduction of a notional royalty. The corporation may have incurred and deducted the expenses that relate to the patent before the branch was set up so that the branch never shares in them, and it may have abandoned research and development activities so that no current deductions for the branch arise.

This treatment of royalties and research and development deductions is a complete departure from the separate approach and effectively adopts consolidation. No guiding principle is suggested in the Commentary for when separate or consolidated treatment is to apply; indeed the Commentary, in hopping from one standard to the other in the examples discussed, shows little awareness of the fundamental difference involved.[79] While this example demonstrates another source of incoherence in the current OECD Model for the critical area of transfer pricing, it has been mainly referred to here to show that it is possible to combine separate and consolidated elements in the international tax system. But consolidation should be the rule and the ultimate goal, and not the separate treatment found in the OECD Model, with consolidation as an occasional exception.

Ultimately the consolidation approach implies a fundamental shift from the current approach of reconciliation at the interface of tax systems even though that approach may be maintained during the shift from the bilateral OECD Model to a multilateral international tax base. Although the international tax base for transnational corporations and corporate groups can operate alongside a domestic tax base defined in different terms, it is likely that agreement by countries on the definition of an international tax base will produce a flow-on to the domestic tax base. In other words, even if uniformity of tax systems is not an explicit goal of the consolidation approach, indeed even if there is nothing inherently valuable from an economic perspective in such uniformity, the likely by-product of a shift to international consolidation is (greater) uniformity of tax systems.

THE DIRECTION FOR THE ASIAN-PACIFIC REGION

If we summarize some tentative conclusions from this discussion of international alternatives to the OECD Model, most of the flaws identified in the bilateral tax treaty network based on the Model cannot be achieved by bilateral developments, and in any event the bilateral network has reached a stage where fundamental bilateral change is impossible because of the lock-in effect of the existing treaty network. International consolidation of transnational corporations and corporate groups represents the solution to current flaws. This method implies a multilateral approach to international tax problems but multilateralism will not simply arise by evolution from the bilateral OECD framework.

What is needed is an international tax institution with (relatively modest) powers that cede some national tax sovereignty to the international level. Even though the objective may be consolidation, the first step is to put in place the multilateral means to the end. It is not even necessary that the end be defined in any clear sense at the outset as the mission of the tax institution, for such an institution can achieve many benefits apart from consolidation of transnational corporations' income. Once this catalyst is provided, the path of development is unlikely to be adoption of uniform tax laws as an end in itself (although this possibility is not to be ignored), but rather a shift of emphasis to flexibility and non-reciprocity of international tax rules which may at first be within an OECD-type rule structure.

Many proponents of formulary apportionment of the consolidated income of corporate groups in lieu of arm's length

78. OECD Model, at 74-79. It has been held in Australia in *Max Factor v FCT*, 84 Australian Tax Cases [ATC] 4060, that a branch cannot deduct a loss on an actual transaction, namely an exchange loss on remittance of funds to head office, which is consistent with the consolidated approach.
79. It might be argued that deductions are expressly dealt with in Art. 7(3) of the OECD Model which may impose a different standard. The Commentary says at one point that "the principle set out in paragraph 2 is *subject* to the provisions contained in paragraph 3" and later that "paragraph [3] *clarifies* ... the general directive laid down in paragraph 2". Whatever the reconciliation of these statements, the Commentary clearly adopts both approaches. An awareness of departure from the separate approach is evident (see OECD Model Commentary, at 77), but not of the basic distinction involved.

pricing probably underrate two features of the international tax base implied in their proposal, the work required to define the tax base and the effective limitations on national tax sovereignty that the international tax base will produce. Although the proposal offers the most elegant and complete solution to the problems of taxation of transnational corporations, it should be viewed as a goal to be achieved by many intermediate steps and not directly. Apart from these considerations, the success of the OECD Model formula is something that will not simply be abandoned before a practical alternative has been agreed on and tested in some way.

Regionalism and International Tax Development

The need for testing suggests that development is likely to start at the regional level, which is confirmed by experience with alternatives to date. The general alternatives that are implicit in the discussion are summarized in the following table:

Type of system	*Regional*	*International*
Multilateral OECD style	Nordic	Not achieved
Uniformity	EC	Not tried
Institution and flexibility	Not tried	Not tried (cf. GATT)

As the regional successes of the Nordic Treaty and the EC seem unlikely themselves to shift to the general international level, a regional tax institution of the GATT type seems indicated as the best path of development (which could also include elements of the other two approaches). Considerable regional cooperation already exists at the tax administration level in various parts of the world and it would be a small step, for example, to confer power on such an informal body to appoint an arbitrator where the competent authorities of two countries cannot agree on transfer pricing adjustments, whether or not the competent authorities involved agree on the need for an appointment. Such a power to appoint *without agreement* would be the critical step forward from the few current arbitration procedures in bilateral tax treaties.[80] Indeed the directives recently approved by the Commission of the EC contain such a power[81] but that is in the context of the existence of EC institutions and harmonization of tax laws, rather than the first step.

It would be natural for this step to be accompanied by power to develop further regional initiatives such as in the multilateral administrative Convention.[82] Although in themselves these steps do not amount to a regional GATT for tax and are one of a number of possibilities, the potential for development is already there. As I have emphasized, it is the mechanism for change rather than change itself which is critical and that mechanism is an institution that has some power and initiative with respect to its members. Of course it would be better in my view to move to a regional GATT model more directly, but failing that, it is necessary to identify the incremental steps that are likely to lead to further development as compared to those (such as the regional multilateral OECD-type treaty, in my opinion) which are not.

Beginning at the regional level with such an institution involves some limitations that were not canvassed in the discussion of the GATT alternative above. First, the existing bilateral network would remain in force outside the network and regional developments would need at least to be compatible with the operation of the bilateral treaty network between the region and the rest of the world. Secondly, even within the region it is likely that bilateral tax treaties would only be replaced gradually with multilateral elements, again partly because of the bilateral framework outside the region. Thirdly, it would not be possible to tackle all tax problems of transnational corporations and corporate groups as most such groups operating in the region would extend their activities beyond it; hence formulary apportionment of an international tax base would produce some of the problems of inconsistencies with the arm's length principle that we have witnessed in the unitary tax debate.

On the other hand, possible slow progress at the regional level could be compensated by greater speed at the international level if the regional initiative is judged a success and moves to the international level. Unlike the other two approaches it seems to me that shifting from the regional to the international level is much more likely through the institutional approach because of the great flexibility that is offered. Once that shift has occurred, then finding very different solutions to international tax problems, as compared to the reconciliation mode of the OECD Model, becomes possible by a series of incremental steps. As has been suggested above, once an agreed international tax base has been adopted, uniformity of tax systems becomes very likely so that ultimately an outcome similar to the EC at the international tax level may be the result, but by a very different route to the trade bloc harmonization approach.

Characteristics of the Asian-Pacific Region

Before sketching some possible avenues of Asian-Pacific tax development, the unique character of the region should be noted. If we think of the Asian-Pacific region as the arc of larger countries from Japan down to New Zealand (excluding the communist countries) and the small island nations of the South Pacific, there is a blend of developed, newly industrialized, developing and least developed countries. The mix does not lend itself to the same characterization as other regions (such as the developed Western Europe and North America contrasted respectively with the developing Eastern Europe and Central and South America, and the poverty of Africa). The region is generally conceded to be the most dynamic economic growth centre of the world; it is generally free of the debt problems that burden other regions, especially Eastern Europe, South America and Africa. More specifically, the region is less encumbered overall with bilateral tax treaties than Europe and the Americas, and in the case of the small nations, there are hardly any treaties at all.

The region is ideal for developing and trialling international tax initiatives. The nations in it are representative of the world as a whole, they are not troubled by many of the problems that figure in other parts of the world and their rapid economic development means both that the need for international tax measures is growing rapidly and that existing international tax practices have not crowded out other possibilities.

For all its growing economic power the Asian-Pacific region has very little effect on the direction of world affairs and policy which is dominated by the EC countries, the United States and (until recently) the communist bloc. Japan is beginning to assert its views on the world stage but its influence is hardly commensurate with its economic standing (for instance, it is now the largest aid donor in the

80. See *supra* note 72.
81. See *supra* note 61.
82. See *supra* note 70.

world). Apart from the fact that influence inevitably lags behind shifts in economic power, some reasons can be suggested for this lack of influence. The region has not thus far acted as anything like a united force in world affairs. While this may be partly explained by the diversity and economic competitiveness within the region, the region seems to have an image of itself as a policy taker, not a policy maker.

Whether the region desires it or not, the current state of affairs seems set for change. The development of super trade blocs in Europe and the Americas (with the planned integration of Eastern Europe into the EC, and President Bush's desire for a free trade pact with Mexico and his Initiative for the Americas) means that the Asian-Pacific region will need to form its own alliance if it is to protect its recent economic gains. The growth of trade within trade blocs resulting in the removal of tariff and other barriers is always partly at the expense of nations outside the bloc which still face the barriers. Hence penetration of the enlarged European and American markets is going to become more difficult for Asian-Pacific countries even if the Uruguay round of GATT negotiations does not break down. If the negotiations do break down and a European-American trade war develops, the Asian-Pacific region stands to be a major victim. Japan will find it difficult to negotiate with the enlarged trading blocs on equal terms, and certainly for other nations in the region the only viable response to such developments will be some kind of joint action.

Of course it is possible that the region may wait until the course of events forces its hand. There are signs, however, that some nations in the region are willing to become initiative takers in international affairs. Japan has taken a positive role in its 1990 bilateral trade negotiations with the United States by suggesting improvements that the United States could make in its economy rather than merely defending Japanese practices. The activities in the GATT Uruguay round of the Cairns group of agriculture-producing countries initiated by Australia show that it is possible to produce some influence for interests other than the Europeans and Americans.

Plans are already afoot for the major trading countries of Southeast Asia to begin cooperation on trade matters. This was seen until recently as a very delicate exercise and the formation of a trade bloc was stoutly denied by all concerned. It was difficult enough to imagine just a year or two ago how such a diverse group of countries could form a trade bloc, let alone a tax bloc. Yet the rapidity of recent events – in Eastern Europe where it became clear during 1989 that Eastern Europe will eventually join the EC, in the 1990 U.S.-pan-American trade initiatives partly in response to European events and most recently in the East-West unity in the UN over the Persian Gulf war suggest that the idea could quickly develop into much greater regional cooperation. Further, it is possible to identify within the region a number of sub-blocs which, for one reason or another, may be regarded as coherent. For example, one can group say, Japan, Taiwan, South Korea and possibly Hong Kong as one bloc, the ASEAN countries as another, the Pacific Island states as a third, and New Zealand and Australia as a fourth. Tax developments within such sub-groupings are possible though full regional effort is likely to be more desirable.

An Asian-Pacific Tax Initiative

It will be apparent from the previous discussion that I do not consider it useful for the region to seek to develop a variation on the OECD Model for use in bilateral negotiations, though this is suggested by the title of this paper.[83] If we think of the Asian-Pacific region in terms of closer regional cooperation and of the previous discussion of alternatives to the OECD Model, various possibilities are raised.

First, there is the application of multilateralism to the region along the lines of the Andean Group and the Nordic Treaty, that is, multilateral treaties within the region and perhaps a joint negotiation of treaties outside the region. While this approach would be particularly appropriate to the Pacific Island states as a regional sub-grouping, it is unlikely to be feasible across the whole region as a first step because of the very diversity that makes the region unique. Further, from the perspective of an approach that is likely to be carried over to the international level, a multilateral treaty on its own has already been rejected.

The second possibility is the EC approach where within the context of a trade bloc an attempt is made to make the members' tax systems more uniform. While the EC experience suggests that some gains can be made on the uniformity front, the difficulties encountered to date, the nature of the model with a relatively strong well-staffed central institution and the way in which income tax is regarded as an appendage to trade rather than with a combined tax and trade focus suggest that this should not be an immediate goal for the region. After all the EC has only been able to tackle such issues after getting tariff barriers out of the way which is a point not yet reached in our region. Still we should not lose sight of the possibility of convergence of our tax systems even if the EC institutions are not the immediate model. Again from the broader viewpoint, I have already indicated that the EC model is not the way to uniform international laws even if uniformity is adopted as the major goal.

The third possibility is the GATT model and it will already be obvious that this in my view is the most useful contribution that can be made by the region. I am not suggesting that the GATT model is somehow peculiarly suited to the region, rather that the Asian-Pacific region is the most likely place for desirable new international tax developments to occur. The elements involved have already been sketched – an international institution that has some modest powers (such as interpretation and dispute settling) with respect to its members, some permanent staffing even if on the secretariat scale and a role as instigator of further changes. Likewise the relatively small and incremental changes to the OECD framework have been noted, but unlike the current bilateral treaty network which is largely confined to growth by replication, the proposal contains the seed for developmental growth.

In the initial stages the existing regional bilateral treaty network could be left in place apart from changes to the mutual agreement procedure to provide powers for the new institution. A multilateral treaty akin to that suggested above for the Pacific Island states could then be generalized to the region for those cases where bilateral arrangements were not yet in place (which in the case of this region provides substantial room) and next regional bilateral arrangements could progressively be replaced by the multilateral treaty which would be an evolving instrument. At the same time the tax organization may seek to bring about convergence of domestic tax systems within the region, perhaps in the initial phases concentrating on the least de-

83. Dery, "Model Tax Treaty for the Region", in *Anti-Avoidance and Tax Treaty Policies in the Asian-Pacific Region* (Singapore: APTIRC, 1990), at 341-349.

veloped and developing countries through the medium of tax law aid projects.

At this point the main formal departures from the OECD Model are only likely to be the abandonment of reciprocity of tax rates and the addition of some general obligations (such as most favoured nation status and relief of double taxation for cases not specifically covered). The fact that the regional enterprise may in part seem to mimic the OECD Model is not a drawback. The critical break with tradition is the putting in place of a truly multilateral treaty combined with a supranational tax institution.

The first major departure from the content of the OECD Model is likely to be treaty provisions dealing with those tax issues identified above as being of international concern but by and large ignored by the OECD Model (thin capitalization, etc.). This process may well be additive rather than substitutive. It is only when the heart of the OECD Model is tackled – its schedular structure, separate taxation of corporations and arm's length pricing formula replaced by cross border consolidation of the tax accounts of transnational corporations and corporate groups – that the formal abandonment of the OECD Model need occur.

This, I suggest, is the model that the Asian-Pacific region should follow – a multilateral, institutional rather than a bilateral, textual mode for international tax change. Ultimately, however, in the international tax area, as in many other areas, substantial worldwide changes are likely to be affected by the attitude of the United States and Europe. Officially, the United States remains committed to the current bilateral tax treaty network based on the OECD Model. There is an undercurrent in academic circles in North America for fundamental changes to the international tax order but little in the way of specifics of how changes are to be achieved.[84] In Europe important experiments with alternative international tax regimes are under way but the possibility of transforming them into worldwide practice seems remote. If the Asian-Pacific region were to take the lead in the international tax area in the way suggested, it would not only break its mould of being a policy taker, but may provide the specifics and means for fundamental improvement of the international tax order.

84. See Bird, *supra* note 25, 62 and 65. A recent volume describing "international taxation economics" as an "important new area" has one page devoted explicitly to tax treaties and one study implicitly on them (an empirical study of transfer pricing), Razin & Slemrod, *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990), at 8, 26-27, 123- 159. Is this a sign of the failure or the success of the OECD Model?

AUSTRALIA:

REFORMING A TAX SYSTEM TO REDUCE OPPORTUNITIES FOR TAX EVASION

Ian Wallschutzky

Ian Wallschutzky is Associate Professor in Taxation, University of Newcastle, Australia.

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I. INTRODUCTION

Traditionally tax systems have been required to achieve a number of purposes including raising revenue, redistributing income and/or wealth, encouraging efficiency in the use of resources, acting as an incentive in one way or another, and influencing economic activity. Tax reforms are proposed and judged on the basis of how well they achieve these or other purposes and meet other criteria. Those other criteria can include certainty, simplicity, ease of administration and neutrality. Reforms which seek to achieve one purpose, however, often do so at the expense of another.

The aim of this article is to suggest reforms that will reduce the scope for tax evasion. Whereas this criterion does not fit neatly into traditional ideas, it is assumed that reforms which reduce evasion assist in meeting one or another of the traditional taxation criteria.

This research is based mainly on an analysis of changes made to the Australian tax system. Australia was chosen because of the author's familiarity with it, because it has experienced a sustained attack on evasion by the taxation authorities and because a number of significant measures to combat evasion have been implemented. These measures involve changes to the tax system itself (e.g. additional source deduction rules) and changes in Tax Office philosophy in administering it (e.g. from one of imposing sanctions in every instance of evasion to one of encouraging voluntary compliance). The Australian authorities carried out this sustained attack as a result of large scale avoidance and evasion in the late 1970s and early 1980s.

This research is limited. It focuses only on reforms directed at reducing opportunities for tax evasion. It ignores reforms directed at reducing taxpayers' desire or motivation to undertake evasion. For the sake of thoroughness both issues would really need to be considered. The research is also limited in that it does not attempt to outline all those reforms that might reduce evasion. Perhaps this is based on a realization that in modern tax systems it is not possible to build in all the controls necessary to prevent evasion. Some reforms are not feasible because, whilst they may be desirable they are politically unacceptable. Others are not feasible because they would involve high administrative or compliance costs, despite their desirability on other grounds. This research also is constrained through the recognition that in the long term tax systems will be more effective if they are based on voluntary compliance.

II. DEFINITION OF TAX EVASION

Before one can suggest measures to prevent tax evasion it is first necessary to define it. Usually tax evasion is defined as an act in contravention of the law whereby a taxpayer pays less tax than he is legally bound to pay.[1] Evasion presupposes that a liability to tax has already fallen on a taxpayer who then takes steps to escape payment, either in whole or in part. The methods by which this is done include failing to lodge a return, omitting income, overclaiming deductions, rebates or credits, or falsely claiming exemptions.

Because evasion is contrary to the law, tax legislation does not need to include a general anti-evasion provision. All the revenue authorities need, to frustrate tax evasion, is perfect information.

1. See, for instance, Royal Commission on the Taxation of Profits and Income, Final Report, Cmnd 9474 (London: MMSO, 1955), at para. 1015 or Taxation Review Committee, *Full Report* (Canberra: Australian Government Publishing Service, 1975), at para. 11.1.

It has been noted that because evasion refers to acts that are against the law, evasion depends upon what the law states and, in some instances, how evasion is interpreted by the courts. "What proves to be against the law in country A, may be perfectly lawful in country B. Thus we cannot identify a transaction, a treatment, or a circumstance that is from an international point of view illegal."[2]

It is also true that what might be evasion in country A this year might not have been evasion in country A last year. An example in this context is capital gains. In Australia, prior to 19 September 1985, most capital gains were not assessable. Taxpayers who omitted such gains from their tax returns were not evading tax. However, in respect of assets acquired and disposed of after that date, taxpayers who omit capital gains are evading tax.

The above comments do not detract from the definition of tax evasion. They emphasize some of the practical problems in concentrating on a particular type of transaction to evidence tax evasion. Perhaps they also emphasize the importance of defining in clear and unequivocal terms what the law requires.

III. REFORMS TO REDUCE EVASION OF INCOME TAX

What follows is a review of reforms to the Australian tax system which have been designed, at least in part, to reduce evasion of income tax. It is hoped that others might benefit from knowing what has happened in Australia.

A. *Tax collection practices*

Unless tax is deducted at source, alternative means must be found to collect tax. Such alternatives usually rely on voluntary disclosures by taxpayers, and are generally considered to be less effective. This is not surprising as taxpayers may already have consumed tax due in their consumption expenditures. Estimates of compliance rates for four classes of income for the United States confirm the beneficial effect source deduction has on compliance.

Table 1 shows that wages and salary income had the highest rate of compliance. This income was subject to deduction at source. Interest income experienced the next highest rate of compliance. This class of income was not subject to deduction at source, but it was subject to information reporting.

Compliance was least for income of informal suppliers. This category was not subject to either deduction of tax at source or information reporting. It is not to be inferred from this that there must be deduction of tax at source for all types of income. Rather it is that where deduction at source is administratively and politically feasible, high levels of compliance can be expected to follow. The increase in the compliance level for capital gains is significant. It has been attributed generally to the introduction of information reporting for this type of income. A reporting mechanism for shares was introduced in 1983, and for real estate in 1986.

In many tax systems it is common for tax to be collected at source in respect of salary or wages or similar payments. It is less common for it to be required to be deducted from interest, dividends or royalties paid to residents.[3]

When it comes to deduction at source, two aspects of the Australian tax system deserve analysis: the "prescribed payment system" and "imputation".

Table 1

Compliance rates for different classes of income for the United States 1981 and 1987

	1981	1987
Wages and salaries	94%	97%
Interest	86%	90%
Capital gains	58%	85%
Informal supplier income	20%	11%

Source: Income Tax Compliance Research: Estimates for 1973-81, Internal Revenue Service (Washington, D.C.: U.S. Government Publishing Service, July 1983), Table III and Income Tax Compliance Research: Supporting Appendices to Publication 7285, Publication 1415, (Washington, D.C.: U.S. Government Publishing Service, July 1988), Table D 16.

1. Prescribed payment system

A 1975 Report identified a number of activities which, because of suspected low compliance, ought to have been covered by source deduction rules.[4]

> The areas of activity to be covered by extended tax deductions at source might include the building and construction industry; primary production, including forest operations and fishing; the entertainment industry, including professional sport; and free-lance writing. The experience of the Taxation Office in these and other fields of activity where difficulties have been experienced in collecting tax should be drawn upon in delineating the areas to be covered.

Prior to 1 September 1983 few changes resulted from this recommendation.[5] From 1 September 1983 a new system was introduced for deducting tax at source from certain payments for labour and services. This system is known as the Prescribed Payments System ("PPS") and applies to intra-industry[6] payments in the following industries:

- building and construction;
- joinery and cabinet-making services;
- architectural services;
- engineering services;
- surveying services;
- professional building and construction services other than architectural, engineering and surveying services;
- road transport;
- motor vehicle repair; and
- cleaning industries.

Compliance in these industries was low.[7] Other industries

2. Prof. dr. J.C.L. Huiskamp, "Definition, Scope and Importance of International Tax Avoidance", in *International Tax Avoidance and Evasion* (Amsterdam: International Bureau of Fiscal Documentation, 1981), at 19.
3. For countries with double tax agreements it is common for tax to be required to be deducted at source for interest, dividends and royalties paid to non-residents.
4. Taxation Review Committee, *Full Report* (Canberra: Australian Government Publishing Service, 1975), at para. 22.99.
5. One exception was the amendment, in 1979, to include in the PAYE provisions "payment made for services or performances given by a musician, entertainer or other person of creative talent".
6. The PPS also applies to some inter-industry payments in the building and construction industry and in the road transport industry.
7. Taxation Office audits and investigations suggested it might have been as low as 51 to 60 percent. See "Cash Economy", *Tax Rules,* (Sydney: CCH, 1983), at 2.

were to be identified for inclusion in PPS but to date they have not been included.

Initially the system required a basic rate of deduction of 10 percent. At present the basic rate is 20 percent although a higher rate of 48.25 percent applies where the payee does not provide the payer with a tax file number. Lower rates can apply in certain circumstances.[8]

Tax deducted at source from a prescribed payment does not represent the payee's final tax liability in respect of the payment. That liability is calculated in the normal way after the end of the year, at which time the amounts of tax deducted are allowed as credit against the tax assessed. Tax collections from the system are shown in Table 2.

The mechanics of the PPS are as follows:

Prescribed Payment

Payer ⟶	Payee
Obligations	*Obligations*
1. Must register with the Tax Office.	2. Must provide payer with a completed Deduction Form.
3. Must deduct tax from payment, note details on Deduction Form, send original to Tax Office and duplicate to payee.	4. Claim credit for tax when lodging annual return.

Based on the number of payees who have registered and the amount of tax collected the PPS can be regarded as highly successful. During the early stages of operation the system identified about 30,000 non-lodgers. This was accomplished through the applications for file numbers, voluntary lodgements and associated inspection activity, which were the result of the introduction of the system.

2. Dividend imputation

Since 1 July 1987 Australia has had an imputation system for company tax. This system was introduced primarily for equity reasons. However, it does have implications for evasion. The Australian imputation system, which provides shareholders with a full credit for tax paid by the company on its income, is compared below with the previous classical system of taxation.

	Classical System (Pre 1 July 1987)	*Imputation System* (1987/88)
At the corporate level		
Profit	100	100
Tax	(46)	(49)
Profit after tax	54	51
At the shareholder level		
Dividend	54	51
Maximum personal tax	(32.4)	(49)
Tax credit	nil	49
Balance	21.6	51
Total tax ÷ Profit	78.4%	49%

Under an imputation system personal tax on dividend income is, in effect, collected at source by way of corporate tax. In Australia this has encouraged compliance as has the lower overall rate of tax.

Table 2

Tax Collected By the Prescribed Payment System

	Number of Payees	A$M	% of Total Tax Collected
1983-4	289,091	* 251	0.7
1984-5	311,405	412	1.0
1985-6	318,185	515	1.1
1986-7	357,220	765	1.5
1987-8	457,830	958	1.6
1988-9	580,123	1308	1.9
1989-90	n.a.	1734	2.3

Source: Commissioner of Taxation Annual Reports, 1983-4 to 1989-90.

* This is for a part year (17/24).

Since the introduction of imputation the corporate rate of tax has been reduced from 49 percent to 39 percent. While this means individual shareholders with marginal rates in excess of 39 percent may have to pay additional tax on dividend income, they still have an incentive to report the income so that they can receive credit for company tax already paid.

Another advantage of imputation is that it has virtually alleviated the need to collect tax in respect of fully franked dividends paid to resident shareholders. It also has streamlined the withholding tax system for dividends paid to non-residents because fully franked dividends paid to non-residents are exempt from withholding tax.

3. Pay-as-you-earn (PAYE) system of tax collection from salary and wages

One of the implications of requiring deductions at source from salary or wages, again, is the need for an operable definition. In Australia this has been done by linking salary or wages to the existence of an employer/employee relationship. In determining whether a person is an employee the courts have developed several tests. In addition, the definition of the term "salary or wages" has had several express inclusions, for instance:
- pensions;
- retirement allowances;
- directors' fees;
- commissions paid to insurance collectors;
- workers compensation, sickness or accident payments.

Further there has been an attempt to capture payments which are in essence for "the labour of the person to whom the payments are made". In *Neale v. Atlas Products (Vic) Pty. Ltd.*,[9] it was decided that where contracts left contractors free to do the work themselves or engage others, the payments were not salary or wages. When the PPS changes were introduced, the definition of "salary or wages" was expanded to include "payments made under a contract that is wholly or principally for the labour of the person to whom the payments are made".[10]

8. The system permits taxpayers to apply to the Tax Office for exemption certificates or variation certificates. Where granted these would result in no deduction or deduction at rates from 1 to 19 percent.
9. (1955) 10 Australian Tax Decisions [ATD] 460.
10. A contract is regarded as being "principally" for labour where the labour content exceeds 50 percent of the value of the contract. See Income Tax Ruling 2129.

In interpreting the above, the legislation also provides that a payment will be regarded as wholly or principally for the labour of the person to whom payment is made if "it can reasonably be expected to believe that the person to whom the payment is made will perform the whole or a principal part of the labour in respect of which the payment is made".

It is intended that this will cover the situation where a payee has the *right* under the contract to engage others. By doing so it is hoped to overcome the decision in *Neale v. Atlas Products (Vic) Pty. Ltd.*

There is scope for further extension of tax collection at source, particularly where there are few paying agents. In Australia one such industry is primary production, while at present only wage and salary earners are covered. Farmers themselves could be covered as much of their product, e.g. wool and wheat, is sold through central marketing authorities. Deduction at source could also be extended to interest, royalties, trust income, rents and partnership profits. If source deductions of tax would result in excess tax being paid, payees could apply for exemption or variation certificates as they can under either the PPS or the PAYE system.

B. *Taxpayer identification*

Identification is a key feature of successful administration of a tax system. Although this includes identification of all potential taxpayers, withholding agents and information agents, comment here will be limited to identification of taxpayers. When used with taxpayers' names, identification numbers (I.D. numbers or file numbers) can be used to determine whether taxpayers:
- have lodged returns;
- are entitled to credit for source deductions; and
- are declaring all their income.

There are two basic approaches to issuing I.D. numbers. One is to try to cover the whole population and the other is to try to cover only those likely to be required to lodge tax returns. Usually the latter is favoured as it is less costly and does not require a number of classes of persons (e.g. the very young and the very old) to be involved with the tax system. The latter approach does require steps to be taken to ensure that all those who are required to have an I.D. number have one (and only one).

In Australia the approach now adopted to ensure that taxpayers have a tax file number (TFN) is to penalize them in certain circumstances if they do not. Prior to 1 January 1990 the only example of this was in the PPS. Taxpayers with a file number face a maximum deduction at source of 20 percent. Those without a number face a maximum deduction at source of 48.25 percent.

In 1989 extended tax file number arrangements were announced and these are being introduced progressively over a two-and-a-half year period. The Treasurer stated in his second speech that:

> . . . this Bill will implement measures to attack the last remaining area of widespread tax evasion in our economy.
>
> . . . this Bill mounts a fundamental attack on tax evasion, where people use false names, do not declare income, or fail to lodge returns. The measures . . . will attack these practices by increasing the efficiency and effectiveness of the Australian Taxation Office's income matching system.

It was expected that the expanded tax file number system would have a revenue effect of A$ 337 million (US$ 250 million) annually. A summary of proposals is given below.

Table 3

Consequences of Failure to Quote a Tax File Number

	Tax File Number	No Tax File Number
Recipient of a Prescribed Payment (From 1/7/89)	Tax deducted at 20%	Tax deducted at 48.25%*
Employees (From 1/1/90)	Tax deducted at varying marginal rates ranging from zero to approx 48.25%* when "salary or wages" reaches approx. A$ 700 per week	Tax deducted on all "salary or wages" at 48.25%*
Unemployment and sickness beneficiaries (From 8/1/90)	Entitled to benefits	Not entitled to benefits
Age and invalid pensions (From 1/1/91)	Entitled to benefits	May not be entitled to benefits
Investors interest** bearing accounts (From 1/7/91)	No tax deducted	Tax deducted at 48.25%*
– unfranked dividends	No tax deducted	Tax deducted at 48.25%*

* Or at prevailing maximum marginal rate of tax (including Medicare levy).

** Subject to a de minimis rule, set initially at interest of A$ 120 per annum.

It should also be noted that the extensions to the tax file number system, along with increased use of computerized matching of income to taxpayers, have increased the efficiency of the income matching process. This in turn has reduced the scope for evasion.

1. Identity verification procedures

Sections 18-23 of the Cash Transactions Reports Act impose identity verification procedures. From 1 February 1991 cash dealers are required to undertake prescribed verification procedures for all signatories to accounts opened on or after that date. Regulations set a verification threshold of 100 points. Each check made is worth a certain number of points depending on its integrity. For example, a passport or birth certificate is worth 70 points, and an electoral roll check is worth 25 points.

For existing accounts, verification is required when certain balance or transaction thresholds are exceeded.[11] Cash dealers are required to block withdrawals from accounts in respect of which there are any unverified signatories. In some instances,[12] all rights and interests in relation to accounts held by unverified signatories are forfeited to the Commonwealth.

11. As originally enacted the thresholds in Sec. 18(1) were a balance of A$ 1,000 plus transactions, over a 30 day period, exceeding A$ 2,000.
12. See Sec. 19 of the Act which generally applies after signatories to accounts have failed within three months to comply with certain warning notices.

2. Company number system

Legislation is also before Parliament to establish the Australian Company Number (ACN) system. If enacted, numbers will be allocated to every Australian company which will then be required to show the ACN on its common seal; every public document it signs, issues or publishes; and every negotiable instrument it signs or issues.

3. Amnesty

Sometimes taxpayers are reluctant to come forward and register for a tax file number because they have not been lodging tax returns. In Australia prior to the new penalties for not having a tax file number an amnesty was offered allowing taxpayers to lodge past returns without being subject to any penalty.[13] The amnesty was a great success. According to the Commissioner of Taxation's 1988-89 Annual Report:

> Of the estimated 360,000 taxpayers who were not lodging returns, a total of 274,000 have either lodged or have indicated that they have a requirement to lodge. On this basis the major amnesty objective of getting clients 'back on the books' was clearly achieved.
>
> I consider the two major benefits of the amnesty to be the increased public awareness of lodgment responsibilities and the future revenue gain from clients joining or rejoining the system. The table below indicates the revenue gain from the amnesty exercise (1988-89 Annual Report, p. 24).

More recent data is given in Table 4. It is also worth noting that when the amnesty was offered, taxpayers were not required to submit returns for *all* years of non-lodgement. They were required to lodge only those returns which had not been lodged for the previous five years.

Table 4

Amnesty Issues 31 May 1988 to 30 June 1990

	Individuals	Companies
Debit Assessments		
Number of Assessments	245,708	8,755
Balance Payable (A$'000)	404,673	119,338
Credit Assessments		
Number of Assessments	510,893	0
Balance of Refundable (A$'000)	321,798	0
Non-Taxable Assessments		
Number of Assessments	133,915	40,987
Total Assessments Issued	890,516	49,742
Balance Payable / Refundable (A$'000)	82,875	119,338

The above table shows amnesty assessments issued up to 30 June 1990.

Assessments for amnesty designated taxpayers are still being issued.

Source: Commissioner of Taxation Annual Report 1989-90 (Canberra: Australian Government Publishing Service, 1990), at 143.

C. *Fringe benefits tax*

Prior to 1 July 1986 non-cash fringe benefits were assessable under Section 26(e) of the Income Tax Assessment Act. This section provided that "the value to the taxpayer" of all allowances, gratuities, benefits and bonuses received directly or indirectly in relation to employment were assessable. However it was noted:[14]

> Despite the comprehensive coverage of Section 26(e), the taxation of benefits which do not take the form of outright cash payments (and of some which do) poses practical difficulties. For non-cash benefits, there is a difficult question in each case, for taxpayer and tax administrator alike, of determining the value to the taxpayer of the benefit provided. These difficulties have led to almost universal non-inclusion by employees of fringe benefits received in kind; effective policing of non-compliance in this area would require a heavy investment of resources. In practice, therefore, many of the benefits that ought properly to be subjected to tax escape taxation in part or in whole. Because Section 26(e) is concerned with benefits granted to employees, there are also difficulties in bringing to tax the value of fringe benefits which are formally conferred on family members of the employee (e.g. an airline ticket provided to the spouse of an employee).
>
> The consequential loss to revenue cannot be gauged accurately but it is thought to be of the order of $ 700 million. It is estimated that the potential tax uncollected on the provision of cars, for example, might be of the order of $ 280 million a year, and of the order of $ 80 million in respect of subsidised housing and $ 90 million in respect of low-interest housing loans. The fringe benefits area is, therefore, a major source of tax avoidance and evasion under the current taxation system. Growing awareness of the 'perks' enjoyed by certain groups has helped to create the impression that the tax system is unfair.

It was decided to introduce a tax on employers in respect of fringe benefits provided to employees or to their associates. Employers self assess the tax according to specific valuation rules for different classes of fringe benefits. The rate of fringe benefits tax has been equal to the maximum marginal rate of tax payable by individuals. From 1 April 1990 the rate at which tax is payable is 47 percent. Valuation rules apply for most benefits including:
- motor vehicles;
- waiver of a debt;
- interest-free or low interest loans; and
- payment or reimbursement of expenses.

Benefits not included in a specific valuation category are taxed as residual benefits. Any benefit on which an employer has paid fringe benefits tax is free from tax in the employee's hands. Fringe benefits tax paid by the employer is not a tax deductible expense. Tax collections from fringe benefits tax are shown in Table 5.

Table 5 shows that fringe benefits tax has produced a significant amount of tax revenue with over A$ 1 billion being collected in 1989-90. Of this total about half came from

13. The main features of the tax amnesty were:
- it applied to the lodgement of outstanding income tax returns;
- the amnesty commenced on 30 May 1988 and ended on 31 October 1988;
- penalties and prosecutions were waived for late lodgement of returns only, i.e. it did not apply to penalties for incorrect returns, or unpaid overdue taxes;
- to qualify, outstanding returns had to be lodged, but the Tax Office would limit the maximum number required from taxpayers, who had not lodged for some time, to the previous five years (i.e. for years 30 June 1983 to 30 June 1987); an option to lodge more returns existed, particularly if refunds were expected.

14. *Reforming the Australian Tax System: Draft White Paper* (Canberra: Australian Government Publishing Service, 1985).

motor vehicle fringe benefits. Fringe benefit returns are subject to audit. To date only limited data are available.

If other countries do not adopt a fringe benefits tax similar to that introduced in Australia then they should consider other remedies to stop wages and salaries from being converted into fringe benefits. One option would be to deny employers tax deductions for fringe benefits paid. Such a system would work well where most employers are taxpayers. This system is of limited use where large numbers of employers are exempt from tax.

Another alternative is to redefine salary and wages to ensure that it includes non-cash fringe benefits.

Table 5

Tax Collected from Fringe Benefits Tax
1986-7 to 1988-9

	A$M	% of Total Tax Collected
1986-87	* 535	1.0
1987-88	881	1.5
1988-89	989	1.4
1989-90	1,168	1.5

* Part year (0.75) for the first year.

Source: Commissioner of Taxation Annual Reports, 1986-87 to 1989-90.

D. *Record-keeping requirements*

Where taxpayers fail to keep adequate records it is difficult to establish their proper tax liability. Tax systems should therefore contain provisions which encourage good record keeping or which penalize poor record keeping. In Australia the general record-keeping requirements have been amended and the penalties for failure to comply have been increased. In relation to some expenses more drastic action has been taken.

Since 1 July 1986 the general rule for "employment related expenses"[15] is that a deduction is *not* allowed unless "documentary evidence" is obtained. Documentary evidence usually consists of a receipt, invoice or similar document.[16]

Substantiation rules also apply for car expenses whether incurred by employees or self-employed persons (though not for companies or trusts). Again, if the rules are not met a deduction is not allowed. The substantiation rules for car expenses can include both receipts and a "log book". Where log books are required to be kept they need only record required details for a 12 week period.

The substantiation provisions were introduced to correct a deficiency in the law which, while specifying the type of expenses that qualified for deduction, failed to specify what proof was required to substantiate those claims. The Explanatory Memorandum accompanying the Bill which introduced these provisions estimated the financial impact of substantiation to be A$ 105 million (US$ 80 million) in 1987-88, increasing to A$ 200 million after about four years.

The Australian Tax Office sees substantiation as part of an overall strategy in achieving and maintaining the highest levels of voluntary compliance possible. Its success in improving levels of compliance was acknowledged by the Commissioner of Taxation in a speech, "Current and Emerging Issues in Tax", [Commonwealth Club, Adelaide, 22 March 1988], in which he attributed increased voluntary income reporting to the effect of substantiation and desk audit:

> In 1986-87 increased voluntary compliance led to better reporting of taxable income to the tune of $ 700 million. This year with the bulk of salary and wage returns lodged and assessed it is quite clear that the trend to better compliance is continuing. Adherence to the substantiation rules and our desk audit activities have played a major role in this trend.

E. *Self-assessment*

Until recently the Australian tax system required the lodgement of detailed tax returns which, in theory, were then subject to close scrutiny by assessors in the Tax Office. An assessment would ultimately issue and if this was not subject to adjustment this was usually the last involvement of the taxpayer and the Tax Office in relation to that return.

Sometimes assessments would be accompanied by an adjustment sheet which indicated how an assessor amended the return. As this was often done without requiring further information from taxpayers and in many cases without any contact with them, it resulted in formal objections being lodged.

After 1986 it was decided to do away with the assessment process and to shift staff into audit. Now returns are accepted on their face value and compliance is achieved through audit, taxpayer education and service. There are good grounds for the belief that this change from an "assessment system" to a "self-assessment system" took place at least in part because the former system was slowly grinding to a halt. In the decade before the change, the rate at which objections were lodged had more than doubled[17] and inward mail (other than objections) had increased significantly,[18] to the point where, on average, one in every two taxpayers were entering into correspondence with the Tax Office. During this time staffing levels, as a percentage of returns lodged, remained relatively stable.[19] Within the Tax Office it was generally acknowledged that the "traditional" assessment system had become inadequate. It was, in some cases, costly to administer, not effective in promoting compliance and it contributed to low job satisfaction for staff.

15. The term "employment related expenses" is extensively defined but in essence means an expense incurred in producing salary or wages of a taxpayer.

16. For small items: where a taxpayer incurs deductible expenditure and each item is less than A$ 10, with the total of all items being less than A$ 200, receipts will not be required. A contemporaneous diary record showing date, amount and description will suffice.
<u>Exception 1:</u> receipts will not be required to substantiate claims where total deductible expenditure does not exceed A$ 300. However, all other appropriate requirements of the Act will need to be satisfied.
<u>Exception 2:</u> where receipts or other documentary evidence have been:
- lost or destroyed;
- in circumstances beyond the taxpayer's control;
- and the Commissioner is satisfied that all reasonable steps had been taken to avoid such loss or destruction;
- copies or replacement documentation will be deemed to be the original documentation. If replacements or copies cannot be obtained the record-keeping rules will not apply.

17. In 1975-76 the ratio of objections lodged to returns received was 0.9 percent whereas in 1985-86 the ratio was 2.3 percent.

18. Inward mail (other than returns) as a percentage of number of returns lodged increased from 38 percent in 1975-76 to 49 percent in 1985-86.

19. The number of Tax Office staff per thousand returns was 1.5 in 1975-76 and 1.77 in 1985-86.

The official view of self-assessment coupled with an audit programme is that it is designed to improve compliance. Some data on the desk audit aspect[20] of the new audit programme are already available. These are given in Table 6.

Table 6

Desk Audit Statistics 1986-7 to 1988-9

	1986-7	1987-8	1988-9	1989-90
Audits completed	20,246	28,733	27,298	17,980
Percentage revealing omissions	78	78	74	66
Average increase in tax and penalty	949	1,023	1,014	1,435

Source: Commissioner of Taxation Annual Reports, 1986-7 to 1989-90.

It is not clear what implications should be drawn from the above table. On the one hand, the revenue authority might argue that audits are successful because of the level of revenue raised relative to the cost of conducting the audit. On the other hand, it might be argued that audits are failing because widespread non-compliance is still being detected. It might also be argued that it is not possible to draw conclusions because the data do not show what effect audits have had on voluntary compliance. The Australian Tax Office might argue that lower numbers in 1988-89 were temporary and that a sharp rise might be expected in 1989-90. The lower numbers, it might be argued, were due to job redesign.

When self-assessment was introduced a new Section 169A(2) was enacted to provide taxpayers with a facility to obtain private rulings from the Commissioner of Taxation about any matter relating to their liability to income tax. For instance, taxpayers can ask whether a particular amount received is assessable and whether a particular expenditure is deductible. As an added incentive to flag and obtain rulings on doubtful items taxpayers are not generally liable to any penalties where they have included items in or excluded items from a return "subject to a ruling".

The ruling system is part of a new emphasis in the Australian Tax Office towards "a truly service-oriented system of tax administration".[21] In the longer term it is hoped that this emphasis will improve voluntary compliance. At the same time it is expected that this will mean more rewarding careers for Tax Office staff.

Under self-assessment there have been fewer formal disputes between taxpayers and the Tax Office. For instance at 30 June 1990 there were just over 2,000 appeal cases waiting transmission to Tribunals. This compares with over 100,000 at 30 June 1986.

Self-assessment has encouraged a review of other ways in which the Tax Office can assist taxpayers in meeting their obligations. It has been stated that "tax simplification is one of the vehicles [the Australian Tax Office] is looking to".[22] Simplification is judged not on how many pages of legislation there are but on what it costs to operate a tax system. In some ways simplification will lead to more rules, but it is expected these will resolve doubt and lead to greater certainty. In this regard the Tax Office is considering issuing general rulings on the way the Commissioner will exercise discretion and what records and information should be kept by taxpayers under the self-assessment system.

In the future, as the Electronic Lodgement System (ELS) is more widely used, the Tax Office expects to have more time available to service taxpayers and tax agents. The 1990 tax season was the first in which the system was generally available and it was expected to cater to 2.5 million (about 25 percent of all returns lodged).[23] Taxpayers are promised refunds within 14 days under ELS compared with 42-56 days under the manual system.

F. *Penalties*

It has already been mentioned that in 1984 the level of penalties imposed for various tax offences was increased significantly. Generally the penalties, which were expressed in fixed dollars, were increased tenfold. At the same time the main provision imposing penalties was amended to overcome defects which had become apparent. It is worth spending a little time on these changes as they emphasize several issues about penalty provisions.

Prior to 12 December 1984 the section which raised most revenue by way of penalty was Section 226(2). It applied where, *inter alia,* taxpayers omitted assessable income or included deductions for amounts in excess of expenditures actually incurred. The defect of this wording was exposed in *Rabinov v. F.C. of T.*[24] In this case the taxpayer actually paid $ 250,000 to a particular organization. He then claimed a deduction for this amount as a gift. As it turned out a gift, in the technical sense of the word, had not been made and the taxpayer was not entitled to any deduction. The Court decided that the Commissioner was not authorized under Section 226(2) to impose a penalty as the taxpayer was not claiming a deduction in excess of an amount actually incurred. It followed that taxpayers could be penalized under the section only where they had not incurred expenditure or had overstated the amounts claimed as deductions.

Whether or not one agrees with the decision in this case it raises the issue of how one drafts a provision which penalizes those who are caught attempting to evade tax. The response of the Australian legislator was to replace Section 226(2) with a provision which took a completely new approach to the problem. The replacement provision is Section 223 which provides in part as follows:

223(1) Where –

(a) a taxpayer –
(i) makes a statement to a taxation officer, or to a person other than a taxation officer for a purpose in connection with the operation of this Act or the regulations, that is false or misleading in a material particular; or

(ii) omits from a statement made to a taxation officer, or to a person other than a taxation officer for a purpose in connection with the operation of this Act or the regulations, any matter or thing without which the statement is misleading in a material particular; and

(b) the tax properly payable by the taxpayer exceeds the tax that would have been payable by the taxpayer if it were assessed on the basis that the statement were not false or misleading, as the case may be,

20. Desk audits are only part of the total audit programme which includes business audit, large case audit, strategic audit and audits of illegal activities.

21. B. Nolan, Second Commissioner of Taxation, "What the Commissioner Said: The Janus Mask – Aspects of Self Assessment", *Taxation in Australia* (August 1990), at 155.

22. *Id.*, at 156.

23. *Id.*, at 160.

24. (1982) 13 Austral-Asian Tax Reports [ATR] 496.

> the taxpayer is liable to pay, by way of penalty, additional tax equal to double the amount of the excess.

Section 223(1) was followed by a ruling which indicated when the Commissioner of Taxation regarded a statement as "false or misleading".[25] A more important ruling in relation to penalties is IT 2517 which outlines to the Commissioner of Taxation's policy in relation to remission of penalties. Both Sections 226(2) and 223(1) impose additional tax (penalty) of up to 200 percent. In practice, such high penalties are never imposed. The Commissioner usually remits the penalty to around 40 percent. However, under the former provision it was rare that penalties were remitted below 40 percent whatever the reason.[26]

Table 7

Penalties for False or Misleading Statements

Reason for the False or Misleading Statement	Additional Tax (Penalty)	
	"Per Annum"* Component	"Culpability"** Component
Deliberate evasion (without aggravating factors)	Yes	45
Recklessness (short of deliberate evasion)	Yes	30-40
Carelessness	Yes	15-30
Minor case of carelessness	Yes	5-15
Inadvertent error, honest mistake, dependent on the degree of care	Yes	0-5
Contentious item	Yes	0-5
Genuine misunderstanding of the requirements of the legislation (see paragraph 37(d))	Yes	Nil
Did not know and could not be expected to know	Yes	Nil
Genuinely misled by actions of the ATO	No	Nil

* Penalty for late payment; which can be as high as 20 percent per annum.

** Penalty for the offence; expressed as a percentage of unpaid tax.

IT 2517 also sets out the Commissioner's policy in relation to voluntary admissions of false or misleading statements, i.e. the penalty is usually remitted to ten percent per annum of the tax avoided. This policy is, like the change in philosophy reflected in IT 2517, *designed to promote voluntary compliance*. It is intended that those who are detected evading tax be penalized but not in a way that will alienate them from the tax system altogether. An example of this is evident in the number of returns that are subject to review once evasion is detected. At one time audit staff would not only correct a current year's return, but would review returns for the previous three or four years as well. Now, normally only the last one or two year's returns are reviewed.

This approach to the administration of the penalty provisions is to be commended. It is also considered that the redefinition of the relevant provisions is worthy of consideration.

G. *Audit programme*

One of the key objectives of the Australian Tax Office audit programme is "to secure maximum possible improvements in taxpayer voluntary compliance".[27] During 1988-89 this meant significant changes to the allocation of resources within the audit programme, in particular, development of "Project Based Audits" and expansion of the audit programme among large companies (Large Case Programme).

Project Based Audits monitor compliance by industry or by particular issues.[28] Small samples of taxpayers are chosen and the results of these audits determine whether further activity is warranted. If so, it usually is preceded by a publicity programme which highlights the types of errors detected. It also gives taxpayers an opportunity for voluntary disclosure. For example, plumbers may be selected as an occupation, or the proceeds from the sale of land as a transaction type. Once the particular area is selected steps are taken to identify the relevant population so that a small sample of cases can be drawn (the "scoping" phase).

This audit-based research is designed to assist the Tax Office:
- in improving its understanding of taxpayer compliance;
- in directing its audit resources to those areas with low compliance levels, and thereby improve its case selection and targeting capabilities; and
- in developing strategies which represent more effective responses to tax compliance problems in the area.

More particularly, the results from the "scoping" phase form the basis of decisions:
- to conduct further audits in the area;
- to conduct publicity on findings to encourage taxpayers to make voluntary disclosures; or
- to develop alternative strategies for improving compliance.

25. See paras. 18 and 26 of IT 2141 which in essence provide:
Putting it quite simply, a "false" statement is one that is contrary to fact, untrue, erroneous or incorrect (see *Given v. C.V. Holland (Holdings) Pty Ltd,* (1977) 29 Commonwealth Law Reports [CLR] 212 at 217; and *F.C. of T. v. Turner,* 84 Australian Tax Cases [ATC] 4161, at 4163, 15 ATR 379).
A statement may be misleading if it is uninformative, unclear or deceptive, notwithstanding that it may be in a sense literally true. The crucial question to be decided is whether or not the statement could reasonably mislead a typical person in the class of persons to whom it is directed.
26. The former policy was set out in IT 2206, where at para. 19 it was stated:
> In these cases, in the absence of aggravating or mitigating factors (see later), the discretion under subsection 227(3) should be exercised to reduce the additional tax imposed by section 223 to an amount equal to –
> 20% per annum of the tax avoided (the per annum component), plus
> 40% of the tax avoided (the culpability component).

27. Commissioner of Taxation Annual Report 1988-89 (Canberra: Commonwealth Government Publishing Service, 1989), at 33.
28. In the second half of 1990 the Australian Taxation Office gave advance notice of audits to be carried out on the following groups: barristers and solicitors, builders, caravan park proprietors, chemists, clothing manufacturers, horse breeders, hoteliers, market gardeners, motor vehicle dealers, newsagents, repairers and wreckers.

The objective of the "Large Case Programme" is to have a 100 percent coverage of the top 100 companies. While this programme was not intended to be judged solely by revenue raised, early indications are that substantial sums will be raised.[29]

Within the Tax Office a high priority has also been given to training to ensure that at all levels auditors have the skills needed to effectively implement the audit programme. The auditors now also have greater freedom to decide how an audit should evolve. Audits are less intrusive and do not try to find or recover every dollar evaded. Rather they try to ensure that taxpayers are aware that their taxpaying behaviour is being monitored. Audits aim to achieve long-term voluntary compliance.

H. *Other government initiatives to improve compliance*

Listed below are some other initiatives of the Australian Government which have been designed in part to improve compliance.

1. An essential to effective audit activities and a prerequisite to providing services to taxpayers is the establishment of regional tax offices. Once tax administration in Australia was highly centralized with branch offices only established in capital cities. This has now changed, as has the concept of the ideal size of a branch office (big is no longer regarded as beautiful).

2. While Australian tax legislation has given the Commissioner of Taxation "full and free access to all buildings, places, books, documents and other papers", the relevant section (Section 263) had not, until recently, required taxpayers to offer positive assistance. By amendment, effective from 7 June 1987, "the occupier of a building or place is now required to provide the Commissioner with all reasonable facilities and assistance for the effective exercise of the above powers" (Section 263(3)).

3. In 1988 the Government introduced legislation, known as the Cash Transactions Reports Act 1988, which inter alia:

(a) makes it an offence to open or operate an account in a false name (Section 24);
(b) requires cash dealers to report transactions for which there are reasonable grounds to suspect that information concerning the transaction may be relevant to the investigation of tax evasion or an attempted evasion (Section 16);
(c) requires cash dealers to report significant cash transactions (i.e. those of A$ 10,000 (US$ 7,800) or more) and foreign currency transfers of A$ 5,000 (US$ 3,900) or more;
(d) requires individuals becoming signatories to an account to prove their identity.

Transactions are reported to the Cash Transactions Agency which is located in Sydney. This agency proposes to develop a data base for both "significant" and for "suspect" transactions. Most reports will be received electronically and the data will be available to nominated persons in the Australian Tax Office by way of on-line facilities.

4. Prohibition, since 19 September 1985, of deductions for entertainment expenses. Expenses incurred for business lunches, cocktail parties, tickets to sporting and theatrical events, sightseeing, etc. are no longer deductible even though they may have involved a genuine connection with business activities.

5. Introduction, from 1 July 1990, of an accruals system for the taxation of foreign-source income of residents. This legislation is designed to combat the sheltering of profits in low tax countries by attributing income derived by foreign companies and trusts to controlling Australian residents and taxing the income on an accruals basis. Such income is now taxed as it is earned and not when it is remitted.

6. Introduction, with effect from 4 December 1980, of the Crimes (Tax Offences) Act 1980 which makes it a criminal offence to render trusts or companies incapable of paying their tax liabilities when they fall due. It is also an offence to aid, abet, counsel or procure another person to enter into such an arrangement.

This legislation was necessary because some 5,664 entities were identified as having been stripped during the period 1 January 1972 through 4 December 1980.[30] It is not clear how much tax was involved in these schemes. Most estimates exceeded A$ 1 billion though much of this has since been recovered through subsequent legislation introduced in 1982 but having effect from 1 January 1972.[31]

I. *Other Tax Office initiatives to improve voluntary compliance*

Over recent years the Tax Office has developed a strategy to improve voluntary compliance and combat non-compliance. Mention has already been made of the shift in emphasis to providing a service to taxpayers to facilitate voluntary compliance. Additional specific initiatives include:

- production of a preliminary overall compliance strategy;
- strategic planning for additional computer support for compliance activities;
- conduct of two national compliance conferences on income tax audits;
- completion of national audit techniques manuals and training packages;
- issuing of a national enforcement bulletin on audit projects highlighting projects with good revenue yields;
- development of an audit analysis package for auditors' use on microcomputers;
- simplification of tax forms;
- production of a plain English "*Tax Pack*";
- establishment of a compliance research unit;
- liaison with the National Crime Authority in relation to income generated from illegal activities;
- acquisition of portable computers for use by auditors and support staff;
- improvements to enquiry service in terms of staffing and physical facilities;
- establishment in July 1987 of Advising Groups;
- the development of taxpayer "profiles" for various sectors of the taxpaying population to improve the efficiency of the case selection process;
- the increased use of EDP audit techniques to help process and analyze large amounts of data when auditing large companies;
- the creation of Intelligence Units in all major branch offices to detect new developments in taxpayer compliance at an early stage;

29. According to the 1988-89 *Annual Report of the Commissioner of Taxation,* large case audits yield A$ 3.3 million per case.

30. Commissioner of Taxation's Annual Report 1982-83 (Canberra: Commonwealth Government Printer, 1983), at 14.

31. Taxation (Unpaid Company Tax) Assessment Act 1982, Taxation (Unpaid Company Tax – Vendors) Act 1982, and the Taxation (Unpaid Company Tax – Promoters) Act 1982.

- establishment in November 1987 of a Problem Resolution Unit;
- increased amounts of information being made available to the general public to help them comply voluntarily. Market research commissioned by the Tax Office had indicated, that of all the information services provided by the Tax Office, taxpayers wanted more printed material written in everyday language. These booklets were then published in 13 languages and distributed through various outlets including migrant resource centres;
- the issue of a booklet outlining the most common errors made in income tax returns;
- acknowledgment of a need for a publication for people preparing their first tax returns;
- increased frequency by the Commissioner of Taxation and senior Tax Office staff in addressing professional and community groups. This had generally been coupled with increased media coverage of Tax Office activities. The above presumably had the dual purpose of changing taxpayers' perceptions about Tax Office activities as well as breaking down the "us versus them" attitude which might have otherwise existed between professional and community groups and the Tax Office;
- increased attention to the special needs of tax agents. This was in response to a recognition that some 67 percent of returns were lodged by tax agents;
- after-hours phone-in services being made available to taxpayers during the period of the year they are most likely to be lodging their income tax returns;
- coordinating volunteer helpers for tax return preparation.

IV. EFFECTS OF TAX REFORMS ON TAX EVASION

During the 1980s a large number of reforms were made to the Australian tax system. Some were directed, at least in part, at reducing tax evasion. Whether these have been successful is an empirical question. In this regard little data are available. For another purpose[32] the author conducted research in 1982 and 1988 the results of which are relevant here.

The survey contained three surrogate measures of the extent of evasion. These were:
(1) the level of taxpayers' approval/disapproval of evasion activity, where it was assumed that greater disapproval was equivalent to less evasion;
(2) the number of people known to respondents who the respondents suspected were evading tax; and
(3) respondents own orientation to evade tax.

The results obtained are given in Table 8.

Table 8

Surrogate Measures of Tax Evasion

(a) Percentage of respondents disapproving of others omitting income

Amount of income omitted*	1982	1988
A$ 100	38	45
A$ 1,000	63	76
A$ 10,000	81	92

* In constant dollars

(b) Average number of people respondents thought would be discovered omitting income if ten people they knew were investigated by the Tax Office.

Amount of income omitted	1982	1988
A$ 100	3.8	3.8
A$ 1,000	2.7	2.3
A$ 10,000	2.4	1.7

(c) Percentage of respondents who, when preparing their income tax returns, would omit cash earnings from a part-time job.

Amount of income omitted	1982	1988
A$ 100	69	54
A$ 1,000	26	22
A$ 10,000	6	3

Source: I.G. Wallschutzky, *The Effects of Tax Reform on Tax Evasion*, Research Study No. 8 (Sydney: Australian Tax Research Foundation, 1988).

The data in Table 8 are indicative, though not conclusive, of a decline in the level of evasion. The reasons for this possible trend were not fully explained, though it was thought that (apart from the reforms already mentioned) greater awareness of penalties might have had some impact. During the period under review penalties had increased tenfold..

V. SPECIAL PROBLEMS IN REDUCING EVASION IN DEVELOPING COUNTRIES

Whether the policy options adopted in Australia to help reduce evasion will be effective in developing countries is not known. Some might be effective, others not. Those who are aware of the special circumstances of each country will be better placed to judge. It is recognized that developing countries have special needs and problems. However, an awareness of what others have done must only help.

Particular problems could be encountered because of the quality and quantity of resources available to administer the tax system. Aspects such as self-assessment might not be feasible if the population literacy level is low. Deduction at source might not be a solution if a large proportion of the population lives outside the money economy (e.g. in subsistence farming). Tax systems that have a narrow tax base, high tax rates, many rates, exemptions, credits, rebates, deductions or that try to achieve too many other social and economic goals might be in need of fundamental reform before compliance objectives can be tackled.

Where corruption is widespread, even if as a way of life, problems will always exist to frustrate progress towards an efficient tax collection system. In economies where inflation is high, late payment of tax is equivalent to evasion. In these circumstances a late payment penalty is required. The rate of interest charged should be at least equal to the market rate of interest which would normally take account of the rate of inflation.

Developing countries can face problems when they introduce a "Pay-As-You-Earn" system where previously they had a payment in arrear system. The main problem is the possibility of taxpayers having to pay two years' tax liability

32. The Australian Tax Foundation sponsored a research study entitled "The Effects of Tax Reform on Tax Evasion". This was published in 1988 as Research Study No. 8.

in the transition year. Developed countries have faced these problems and a number of options for overcoming the problems are given by Yudkin.[33]

VI. CONCLUSION

Many countries have taken steps to reduce the opportunity for evasion of income tax. Lessons can be learned from studying the changes made in these countries. This article has attempted to outline the lessons for others flowing from reforms made in Australia.

Of particular significance are specific legislative reforms and a general change in philosophy on the part of the tax administration. Specific legislative changes discussed included changes to tax collection practices, improvements in taxpayer identification procedures, changes to record-keeping requirements, and changes to penalty provisions. The new philosophy in tax administration is one of trying to promote voluntary compliance. This is reflected in the audit programme, administration of penalty provisions and the move by the Australian Taxation Office to provide greater quantity and quality of service to taxpayers and their agents.

It is conceded that not all of the policy options identified in this are suitable for developing countries. Only those with an understanding of local circumstances can assess what measures might be relevant in particular countries. Nevertheless, an awareness of steps taken in other jurisdictions may well contribute to the solution of these perennial problems.

33. See L. Yudkin, *A Legal Structure for Effective Income Tax Administration*, op. cit., at 40-1.

Conference Diary

APRIL 1991

International Tax Aspects of Banking, Financial and Treasury Management. Amsterdam, 4-5 April (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31 20 6267726; Fax: +31 20 6209397.

Vennootschapsbelasting. Velp, 10-12 April (Dutch):
Studiecentrum voor Bedrijf en Overheid, t.a.v. Mädy van der Linden Vooren, Postbus 828, 5600 AV Eindhoven, The Netherlands. Tel.: (3140) 608888.

Internation Tax Management Techniques: Transfer Pricing; Mergers and Acquisitions. Brussels, 11-12 April (English):
The Customer Service Department, Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium. Tel.: (322) 516-1911, ext. 934. Fax: (322) 513-7108.

Meddling or Management? Tax Policies for the 1990s. The Institute for Fiscal Studies Fifth Residential Conference, Oxford, 12-13 April (English):
The Conference Organiser, The Institute for Fiscal Studies, 7 Ridgmount Street, London WC1E 7AE, United Kingdom. Tel.: 071-636 3784.

Tax Strategies for U.S. Investment – the Revenue Reconciliation Act 1990. London, 17 April (English):
Westminster and City Programmes, 231 Kennington Lane, London SE11 5QU, United Kingdom. Tel.: 071-582 6516. Fax: 071-582 7245.

VAT Conference. Brussels, 18-19 April (English):
The American Tax Institute in Europe, 9 avenue Matignon, 75008 Paris, France. Tel.: (1) 42.56.33.70; Fax: 42.99.17.51.

De Praktijk van Fusies & Overname. Heelsum, 23-24 April (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608888; Fax: 040-460405.

Recent Developments in International Transfer Pricing. London, 25 April (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Tel.: 071-936 3000.

MAY 1991

U.S. Tax Procedures (IRS Audit/Appeals). London, 2-3 May (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London, W1M 5FT, United Kingdom. Tel.: (071) 935 7502; Fax: (071) 935 1308.

Fundamentals of International Taxation (Course on the Practical Aspects of International Tax Problems, Pitfalls and Planning Opportunities). Singapore, 9-11 May (English):
Asian-Pacific Tax And Investment Research Centre (APTIRC), 2 Nassim Road, Singapore 1025. Tel.: (65) 2351954; Fax: (65) 7331540.

4th East-West Tax Conference. Prague, 13-14 May (English):
IBFD International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31 20 6267726; Fax: +31 20 6209397.

Accounting and Taxation for New Financial Instruments. London, 13-15 May (English):
Ms. Hilary McCann, Director-Europe, Euromoney Institute of Finance, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom. Tel.: 071 779 8780; Fax: 071 779 8799.

Current developments from the work of the Tax Law Consultative Committee. London, 14 May (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom, Tel.: 071-936 3000.

Euromoney's First International Tax Planning Forum. Amsterdam, 15-16 May (English):
Mr. Peter Sabine, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom. Tel.: 071 779 8888. Fax: 071 779 8799.

Internationaal Ondernemen en de Fiscus. Bussum, 15-16 May (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Tel.: 040-60 88 11.

Dublin International Finance Service Centre – U.S. Interest deduction – Fiscal Transparency – Offshore Trusts and other subjects. Dublin, 16-17 May (English):
Ms. Elisabeth Husband, Conference Director ITPA, Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks IT15 6SZ, Kent, United Kingdom. Tel.: (0) 732 62910; Fax: (0) 732 63762.

Fundamental Elements of U.S. Corporate Taxation. Hong Kong, 20-21 May (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel.: (071) 935 7502; Fax: (071) 935 1308.

U.S./International Taxation of Oil & Gas. London, 20-22 May (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel.: (071) 935 7502; Fax: (071) 935 1308.

Der angelsächsische Trust. Zürich, 22 May (German):
Kammer-Seminar, Postfach 892, 8025 Zürich, Switzerland. Tel.: 01 252 3212; Fax: 01 252 3911.

U.S./International Taxation: Tax Strategies for Cross Border Activities. Hong Kong, 22-24 May (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel.: (071) 935 7502; Fax: (071) 935 1308.

Pacific Region Conference, Maui, Hawaii, 22-24 May (English):
International Fiscal Association, P.O. Box 756, Rainier, Oregon 97048-0756, U.S.A.

JUNE 1991

Taxation of Branches and Subsidiaries. Brussels, 3-4 June (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium. Tel.: 32/2/516.19.11; Fax: 32/2/513.71.08.

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UNITED KINGDOM:

UNSCRAMBLING THE EGG – CLAIMS UNDER SECTIONS 242 AND 243 OF THE INCOME AND CORPORATION TAXES ACT

Nicholas C. Webb
Member of the research staff of the IBFD

I. INTRODUCTION

The starting point for this article is two general rules of the United Kingdom's corporation tax system. The first of these rules is that a U.K. resident company is not normally entitled to repayment of the tax credit attaching to a dividend paid to it by another U.K. resident company. The second is that items such as losses, capital allowances and so forth which a U.K. resident company may set off against its mainstream corporation tax profits may not normally be relieved against income received in the form of dividends from other U.K. companies. Under certain circumstances, however, a U.K. company may make a claim which overrides both these general rules. This article examines those sections of the Income and Corporation Taxes Act 1988 ("ICTA 1988") which provide for the making of such a claim and attempts to unravel the somewhat labyrinthine chain of consequences which invoking these sections initiates.[1]

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II. BACKGROUND

In 1973 the United Kingdom replaced its classical system of taxing company profits with an imputation regime. One of the elements on which this imputation regime rests is the exclusion from company profits chargeable to corporation tax of dividends received from other U.K. resident companies. The framework within which this exclusion operates may be briefly summarized.

When a U.K. company pays a dividend[2] it must make a corresponding payment of "advance corporation tax" ("ACT")[3] – the sum of the dividend and the relevant ACT being known as a "franked payment".[4] This ACT will generally be set off against the company's mainstream corporation tax liability for the accounting period during which the dividend was paid. In this way the company's overall liability is not affected, merely a part of it collected at an earlier date.[5] Conversely, a U.K. resident shareholder – whether corporate or individual – in receipt of a dividend from a U.K. company is entitled to a tax credit, the amount of which equates to the amount of ACT paid by the distributing company.[6] The significance of this tax credit depends on whether the shareholder is an individual or a company. An individual will be liable for income tax on the sum of the dividend and the tax credit but his basic rate liability will be satisfied by the tax credit. Where the tax credit exceeds the individual's income tax liability he will be able to claim repayment of the excess.[7] In the case of a company the dividend is excluded from the company's profits chargeable to corporation tax and instead forms, together with the accompanying tax credit, what is called "franked investment income" ("FII") of the recipient company.[8] The recipient company uses the FII to set against its franked payments for the purpose of reducing or eliminating its own ACT liability.[9] To the extent that the recipient company has an excess of FII over franked payments in an accounting period it is said to have a "surplus of franked investment income".[10] In normal circumstances surplus FII is carried forward and set against franked payments made in subsequent accounting periods.[11]

1. For the reader's convenience, the sections with which this article is concerned (Sections 242, 243 and 244 of the Income and Corporation Taxes Act 1988 (ICTA 1988)) have been printed in a slightly smaller letter type on pages 178 and 179.

2. The legislation actually imposes the obligation on a company making a "qualifying distribution", the definition of which encompasses more than dividends. For convenience's sake, the word "dividend" is used throughout this article wherever "qualifying distribution" is meant. The definition of "distribution" may be found at Secs. 209 – 211 ICTA 1988. "Qualifying distribution" is defined, by reference to those sections, in Sec. 14 subsec. (2) ICTA 1988.

3. Sec. 14 ICTA 1988.

4. Sec. 238 subsec. (1) ICTA 1988.

5. Sec. 239 ICTA 1988.

6. Sec. 231 ICTA 1988.

7. Sec. 231 subsec. (3) ICTA 1988.

8. Secs. 208 and 238 subsec. (1) ICTA 1988.

9. Sec. 241 ICTA 1988.

10. Sec. 238 subsec. (1) ICTA 1988.

11. Sec. 241 subsec. (3) ICTA 1988.

SECTIONS 242, 243 AND 244 OF THE INCOME AND CORPORATION TAXES ACT 1988

242. Set-off of losses etc. against surplus of franked investment income

(1) Where a company has a surplus of franked investment income for any accounting period–

(a) the company may, on making a claim for the purpose, require that the amount of the surplus shall for all or any of the purposes mentioned in subsection (2) below be treated as if it were a like amount of profits chargeable to corporation tax; and

(b) subject to subsection (4) below, the provisions mentioned in subsection (2) below shall apply in accordance with this section to reduce the amount of the surplus for purposes of section 241(3); and

(c) the company shall be entitled to have paid to it the amount of the tax credit comprised in the amount of franked investment income by which the surplus is so reduced.

(2) The purposes for which a claim may be made under subsection (1) above are those of

(a) the setting of trading losses against total profits under section 393(2);

(b) the deduction of charges on income under section 338 or paragraph 5 of Schedule 4;

(c) the deduction of expenses of management under section 75 or 76;

(d) the setting of certain capital allowances against total profits under [section 145(3) of the 1990 Act];

(e) the setting of losses against income under section 573(2).

(3) Where a company makes a claim under this section for any accounting period, the reduction falling to be made in profits of that accounting period shall be made, as far as may be, in profits chargeable to corporation tax rather than in the amount treated as profits so chargeable under this section.

(4) Where a claim under this section relates to section 393(2) or 573(2) of this Act or to [section 145(3) of the 1990 ACT] and an accounting period of the company falls partly before and partly within the time mentioned in that subsection, then–

(a) the restriction imposed by section 393(3) or 573(3) of this Act or by [section 145(4) of the 1990 ACT] on the amount of the relief shall be applied only to any relief to be given apart from this section, and shall be applied without regard to any amount treated as profits of the accounting period under this section; but

(b) relief under this section shall be given only against a part of the amount so treated proportionate to the part of the accounting period falling within that time.

(5) Where–

(a) on a claim made under this section for any accounting period relief is given in respect of the whole or part of any loss incurred in a trade, or of any amount which could be treated as a loss under section 393(9); and

(b) in a later accounting period the franked payments made by the company exceed its franked investment income;

then (unless the company has ceased to carry on the trade or to be within the charge to corporation tax in respect of it) the company shall, for the purposes of section 393(1), be treated as having, in the accounting period ending immediately before the beginning of the later accounting period mentioned in paragraph (b) above, incurred a loss equal to whichever is the lesser of –

(i) the excess referred to in paragraph (b) above; and

(ii) the amount in respect of which relief was given as mentioned in paragraph (a) above or so much of that amount as remains after deduction of any part of it dealt with under this subsection in relation to an earlier accounting period.

(6) Subject to subsection (7) below, subsection (5) above shall apply, with the necessary adaptations –

(a) in relation to relief given in respect of management expenses; and

(b) in relation to relief given in respect of capital allowances; and

(c) in relation to relief given in respect of losses under section 573(2);

as it applies in relation to relief given in respect of a loss (the reference to the company ceasing to be within the charge to corporation tax in respect of the trade being construed as a reference to its ceasing to be within that charge at all, and as respects the relief mentioned in paragraph (c) above, the reference to the purposes of section 393(1) being construed as a reference to the purposes of corporation tax on chargeable gains).

(7) Any amount which may be dealt with under subsection (5) above as a loss shall be so dealt with rather than under subsection (6) above, except in so far as the company concerned otherwise elects.

(8) The time limits for claims under this section shall be as follows–

(a) if and so far as the purpose for which the claim is made is the setting of trading losses against total profits under section 393(2), two years from the end of the accounting period in which the trading loss is incurred;

(b) if and so far as the purpose for which the claim is made is the deduction of charges on income under section 338 or paragraph 5 of Schedule 4 or of expenses of management under section 75 or 76, six years from the end of the accounting period in which the charges were paid or the expenses of management were incurred;

(c) if and so far as the purpose for which the claim is made is the setting of capital allowances against total profits under [section 145(3) of the 1990 Act], two years from the end of the accounting period for which the capital allowances fall to be made;

(d) if and so far as the purpose for which the claim is made is the setting of a loss against income under section 573(2), two years from the end of the accounting period in which the loss was incurred.

(9) For the purposes of a claim under this section for any accounting period, the surplus of franked investment income for that accounting period shall be calculated without regard to the part, if any, carried forward from an earlier accounting period; and for the purposes of subsection (5) above franked investment income which by virtue of section 241(5) cannot be used to frank distributions of a company shall be left out of account.

243. Set-off of loss brought forward, or terminal loss

(1) Where a company has a surplus of franked investment income for any accounting period, the company, instead of or in addition to making a claim under section 242, may on making a claim for the purpose require that the surplus shall be taken into account for relief under section 393(1) or 394, up to the amount of franked investment income for the accounting period which, if chargeable to corporation tax, would have been so taken into account by virtue of section 393(8); and (subject to the restriction to that amount of franked investment income) the following subsections shall have effect where the company makes a claim under this section for any accounting period.

(2) The amount to which the claim relates shall for the purposes of the claim be treated as trading income of the accounting period.

(3) The reduction falling to be made in trading income of an accounting period shall be made as far as possible in trading income chargeable to corporation tax rather than in the amount treated as trading income so chargeable under this section.

(4) If the claim relates to section 393(1), section 242(5) shall apply in relation to it.

(5) If the claim relates to section 394 and an accounting period of the company falls partly outside the three years mentioned in subsection (1) of that section, then–

(a) the restriction imposed by subsection (2) of that section on the amount of the reduction that may be made in the trading income of that period shall be applied only to any relief to be given apart from this section, and shall be applied without regard to any amount treated as trading income of the accounting period by virtue of this section, but
(b) relief under this section shall be given only against a part of the amount so treated proportionate to the part of the accounting period falling within the three years in question.

(6) The time limits for claims under this section shall be as follows–
(a) if and so far as the purpose for which the claim is made is the allowance of relief under section 393(1), six years from the end of the accounting period for which the claim is made,
(b) if and so far as the purpose for which the claim is made is the allowance of relief under section 394, six years from the time when the company ceases to carry on the trade.

(7) For the purposes of a claim under this section for any accounting period the surplus of franked investment income for that period shall be calculated without regard to the part, if any, carried forward from an earlier accounting period.

244. Further provisions relating to claims under section 242 or 243

(1) Without prejudice to section 242(9) or 243(7), the surplus of franked investment income for an accounting period for which a claim is made under either of those sections shall be calculated without regard to any part of that surplus which, when the claim is made, has been used to frank distributions made by the company in a later accounting period.

(2) Where in consequence of a claim under either section 242 or section 243 for any accounting period a company is entitled to payment of a sum in respect of tax credit–
(a) an amount equal to that sum shall be deducted from any advance corporation tax which apart from this subsection would fall, under section 239, to be set against the company's liability to corporation tax for the next accounting period or the benefit of which could be surrendered under section 240; and
(b) if that amount exceeds that advance corporation tax or there is no such advance corporation tax, that excess or that amount (as the case may be) shall be carried forward and similarly deducted in relation to the following accounting period and so on.

Two consequences of the system just described, and in particular of the exclusion of intercorporate dividends from corporation tax profits, are important to the present theme. The first of these is that the reliefs and allowances which may be set off against corporation tax profits – losses, capital allowances, etc. – are not normally available to set off against FII which does not form part of those profits. The second is that because FII is not assessable income, a company may not claim repayment of the tax credit included in its FII except in the two sets of circumstances where the Taxes Act specifically provides for it to do so. One of these sets of circumstances, which need not greatly concern us here, is where the recipient company is exempt from corporation tax or is liable to corporation tax only on its trading income or where the dividend to which the tax credit is attached is the subject of an express exemption.[12] The other is where the company makes a claim under either of the sections which are the subject of this article.

III. THE LEGISLATION AND ITS HISTORY

The provisions with which this article is primarily concerned are currently located at Sections 242, 243 and 244 ICTA 1988. The forerunner of these provisions first found its way into U.K. tax legislation as Section 62 of the Finance Act 1965 – the Act which introduced corporation tax to an expectant nation. When Finance Act 1965 and subsequent Finance Acts were consolidated in 1970 the original section was split into two to become Sections 254 and 255 of the Income and Corporation Taxes Act 1970 – Section 254 providing for the relief in its basic form and Section 255 an extended form of the relief for financial concerns. 1972 brought the introduction of a new related provision in the shape of Section 90 of that year's Finance Act designed to counter anomalies which would otherwise have arisen with the advent of the imputation system. Finally the latest consolidation of U.K. tax legislation saw Sections 254 and 255 become respectively Sections 242 and 243 ICTA 1988 and Section 90 Finance Act 1972 become Section 244 ICTA 1988.[13]

IV. THE BASIC MECHANISM

The basic mechanism of a claim under Section 242 is provided for in subsections (1), (2) and (3). This mechanism works, where a claim is made, by treating a surplus of FII for an accounting period as an equal amount of profits chargeable to corporation tax. The effect of this is threefold. First, these "profits" may be utilized to absorb certain allowances and reliefs which cannot be allowed in the mainstream corporation tax computation because the company does not have sufficient profits. Second, the surplus FII available to carry forward and set against franked payments made in subsequent accounting periods is reduced by the amount treated as corporation tax profits. Third, the company becomes entitled to a repayment of the tax credit included in so much of the surplus FII as is used in absorbing the reliefs and allowances. The reliefs and allowances in question are:
(a) trading losses available to set off against total profits of the same or preceding accounting periods;[14]
(b) charges on income;[15]

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12. Sec. 231 subsec. (2) ICTA 1988. A Friendly Society is an example of a company which is exempt from corporation tax, and a registered trade union of a company which is only not exempt in respect of its trading income. An example of an express exemption which would entitle the recipient of a dividend to repayment of the tax credit attaching to it, is that conferred on charities by Sec. 505 subsec. (1)(c)(iii) ICTA 1988. Sec. 231 subsec.(2)(b) ICTA 1988 specifically states that Sec. 208 ICTA 1988 – which provides for the general exclusion of dividends from chargeability to corporation tax – does not give rise to an entitlement to repayment of tax credits attaching to dividends.
13. Sec. 90 subsec. (1) Finance Act 1972 disappeared with the advent of ICTA 1988 as being no longer necessary. Thus Sec. 244 ICTA contains what was previously Sec. 90 subsecs. (2) and (3).
14. See Sec. 393 subsec. (2) ICTA 1988. Under this subsection a company may claim to set a trading loss against the total corporation tax profits of the accounting period in which the loss is incurred (instead of carrying it forward for set-off against the trading profits of future accounting periods under subsec. (1) of the same section). The balance of the trading loss not absorbed in this way may be carried back and set against the total profits of previous accounting periods (subject to the time limitations described in the text *infra* at note 21).
15. See Sec. 338 ICTA 1988. "Charges on income" are items such as annuities, patent royalties, payments of yearly interest, etc. These items, when paid out of a company's profits brought into charge to corporation tax, may be deducted in computing the profits on which corporation tax is charged.

(c) management expenses of an investment or life assurance company;[16]
(d) capital allowances which are given (to the extent that this is possible) against a particular source of income;[17]
(e) capital losses on unquoted shares incurred by certain investment companies which may be relieved against income;[18] and
(f) deductions in respect of discounts for companies issuing deep discount securities.[19]

As this article is primarily concerned with the mechanics of Section 242 claims it is not proposed to enter into a detailed analysis of these reliefs and allowances (interested readers are referred to the footnotes). However, a number of remarks on the subject need to be made at this point insofar as they are pertinent to the circumstances in which a claim may be made.

Section 242 makes use of allowances and reliefs which are given as deductions either from total corporation tax profits or in computing total corporation tax profits as opposed to those which are allowed against specific sources of income.[20] This presents no problem in the case of allowances/reliefs of the current accounting period. However, with the exception of management expenses incurred by an investment or life assurance company, the reliefs and allowances listed above, when carried forward, are only deductible from income from particular sources and therefore (except for management expenses of an investment or life assurance company) not available for Section 242 purposes. Of the reliefs and allowances listed above only trading losses and capital allowances may be carried back (subject to the limitations described below), in which case they are deducted from total corporation tax profits and therefore may be the subject of a Section 242 claim.

The carryback of trading losses and the capital allowances listed at (d) above is limited by reference to the length of the accounting period for which they were originally available.[21] The amount carried back may be set against the profits of a period of time equal to the length of the original accounting period and immediately preceding that accounting period. Normally, of course, this means that the carryback is limited to one year unless accounting periods of different lengths are involved. These rules are important to the present theme because the amount of surplus FII against which carried-back losses or capital allowances may be set is limited in a similar manner. An example will clarify their effect on a Section 242 claim:

The tax computations of Shubunkin Ltd. show the following:

(i) Accounting period 1 June 1987 to 31 May 1988 (12 months)
 – trading profits £ 2,400
 – surplus FII £ 2,100
(ii) Accounting period 1 June 1988 to 31 December 1988 (7 months)
 – trading profits £ 6,000
(iii) Accounting period 1 January 1989 to 31 December 1989 (12 months)
 – trading loss £ 14,000

Shubunkin Ltd. makes a claim to carry back the trading loss of the accounting period to 31 December 1989 and also a claim under Section 242 in respect of its surplus FII for the accounting period to 31 May 1988. The result will be:

Accounting period 1 June 1988 to 31 December 1988
 – trading profit £ 6,000
 – less loss carried back £ 6,000
 NIL

Accounting period 1 June 1987 to 31 May 1988
 – trading profit £ 2,400

Profits against which loss carried back may be set
 – 2,400 × $\frac{5}{12}$ = 1000

Therefore loss carry-back limited to £ 1,000
Revised corporation tax profits £ 1,400

Surplus FII against which the loss carried back may be set under Section 242 is limited in the same way, i.e. to 2,100 × $\frac{5}{12}$ = 875. This leaves losses available to carry forward at 31 December 1989 of 6,125, i.e. 14,000 – (6,000 + 1,000 + 875).

A final point needs to be made in connection with the carryover of reliefs/allowances concerning the order of set-off. The general rule is that the reliefs/allowances must first be set against profits normally chargeable to corporation tax before being set against surplus FII. However, where trading losses or capital allowances are available to carry back to the preceding accounting period, they may be set against the surplus FII of the original period in preference to the profits of the earlier period. Thus, for instance, a company

16. See Secs. 75 and 76 ICTA 1988. A company whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived from this activity (Sec. 130 ICTA 1988) and a company which carries on life assurance business (as defined in Sec. 2 Insurance Companies Act 1982) may deduct *management expenses* in arriving at its total profits. "Management expenses" are not statutorily defined but include items such as directors' remuneration, staff salaries, commissions and office expenses to the extent that these have not otherwise been taken into account. To the extent that the management expenses of an accounting period cannot be absorbed by total profits, they may be carried forward and treated as management expenses of the next accounting period.
17. See Sec. 145 Capital Allowances Act 1990 (CAA 1990). Certain capital allowances are described as being "given by discharge or repayment of tax, and .... primarily available against a specified class of income". Such allowances (for example industrial buildings allowances granted to a company which is a lessor of industrial buildings) have to be deducted against the specified source of income against which they are primarily available, as far as this is possible. To the extent that this is not possible, the company may claim to have the excess allowances set against other profits of the accounting period and preceding periods (subject to the time limitations described in the text *infra* at note 21).
18. See Sec. 573 ICTA 1988. Normally capital losses incurred by a company on the disposal of shares which it holds will be set off against its capital gains. However, an investment company (see *supra* note 16) which has subscribed for shares in a qualifying trading company (defined in Sec. 576 subsec. (4) ICTA 1988) and which incurs a loss on the disposal, after 31 March 1981, of those shares may claim to set the loss against its income for corporation tax purposes.
19. See Sch. 4 para. 5 ICTA 1988. Subject to a number of conditions, companies issuing deep discount securities (defined in Sch. 4 para. 1 ICTA 1988) after 18 March 1985 may claim a special deduction from total profits in respect of the discount. The deduction is computed by reference to a formula which relates the discount to the life of the security (Sch. 4 para. 4 ICTA 1988).
20. To arrive at profits chargeable to corporation tax, the income from each source is computed separately according to the rules of the appropriate Schedule and taking into account allowances and reliefs which are given against specified sources of income. The various amounts so calculated are then aggregated to give total profits. From this figure are deducted trading losses (see *supra* note 14), management expenses (see F.N. 15) and certain capital allowances (see *supra* note 16). Charges on income are deducted after all other adjustments and reliefs (apart from group relief). Secs. 9 and 338(1) ICTA 1988.
21. Sec. 393 subsecs. (2) and (3) ICTA 1988; Sec. 145 subsecs. (3) and (4) CAA 1990.

with a trading loss of £ 8,000 and surplus FII of £ 5,000 for the same accounting period, with a profit of £ 3,000 for the preceding accounting period, has a choice. It may elect either to set £ 5,000 of the loss against its surplus FII and carry back £ 3,000 to set off against the profits of the earlier period, or to carry back £ 3,000 and carry the remaining £ 5,000 forward against future trading profits.

Before proceeding, two important restrictions on the surplus FII which can be included in a Section 242 claim need to be noted. First surplus FII of an accounting period may only be included to the extent that it has not already been carried forward and set against franked payments of a later accounting period.[22] Second, the calculation for Section 242 purposes of the amount of surplus FII for an accounting period must exclude surplus FII brought forward from an earlier accounting period. Surplus FII brought forward may still, however, be set against the franked payments of the accounting period in the normal way, thus releasing surplus FII of the accounting period for inclusion in a Section 242 claim. Take, for example, a company with surplus FII brought forward of £ 21,000 which receives FII in the accounting period amounting to £ 14,000 and makes franked payments of £ 18,000. The company may set the £ 21,000 surplus FII brought forward against the franked payments of £ 18,000 leaving £ 3,000 surplus FII to carry forward and surplus FII of the accounting period £ 14,000 available for inclusion in a Section 242 claim.

Returning to our central theme, the most effective way to illustrate the consequences of making a claim under Section 242 is to resort to a hypothetical example. For this purpose, let us take A. Forethought Ltd., a U.K.-resident trading company whose results over a three-year period may be summarized as follows:

(i)	1 January 1989 to 31 December 1989 (in £)	
	Trading loss	150,000
	FII	225,000
	Dividends paid	63,000
(ii)	1 January 1990 to 31 December 1990	
	Trading profit	650,000
	FII	50,000
	Dividends paid	126,000
(iii)	1 January 1991 to 31 December 1991	
	Trading profit	450,000
	FII	62,500
	Dividends paid	105,000

(For the purposes of this example it is assumed that the full company tax rate is 35 percent throughout the period and that the rate of ACT is 1/3.[23] It is also assumed that for the entire period A. Forethought Ltd. has two active associated companies, M. Forethought Ltd. and B. Forethought Ltd., and is therefore not able to benefit from the special rate for "small companies".[24]

If A. Forethought Ltd. makes no Section 242 claim its corporation tax and ACT liabilities will be computed in the normal manner as follows:

(i) Accounting period to 31 December 1989 (in £)

ACT		
FII	225,000	
Franked payments	84,000	(dividends paid 63,000 + 1/3 ACT 21,000)
Surplus FII to cf.	141,000	
ACT payable	NIL	
Corporation tax		
Corporation tax payable	NIL	
Trading loss to cf.	150,000	

(ii) Accounting period to 31 December 1990 (in £)

ACT		
FII	50,000	
Surplus FII bf.	141,000	
	191,000	
Franked payments	168,000	(dividends paid 126,000 + 1/3 ACT 42,000)
Surplus FII to cf.	23,000	
ACT payable	NIL	
Corporation tax		
CT (trading) profits	650,000	
Less loss bf.	150,000	
Corporation tax @ 35% on	500,000	= 175,000

(iii) Accounting period to 31 December 1991 (in £)

ACT		
FII	62,500	
Surplus FII bf.	23,000	
	85,500	
Franked payments	140,000	(dividends paid 105,000 + 1/3 ACT 35,000)
ACT payable @ 25% on	54,500	= 13,625
Corporation tax		
Corporation tax @ 35% on (trading) profits	450,000	= 157,500
less ACT set off		13,625
Corporation tax payable		143,875

Let us now compare the position if A. Forethought Ltd. makes a claim under Section 242 in respect of its surplus FII for the accounting period to 31 December 1989. At this point we shall ignore the consequential adjustments affecting the two subsequent accounting periods which will be discussed below.

(i) Accounting period to 31 December 1989 (in £)

ACT	
FII	225,000
Franked payments	84,000
Surplus FII	141,000

Repayment under Sec. 242 of tax credit included in surplus FII – 141,000 × 25% = 35,250.

22. Sec. 244 subsec. (1) ICTA 1988.
23. The rate of corporation tax is set for a financial year (1 April to 31 March). The full company tax rate for each of the financial years 1988 (1 April 1988 to 31 March 1989), 1989 and 1990 is 35 percent (Sec. 26 Finance Act 1988, Sec. 34 Finance Act 1989 and Sec. 19 Finance Act 1990). At the time of writing, the rate for 1991 has yet to be fixed. The rate of ACT has been fixed by reference to the basic rate of income tax since the financial year 1986 (Sec. 17 Finance Act 1986). For 1988, 1989 and 1990 the rate of ACT is 1/3, the rate for 1991 not having been set at the time of writing.
24. There is a special lower rate of corporation tax (the "small companies rate") for companies with profits below a certain amount (currently £ 200,000) and an accompanying marginal relief for companies with profits in excess of that amount but below another, higher amount (currently £ 1,000,000). Where a company has non-dormant associated companies these figures are divided by one plus the number of associated companies. Thus, in the example, A. Forethought Ltd. is entitled neither to pay tax at the small companies rate nor to any marginal relief (Sec. 13 ICTA 1988).

Corporation tax	
Surplus FII treated as CT profits	141,000
Trading loss	150,000
Trading loss to cf.	9,000
Corporation tax payable	NIL

(ii) Accounting period to 31 December 1990 (in £)

ACT		
FII	50,000	
Franked payments	168,000	
ACT payable @ 25% on	118,000 =	29,500

Corporation tax		
CT (trading) profits	650,000	
Less loss bf.	9,000	
Corporation tax @ 35% on	641,000 =	224,350
Less ACT set off		29,500
Corporation tax payable		194,850

(iii) Accounting period to 31 December 1991 (in £)

ACT		
FII	62,500	
Franked payments	140,000	
ACT payable @ 25% on	77,500 =	19,375

Corporation tax	
Corporation tax @ 35% on (trading) profits 450,000 =	157,500
Less ACT set off	19,375
Corporation tax payable	138,125

V. RESTORING THE LOSS

If we examine the results of A. Forethought's Section 242 claim as they appear in the above example, two features emerge. First, the company enjoys a short-term advantage in the shape of a cash repayment of £ 35,250 representing the tax credit included in its surplus FII for the year to 31 December 1989. If the company does not make a claim it will not reap the full benefit of the tax credit until the year to 31 December 1991 when it will be fully exhausted by set-off against the company's ACT liability.

Secondly, the company's total tax bill for the three years will ultimately be £ 14,100 more than it would have been had it not made a claim:

(Amounts in £)		
No claim –		
Corporation tax 175,000 + 143,875 =	318,875	
ACT	13,625	
		332,500
Sec. 242 claim –		
Corporation tax 194,850 + 138,125 =	332,975	
ACT 29,500 + 19,375 =	48,875	
Less tax credit repaid	(35,250)	
		365,600
Difference		14,100

The difference arises because where no claim is made the trading loss for the year to 31 December 1989 is relieved at the (correct) corporation tax rate of 35 percent – the relief amounting in terms of tax to £ 52,500. Under Section 242 only £ 9,000 of the loss is relieved at the correct rate of 35 percent, the remainder being relieved at 25 percent which corresponds to the 1/3 ACT rate. In tax terms this means relief of £ 38,400.

This discrepancy is addressed in subsections (5) and (6) of Section 242, which come into operation where in a later accounting period (that is, in an accounting period later than that for which the Section 242 claim was made) franked payments made exceed FII received. In these circumstances an adjustment is made with the result that the relief or allowance which was utilized in giving effect to the Section 242 claim is again made available to the company. The amount of relief or allowance restored in this way is, however, limited by reference to the extent to which the franked payments exceed the FII in the later period. If this excess is greater than the amount of the relief or allowance used in the Section 242 claim, the whole of the relief or allowance is restored. If the excess of franked payments over FII is less than the amount of the relief/allowance, the remainder of the relief/allowance is restored in subsequent accounting periods where the same circumstances pertain, until the entire relief/allowance has been reinstated.

The manner in which the adjustment is effected depends on the particular relief or allowance which was the subject of the Section 242 claim. In the case of trading losses, charges on income and deductions in respect of discounts for companies issuing deep discount securities, the company is treated as having incurred a loss in the accounting period immediately before that in which franked payments made exceed FII received. The rationale for linking these three items together in this way is that for ordinary corporation tax purposes deductions in respect of discounts are treated as charges on income[25] and charges on income, to the extent that they are not absorbed by set-off against the profits of an accounting period, are treated (subject to the proviso described below) as a trading loss available to carry forward to subsequent accounting periods.[26] Subsection (5) specifically applies the normal corporation tax rules on loss relief to the deemed loss restored to the company so that it is carried forward and available to set off against corporation tax profits of the next accounting period which, it will be remembered, is an accounting period in which franked payments exceed FII.

Two details of this process need to be noted. The first is that where charges on income are the subject of a Section 242 claim they are only revived under subsection (5) to the extent that they were incurred wholly and exclusively for the purposes of the company's trade. This follows from the fact that according to the normal corporation tax rules excess charges on income may only be treated as a trading loss available to carry forward to the extent that they are incurred for trade purposes, excess non-trade charges being lost.[27] Secondly, the company may only have these reliefs/allowances restored to it under subsection (5) if it is still carrying on the same trade as it was when it originally became entitled to them and if it is still within the charge to corporation tax in respect of that trade. This parallels the normal continuity of trade requirements for the carry forward of trading losses.[28]

Subsection (6) of Section 242 provides for corresponding adjustments to restore the other reliefs/allowances which

25. Sch. 4 para. 5 subsecs. (1) and (2) ICTA 1988.
26. Sec. 393 subsec. (g) ICTA 1988.
27. *Id.*
28. Sec. 393 subsec. (1) ICTA 1988.

may be the subject of Section 242 claims – management expenses, capital allowances given primarily against a specified source of income and capital losses on unquoted shares. Again the process is synchronized with the general corporation tax rules applicable to the relief or allowance in question. Thus management expenses are restored to an investment company by treating the amount utilized in the Section 242 claim (or the excess of franked payments over FII, if less) as management expenses of the accounting period immediately preceding the accounting period in which franked payments exceed FII. This amount is then available for carryforward and set-off against corporation tax profits under the normal rules on excess management expenses.[29] There is a proviso in subsection (7) which applies to subsection (6) and states that any amount which may be dealt with under subsection (5) as a loss is to be so dealt with (in the absence of an election by the company to the contrary). This allows, again by reference to ordinary corporation tax rules,[30] capital allowances to be restored to the company as a loss, as described in the previous paragraph. In the case of losses on unquoted shares the restoration is made in the form of a capital loss,[31] subject to the requirement that the company remains within the charge to corporation tax on its chargeable gains (an adaptation of the subsection (5) requirement that the company remain within the charge to corporation tax in respect of its trade).

Before returning to our example, it is worth reiterating that, whatever the details of their operation, both subsection (5) and subsection (6) produce the same result – that is, the restoration to the company of the benefit of the relief or allowance which would otherwise have been lost because it was exhausted in giving effect to the Section 242 claim.

If we now apply subsection (5) to the case of A. Forethought Ltd. we can see that the position is as follows:

(i) Accounting period to 31 December 1989 (in £)

Position as before, i.e.:

ACT payable	NIL
Repayment under Sec. 242	35,250
CT payable	NIL
Trading loss to cf.	9,000

(ii) Accounting period to 31 December 1990 (in £)

ACT
Position as before, i.e.:

ACT payable		29,500	
Corporation tax			
CT (trading) profits		650,000	
Less loss bf.	9,000		
Loss restored under Sec. 242(5)*	118,000	127,000	
Corporation tax @ 35% on		523,000	= 183,050
Less ACT set off			29,500
Corporation tax payable			153,550

* Limited to excess of franked payments over FII (168,000 – 50,000).

(iii) Accounting period to 31 December 1991 (in £)

ACT
Position as before, i.e.:

ACT payable	19,375	
Corporation tax		
CT (trading) profits	450,000	
Less loss restored under Sec. 242(5)*	23,000	
Corporation tax @ 35% on	427,000	= 149,450
Less ACT set off		19,375
Corporation tax payable		130,075

* Excess of franked payments over FII 77,500 (140,000 – 62,500) is greater than remaining unrestored loss 23,000 (141,000 – 118,000), therefore entire remaining loss is restored.

VI. RESTRICTING THE ACT SET-OFF

Glancing at the result produced by applying subsection (5) of Section 242 in the above example, it is at once clear that the trading loss of £ 150,000 has now been relieved in its entirety at the appropriate corporation tax rate of 35 percent. One further anomaly remains, however.

The repayment of the tax credit included in the surplus FII for the accounting period to 31 December 1989 produced the result that the surplus FII to carry forward from that accounting period was eliminated. This in turn increased the ACT payable for the two following accounting periods – from £ NIL to £ 29,500 for the accounting period to 31 December 1990 and from £ 13,625 to £ 19,375 for the accounting period to 31 December 1991. Because ACT can be set off against mainstream corporation tax, this means effectively that £ 141,000 of the loss was relieved twice – once at 35 percent and once at 25 percent. Section 244(2) provides for the removal of this anomaly.

Section 244(2) applies to restrict the set-off of ACT against mainstream corporation tax where a company has made a Section 242 claim for a previous accounting period. The amount of ACT available for set-off is reduced by the amount of the tax credit repaid to the company in consequence of its Section 242 claim. This restriction operates until the entire amount of the tax credit has been recovered, so that where the ACT available for set-off is less than the amount of the tax credit repaid, ACT set-offs for subsequent accounting periods are restricted by the balance of the tax credit unrecovered.[32]

Although designed to produce an equitable result in tandem with Section 242(5) and (6), Section 244(2) works independently of those subsections. This means that even where subsections (5) and (6) do not have the effect of restoring an allowance or relief (for example in the case of a claim involving non-trade charges or trading losses where a company has ceased to carry on the trade in which the losses were incurred), Section 244(2) nonetheless restricts the company's right to set its ACT against mainstream corporation tax.[33]

Returning once more to our hypothetical case, we find that the consequences of Section 244(2) for A. Forethought Ltd. are as follows:

(i) Accounting period to 31 December 1989 (in £)

Position as before, i.e.:

Repayment under Sec. 242	35,250

29. Sec. 75 subsec. (3) ICTA 1988.
30. Sec. 145 subsec. (3) CAA 1990.
31. This follows from the fact that under the normal rules losses on unquoted shares, to the extent that they are not relieved under Sec. 573 ICTA 1988, are carried forward and set against the chargeable gains of future accounting periods in the same way as other allowable capital losses (Sec. 345 subsec. (1) ICTA 1988).
32. The subsection also operates to restrict the ability of a parent company to surrender its surplus ACT for setoff against the corporation tax liability of a subsidiary (Sec. 240 ICTA 1988).

(ii) Accounting period to 31 December 1990 (in £)

ACT

Position as before, i.e.: ACT payable –	29,500	

Corporation tax

Corporation tax, as before, @ 35% on 523,000 =	183,050
ACT setoff, restricted by Sec. 244(2)*	NIL
Corporation tax payable	183,050

* ACT otherwise available for set-off is less than tax credit repaid under Sec. 242; therefore Sec. 244(2) has the effect of reducing ACT set-off to nil. Balance of tax credit to be recovered by restriction of ACT set-off in future accounting periods is £ 5,750 (i.e. £ 35,250 – £ 29,500).

(iii) Accounting period to 31 December 1991 (in £)

ACT

Position as before, i.e.: ACT payable –	19,375	

Corporation tax

Corporation tax, as before, @ 35% on 427,000 =	149,450
ACT setoff, restricted by Sec. 244(2)*	13,625
	135,825

* ACT otherwise available for set-off £ 19,375 is reduced by unrecovered balance of tax credit repaid £ 5,750.

We have now finally arrived at the point where the combination of Sections 242(5) and 244(2) has rectified the anomalies arising from the Section 242 claim because of the difference between the rate of corporation tax and the "ACT rate". The company's trading loss has been relieved at the appropriate corporation tax rate, and the additional relief of the loss at the ACT rate necessary to achieve this has been cancelled by restricting the company's entitlement to set off its ACT against its mainstream corporation tax. The result is that A. Forethought's total tax liability for the three years is exactly the same as it would have been had the company not made a claim under Section 242:

(Amounts in £)
No claim –

Corporation tax 175,000 + 143,875 =	318,875
ACT	13,625
Total tax liability	332,500

Sec. 242 claim –

Corporation tax 183,050 + 135,825 =	318,875
ACT 29,500 + 19,375 =	48,875
Less tax credit repaid	(35,250)
Total tax liability	332,500

VII. SECTION 243 – FINANCIAL CONCERNS

Section 243 provides an extended form of the relief to companies whose FII would be treated as trading income for corporation tax purposes were it not for the exclusion of dividends received from other U.K. companies from profits chargeable to corporation tax.[34] The kinds of company in question are banks, discount houses and share-dealing companies. The relief is available in addition or as an alternative to that available under Section 242.

Whereas only those reliefs or allowances which are deductible from total corporation tax profits may be the subject of a claim under Section 242, Section 243 enables an eligible company to utilize reliefs which are only deductible from trading profits. Such reliefs are trading losses brought forward[35] and terminal losses.[36] The mechanics of Section 243 parallel those of Section 242, so that where a claim is made the company's surplus FII is treated as trading income of the accounting period against which the trading loss brought forward or the terminal loss may be set. In the case of a trading loss brought forward, Section 243(4) provides for the restoration of the loss used in the Section 243 claim in exactly the same manner as Section 242(5) restores the allowance or relief used in a Section 242 claim. With regard to the subsequent restriction of the set-off of ACT, Section 244(2) applies equally to claims under Section 243 as it does to claims under Section 242.

A restriction on the amount of relief available under Section 243 (or, more accurately, the amount of surplus FII which can be included in the claim) when the claim relates to a terminal loss is imposed by subsection (5). To understand this restriction it is necessary to refer briefly to the terminal loss relief provisions themselves. These provisions essentially allow a company which has incurred a trading loss in an accounting period ending within the 12 months immediately before the cessation of its trade to set that loss against the profits of the same trade in the preceding three years.[37] Where an accounting period straddles the beginning of the three-year period, the trading profits against which the terminal loss may be set are apportioned accordingly.[38] Subsection (5) provides that the surplus FII of such an accounting period which may be included in a Section 243 claim is to be restricted by reference to a similar apportionment.

VIII. CLAIMS

Claims for relief under Sections 242 and 243 are made in accordance with the general claims procedure.[39] In essence this requires a claim to be made to an inspector (rather than "the Board") and provides for a right of appeal against the inspector's decision. There are no special rules regarding the form in which a Section 242 or 243 claim must be made.

The time limit for making a claim depends on the particular relief or allowance involved, as follows:

under Section 242 – [40]

(a) trading losses available to set off against total profits – two years from the end of the accounting period in which the loss was incurred;
(b) charges on income, management expenses and deductions in respect of deep discount securities – six years from the end of the accounting period in which the charges were paid, the management expenses were incurred or the deduction in respect of the deep discount security was allowed;
(c) capital allowances – two years from the end of the accounting period for which the allowances were given;
(d) capital losses on unquoted shares – two years from the end of the accounting period in which the loss was incurred;

under Section 243 – [41]

(e) trading losses brought forward – six years from the end of the accounting period for which the claim is made;

33. *Id.*
34. Sec. 393 subsec. (8) ICTA 1988.
35. Sec. 393 subsec. (1) ICTA 1988.
36. Sec. 394 ICTA 1988.
37. Sec. 394 subsec. (1) ICTA 1988.
38. Sec. 394 subsec. (3) ICTA 1988.
39. Sec. 42 Taxes Management Act 1970.
40. Sec. 242 subsec. (8) ICTA 1988.
41. Sec. 243 subsec. (6) ICTA 1988.

(f) terminal losses – six years from the date on which the company ceases to carry on the trade.

IX. CONCLUSION

It is probably fair to say that Sections 242, 243 and 244 warrant attention as much for their intrinsic features as for their potential for practical application.

Most striking of these intrinsic features is the lengths to which the legislation goes to preserve the equality of the tax burden between a company which makes a claim and one which does not. It could, after all, be argued that it would not be unreasonable, given the context of the imputation system, simply to give companies the option of obtaining the immediate benefit of a cash repayment with the forfeiture of full relief for their losses, charges, etc. as a suitable quid pro quo. In other words the legislation might very well have omitted to provide for compensating adjustments on the grounds embodied in the celebrated doggerel, "You pays your money and you takes your choice".

Furthermore, in most instances the legislation will be doomed to failure in its attempt to maintain an exact equation between claimants and non-claimants because of fluctuations in the rates of ACT and corporation tax. For example, if we return to our hypothetical case of A. Forethought Ltd. and suppose that the accounting periods involved were the years to 31 March 1985, 1986 and 1987, we find that if the company had made a claim under Section 254 Income and Corporation Taxes Act 1970 (the equivalent of Section 242 at that time) it would have ended up paying £ 1,232 more than if it had not made a claim.[42]

There are a number of reasons why claims under Sections 242 and 243 are not widely made in practice. The most obvious and the most telling is that in the current climate of falling profitability, companies are more likely to find themselves faced with a surplus of ACT than a surplus of FII. For companies with overseas income, claims under these sections are very often unattractive because the losses, etc. must be set against profits normally chargeable to corporation tax before being set against surplus FII, with the consequence that double taxation relief may be forfeited. (This consequence is avoided by companies with U.K. subsidiaries which receive their overseas income.)

Nevertheless claims under Section 242 may prove advantageous in particular circumstances. To take a simple example: let us suppose that a trading company with a 100 percent-owned U.K.-resident subsidiary has an excess of (trade) charges for two consecutive accounting periods amounting to £ 20,000 and £ 24,000 respectively. For two coterminous accounting periods the subsidiary has profits of £ 40,000 and NIL. (For simplicity's sake the applicable rate of corporation tax is assumed to be 35 percent and the ACT rate 1/3 throughout.) The parent company may surrender its excess charges of the first accounting period to the subsidiary under the group relief provisions with the result that the latter will pay corporation tax of £ 7,000.[43] If in the second accounting period the subsidiary pays a dividend of £ 18,000 to the parent, the parent will be able to make a claim under Section 242 and obtain repayment of £ 6,000, the tax credit included in its surplus FII. The subsidiary will, in turn, be able to set the £ 6,000 ACT it was required to pay on making the distribution against the previous years' corporation tax bill.

The circumstances which call for a claim under Section 242 or 243 are relatively limited but when those circumstances arise the advantages of making a claim may be considerable.

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42. No claim–

(i) 1 April 1984 to 31 March 1985			
FII	241,071		
Franked payments	90,000		
Surplus FII cf.	151,071		
Trading loss cf.	150,000		
(ii) 1 April 1985 to 31 March 1986			
FII	53,571		
Surplus FII bf.	151,071		
Franked payments	180,000		
Surplus FII cf.	24,642		
CT profits	650,000		
Less loss bf.	150,000		
CT @ 40% on	500,000	= 200,000	
(iii) 1 April 1986 to 31 March 1987			
FII	66,021		
Surplus FII bf.	24,642		
Franked payments	147,887		
ACT @ 29% on	57,224	= 16,595	
CT @ 35% on 450,000 =		157,500	
less ACT setoff		16,595	
CT payable		140,905	

Section 254 claim –

(i) 1 April 1984 to 31 March 1985			
Repayment of tax credit – 150,000 × 30% = 45,000			
Surplus FII	151,071		
Trading loss	150,000		
Surplus FII cf.	1,071		
(ii) 1 April 1985 to 31 March 1986			
FII	53,571		
Surplus FII bf.	1,071		
Franked payments	180,000		
ACT @ 30% on	125,358	= 37,607	
CT profits	650,000		
Less loss restored	125,358		
CT @ 40% on	524,642	= 209,857	
(iii) 1 April 1986 to 31 March 1987			
FII	66,021		
Franked payments	147,887		
ACT @ 29% on	81,886	= 23,741	
CT profits	450,000		
less loss restored	24,642		
CT @ 35% on	425,358	= 148,875	
	less ACT set off	16,348	
	CT payable	132,527	
Total tax liability –			
No claim: CT	200,000 + 140,905	= 340,905	
ACT		16,595	357,500
Sec. 254 claim: CT	209,857 + 132,527	= 342,384	
ACT	37,607 + 23,741	= 61,348	
Less tax credit repaid		(45,000)	358,732
		Difference	1,232

43. Sec. 407 subsec. (3) ICTA 1988.

BARBADOS:

IFA BARBADOS BRANCH CONSIDERS CARICOM TAX TREATY AND TAX ISSUES

Bruce Zagaris

The author is of counsel, Oppenheimer, Wolff & Donnelly, Washington, D.C.; chair, Committee on International Tax Law, Section of International Law & Practice, American Bar Association; was a lecturer, Law Faculty of the University of the West Indies, 1977-78; was a consultant to the U.S. Agency for International Development on the establishment of the Caribbean Justice Improvement Project; and is a member, editorial board, *Caribbean Law and Business.*

On 2-3 November 1990 the International Fiscal Association (IFA) Barbados Chapter, in association with the Caribbean Law Institute (CLI) presented a special seminar on the Caribbean Common Market and Community (CARICOM)[1] tax treaty[2] and tax issues within CARICOM at the Heywoods Resort in St. Peter, Barbados. Dr. Trevor Carmichael, President, IFA, Barbados Chapter, outlined the work of IFA in his introductory remarks.

Spirit of cooperation

Mr. Winston Cox, Director of Finance and Planning, Ministry of Finance and Economic Affairs, Barbados, gave a feature address. Mr. Cox noted the new spirit of cooperation and cohesiveness coming out of the 1989 and 1990 CARICOM Heads of Government Conferences and suggested that the conference participants try to capitalize on the new spirit.[3] Cox stated that, in spite of efforts, room exists for closer cooperation. Countries in CARICOM have shifted from direct to indirect taxes, such as the institution of a value added tax in Trinidad & Tobago and Grenada. Mr. Cox called for the harmonization of tax law in conjunction with the Treaty of Chaguaramus. CARICOM policy should now place more incentives on business development rather than emphasize revenue raising. Cox wondered whether it was time to revisit the treaty. Several countries in CARICOM have attracted international financial services. He believes that it is important to attract active business to the international financial sector – businesses with their mind and management in Barbados – and that this will generate employment. He warned against developing short cuts to the international financial sector due to competitive action in the Caribbean.

Cox stated that Barbados has always treated CARICOM countries as if they were domestic with respect to international tax policy. He stated that such policy can also be extended to the negotiation of international tax treaties and that CARICOM should ask whether negotiations to achieve such a change would be useful.

Role of CLI

Professor Elwyn Griffith, Executive Director, the Caribbean Law Institute (CLI), delivered a special address on the role of the CLI. He explained that the U.S. Congress has funded CLI for a five-year period and that it is a joint venture of the University of the West Indies and Florida State University. Its emphasis has been holding conferences to prepare uniform laws on subjects such as maritime law, bankruptcy, insurance and banking. The CLI also publishes a journal, *Caribbean Law and Business,* and it is planning to publish a commercial law reporter. Griffith revealed that the CLI has just decided to support the publication of monographs on commercial law. One of its missions is continuing education, so it recently held a seminar in Belize on international business company laws in the Caribbean. It intends to promote cooperation among the bar, accounting firms and other professionals within the Caribbean. CLI also cooperates closely with the Organization of East Caribbean States (OECS)[4] and the CARICOM Legal Secretariat.

To Colin Brewer's query about the role CLI can play in helping revitalize the CARICOM tax treaties, Professor Griffith responded that CLI could re-examine this as part of its project.

1. CARICOM came into existence on 1 August 1973, under the Treaty of Chaguaramus. Its principal function is to provide a Caribbean Common Market and duty-free trade among the 12 CARICOM member countries. It also provides for a common external tariff and a harmonized system of fiscal incentives for industry.
2. Agreement between the Government of Barbados, Guyana, Jamaica and Trinidad & Tobago on the one hand, and Antigua, Belize, Dominica, Grenada, St. Kitts-Nevis-Anguilla, St. Lucia and St. Vincent on the other hand, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and profits and for the encouragement of international trade and investment, 1973.
3. During the Tenth Conference of the Heads of Government in 1989, an accelerated integration programme was adopted. It provides for a variety of measures to establish a single market and economy.
4. The OECS, established as a result of a treaty signed on 18 June 1981 by the representatives of Antigua, Dominica, Grenada, Montserrat, St. Kitts-Nevis, St. Lucia and St. Vincent is a subregional integration group. Its objectives include: (1) the adoption of common positions on international issues; (2) the establishment of arrangements for joint overseas representation and common services; (3) the promotion of economic integration among the member states by agreeing to create the East Caribbean Common Market; and (4) the establishment of a framework for the progressive development of common services, such as the judiciary, currency and civil aviators.

Financial services

H. Bernard St. John, Q.C., attorney at law and former Prime Minister of Barbados, spoke on "Legal Aspects of Financial Services in the Caribbean". Mr. St. John explained that developments in the region and the world demand that Caribbean leaders re-examine regional documents on which CARICOM is based and chart a new course. He lamented that without a regional court to enforce and implement the Treaty of Chaguaramus and because of the requirement of unanimity, CARICOM integration has not lived up to expectations, but it is nevertheless one of the strongest economic integration groups. According to St. John, services such as banking, insurance, securities and financing will be critical in CARICOM's future. In looking ahead, he urged that CARICOM do away with the requirement of work permits in order to allow individuals to move easily in the Caribbean for their work. Exchange control is another serious problem with which the region must cope. He noted that, while a common currency would be difficult without an organization and mechanisms to integrate the economies, CARICOM at least needs a mechanism to ensure that violent fluctuations that have occurred in the past do not happen in the future. Mr. St. John warned that with liberalization would come a need to develop better regulatory systems and ethics or else a rise of white collar crime would accompany the regional stock exchange. Some of these proposed changes in CARICOM will require financing, which is always difficult in CARICOM. He suggested that the addition of a small amount to the stamp duty in each of the islands would be a source of revenue. St. John discussed the attempt in CARICOM to establish common operations through an Agreement for the Establishment of CARICOM Enterprises and noted that the requirement of unanimity had hampered this and other initiatives.

During the question and answer period, Yolande Bannister, counsel with the Central Bank of Barbados, stated that all CARICOM countries with international financial services tend to look suspiciously at each other and are fragmented in their approaches to many issues. She wondered how the countries could harmonize their efforts. Mr. St. John stated that it is important to ensure the integrity of the international financial regime in order to be successful. He stated that he hoped the CLI would work on that.

CARITAX

At lunch Carl Thorburn, senior partner of Touche Ross & Thorburn, Kingston, Jamaica, discussed a project of the Caribbean Institute of Chartered Accountants (CICA), CARITAX. The organization was started in 1988 and came into operation in 1989. The idea, which was first conceived in 1965, is to establish a Caribbean-wide examination for accountants in company law and taxation by 1993. The CICA is now preparing a syllabus to use in preparing for the examination. Mr. Thorburn is editing the tax portions of the syllabus. The syllabus is based largely on an Australian model. The participating countries are Barbados, the Bahamas, Belize, Guyana, Jamaica, Trinidad & Tobago and St. Lucia.

Trinidad & Tobago

Judy Chang, a chartered accountant from Trinidad & Tobago, highlighted the Chartered Accountant's Company Law Project in Trinidad & Tobago. She explained that Trinidad & Tobago has a cabinet committee working on company law reform and currently is considering a draft bill, which is based on the CARICOM and Barbados bills. Ms. Chang noted that several other CARICOM countries, including Jamaica and Guyana, are considering revision of their company laws.

Guyana

At the beginning of the afternoon session, which Colin Brewer, Price Waterhouse & Co., Barbados, moderated, Mr. Brewer stated that circumstances in CARICOM have changed, Guyana is no longer a more developed country and offshore tax sectors have emerged. Hence, it is necessary to re-examine the CARICOM tax system. There is a possibility of having a bilateral or trilateral treaty to which others can accede. He wondered whether CARICOM should not harmonize tax law and treaties simultaneously and whether it should be a single step project.

Pension schemes

A. Charles Herbert, Assistant Vice President, Actuarial/Pensions, Barbados Mutual Life Assurance Society, discussed "Special Issues in the Law and Tax Relating to Pension Schemes in CARICOM". His paper provides an overview of the legislation in Barbados, Trinidad, Jamaica and St. Lucia. Mr. Herbert explained that a favourable tax regime exists for pensions. For instance, in Barbados pensions are entirely tax-free and in Jamaica pensioners are given special tax allowances which in effect make pensions tax-free up to that limit. Herbert noted the tax anomaly in Barbados: contributions into a pension plan, investment earning on pension funds and the pensions paid at retirement are all given full relief from tax. This differs from the more usual position where pensions are seen as deferred income and tax is assessed when they are finally received. Mr. Herbert also raised the need for legislation throughout CARICOM to recognize the need for pension plans that span CARICOM countries. If companies will expand into other CARICOM countries and freely move personnel, pension plans must be recognized in other countries with respect to transfer payments. Mr. Herbert revealed that Barbados has established a working party to review local pension legislation.

Permanent establishment and residence

Mr. Ponniah Karalasingham, International Tax Consultant and Special Adviser of the Caribbean Fund for Technical Cooperation, discussed "Permanent Establishment and Residence in the CARICOM and Other Treaties". Mr Karalasingham congratulated the Barbados professionals on the formation of a national branch of IFA and implored Jamaica and Trinidad & Tobago to either form their own branch or join the Barbados branch. He explained that much of the CARICOM tax treaty, which was concluded in 1973, follows the 1963 OECD Model Income Tax Convention. Mr. Karalasingham pointed out that when the CARICOM Income Tax Convention was concluded, neither the 1977 OECD Model nor the 1980 U.N. Model Convention was in existence.

Selected tax issues

Robert Patrick, a chartered accountant for Price Waterhouse in Washington, D.C., and former International U.S. Tax Counsel, discussed "Selected Tax Issues within CARICOM". Patrick discussed two major subjects: models for multi-tax harmonization and the environment in the United States and the OECD countries with respect to outbound investment and the impact on CARICOM.

Patrick explained that in all models all principles on multi-tax harmonization are reduced to non-discrimination principles even if countries have different tax rates. He explained that in the United States the law provides for the prohibition on states to withhold taxes on transactions across state borders; the determination of jurisdiction to tax and the base of taxation; and the problems of unitary tax and formula allocation, that is, what income should be included within the tax base (parents and their entire base). Patrick explained that harmonization of taxes in the EC has achieved the most success with respect to indirect taxes. The EC has also been working on harmonizing tax rates, first in bands in normal transactions. Among the issues are: how to collect such taxes; the point of origin; and the place of the transaction. According to Patrick, the variation of integration between corporations and shareholders on dividends has made cross border mergers difficult and has impeded tax harmonization. Patrick explained that the EC has recently approved three directives: intercompany suppression of dividend withholding, phased in for Germany; deferral of gains for intercompany mergers and the allowance of consolidated returns; and arbitration of double tax disputes. Difficulty remains on arm's length pricing and where expenses should be borne. As to external policy, Patrick explained that there is coordination of policy and where expenses should be borne. An open issue is whether the EC will be able to negotiate a single income tax treaty with non-EC countries. Patrick explained that at present imputation systems prevent and will continue to prevent achievement of this goal for some time.

On developments in the United States and OECD countries on outbound investment, Patrick stated that the focus has been on the single European market and Eastern Europe. A growth of anti-tax haven provisions has occurred, with eight countries adopting subpart F-type provisions. There is a discernible trend towards increased compliance on intercompany pricing, especially where a tax haven intermediary is involved. Increased emphasis has been placed on compliance in the taxation of technology outflow and on increased record-keeping requirements and the designation of affiliates to receive summons, and on the imposition of harsh penalties for understating tax. Patrick explained that the latter provision was close to a non-tariff barrier on trade. However, the United States and other countries have endorsed exemptions in tax havens for operations consisting of active conduct of trade or business. Patrick noted that there is a remarkable amount of joint venture activity. Hence, a growing interest and practical use of partnership ventures has occurred. With respect to tax treaty policy, the United States has made progress in concluding treaties with developing countries. Although the United States has locked itself into a position of not allowing tax sparing provisions, maintenance of this position will not be practical within the next five years.

Barbados

On 3 November Bruce Zagaris, Oppenheimer Wolff & Donnelly, Washington, D.C., discussed "The Potential Role of Barbados in Strengthening Tax Policy and Tax Administration in CARICOM". Zagaris explained that Barbados has both the potential and the responsibility to play a significant role in strengthening tax policy and tax administration in the Caribbean due to its pivotal role in the development of Caribbean integration, the strength of its Central Bank, the relative success of its macroeconomic and tax policy within the Caribbean and the location of regional institutions in the Caribbean, such as the Caribbean Development Bank, the University of the West Indies, the Caribbean Financial Services Corporation and the excellent quality of its professionals.

After providing an overview of tax administration in developing countries, Zagaris explained that a trend exists for developing countries, such as Mexico and Brazil, emulating the United States and other developed countries, to seek more aggressively revenue from foreign investors as well as from their own citizens and residents who have taken money out of the country. In this regard, developing tax authorities realize that the United States has a reservoir of tax information and a pool of knowledge on conducting financial investigations. As a result, foreign tax authorities have concluded tax information exchange agreements with the United States and participated in financial investigation training courses.

According to Zagaris, the regionalization of tax administration is in its infancy. One of the principal organizations for regional tax administration is the Inter-American Center for Administrators (CIAT), which has its headquarters in Panama. Three CARICOM countries (Barbados, Trinidad & Tobago and Jamaica) as well as Bermuda are members. The principal subregional organizations for tax adminstration in the Caribbean are the Caribbean Organization of Tax Administrators (COTA) and the Secretariat of the Caribbean Common Market and Community. Training and improvements in tax administration (e.g. Automated Data Processing) in the Caribbean are sometimes funded by technical assistance grants from the United States and the Inter-American Development Bank. Another training mechanism has been the office of Tax Administration Advisory Services (TAAS) which has been providing overseas advisory assistance programmes since 1963. Two types of technical assistance are offered: a general comprehensive assistance and a more limited specialized assistance. It provides training for middle management, including a financial investigative course. The latter teaches, inter alia, financial interviewing, indirect methods of tracing funds and effective communications. The course is particularly of use to persons working in criminal investigation and examination. Jamaica and other Caribbean countries have attended these courses. Zagaris explained that a major initiative to improve tax administration is to provide a regional training centre, similar to the one started for Latin American tax administrators in Venezuela that the Inter-American Development Bank has funded.

The high degree of politicization of tax policy will limit the extent of inclusion of tax policy in future integration. However, Zagaris stated that the success in partly including tax policy in European integration presages some utilization of tax policy and regional integration in the Caribbean. Another means whereby Barbados can assist the region is to create a Caribbean Institute for Services within the University of the West Indies. The Institute would have a particularly strong component on financial services within which tax policy would be strong. The Institute could utilize the University of the West Indies Extramural Departments to provide programmes throughout the Caribbean. While it would offer diploma programmes, it would also serve as a research and development arm. It would hold seminars and sponsor research and internships. It would recognize and honour students and professionals who, through their hard work and excellence, make outstanding contributions to national and regional tax policy. It would hold specialist programmes and invite experts when necessary. The Institute's goal will be to involve the mass of the citizens in shaping and implementing tax policy. The Institute would have a conference arm and a newsletter to inform and solicit ideas from individuals worldwide. Zagaris stated that the Caribbean Law Institute and the IFA Barbados branch, the two sponsors of the programme, could play a role in facilitating the discussions and in establishing an Institute and other organizations and policies. Zagaris urged the private sector to become involved in tax policy, since in a democratic and free enterprise society the private sector must bear a significant share of the burden of research and development and marketing.

Non-tax treaties

Stephen Gray, Oppenheimer Wolff & Donnelly, Washington, D.C., discussed "The Use of Non-Tax Treaties for Encouraging Investment and Economic Development". The written paper explained that bilateral investment agreements (BITs) can play a complementary role to income tax treaties in attracting investment. They provide national and most favoured nation treatment in a number of investment areas outside of taxation, such as allowing investors to bring individuals of their choice from whatever countries desired. BITs will also be utilized in connection with the Enterprise for Americas Initiative. In connection with the Initiative, the United States will likely conclude a framework agreement with CARICOM or some members of CARICOM. The determination on whether to have one regional framework agreement or a series of bilateral agreements may depend on the nature of any initiative from the region. Mr. Gray then highlighted various financial products that Caribbean countries could utilize to attract investors (i.e. investors' visas, mutual funds, offshore protection of asset trusts).

Summary and conclusion

The programme was innovative in that CARICOM is in the midst of an accelerated economic integration programme and is just beginning to grapple even conceptually with the future of tax issues in the proposed economic integration. The programme raised many questions and identified issues. Few dispositive answers were given, but this was not the expected outcome. In fact, there was realization that in economic integration, especially in the stage and circumstances of the Caribbean, there are many answers and potential tax roads to take, depending on the economic integration decisions that are chosen. The enthusiasm displayed by the participants and the size of the attendance will undoubtedly mean that IFA and the Caribbean Law Institute, in cooperation with CARICOM and the OECS, are likely to continue to facilitate the discussion.

IFA NEWS

INTERNATIONAL FISCAL ASSOCIATION

SINGAPORE BRANCH

The Singapore branch recently announced its 1991 programme, which will consist of regular meetings with talks given by prominent speakers and leaders of the business community. An informal dinner will generally follow the meeting. The 1991 programme may be supplemented by additional lectures on topical items as the need and opportunity arises. In addition, two "members only" Tax Tidbit lunches will be scheduled throughout the year to allow members to share with each other interesting and current information on their tax practice.

The following topics are planned for 1991:

The possible impact of the current GATT negotiations on investments into Singapore, with particular emphasis on the fiscal and financial incentive regime – Panel Discussion	20 March
Singapore Branch reports for 1991 Barcelona IFA Congress – The Determination of Tax Base for Real Property – Protection of Confidential Information in Tax Matters	9 May
Labuan as an Offshore Business Centre – An Update on the Latest Developments	10 July
Singapore Branch Reports for 1992 – Transfer Pricing in the Absence of Comparable Market Prices – Income Tax Consequences of Internal Acquisitions – Panel Discussion	16 September
Singapore-Malaysia-Indonesia Growth Triangle	23 October
Annual General Meeting	20 November

INTERNATIONAL:

THE USE OF NON-TAX TREATIES FOR ENCOURAGING INVESTMENT AND ECONOMIC DEVELOPMENT

David A. Gantz*

This paper was presented during the seminar on the CARICOM tax treaty and tax issues within CARICOM, held on 2-3 November 1990.

In recent years, the inter-relationship between international tax issues, and other international issues facing lawyers, particularly issues relating to investment, has intensified. No international tax attorney can thrive without having a clear understanding of how international rules and agreements affecting investment may impact on his client's interests. In recognition of this fact, this article will address the impact of non-tax treaties on investment and economic development.

In doing so, I intend to focus on bilateral agreements between the United States and the Caribbean nations, and on the U.S. "Enterprise for the Americas" Initiative. Historically, these treaties have had significant tax implications even when this was not their primary purpose. Similar results may be anticipated from the agreements concluded under the Initiative.

We should also keep in mind the particularly significant impact of unilateral measures of such governments as the United States designed to encourage investment in the region, such as the Caribbean Basin Economic Recovery Expansion Act of 1990. The Act, a permanent extension of the Caribbean Basin Initiative ("CBI") about which there has been much discussion in recent years, provides duty-free or duty-reduced entry for many products into the U.S. market, as well as benefits for tourism and education.[1] While not guaranteed by international agreement, the CBI may nevertheless have some favourable impact on investment and trade in the region, despite the unfortunate exclusion of coverage of such potentially important export products as textiles and apparel, footwear, handbags, luggage, petroleum or petroleum products, watches or watch parts, processed tuna, sugar and beef products.[2]

In this article, I will discuss past and current bilateral agreements relating to investment, as well as the new possibilities raised in the U.S. Enterprise for the Americas Initiative and how those arrangements could assist nations such as Barbados in encouraging U.S. and third-country investment.

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I. FRIENDSHIP, COMMERCE AND NAVIGATION TREATIES

Traditionally, the United States and, to a lesser extent other developed countries, particularly in Europe, have sought to conclude bilateral treaties designed to facilitate and protect investment in the developing world. The United States, for example, concluded more than 60 "friendship, commerce and navigation" ("FCN") treaties between 1815 and the late 1960s, of which almost 48 remain in force,[3] but none have been concluded with the nations of the Caribbean. These agreements have provided in varying degree of specificity and comprehensiveness for the protection of citizens and companies of one party doing business or residing in the territory of the other. Typically, they have focused on treatment of individuals, including consular access, visas, the right to own property, "national treatment" for the establishment of trade or business, and freedom of travel. In some cases, such as the United States treaty with Iran,[4] arbitration or other binding dispute settlement mechanisms were included.

Most of the U.S. FCN treaties pre-date the series of post-World War II bilateral income tax treaties entered into by the United States. Nevertheless, non-discrimination provisions in these FCN treaties, although not specifically intended for tax purposes, may nevertheless provide important benefits for countries that do not have tax treaties with the United States. For example, the Convention of Establishment between the United States and France, concluded 25 November 1949, contains a non-discrimination provision that is considerably broader than those in most current tax treaties.[5]

* Reid & Priest, Washington, D.C., practicing in the areas of international law and international trade.

1. 19 U.S.C. §2701 et. seq., P.L. 101-382, 101st Cong., 2nd Sess., 20 August 1990.
2. 19 U.S.C. § 2703(b).
3. See 20 I.L.M. 565 (1980) for a current list.
4. Treaty of Amity, Economic Relations and Consular Rights of 15 August 1955, 8 U.S.T. 899, T.I.A.S. No. 3853, 284 U.N.T.S. 93.
5. 11 U.S.T. 2398, T.I.A.S. No. 4625, Art. IX(4).

In most circumstances, the non-discrimination clause stipulates that citizens or nationals of one country resident in the other country may not be subjected to local taxation that is different from or more burdensome than the tax and related requirements to which citizens or nationals of the host country are subjected under the same circumstances. (What constitutes the same or similar circumstances may be open to dispute. The United States has taken the position that a non-resident alien is not in circumstances similar to that of a U.S. citizen or permanent resident, since the latter is taxable on his worldwide income in the United States, while the former is taxable only on his U.S.-source income). Arguably, the term "citizen or national" is sufficiently broad to cover corporate entities.

Among the important provisions of most FCN treaties are those which have allowed investors or traders special immigration status, the so-called "treaty trader" and "treaty investor" E-1 and E-2 visas, which as non-immigrant visas nevertheless greatly facilitate the entry of individuals and corporate employees for commercial activities within the United States, often for extended periods of time.

As a means of fostering and protecting investment, FCNs were less than ideal. The desire of the United States to cover consular relations and personal rights in some instances detracted from any focus on corporate commercial activities. After World War II, growing concerns in developing countries, and in capital-importing developed countries such as Canada and Australia, over unrestricted access to foreign investment reduced the attractiveness of the FCNs for those nations. The entry into force of the Geneva Convention on Consular Relations of 1962 provided a broad, binding international framework for protection of individual citizens that in the past could be assured only through bilateral agreements. Consequently, in the early 1970s the United States abandoned further efforts to negotiate FCNs.

II. BILATERAL INVESTMENT TREATIES ("BIT")

It was the major European nations, not the United States, that first developed the concept of a bilateral treaty confined to investment-related issues, such as treatment standards, expropriation, currency conversion rights and mandatory dispute settlement. From 1959 to 1988, the European nations, led by the Federal Republic of Germany, Switzerland and the United Kingdom, concluded more than 250 bilateral treaties, approximately 30 of which involved nations of Latin America and the Caribbean, including but not limited to former colonies.[6] (Japan and other Asian capital-exporting countries have only recently shown interest in BITs. I am aware of no Japanese BITs actually in force, and of only one Korean BIT with a developing country, i.e. Sri Lanka.)

By the mid-1970s the State Department's office of the Legal Adviser, which had responsibility, *inter alia,* for investment protection and expropriation matters, saw the BIT as a means of reaching agreement on a country-by-country basis on rules governing and protecting foreign investment.[7] Frustration with multilateral efforts through the United Nations, UNCTAD, the Organization of American States and other fora undoubtedly contributed to this policy decision.

Since that time the United States has engaged in the negotiation of several dozen of these agreements, of which eight have entered into force, i.e. agreements with Senegal, Zaire, Morocco, Turkey, Cameroon, Bangladesh, Egypt and Grenada.[8] Treaties have been negotiated and signed between the United States and Panama (1982), and the United States and Haiti (1983), but for political reasons have not been submitted for ratification to the United States Senate.

To date, only three BITs have been signed by the United States with the nations of Latin America and the Caribbean, Grenada, Haiti and Panama. In part the reason for this is the United States' insistence in including provisions for binding arbitration for the settlement of investment disputes, usually through the World Bank-sponsored International Center for the Settlement of Investment Disputes ("ICSID").[9] "Calvo" Clause[10] concerns among the Latin American nations, which preclude the settlement of such disputes except under the jurisdiction of the host country's courts, have meant that the vast majority of BITs concluded by the United States and the European nations have been concluded with countries other than those of Latin America.

European nations have had more success, in part because of greater flexibility on dispute settlement provisions. Apparently a political decision was made to accept less stringent rules in exchange for the more extensive coverage possible with that approach. The United Kingdom has BITs with 11 Latin American and Caribbean nations, including Belize, St. Lucia, Jamaica, Dominica, Antigua and Barbuda and Grenada. The Federal Republic of Germany has nine such agreements, including BITs with Dominica, St. Lucia, St. Vincent and the Grenadines. Barbados and Trinidad & Tobago have apparently concluded no BITs.

U.S. policy continues to favour the conclusion of BITs both to protect U.S. investment and to foster the economic development such investment brings. Currently, U.S. Government officials are engaged in the negotiation of BITs with Uruguay, Argentina, Bolivia, Nigeria, Togo, Czechoslovakia and Yugoslavia. An agreement was recently signed with Poland. Negotiations with Hungary will commence in the near future. While from time to time the issue of a BIT with Jamaica has been discussed, there have been no negotiations.

The U.S. BIT, as reflected in the 1984 "model" treaty, is designed to further certain mutual objectives relating to investment. The most important objectives for the United States are the following:

(a) conditions of entry for foreign investment and rules of treatment, particularly "most favoured nation" or "national" treatment and protection against performance requirements;
(b) convertibility of currency guaranties;
(c) protection against expropriation;
(d) compulsory dispute settlement through international mechanisms.

It is important to note that while these agreements are clearly designed to facilitate the investment of developed

6. For a listing of BITs concluded between 1959 and 1988, see A.J. Pappas, "References on Bilateral Investment Treaties", 4 *ICSID Rev.* (1989), at 189, 194.

7. See K.S. Gudgeon, "United States Bilateral Investment Treaties: Comments on Their Origin, Purposes, and General Treatment Standards", 4 *Int'l Tax & Bus. Lawyer* (1986), at 105, 108.

8. See J.W. Salacuse, "BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries," 24 *Int'l L.* (1990), at 655, 658.

9. Convention on the Settlement of Ivestment Disputes Between States and Nationals of Other States, signed 18 March 1965. 575 U.N.T.S. 159. As of 1 January 1989, 89 nations had become party to the Convention.

10. A Calvo Clause is a provision frequently inserted in contracts between the nationals of a foreign state and nationals or the government of the host country – chiefly in Latin America – in which the foreign national agrees that any claim or dispute arising under the contract shall be disposed of by the local court, and shall not be the subject of diplomatic intervention. In some instances, the Calvo Clause is inserted in the contract as a requirement of the law or constitution of the host country.

country nationals in developed countries, they are reciprocal, and afford the same protection to developing country nationals (including national companies) that invest in the United States.

The 1984 model BIT is currently in a state of evolution, but there is no new model as such. With Eastern European countries, for example, new issues arise with regard to debt problems and state-owned enterprises; with Uruguay and Argentina, U.S. officials are continuing efforts to find a solution to Calvo Clause problems.

Virtually all U.S. BITs provide national treatment for the "investments" of one party in the territory of the other. While this national treatment requirement does not apply specifically to taxation, it is evident that tax treatment must necessarily be included in order to give any national treatment provision significance. To our knowledge, the breadth of this provision, and its applicability, have not been tested under any of the eight U.S. BITs currently in force; presumably, the non-discrimination provisions of a tax treaty between the same two parties would govern in the case of ambiguity. However, where there is no tax treaty, or the tax treaty is abrogated, the provisions of the BIT, like those of an FCN treaty, could be useful for tax purposes.

One particularly significant aspect of the model BIT is the inclusion of language similar to that in the FCN treaties providing the "treaty trader" and "treaty investor" immigration status:

> Subject to the laws relating to the entry and sojourn of aliens, nationals of either Party shall be permitted to enter and to remain in the territory of the other Party for the purpose of establishing, developing, administering or advising on the operation of an investment to which they, or a company of the first party that employs them, have committed or are in the process of committing a substantial amount of capital or other resources.

In negotiating these treaties on an individual basis, it may be possible to gain modifications of this language to include employees of eligible companies, whether or not the individuals are *nationals* of the treaty state. For example, the Panamanian BIT provides in Article III(2) that:

> Nationals and companies of either Party, and companies which they own or control, shall be permitted to engage, within the territory of the other Party, top managerial personnel, *regardless of nationality*. Moreover, subject to the employment laws of each Party, nationals and companies of either Party shall be permitted to engage, within the territory of the other Party, professional, technical and managerial personnel of their choice, *regardless of nationality*, for the particular purpose of rendering professional, technical and managerial assistance necessary for the planning and operation of their investment. (Italics added.)

This could be a significant attraction for third country investment in substantial local projects, since the owners of such projects resident in the local jurisdiction (Barbados, for example) would presumably qualify for entry into the United States, even when third country nationals (e.g. Japanese, Korean) are in "top managerial" positions.

The U.S. BIT is not specifically designed to provide a vehicle through which third country investment may enjoy the protection of the treaty simply through the formation of a corporation in a treaty party country. In fact, either party to the model U.S. BIT may deny treatment under the treaty to a company of the other party that does not have "substantial business activities" in the country of incorporation and is controlled by third country nationals. However, this exception would not apply to significant third country investments in one of the parties to the treaty, and could thus be a factor in attracting certain types of foreign investment which are drawn because of the region's proximity to the U.S. market.

This may be an appropriate time for nations of the Caribbean, particularly those which do not have strong Calvo Clause traditions, to re-evaluate the advisability of concluding BITs with the United States and other developed countries. Despite the reputation of countries such as Barbados for constitutional government and an independent judiciary, many foreign investors investing for the long-term are made more comfortable by and indeed may be accustomed to the existence of binding international rules for the treatment of such investment. Moreover, compliance with the requirements of the model BIT in Barbados would presumably require no significant changes in current policies toward foreign investment. (Barbados, Jamaica, Trinidad & Tobago and St. Lucia are all parties to the ICSID Convention.)

Moreover, the conclusion of such a treaty with the United States could be a significant factor in encouraging third country investment into Barbados. With the advent of CBI, much third country investment in the region is focused on trade with the United States. A legitimate third country joint venture located in Barbados, with substantial investment there, would qualify for the protection of the treaty for any investment in the United States. In certain product areas, particularly electronics and footwear, this could be a notable incentive to third country investors – particularly in the Far East – to structuring a trade and investment relationship with the United States through a Barbados joint venture. Moreover, a treaty on investment issues with the United States could have a "spinoff" effect on third country investors from outside the region, who would look at a U.S.-Barbados BIT as a significant indication of a country's dedication to fair treatment of foreign investment.

Similarly, the advent of CBI and the prospect of free trade area relationships with the United States, which are discussed below, make it appropriate for the nations of the Caribbean to consider additional BITs with other major capital exporting countries, particularly in Europe. Duty-free or reduced duty access to the U.S. market for products manufactured in the Caribbean will be a significant incentive for third country investment in the region, investment which will be encouraged if the host country has a BIT with the home country of the investor.

Thus, the decision of one or a few Caribbean nations, such as Barbados, to conclude a series of BITs could give that or those countries a competitive advantage in attracting investment destined for the region. While the existence of a BIT is only one factor in a foreign investment decision, in close cases it could be determinative, particularly given the advantages of a highly literate work force, fluency in English and a stable democratic government.

III. ENTERPRISE FOR THE AMERICAS INITIATIVE

Legislative proposals transmitted by President Bush to Congress in the fall of 1990 will, if enacted, implement a broad programme to encourage and support market-oriented reform and economic growth in Latin America and the Caribbean. The Enterprise for the Americas Initiative contemplates new lending to Latin America to foster market-oriented investment reform; authorization for debt reduction and debt for education and debt for environment "swaps"; and related financial features. It also contemplates a series of free trade agreements with Mexico, the nations of the Caribbean and the nations of Latin America. It is this new initiative to conclude free trade agreements which I believe can be a significant vehicle not only for encouraging trade, but for stimulating investment in a manner complementary to a BIT.

We do not yet know exactly how the United States will proceed to implement the bilateral agreement phase of the Enterprise for the Americas. Clearly, the conclusion of a free trade agreement with Mexico remains the highest priority. Yet it is already obvious that U.S. efforts will not be confined to Mexico. For example, the United States has already concluded agreements with Colombia, Ecuador and Bolivia, in each case to create a "joint commission on trade and investment".[11] These framework agreements are expected to be repeated with Chile, Costa Rica and others.

The councils created under these accords have as their objectives:

(1) To monitor trade and investment relations, to identify opportunities for expanding trade and investment, and to negotiate agreements where appropriate.
(2) To hold consultations on specific trade and investment matters of interest to the Parties.
(3) To identify and work towards the removal of impediments to trade and investment flows. (Article Five)

While the consultation mechanism is not insignificant, these "framework" agreements are an important step toward broader substantive accords, ultimately including free trade agreements, and the Latin American parties to these agreements clearly contemplate further actions in the near future.

Certainly a free trade agreement will provide greater market access on a mutual basis, but what relevance does it have to investment? While we have no accurate model to work from, if we assume that at least some portions of the U.S.–Canada Free Trade Agreement ("FTA") will ultimately be incorporated into subsequent bilateral agreements with Mexico and others, the impact on investment will be both direct and indirect. Chapter 16 of the U.S.–Canada FTA is specifically devoted to investment issues. Like the BITs, it provides for national treatment; limitations on any performance requirements; protection against expropriation; guaranties for international funds transfers; and an arbitral mechanism for resolving investment disputes.[12] (The U.S.–Israel Agreement on the Establishment of a Free Trade Area, concluded in 1985, contains limitations on performance requirements and dispute settlement provisions, but no other provisions governing investment.)

Indirectly of course, any free trade agreement between the United States and a developing country should promote investment in the developing country by offering unrestricted access to the U.S. market. Presumably, there will be few if any exceptions to the products ultimately eligible for free trade. With the U.S.–Canada FTA, many products became duty-free upon the FTA's entry into force on 1 January 1989; tariffs on other products are being phased out over five years or ten years. Moreover, with Mexico and other developing nations, unlike Canada, labour cost differentials are such that significant shifts of manufacturing capacity can be anticipated, creating investments and jobs in the lower-cost labour jurisdiction. The advantages for investment purposes will accrue to any investor prepared to establish manufacturing facilities with the objective of serving the U.S. market, not simply to U.S. investors. Of course, the free trade agreements will contain rules of origin – probably similar to those under the CBI or U.S. Generalized System of Preferences programmes, which require a 35 percent local (or regional) value added before a product can enjoy the benefits of the FTA.

Thus, I believe that the nations of Latin America and the Caribbean should view the prospect of a free trade agreement with the United States as an investment encouragement as well as a trade encouragement vehicle. Such agreements are, of course, fully consistent with the BITs discussed earlier. As noted above, at least one Latin American country, Bolivia, that has signed a framework agreement, is also actively negotiating a BIT with the United States. U.S. officials continue to view BITs as consistent with the objectives of the Enterprise for the Americas Initiative, and can be expected to be responsive to requests from Latin American and Caribbean governments to include BITs among the agreements to be concluded under that umbrella.

To the best of our knowledge, there is to date no formal U.S. Government policy regarding U.S. Government preference for concluding a framework agreement and FTA with CARICOM, or with one or more individual members, such as Barbados. State Department officials see advantages and disadvantages in both approaches. Such agreements are likely to be concluded more rapidly with individual countries, and could be tailored to discrete country concerns more effectively, if they are done on a bilateral basis. On the other hand, an agreement with CARICOM could provide an important stimulus to regional economic development, and might require less personnel resources than a series of individual country negotiations. In the end, the approach is likely to be more dependent on the nature of any initiative from the region, since the Caribbean does not appear to be a high priority area for the United States in terms of concluding additional framework agreements and moving toward free trade agreements.

IV. CONCLUSION

Given the demise of friendship, commerce and navigation treaties, bilateral investment treaties are highly useful mechanisms to attract investment, offering both tax and non-tax incentives to nationals of the treaty country and, in many instances, to third country nationals willing to establish joint ventures in countries such as Barbados with an eye to further activities in the United States. The conclusion of a BIT with the United States and with other capital- exporting nations could give Barbados a competitive advantage in competing for regional investment dollars. The United States is actively negotiating such agreements with other countries in the hemisphere, and could probably be induced to include Barbados and/or neighbouring countries.

The U.S. Enterprise for the Americas Initiative similarly offers Barbados and other Caribbean nations an opportunity to demonstrate a commitment to economic development and greater economic integration with the United States that should itself be an incentive for foreign investment. Given the favourable state of U.S.–Barbados relations, it is likely that a request by Barbados to negotiate a framework agreement, such as those concluded by the United States with Chile, Bolivia and Ecuador, would be favourably received. While such an agreement would not obligate Barbados (or the United States) to move further toward economic integration, it would give Barbados a basis for further steps at the appropriate time, including the conclusion of a BIT.

11. Agreement between the Government of the United States of America and the Government of Colombia Concerning a United States–Colombia Joint Commission on Trade and Investment, signed 17 July 1990; Agreement Between the Government of the United States of America and the Government of the Republic of Ecuador Concerning a United States–Ecuador Council on Trade and Investment, signed 23 July 1990; Agreement Between the Government of the United States of America and the Government of the Republic of Bolivia Concerning a United States–Bolivia Council on Trade and Investment, signed 8 May 1990.

12. United States–Canada Free Trade Agreement of 1988, Chapter Sixteen, Arts. 1602, 1603, 1605, 1606, 1608.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1991 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

ASIA & THE PACIFIC

Asia

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Conference, Singapore 26-27 November 1990. Organised by Asian-Pacific Tax and Investment Research Centre (APTIRC). "Practical problems of International Taxation".
Singapore, Asian-Pacific Tax and Investment Research Centre, 1990, pp. 200.
Printed text of lectures on topics covering double taxation agreements in the OECD member countries; management fees, royalties and withholding taxes in Malaysia, Singapore and Australia; U.S. foreign tax credit legislation; Singapore operational headquarters.
(B. 57.555)

BANKING IN THE FAR EAST, 1990.
Structures and sources of finance. Edited by Anne Hendrie.
London, Financial Times Business Information, 1990, pp. 330.
Revised and updated edition covering the latest important developments in the Far East. The operation, supervision and regulation of the financial system of each of the 12 leading economies in the Pacific region are explained in depth, together with the laws governing the establishment of new businesses. The Report includes up-to-date statistics, a directory of banks in each country with addresses, telephone, telex and fax numbers; revised appendices on business organization, covering legal forms, taxation and exchange controls; and, for the first time, a chapter on Taiwan.
(B. 57.542)

Australia

TAXPAYER 1990 TAX SUMMARY.
Melbourne, Australian Taxpayers' Associations, 1990, pp. 1230.
This 1990 annual publication is designed to provide, in a comprehensive but concise form, the major points of the various taxes levied by the Commonwealth and the States (corporate income tax, individual income tax, fringe benefits tax, sales tax, stamp duties, land tax). Superannuation funds are also dealt with.
(B. 57.535)

AUSTRALASIAN TAX REPORTS.
Volume 20.
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North Ryde, Butterworths Pty Ltd., 1990, pp. 1200.
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(B. 57.562)

Japan

GOMI, Yuji.
Guide to Japanese Taxes 1990/91.
North Ryde, CCH Australia Limited, 1990, pp. 342.
This 1990/91 guide to Japanese taxes provides practical and up-to-date information on Japanese national and local taxes for those doing business in or with that country. It examines the basic structure of Japanese income taxation; withholding income tax; assessment income tax on individuals; consumption tax; corporation tax; and inheritance and gift tax.
(B. 57.530)

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HARRIS, Garth A.
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Oxford, Oxford University Press, Walton Street, Oxford OX2 6DP, England, 1990, pp. 456, 35.- £.
Authoritative guide to the New Zealand taxation system, its rules for taxing income received from overseas by New Zealand residents and for taxing income received from New Zealand by overseas residents.
Considerations are made to residence and territorial source of income. It also devotes a section to the anti-avoidance measures in New Zealand law and in its treaties. The law is stated as of 1 December 1989, with reference to provisions of the Tax Reform Bill (No. 6), 1989.
(B. 57.548)

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(B. 57.559)

Papua New Guinea

McGAVIN, P.A.
Enterprise Human Capital Formation. Papua New Guinea Case Studies and Policy Issues.
Port Moresby, INA – Institute of National Affairs, 1990.
INA Discussion Paper No. 43, pp. 136.
(B. 57.561)

EUROPE

FINANCIAL REPORTING BY THE
European Oil Industry.
London, Arthur Andersen & Co., 1990, pp. 90.
Survey of a study to enhance accounting policies and disclosures in the annual accounts of oil and gas companies in Europe.
(B. 110.577)

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DEIBL, Maria.
Sind Sie ein idealer Chef? Führungswissen – Führungsproblematik. 2. Auflage.
Vienne, Industrieverlag Peter Linde, 1990, pp. 154, 278.- AS.
Are you the ideal boss? The book contains various hints on how to deal with people in your firm, how employees are motivated, how they are stimulated, how to solve conflicts, regulations in the workplace.
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CARLIER, A.M.
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Monograph considering the social security contributions payable by employers, employees and free professionals.
(B. 110.371)

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Cyprus

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(B. 110.641)

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Certain member states of the EC include regions which do not form part of continental Europe. In terms of their specific characteristics (e.g. remoteness, small size, deficient economic structure and low levels of development) these regions differ markedly from the rest of the Community. Madeira and the Azores are one such region and the EC Commission has recently issued a proposal to establish a programme of options specifically geared to the specific characteristics of these islands.

TAX POLICY FOR BULGARIA 235 *Charles E. McLure, Jr.*

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CONTRIBUTION OF ARTICLES TO THE *BULLETIN*

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The editor will consider for publication manuscripts by contributors from any country. Manuscripts will be subject to a review procedure and accepted manuscripts will be edited to improve the general effectiveness of communication.

Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

The author should submit biographical data, including his or her current affiliation.

JAPAN:

A SURVEY OF THE FOREIGN TAX CREDIT SYSTEM

Tom Anderson

Tax advisors in many countries have developed strategies to minimize the taxation of Japanese businesses operating in their home countries. However, effective planning often requires an understanding of the Japanese foreign tax credit system.

The purpose of this article is to outline the Japanese foreign tax credit system as it applies to the income derived from investments and business operations in the United States and Europe. Certain areas, such as tax haven rules and tax sparing, are not addressed.

Tom Anderson is a manager with Ernst & Young & Co. based in New York, specializing in international taxation with a specific interest in Japanese taxation. The author gratefully acknowledges the assistance of Ms. Yukie Kuwahara, a manager in the Tokyo office of Ernst & Young.

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I. GENERAL STRUCTURE

Essentially the worldwide income of Japanese corporations is subject to taxation with credit relief for foreign taxes imposed on foreign-source income. The general rule is that a credit can be taken against the Japanese corporate tax in the amount of the lesser of (1) the actual creditable foreign taxes incurred; or (2) an overall limitation as calculated under the following standard formula:

$$\text{Limitation} = \text{Japanese corporate tax} \times \frac{\text{foreign-source income}^{1}}{\text{worldwide income}}$$

Japanese corporate tax under the above limitation formula is calculated as follows:

Corporate tax due (before credits)	xxxx
Minus:	
The special surtax on sales of land held short term	xxxx
The accumulated earnings tax on earnings retained by closely held "family corporations"	xxxx
Japanese corporate tax	xxxx

Foreign-source income is determined by the set of rules as described in Part III.

Worldwide income is calculated as follows:

Japanese corporate taxable income	xxxx
Plus net operating loss carry-over	xxxx
Worldwide income	xxxx

Until the 1988 tax reform this single "basket" limitation resulted in a large degree of cross-crediting of taxes incurred in high tax countries against Japanese taxes arising from income in low tax countries. The 1988 tax reform contained provisions (described below) to limit cross-crediting other than through the creation of numerous income baskets with the accompanying bookkeeping problems.

Foreign income taxes can be credited against local prefectural and municipal taxes up to 5 percent and 12.3 percent,[2] respectively, of the limitation applicable to the national Japanese corporate tax.[3] However, only a deduction (but no credit) is allowed against the local enterprise tax.

The Japanese corporate taxpayer has the annual option to *deduct* against taxable income, rather than *credit,* foreign taxes. A deduction might be preferable to a credit where a foreign tax credit limitation problem exists. With the exception of indirect foreign taxes (see Part V), the election must be made with respect to all foreign taxes incurred.[4]

1. Corporation Tax Law [hereinafter "CTL"], Art. 69(1); CTL Enforcement Order [hereinafter "Enf. Order"] 142(1).
2. These percentages may vary somewhat according to locality.
3. Local Tax Law Enf. Order, Art. 9(7).
4. CTL Art. 41.

II. CREDITABLE TAXES

A. *General*

The principles set forth in Japanese tax law with respect to the creditability of a foreign tax are similar to those in other systems. To be creditable, the foreign tax should be based on income, not gross revenues or capital, except in the case where gross revenues are used as a tax base for practicality's sake (e.g. withholding taxes on interest, dividends and royalties).

Example

The New York State franchise tax is generally determined to be the greater of:
(1) Net income × 9%
(2) Allocated capital × .178%
(3) Modified net income × 5%
(4) $ 1,500

Only the tax as computed by (1) should be creditable.[5]

A creditable foreign tax includes a levy on a corporation's "excess profits" or a surtax based on a corporate income tax amount. The foreign tax should be a compulsory contribution to a national or local public body without goods or services expected in return. Charges for the late payment of tax, interest charges or penalties do not constitute creditable taxes.[6] Appendix I contains an unofficial listing of foreign taxes eligible for credit.[7] Except with respect to the indirect foreign tax credit (Part V), the Japanese taxpayer must actually pay the foreign income tax.

Example 1

A Japanese oil refining company (J-CO) contracts with a Korean construction company (K-CO) to build an oil refinery for an Indonesian company (I-CO), with respect to which J-CO contributes know-how to K-CO. For its use of the technological know-how provided by J-CO, I-CO pays a royalty to K-CO. K-CO in turn pays an amount to J-CO equal to the payments K-CO receives from I-CO. Withholding taxes imposed on the royalty payments from I-CO to K-CO should not be creditable by J-CO upon its receipt of the net payments from K-CO. The tax authorities would follow the form of the arrangement and treat K-CO as the taxpayer.[8]

Example 2

J-CO owns an interest in a South American corporation (SA-CO). Due to legal restrictions against majority ownership of local corporations by foreign entities, J-CO cannot own a majority interest in SA-CO. However, J-CO effectively obtains a majority interest from an arrangement with a local bank which holds the shares as a nominee while J-CO retains beneficial ownership. J-CO should be able to take direct and indirect foreign tax credits from the dividends paid by SA-CO.[9]

B. *1988 Tax reform*

The 1988 tax reform resulted in some major changes affecting the creditability of foreign taxes, in effect creating modified forms of separate country and income baskets.

For taxable years beginning after 1 April 1989, foreign taxes in excess of 50 percent of taxable income, as computed under the laws of the foreign country, are not creditable.[10] However, the excess portion is deductible. Thus a per country limitation has effectively been established which impedes the cross-crediting of taxes.

Example

J-CO has a branch in the United States whose U.S. taxable income from business operations for the year is $ 100,000, upon which U.S. federal and state corporate income taxes of $ 32,000 are imposed. The effective U.S. tax rate is 32 percent and, since it is less than 50 percent, the special tax limitation would not apply.[11]

A portion of withholding taxes levied on interest income may not be creditable. To determine the amount of withholding taxes on interest income not eligible for credit, a flow chart approach would be useful (see Appendix II).

For businesses other than financial institutions, essentially the following sequence of steps must be followed:

Step 1

A determination should be made as to whether the company's interest income over a three-year period ending with the current tax year exceeds 20 percent times the total of (1) the gross profit, plus (2) interest income over the same three- year period. If the answer is no, the special limitation does not apply.

Step 2

Assuming the answer to Step 1 is yes and the average ratio (RATIO) of the net taxable income (with certain adjustments) to the sum of (1) the gross profit, and (2) non-operating revenue for the year and the two preceding years is ten percent or less, then only ten percent of the interest income is creditable against the regular corporate tax with the excess being deductible against taxable income.

Step 3

If RATIO is greater than ten percent but less than or equal to 20 percent, then up to 15 percent of the withholding taxes on interest from each source is creditable with the excess being deductible.

Step 4

If RATIO is greater than 20 percent, the special limitation does not apply.

For financial institutions, RATIO is (1) taxable income over (2) gross receipts (less the adjusted bases of securities and other assets sold) for the most recent three years.

Example

J-CO has the following results for its taxable year ending on 31 March 1991:

Sales	$ 1,350,000
Cost of sales	(1,130,000)
Gross profit	220,000

5. *Kokusai Zeimu* [hereinafter "*International Taxation*"] (August 1984), at 47.
6. CTL Enf. Order 141.
7. T. Watanabe, *Gaikoku Zeigaku Kojo* [hereinafter "Watanabe"], (Tokyo: Do-bun-kan, 1988).
8. *International Taxation* (January 1986), at 45.
9. *International Taxation* (February 1983), at 48.
10. CTL Enf. Order 142(3).
11. *International Taxation* (October 1989), at 22.

Selling and administrative expenses	(172,000)
Non-operating income	63,800
Non-operating expenses	(40,000)
Net income	71,800
Corporate taxes	35,000

J-CO receives interest income from the United States and Puerto Rico:

	$	¥	$	¥
United States	200,000	25,000,000	20,000	2,500,000
Puerto Rico	120,000	15,000,000	34,800	4,350,000

For years one, two and three J-CO has the following results (in thousands of yen):

	Year 1	Year 2	Year 3	Totals
Gross sales	930	1,070	1,350	
Cost of sales	800	900	1,130	
Gross profit	130	170	220	520
Interest received	80	100	77	257
Dividends received	1	1	1	3
Gains from the sale of securities	–	–	1	1
Net income	211	271	299	781
Taxable income	15	30	77	122
Dividends received deduction	1	1	1	3
Income taxes deducted	1	2	5	8
Foreign taxes deducted	7	4	10	21
Adjusted taxable income (numerator of RATIO)				154

Step 1

Since interest income exceeds 20 percent times the sum of interest income plus gross profit, the limitation might apply.

257/(257 + 520) = 33%

Step 2

Average ratio of the net adjusted taxable income to the sum of the gross profit and non-operating revenue in the business year concerned and the two preceding years was 19.7 percent (154/781). Therefore, only withholding taxes of up to 15 percent of each amount of interest income can be credited.

Step 3

Test each source of interest income:
U.S.: $ 20,000 < ($ 200,000 × 15%). Therefore, there is no limitation.

Puerto Rico: $ 34,800 > ($ 120,000 × 15%). Therefore only a limited portion (¥ 2,250,000) would be creditable:

Creditable: $ 120,000 × 15% = $ 18,000 (¥ 2,250,000)
Deductible: ($ 34,800 – 18,000) = $ 16,800 (¥ 2,100,000)[12]

The foregoing provisions are effective for withholding taxes paid after 31 March 1989. However, interest income received on obligations outstanding before 1 April 1989 is not subject to the new provisions until taxable years beginning after 31 March 1994.

C. *Currency translation*

The method of translating creditable foreign taxes into yen depends on various factors:

– Normally the exchange rate used for foreign taxes levied through withholding is the same as that used to translate the underlying interest, dividend or royalty income. Where interest or royalty income is accrued over two periods, the applicable rate is that which prevails at the time of payment of the withholding tax.

– The applicable exchange rate for foreign taxes directly paid from Japan is that used for translating expenses. However, except when the actual cash payment is greatly delayed, the rate applicable on the day of remittance can be used.

– The exchange rate for foreign taxes paid by a foreign branch is that used for translating the branch's items of income and expenses on the intra-company statement of income.

– The rate applicable to refunds is that which prevails on the date of the refund rather than the original date of payment of the taxes.[13]

III. SOURCING OF INCOME AND EXPENSES[14]

A. *Income sourcing rules*

In principle, foreign-source income is determined by first defining domestic-source income[15] and then subtracting that amount from total income.[16] The domestic sourcing rules are superseded by sourcing rules provided in income tax treaties.[17]

Japanese corporate tax law explicitly provides for 11 categories of domestic-source income.[18]

Category 1

Income from business in Japan or the use, possession or transfer of assets located in Japan.

For foreign tax credit purposes, income from sales of inventory property will be foreign sourced if the sale is attributable to a foreign place of business. However, if the sale is subject to foreign taxation, the taxpayer can elect to treat the income as being foreign sourced.[19]

Here as elsewhere, the domestic source rules may be superseded by treaty provisions. For example, the Japan–Korea income tax treaty provides that where goods are purchased or manufactured in one country and sold in another country, and where the resident of one country has a permanent establishment in the other country, the sourcing of income should be divided between the two countries, regardless of the place of sale.[20]

If a company manufactures a product in Japan and sells it overseas or vice versa, the general rule is that the income should be apportioned between foreign and Japanese sources on an arm's length basis.[21] Arm's length should be

12. *Id.*, at 23.
13. CTL Basic Circular 16-3-42 and 16-3-43.
14. See also Huston, Miyatake, and Way, *Japanese International Taxation*, Chapter 3 (New York: Matthew Bender, 1989).
15. CTL Art. 138.
16. CTL Enf. Order 142(3).
17. CTL Art. 139.
18. CTL Art. 138.
19. CTL Enf. Order 142(4).
20. Japan–Korea Income Tax Treaty, Art. 6(5); Exchange of Notes, 3 March 1970.
21. CTL Basic Tax Circular 20-1-3.

determined by using the normal methods used for transfer pricing purposes (e.g. uncontrolled price, resale price or cost plus profit).[22] However, if none of the normal methods are feasible, another method should be used which is based upon a reasonable measure such as the relative domestic vs. foreign:

- manufacturing and selling costs;
- asset values;
- other suitable measure based upon an analysis of the nature of the businesses.[23]

Capital gains and losses from the sale outside of Japan of shares in a foreign corporation are deemed to be foreign source. However, the sale of shares in a Japanese corporation may be deemed to be domestic source regardless of the place of sale, such as where the seller has a significant interest in the corporation.[24]

Other Japanese-source income results from the disposal of the following:

- real estate located in Japan;
- ships and planes registered in Japan;
- debt obligations connected with business carried on in Japan;
- goodwill related to business carried on in Japan.[25]

Category 2

Consideration for services rendered in Japan by persons such as actors, entertainers, professionals, scientists and technicians.

Category 3

Lease payments for the use of real property located in Japan.

Category 4

Interest on debt securities issued by governmental bodies, corporate debentures, certain deposits and distributions of interest income from certain trusts associated with activities in Japan.

Category 5

Dividends from a Japanese corporation.

Category 6

Interest on non-securitized loans attributable to business in Japan.

Example 1

J-CO has a permanent establishment branch in the United States which borrows money for its operations and pays interest which is expensed on its books. The interest would be deemed to be foreign source as long as it is not simply being artificially routed through the United States.[26]

Example 2

J-CO has an eight percent interest in a U.S. corporation (US-CO), which in turn has branch operations throughout the world, including Japan. J-CO receives interest from a loan to US-CO. In its calculation of Japanese taxable income, the Japanese branch of US-CO is allocated approximately ten percent of the total interest expense incurred by the head office of US-CO. Under Japanese domestic law ten percent of the interest income received by J-CO from US-CO would be Japanese domestic-source income. However, the interest received by J-CO should be considered to be foreign source due to the relevant treaty provisions on income sourcing which provide that interest income should be sourced according to the residency of the payor (rather than the location where the loan proceeds are used) unless such interest is directly attributable to a permanent establishment.[27]

Category 7

Royalties from the use of intangible property and personal property in Japan.

The provisions of certain treaties follow those of the domestic law (i.e. place of usage of the intangible asset).[28] However, the provisions of other treaties (e.g. Federal Republic of Germany, the United Kingdom, Singapore) call for the sourcing of royalties to be based on the residency of the payor.[29]

Category 8

Awards connected with advertising and publicity carried on in Japan.

Category 9

Commercial annuity payments attributable to a place of business in Japan.

Category 10

Income arising from certain financial products attributable to a place of business in Japan.

Category 11

Income arising from a *tokumei kumiai* (i.e. a Japanese silent partnership) contract where the number of *tokumei kumiai* members equals or exceeds ten. If the number of members is less than ten, the income of a *tokumei kumiai* is treated as business income (Category 1).

Example

J-CO, along with about 30 other companies, enters into an agreement with a U.S. mining company (US-CO), which provides that J-CO finance 2.3 percent of the costs of a natural gas production project to be undertaken by US-CO. J-CO's return on investment is based on the profits of the venture and a ten percent U.S. withholding tax is imposed upon the distributions to J-CO. If the venture fails, J-CO's losses would be limited to the amount of its investment. The income J-CO receives from the venture would correspond to income from a *tokumei kumiai* and as such should be foreign sourced.[30]

B. *Expense sourcing rules*

For the purposes of sourcing, expenses can be divided into two basic categories:

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22. Watanabe, *supra* note 7, at 63.
23. CTL Basic Tax Circular 2-1-4.
24. CTL Enf. Order 187.
25. CTL Enf. Orders 142(3), 177(2), 187(1) and CTL Basic Tax Circular 20-1-9.
26. U.S.–Japan Income Tax Treaty, Art. 6(2); CTL Enf. Order 176(3); *International Taxation* (March 1983), at 39.
27. *International Taxation* (October 1983), at 39; U.S.–Japan Income Tax Treaty, Art. 6(2).
28. U.S.–Japan Income Tax Treaty, Art. 6(3).
29. CTL Art. 139; *International Taxation* (April 1983), at 41.
30. *International Taxation* (February 1984), at 48.

1. Expenses directly associated with a specific item of income (e.g. cost of goods sold or expenses related to real estate income such as property taxes, insurance costs) should be sourced based on the source of the related income.[31]

2. Expenses which cannot be directly associated with a specific item of income (e.g. certain general and administrative expenses) should be sourced on a separate expense-by-expense item basis, based on factors such as the relative domestic vs. foreign:
(1) gross income amounts;
(2) property values;
(3) number of employees; or
(4) other "reasonable" method.[32]

Expense items are often allocated according to gross income.[33]

Interest which can be directly traced to a borrowing for funds used to generate foreign-source income should be deemed to be foreign source. Thus, for example, if a Japanese home office borrows funds in connection with a specific transaction generating foreign-source income, the interest expense should be offset against foreign-source income.

All other interest ("common interest") should be allocated by formula. With respect to corporations engaged in wholesaling or manufacturing activities, common interest should be offset against foreign-source income according to the following formula:

$$TII \times \frac{FA}{TA}$$

TII = Total indirect interest.
FA = The total tax book value of foreign assets (other than loans or securities not producing income) as of the end of the prior and current period.
TA = The total tax book value of assets as of the end of the prior and current period.

For corporations without a place of business overseas but receiving dividend, interest or royalty income, FA in the above formula would consist only of securities generating foreign-source income.

For banking institutions the formula would be:

$$TII \times \frac{FA}{DEP + \frac{SE - A}{2}}$$

FA = Average foreign loans and securities.
DEP = Average deposits and loans (excluding those relating to direct interest).
SE = Financial statement shareholder's equity at the beginning and end of period.
A = Book value of tangible assets at the beginning and end of period.

The taxpayer may, upon approval of the tax authorities, use a different method of allocating common interest based on such factors as relative foreign to overall gross income, direct expenses, property values and employees.[34]

Special allocation formulas are provided for the following expenses and losses:
- expenses related to the transfer of officers and employees overseas;
- bad debt expense;
- retirement expense reserve;
- overseas investment losses;
- contributions;
- entertainment expenses;
- cost of goods sold by trading companies;
- expenses of international transportation companies;
- expenses connected with the special deduction related to the overseas transfer of technology;
- valuation loss.

C. *1988 Tax reform*

The 1988 tax reform did not make direct changes to the sourcing of income and expense rules. However, statutory language provides that for taxable years beginning after 1 April 1989, foreign-source income should be limited to the greatest of the following:
(1) total taxable income × 90%;
(2) total taxable income × (number of foreign employees / number of total employees);[35]
(3) total income − ((total income − foreign taxes) × (0.1 × total income) / foreign taxes).[36]

Example

J-CO has branches in the United States and Japan. Overall worldwide J-CO has 30 employees, among whom are ten employed at the U.S. branch. J-CO has total taxable income of ¥ 91,537,500 and directly incurred foreign taxes of ¥ 8,750,000, which consists of taxes imposed upon the U.S. branch and withholding taxes imposed upon foreign-source interest income.

J-CO's maximum foreign tax credit limitation under the 1988 tax reform law would be the greatest of the following (¥ 82,383,750):
(1) ¥ 91,537,500 × 90% = ¥ 82,383,750;
(2) ¥ 91,537,500 × (10/30) = ¥ 30,512,500;
(3) ¥ 91,537,500 − ((¥ 91,537,500 − ¥ 8,750,000) × ¥ 91,537,500 × 10% / 8,750,000)) = ¥ 4,929,949.[37]

In addition, one-half of foreign source income not subject to foreign taxation should be excluded from foreign-source income. A phase-in provision provides that for tax years beginning before 31 March 1991, only one-third of tax-free foreign-source income should be excluded from foreign source income.[38]

Example

J-CO has a branch in Country A through which a loan is extended to a resident in Country B, resulting in foreign-source interest income. Neither Country A nor Country B subjects the interest income to regular or withholding taxation. Such income would constitute "tax free income".[39]

IV. TIMING OF CREDITABILITY (DEDUCTIBILITY)

The timing of the creditability of a foreign tax depends upon the particular facts and circumstances. The general rule is that taxes are creditable in the year in which the amount of taxes to be paid is fixed. Estimated tax payments required by local law can be credited at the time of payment.[40]

31. Watanabe, *supra* note 7, at 78.
32. CTL Enf. Order 142(6).
33. CTL Basic Circular 16-3-14.
34. CTL Basic Circular 16-3-12.
35. CTL Enf. Order 142(3).
36. CTL Enf. Order 142(2).
37. *International Taxation* (October 1989), at 24.
38. CTL Enf. Order 142(3).
39. *International Taxation* (February 1989), at 16.
40. Watanabe, *supra* note 7, at 49.

Example 1

J-CO completes a construction project in Country A in Year 1 from which it realizes a profit of 900. Although for Japanese tax purposes it plans to recognize the 900 profit rateably on a deferred payments basis over three years, Country A does not permit a deferral of taxable income and instead imposes a tax of 360 on the full 900 of profits in Year 1. For Japanese tax purposes, the 360 would be deemed creditable in Year 1, with any excess tax amount to be carried back or forward up to three years.[41]

Example 2

J-CO, a calendar-year corporation, has a U.S. branch which makes quarterly estimated tax payments and files an annual U.S. tax return. J-CO can take credit for the U.S. taxes paid either on the basis of (1) the time of payment, or (2) the filing of the tax return on a consistent basis.[42]

A tax determined by assessment becomes creditable on the date of notification of the assessment. Taxes withheld are creditable in the period of the withholding.

Example

J-CO has an outstanding loan to its distributing subsidiary (D-SUB) in Country A, from which it was scheduled to receive periodic interest in Year 1. However, due to cash flow problems, D-SUB did not pay the interest subject to withholding until Year 2. Although J-CO recognized a rateable part of the interest income in Year 1, J-CO cannot take a foreign tax credit until Year 2.[43]

Foreign taxes are applied first against the regular national, then the prefectural and finally the municipal tax limitations.[44]

Until the 1988 tax reform, excess foreign tax credits could be carried forward five years and in effect carried back five years because of a five-year carryforward of excess foreign tax credit limitations. For excess foreign tax credits generated during taxable years beginning after 31 March 1989, the carryforward and carryback period is shortened to three years.[45]

Under the Japanese system a refund of credited foreign taxes does not entail the filing of an amended tax return. Instead, the refund should be offset (1) first against the current period's creditable foreign tax amount; (2) next against the current foreign tax credit amounts being carried forward; (3) then against the creditable foreign tax amounts arising in the two periods succeeding the period of the refund. Any amount then remaining should be included in the taxable income of the second year after the period of the adjustment.[46]

V. INDIRECT FOREIGN TAX CREDIT

A. *Eligible foreign corporation*

Under Japanese domestic law, an indirect foreign tax credit is available only for dividends from a first tier foreign subsidiary whose voting stock is 25 percent or more controlled by a Japanese corporation for a period of six months or more prior to the declaration of a dividend.[47]

Example

Until 20 December of Year 1, J-CO held a 35 percent interest in a German corporation (G-CO). On 20 December, due to an increase in total shares, J-CO's interest in G-CO dropped to 20 percent. On 20 February of Year 2 G-CO declared a dividend from its earnings of Year 1. The dividend would not produce an indirect foreign tax credit since J-CO's interest in G-CO dropped below 25 percent during the six-month period prior to the declaration of the dividend.[48]

Flow-through entities such as U.S. general or limited partnerships are essentially treated as branches for foreign tax credit purposes.[49]

Treaties may modify the holding requirement. For example, the U.S.–Japan income tax treaty reduces the minimum ownership to ten percent of voting shares with no holding period requirement.[50]

For dividends received during taxable years beginning after 31 March 1989, dividends from a holding company or a subsidiary located in a low tax jurisdiction are eligible for an indirect foreign tax credit benefit. A holding company means a company with no business activities of its own (i.e. merely holds non-operating assets such as securities or rights to intangibles).[51]

B. *Calculation of the indirect foreign taxes eligible for credit*

The amount of the foreign taxes deemed paid by the parent is determined by the following standard formula:

$$TAX \times \frac{DIV}{INC - TAX}$$

TAX = Taxes incurred by the foreign subsidiary. This corresponds to a tax creditable for the purposes of the direct foreign tax credit.[52]

DIV = Dividends received by the Japanese parent from the foreign subsidiary.

INC = Income of the foreign subsidiary from which the dividend is distributed.[53]

The limitation for dividends paid during taxable years commencing after 1 April 1989 is adjusted for the 50 percent of income limitation for creditable foreign taxes as described in Part II.[54]

The limitation thus becomes the lower of the immediately foregoing formula or the following:

$$DIV - (2 \times WH)$$

WH = Withholding taxes on dividends.

A first tier subsidiary filing a consolidated return with second or lower tier companies is deemed to have paid taxes on a separate entity basis.

Example

J-CO has a 100 percent interest in a U.S. corporation (US-1) which in turn has a 100 percent interest in another U.S.

41. *International Taxation* (July 1984), at 36.
42. *Id.*, at 39.
43. *Id.*, at 38.
44. CTL Art. 69.
45. *Id.*
46. CTL Arts. 69(5) and 26(2); CTL Enf. Orders 25(2) and 150.
47. CTL Art. 69(4).
48. *International Taxation* (July 1987), at 47.
49. *International Taxation* (May 1986), at 53.
50. U.S.–Japan Income Tax Treaty, Art. 5(1).
51. CTL Enf. Order 146.
52. CTL Enf. Order 141.
53. CTL Enf. Order 147.
54. *Id.*

corporation (US-2). US-1 and US-2 file a consolidated tax return and pay a total U.S. tax of 238 on a taxable income of 700. If computed on a separate return basis, the taxable incomes of US-1 and US-2 would be 1,000 and (300), respectively. Assuming after-tax net earnings of 400 are distributed to J-CO, the available indirect foreign taxes to J-CO would be 206:

$$238 \times \frac{400}{1{,}000-238} = 125$$ [55]

Taxes paid by a first tier foreign subsidiary which are levied by countries other than the country where the subsidiary is located are eligible for credit. For example, withholding taxes on dividends paid to a first tier subsidiary in Country A by a second tier subsidiary in Country B would be eligible for indirect foreign tax credit benefits.[56]

Dividends are sourced from the most recent earnings (i.e. LIFO basis).[57] Earnings include non-taxable income and are net of non-deductible distributions such as charitable contributions, entertainment expenses and bonuses.[58]

Preferred stock dividends do not carry forward an indirect foreign tax credit. For purposes of the Japanese indirect foreign tax credit, preferred stock is defined as stock providing for a fixed dividend amount having priority over dividends from other categories of shares.[59]

Whether or not a distribution is characterized as a dividend is determined under the principles of Japanese tax law.[60] Examples of such dividends include:

- the gain from the liquidation of a foreign subsidiary to the extent of the subsidiary's retained earnings;[61]
- stock dividends of a foreign subsidiary to the extent of the subsidiary's retained earnings;[62]
- a gain from the redemption of shares from a foreign subsidiary to the extent of the subsidiary's retained earnings;
- a gain to the extent of retained earnings from the liquidation of a foreign subsidiary as a result of a merger.

Example 1

J-CO has two 100 percent-owned U.S. subsidiaries (US-1 and US-2). US-1 purchases the stock of US-2 from J-CO. Under U.S. law, the payment from US-1 to J-CO should constitute a dividend to the extent of the earnings and profits of US-1 and US-2.[63] In addition, a withholding tax of ten percent should be imposed.[64] Since the Japanese tax code does not explicitly provide for a deemed dividend in such a situation, an indirect foreign tax credit would not be available. However, the withholding tax paid should be creditable for direct foreign tax credit purposes.[65]

Example 2

J-CO has a 100 percent-owned German subsidiary (G-CO) to which it ships semi-finished goods for assembly. The German tax authorities make a transfer pricing adjustment resulting in a constructive dividend from G-CO to J-CO, subject to a withholding tax. The withholding tax should be eligible for the direct foreign tax credit. However, unless there is an adjustment to J-CO's taxable income by the Japanese tax authorities, J-CO cannot claim an indirect foreign tax credit.[66]

INC consists of the greater of the following:

(1) before-tax profits for accounting purposes. This is in line with the basic Japanese concept of the source of the dividends, namely, retained earnings as computed under financial accounting principles; or
(2) taxable income as computed under the foreign corporate tax principles plus:
- income taxes incurred by the foreign subsidiary deducted for foreign tax purposes;
- non-taxed income;
- excluded intercorporate dividends.[67]

The reason for the provision of (2) is to prevent abuse of the indirect foreign tax credit system through the manipulation of the financial statements.

Japanese corporations taking an indirect foreign tax credit must gross up the dividends received in the amount of the indirect foreign tax credit taken.[68] An option exists between taking the indirect foreign tax credit with the accompanying gross up, or simply reporting the dividend income on a net basis without the indirect foreign tax credit.[69]

C. *Timing of deemed payment*

Income taxes paid by the foreign subsidiary are deemed to be paid on the later of the following:

(1) the date of receipt of the dividend by the Japanese parent company; or
(2) the day the income from which the dividend arose is subject to the foreign tax.[70]

Adjustments to the income taxes paid by a first tier subsidiary on which the Japanese parent has taken a foreign tax credit should be reflected in a manner similar to that for adjustments to the direct foreign tax credit (see Part IV).

Example

In 1990 a 50 percent-owned U.S. subsidiary (US-CO) had income of $ 1,000 on which income taxes of $ 400 were incurred. US-CO pays a $ 300 dividend to J-CO on which a withholding tax of $ 30 is imposed. The indirect foreign tax credit which can be taken by J-CO is $ 200, which is the lesser of the following:

(1) $400 \times \frac{300}{1{,}000-400} = \$\ 200$; or

(2) $300-(30 \times 2) = \$\ 240$.[71]

A subsequent tax refund of $ 100 would result in a lowering of J-CO's foreign tax credit by $ 72, calculated as follows:

$$(400-100) \times \frac{300}{1{,}000-300} = \$\ 128$$

$\$\ 200 - \$\ 128 = \$\ 72$[72]

D. *Applicable exchange rates*

The general rule is that foreign taxes are translated at the applicable exchange rate prevailing on the day of the dividend.[73]

55. *International Taxation* (April 1984), at 29.
56. CTL Basic Circular 16-3-36.
57. CTL Enf. Order 147(2).
58. CTL Basic Circular 16-3-39.
59. CTL Enf. Order 147(2)(3).
60. CTL Art. 24; CTL Basic Circular 16-3-21.
61. CTL Art. 24.
62. CTL Basic Circular 16-3-21.
63. U.S. Internal Revenue Code Sec. 304.
64. U.S.–Japan Income Tax Treaty, Art. 12.
65. *International Taxation* (October 1988), at 36.
66. *International Taxation* (January 1986), at 44.
67. CTL Enf. Order 147(2)(4); CTL Basic Circular 16-3-41.
68. CTL Art. 28.
69. CTL Enf. Order 149.
70. CTL Enf. Order 148(1).
71. The high tax ceiling as enacted under the 1988 Tax Reform Act.
72. Watanabe, *supra* note 7, at 189 (1990 revision).
73. CTL Basic Circular 16-3-42(4).

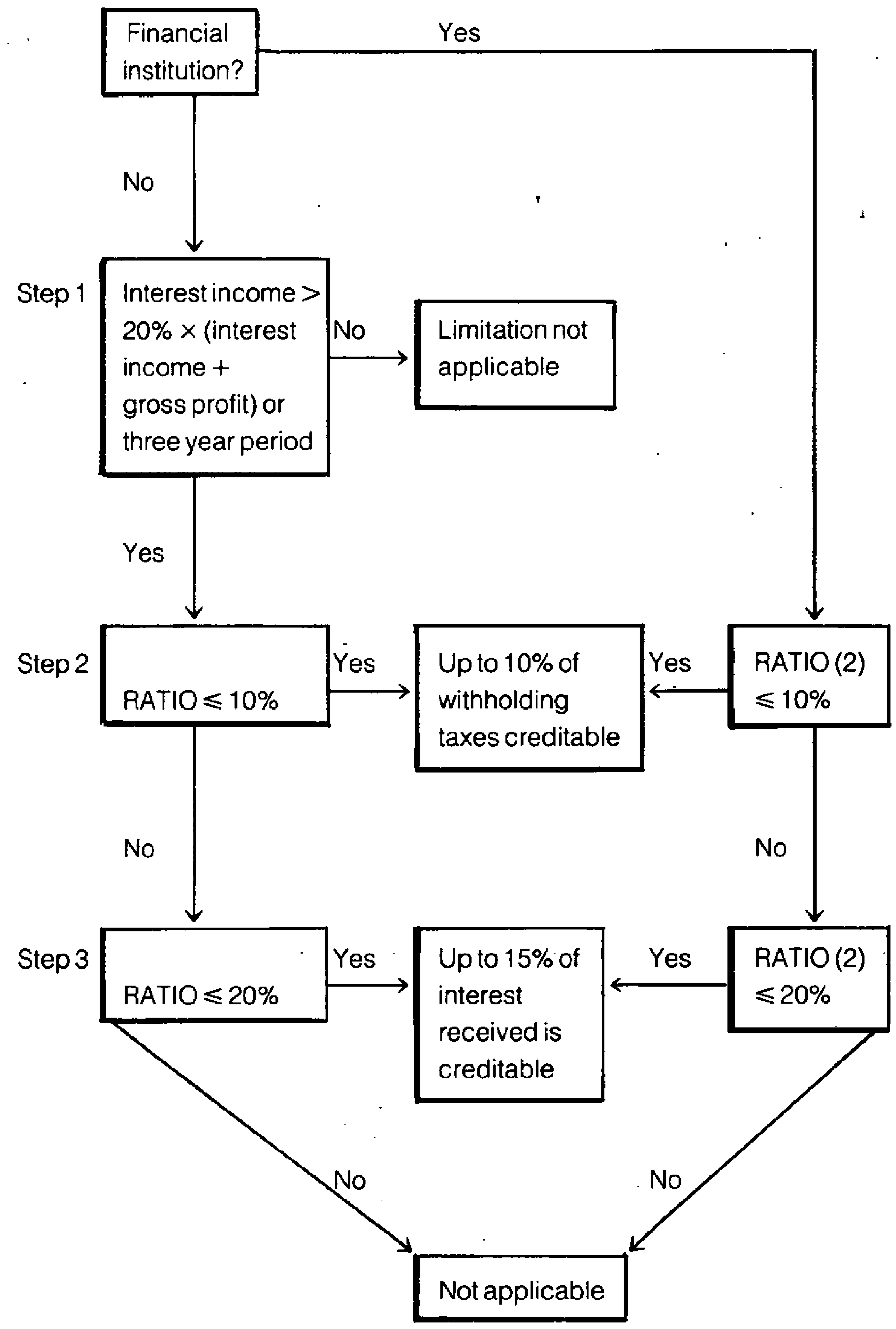
APPENDIX I

CREDITABLE FOREIGN TAXES

Country	Taxes Eligible for Japanese Foreign Tax Credit	Taxes not Eligible for Japanese Foreign Tax Credit
United States	Federal income tax Accumulated earnings tax Personal holding company tax State corporate income tax Minimum tax	Social security taxes Unemployment taxes Sales taxes Texas franchise tax California water's edge election fee Property taxes
United Kingdom	Corporate tax Corporate surtax Capital gains tax Personal holding company tax	VAT Social security taxes
Netherlands	Corporate tax (Vennootschaps-belasting)	VAT Social security taxes
Canada	Income tax Special tax on non-resident corporations Provincial tax Branch tax	Sales taxes Old age social security tax Retail sales taxes Excise taxes
Germany	Corporate tax (Körperschaftsteuer) Withholding taxes (Kapitalertragsteuer) Trade taxes (Gewerbesteuer)	VAT
France	Corporate income tax (Impôt sur les sociétés)	VAT

APPENDIX II

CREDITABILITY OF WITHHOLDING TAXES ON INTEREST INCOME



RATIO = (Taxable income for the most recent three years) / (total receipts less cost of goods sold for the three years)

RATIO (2) = (Taxable income for the most recent three years) / (total receipts less cost basis of securities or assets sold during the most recent three years)

SINGAPORE'S 1991 BUDGET: A SUCCESSFUL NATION'S BUDGET

Lee Fook Hong, MBA, FCIS, FAIA, ACIArb

Mr. Lee Fook Hong, a practicing Chartered Secretary, is the Principal Consultant of Lee Fook Hong & Co., Chartered Secretaries & Management Consultants. Currently he is also an Adjunct Senior Lecturer at the Nanyang Technological University.

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I. INTRODUCTION

On Friday, 1 March 1991, the Minister for Finance, Dr. Richard Hu, presented Singapore's 1991 Budget to Parliament. The Budget speech was divided into three parts: review of the economy; the financial year 1991 Budget; and revenue and tax changes.

In his review of the economy, the Minister dealt with the economic performance in 1990, the economic outlook for 1991 and the "Growth Triangle" (Batam in Indonesia, Johor in Malaysia and Singapore).

Notwithstanding the slowdown in the developed economies, the Singapore economy grew 8.3 percent in 1990. Taking into account the Gulf crisis, the slowdown of the major economies and the latest surveys of business expectations, the Minister was confident that the Singapore economy would have no problem in achieving a growth rate of three to six percent in 1991. With respect to the "Growth Triangle", he encouraged the development of more external linkages and stressed the importance of building a flexible economy.

The Minister then presented the financial year 1991 Budget. With respect to fiscal policy objectives, the Minister announced that the Government would provide a fiscal environment conducive to the growth of the private sector so that it can assume a major role in Singapore's economic development. The public sector, on the other hand, would trim expenditure to contain its share of the nation's financial and manpower resources in order to channel more funds towards education, investments in infrastructure and improvements to the quality of life in Singapore.

Finally, the Minister discussed the Government's revenue position and proposed the following tax changes for financial year 1991. (Unless otherwise noted, the changes are effective from year of assessment 1992.)

II. TAX CHANGES

A. *Tax on companies*

1. Corporate tax rate

The corporate tax rate was reduced from 33 percent to 32 percent in 1989, and to 31 percent in 1991. According to the Minister, Singapore's corporate tax rate is amongst the lowest in the world. It will therefore remain unchanged at 31 percent for 1992.

2. Tax exemption on dividends paid out of foreign income

To encourage Singapore companies to invest overseas and repatriate their profits to Singapore, dividends will be exempt from tax if they are paid out of foreign income for which there is insufficient franking credit due to the foreign tax credit given. Where a recipient of the tax-exempt dividends is a holding company, it can in turn distribute tax-exempt dividends out of those it has received.

3. Approved International Shipping Enterprise (AIS) Incentive Scheme

Presently, many of the shipping companies are merely operational arms of holding companies located outside Singapore. To develop Singapore as an international maritime centre and to attract major international shipowners to locate their base of operations in Singapore and not to act as mere operating arms of their holding company outside Singapore, the Minister proposed to introduce the Approved International Shipping Enterprise (AIS) Incentive Scheme.

Under this scheme, income derived by the AIS from the operation of its non-Singapore flag ships outside Singapore will be tax-exempt. In addition, qualifying dividends from approved subsidiaries and associated shipping companies of the AIS will be granted tax exemption. However, income accruing to AIS from the uplift of freight in Singapore by its non-Singapore flag ships will be subject to normal corporate tax.

The AIS status will be available to resident shipping companies for an initial period of ten years and may be further extended subsequently. The scheme will be administered by the Singapore Trade Development Board.

4. Tax deduction for general provisions made by banks

To further promote Singapore as an international financial centre and to help banks and merchant banks in Singapore build up their reserves and ensure depositors' confidence in a sound and stable financial system, a tax deduction for general provisions will be allowed. General provisions qualifying for tax deduction will be limited to two percent of the bank's total loans and investments excluding Government securities. The tax-deductible amount per year will be limited to 0.25 percent of such loans and investments.

5. Tax incentive for services provided by trust companies

Currently a ten percent concessionary tax rate is available only to Approved Securities Companies and banks on income from financial trustee activities.

To develop Singapore as a centre for international trustee activities for investments in the regional financial markets, the ten percent concessionary tax rate will be extended to income derived by Approved Trust Companies from providing specific trust services to non-residents for their non-Singapore dollar investments. Trustee services are considered important supporting services to fund managers and investors as they help promote the development of fund management and securities trading activities. The promotion of trust business will help to contribute to the growth of the financial centre.

6. Tax incentive for underwriting and managing international securities issues

As a further step to promote Singapore as a centre for not only the trading of international securities but also the issuance of such securities in Singapore, the ten percent concessionary rate currently available to Asian Currency Units and Approved Securities Companies will be extended to cover income derived from arranging, managing, underwriting and placing international securities issued from Singapore. To qualify for this tax concession, the securities must be:

(a) issued by non-resident companies;
(b) issued in non-Singapore dollars; and
(c) placed with non-residents.

B. *Tax on individuals*

1. Personal income tax

No change in personal income tax rates was proposed by the Minister. However, to reward individuals who have contributed in making the past year another successful one for Singapore, he proposed as in the previous year a similar across-the-board and one-off rebate of five percent on personal income tax for the year of assessment 1991 (effective from year of assessment 1991).

2. Tax deduction for contributions to Edusave Scheme

In line with the Government's objective to invest in people and provide equal opportunities for each new generation, the Edusave Scheme will be introduced in January 1992. An initial sum of S$ 100 per child per year will be contributed by the Government to the Edusave Accounts of the first three children of a family. This will eventually be increased to S$ 500. If parents contribute the same amount to the Edusave Account of their fourth child, such amount will be tax-deductible (effective from year of assessment 1993).

3. Tax relief for handicapped spouse

To further encourage families to care for their handicapped dependents, the Minister proposed to extend the handicapped dependent relief of S$ 3,500 to include support of a handicapped spouse provided the handicapped spouse's income does not exceed S$ 1,500 a year. Where a husband is claiming handicapped dependent relief for his wife, he will not be able to claim normal wife relief of S$ 1,500.

4. Tax deduction for CPF contributions of self-employed persons

Self-employed persons who make voluntary contributions to the Central Provident Fund (CPF), including payments to Medisave, are allowed under current law to deduct such contributions from their assessable income. The limit for self-employed persons making voluntary contributions to the CPF, including payments to Medisave, will be increased in line with the revised employer's CPF rate from 15 percent (maximum S$ 10,800 per year) to 16.5 percent (maximum S$ 11,800 per year) with effect from 1 July 1990.

For ease of reference, the changes in CPF rates for the years of assessment 1990 to 1993 are summarized below:

	Amount deductible
Up to year of assessment 1990	10% of assessable income (max. S$ 7,200 per year)
Year of assessment 1991	15% of assessable income (max. S$ 10,800 per year)
Year of assessment 1992	16.5% of assessable income (max. S$ 11,800 per year)
Year of assessment 1993	17.5% of assessable income (max. S$ 12,600 per year)

C. *Tax on property*

1. Property tax refund on vacant residential buildings undergoing construction

In 1990 the Minister announced the reduction of the property tax rate from 16 percent to 4 percent of annual value as of 1 July 1990. To promote home ownership in Singapore, a further concession will be given by allowing a refund of property tax on vacant residential buildings undergoing construction provided the building will be owner-occupied after the construction work is completed. The tax refund will be limited to a maximum period of two years with effect from 1 April 1991.

D. *Other taxes*

1. Entertainment duty

Entertainment duty has been reduced from ten percent to five percent of the payment for admission with the exception of horse and vehicle races. The duty on admission to horse and vehicle races will remain unchanged at 35 percent. (Effective from 1 April 1991.)

2. Tourism cess

To assist certain sectors, such as hotels, restaurants and tourist-related retail shops from the adverse effects of the Gulf War, the tourism cess rate will be reduced by one percent, i.e. from from four to three percent. The reduction will take effect as of 1 April 1991 for a period of one year.

3. Duties on cigarettes and tobacco

As part of the continuing national effort to discourage smoking, import duty on cigarettes will be increased with immediate effect by S$ 15 per kilogram to S$ 100 per kilogram. Import duty on tobacco and excise duty on cigarettes will also be increased by S$ 8 per kilogram and S$ 10 per kilogram, respectively, to S$ 50 per kilogram (effective from 2 March 1991).

4. Water conservation tax

A new water conservation tax will be introduced with effect from 1 April 1991. The rate will be five percent on residential water usage in excess of 20 cubic metres per month. The water conservation tax will be in addition to the existing five percent tax on Public Utilities Board (PUB) bills of domestic consumers that exceed S$ 40 per month. The rate for non-domestic and shipping sectors will be ten percent on water consumption in excess of 20 cubic metres per month.

5. Goods and services tax (GST)

The Minister announced that work on a draft GST legislation had been completed and would be tabled in Parliament when ready. However, its implementation will be deferred for as long as the Government's revenue position permits.

III. CONCLUSION

In December 1990 Malaysia presented its 1991 Budget offering many tax cuts across the board. On 6 March 1991 Hong Kong presented a "delightfully loving" Budget with hefty increases in "sin" taxes, inflicting pain mainly on smokers, drinkers, motorists and travellers. However, Singapore's Budget has been described as "A Successful Nation's Budget" or "A Shenton Way Budget" giving a boost to financial services, shipping and tourism industries. (Shenton Way is said to be the Wall Street of Singapore where most financial institutions are situated.)

In conclusion, the Minister urged the people to be mindful of the highly volatile situation in the Gulf and to remain vigilant. The fiscal measures introduced in the Budget aim at broadening the economic base and tapping into regional growth. Government will continue to invest in its people and the long-term goal is for Singapore to become a developed nation by the turn of the century. The Minister is confident that with well-educated and highly motivated people working in close cooperation with the Government, the long-term goal can be achieved.

NEW ZEALAND:

J.F.P. ENERGY INC. v. COMMISSIONER OF INLAND REVENUE (NEW ZEALAND)[1]

Andrew Alston

Mr. Alston is senior lecturer, Law School, University of Canterbury, Christchurch, New Zealand. He is the author of numerous articles on taxation topics.

This case concerns the taxation of income from employment where the employee resides in one country and derives income from another country and, in particular, it concerns Article 15, paragraph 2(c) of the 1983 Double Taxation Relief Agreement between New Zealand and the United States.

The taxpayer, J.F.P. Energy Incorporated, had its headquarters in Houston, Texas. It operated a mobile offshore drilling unit in New Zealand. A number of the people employed on the rig were U.S. residents. They would alternately spend 28 days on the rig and 28 days in the United States.

The New Zealand Commissioner of Inland Revenue determined that payments received by these employees for their work in New Zealand were assessable in New Zealand and that therefore Pay As You Earn (PAYE) tax deductions were payable to the Inland Revenue by their employer, the taxpayer. The taxpayer objected and the case came before the High Court where the Chief Justice decided in favour of the taxpayer. The Commissioner appealed to the Court of Appeal where Richardson, Somers and Hardie-Boys JJ. unanimously dismissed the appeal.

The issue before the Court was, where was the income taxable? Under New Zealand domestic legislation, it was taxable in New Zealand because the recipients derived it from there. Under U.S. domestic legislation, it was taxable in the United States either because the recipients were U.S. residents or because the recipients were U.S. citizens taxable on their worldwide income. The domestic legislation of both countries provides for tax credits and relief to prevent double taxation. However, these provisions are subject to the tax treaty between New Zealand and the United States. Article 15 of the treaty (the text of which is almost identical to Article 15 of the OECD Model Treaty) deals with income in respect of "dependent personal services", i.e. salaries, wages and other similar remuneration. It provides as follows:

> 1. Subject to the provisions of Article 18 (Pensions and Annuities) and 19 (Government Service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.
>
> 2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
>
> (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any consecutive twelve month period; 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 a Contracting State in respect of an employment as a member of a regular complement of a ship or aircraft operated in international traffic may be taxed only in that State.

Under paragraph 1, income is taxable in the country where the employment is exercised. However, under paragraph 2, the income is taxable in the other country if three conditions are fulfilled: first, the recipient is present in the country where the employment was exercised for not more than 183 days in any consecutive 12-month period; second, the employer is not resident in that country; and third, the remuneration is not borne by a permanent establishment (PE) or a fixed base which the employer has in that country.

The first two conditions were satisfied in this case and, as to the third condition, the rig was a PE of the employer in New Zealand. The issue then focused on whether the remuneration of the employees was *borne* by the PE in New Zealand.

The Commissioner contended that remuneration is borne by a PE if it is an expense that is properly attributable to the establishment, i.e. incurred for the purposes of the establishment; and that, in this case, it was irrelevant that the expenses were not paid from the funds of the establishment and that they were deducted domestically in the United States. This contention was rejected by both the High Court and the Court of Appeal. In the High Court, Eichelbaum C.J. said:

> The starting point then is the ordinary meaning of the expression "borne by" in the context, having regard to the 'broad intentions' of the framers as they emerge from the text. Relevant ordinary dictionary meanings of the term 'borne' include 'carried', 'sustained', and 'endured'. In ordinary parlance and unless the context requires otherwise, the term refers to a matter of fact, as distinct from hypothesis: something actually carried, sustained or endured.

1. [1989] 11 New Zealand Tax Cases 6282.

Richardson and Hardie-Boys JJ. in the Court of Appeal, after referring to this passage with approval, stated the test under subparagraph (c) to be as follows:

> Subparagraph (c) could not be clearer. It requires an answer to the question "Is the remuneration borne by a permanent establishment..." It is not whether it could have been borne or even should on some hypothesis have been borne. It is what actually happened, not what might have been. It is not sufficient that the expenditure was incurred for the benefit of the permanent establishment. Had that kind of nexus been regarded by the framers of Article 15 as sufficient they could readily have used appropriate language such as "attributable" or "referable".

Their Honours held that the Commissioner's contention that "borne by the permanent establishment" to mean properly attributable to the PE would deprive those words of any effective force. The practical effect of such an interpretation would be that remuneration would always be allocated to the PE and subparagraph (c) would never be satisfied.

Both Richardson and Hardie-Boys JJ., in their joint judgement, and Somers J. emphasized the importance of construing double taxation agreements and having regard for the interpretation taken by the other party to an agreement. As Somers J. pointed out, "The agreement is intended to avoid double taxation. That object will obviously not be achieved unless the construction put on it is the same in each state".

To this end, the Court was prepared to have regard for "Commentary and any travaux préparatoires", the nature of which may not have been considered in the interpretation of domestic legislation. In the particular circumstances, the Court rejected most such material as being too insubstantial to take into account. The exception was a U.S. Treasury Department's Technical Explanation of the Agreement which had been tendered to the Senate Foreign Relations Committee for the purpose of gaining the advice and consent of the Senate to the treaty. In this case, the Treasury Department's Technical Explanation reinforced the Court's conclusions as to the meaning of subparagraph (c).

USING MALTESE OFFSHORE COMPANIES IN INTERNATIONAL TAX PLANNING

Jefferson P. VanderWolk

Baker & McKenzie, Hong Kong
Also *Bulletin* co-correspondent for Hong Kong

In late 1988, the Mediterranean island nation of Malta enacted legislation designed to attract international business in the form of (among other things) holding companies, finance companies, and reinvoicing companies incorporated under Maltese law and administered in Malta by local providers of management services.[1] As a result, Malta now offers some startling opportunities to the international tax planner. These opportunities result from the ability of low-taxed Maltese "offshore companies" to qualify for treaty benefits under many of Malta's numerous income tax treaties.

This article will look at the basic elements of this new tax planning tool and suggest a few structures in which a Maltese offshore company may be used to obtain tax advantages. No attempt is made in this article to describe the Maltese offshore companies regime in any detail; rather the focus is on the potential tax benefits that may be realized by a multinational business through the use of a Maltese offshore company.

BACKGROUND: THE CREATION OF A TREATY-QUALIFIED OFFSHORE COMPANY

The Maltese offshore companies legislation was carefully crafted, with the assistance of experts in the use of offshore financial centres by multinational business.[2] The goal was to combine the essential features of any successful offshore centre – negligible taxes on offshore profits, flexible company law and reliable and sophisticated local service providers – with special features that, it was hoped, would set Malta apart from the crowd and make it a particularly desirable location for large multinational groups.[3]

First and foremost among these special features, from the perspective of the international tax planner, is Malta's network of income tax treaties. Malta has entered into such treaties with most Western European nations, Australia, Canada, the United States and others.[4] Cleverly, the drafters of Malta's offshore companies legislation created an option that would enable a low-taxed Maltese offshore company to qualify as a resident of Malta under most of Malta's income tax treaties.

Among the range of special purpose companies that the legislation provides for is the "trading offshore company" (TOC).[5] A TOC is generally subject to Maltese income tax at a five percent rate on its profits from offshore business.[6] However, the tax is self-assessed by the TOC and, in the event of a challenge to any self-assessment, the burden of proof is on the Maltese government to demonstrate that the assessment was erroneous.[7] Moreover, under Maltese tax law and practice there appear to be few, if any, limitations on the ability of a TOC to erode its assessable profits by means of deductible payments to offshore affiliates under intra-group loans, service agreements and the like.

Thus, TOCs are subject to tax in Malta on their profits, but the effective rate of tax can be very low indeed. In addition, as one would expect, no Maltese withholding tax is imposed on dividends or interest paid by a TOC to a non-resident of Malta.[8]

This element of taxability is insufficient, by itself, to cause a TOC to be a resident of Malta under the typical OECD-type income tax treaty.[9] To qualify as a resident of Malta and thereby obtain treaty benefits, a TOC must be managed and controlled in Malta.[10]

The Maltese regulatory scheme for offshore companies serves the international tax planner's purpose in this respect by requiring that TOCs (as well as other types of offshore companies) be "physically and functionally present" in Malta. According to the Malta International Business Authority (MIBA), any new TOC must enter into a management agreement with an approved local nominee company (usually a firm of lawyers or accountants) and submit a copy of the agreement to MIBA; books and records of the TOC must be maintained in Malta; and the nominees must be given a significant degree of power, in the legal sense, over the conduct of the TOC's affairs if no other officers or employees of the TOC reside in Malta.

Therefore, it is generally plausible for a TOC to claim that it is a resident of Malta for tax purposes. It is also possible for a TOC to obtain a certification of residency from the Maltese tax authorities.

Maltese legislation also permits either a TOC or a different type of offshore company – a non-trading offshore company, which is generally tax-free – to agree to be subject to Maltese tax on its income at an agreed rate.[11] Non-trading companies are generally subject to the same local management requirements as TOCs, so they too can qualify for treaty benefits if they are tax-resident in Malta.

PLANNING OPPORTUNITIES: U.S.–MALTA TAX TREATY

With the demise of the U.S.–Netherlands Antilles tax treaty and the widely expected renegotiation of the U.S.–Netherlands tax treaty to prevent treaty shopping, international

1. Malta International Business Activities Act, 1988 ("MIBAA"). See E. Vella, "Malta Goes Offshore", 28 *European Taxation* (December 1988), at 386.
2. According to materials produced by the Malta International Business Authority.
3. See generally Vella, *supra* note 1.
4. The complete list is: Australia, Austria, Belgium, Bulgaria, Canada, Denmark, Finland, France, Germany, Italy, Libya, the Netherlands, Norway, Pakistan, Sweden, the United Kingdom and the United States.
5. MIBAA Sec. 23.
6. MIBAA Sec. 30.
7. MIBAA Sec. 30(3).
8. MIBAA Sec. 30(2).
9. See 1977 OECD Model Income Tax Treaty, Art. 4.
10. Income Tax Act, 1948.
11. MIBAA Sec. 41; Income Tax Act, 1948, Sec. 11.

tax planners have faced limited options in advising foreign investors on tax-efficient structures for U.S. investment. One option that has not yet come to the attention of most tax practitioners is the use of the U.S.–Malta income tax treaty.

The U.S.–Malta treaty reduces the U.S. withholding tax on dividends from 30 percent to 5 percent, where the recipient owns at least 10 percent of the voting stock of the paying company.[12] U.S.-source interest and royalties received by a treaty-qualified Maltese TOC are subject to U.S. withholding tax at a 12.5 percent rate, instead of the normal 30 percent rate.[13]

Combined with the low effective rate of Maltese tax on TOCs, these treaty-reduced U.S. rates are extremely attractive to investors from non-treaty jurisdictions. For example, a Malaysian or Taiwanese investor could hold a U.S. subsidiary through a Maltese TOC rather than a traditional Netherlands Antilles-Netherlands "Dutch sandwich" (see Diagram A). The investor would be likely to receive more after-tax income as a result. The structure would also be simpler and probably cheaper to maintain.

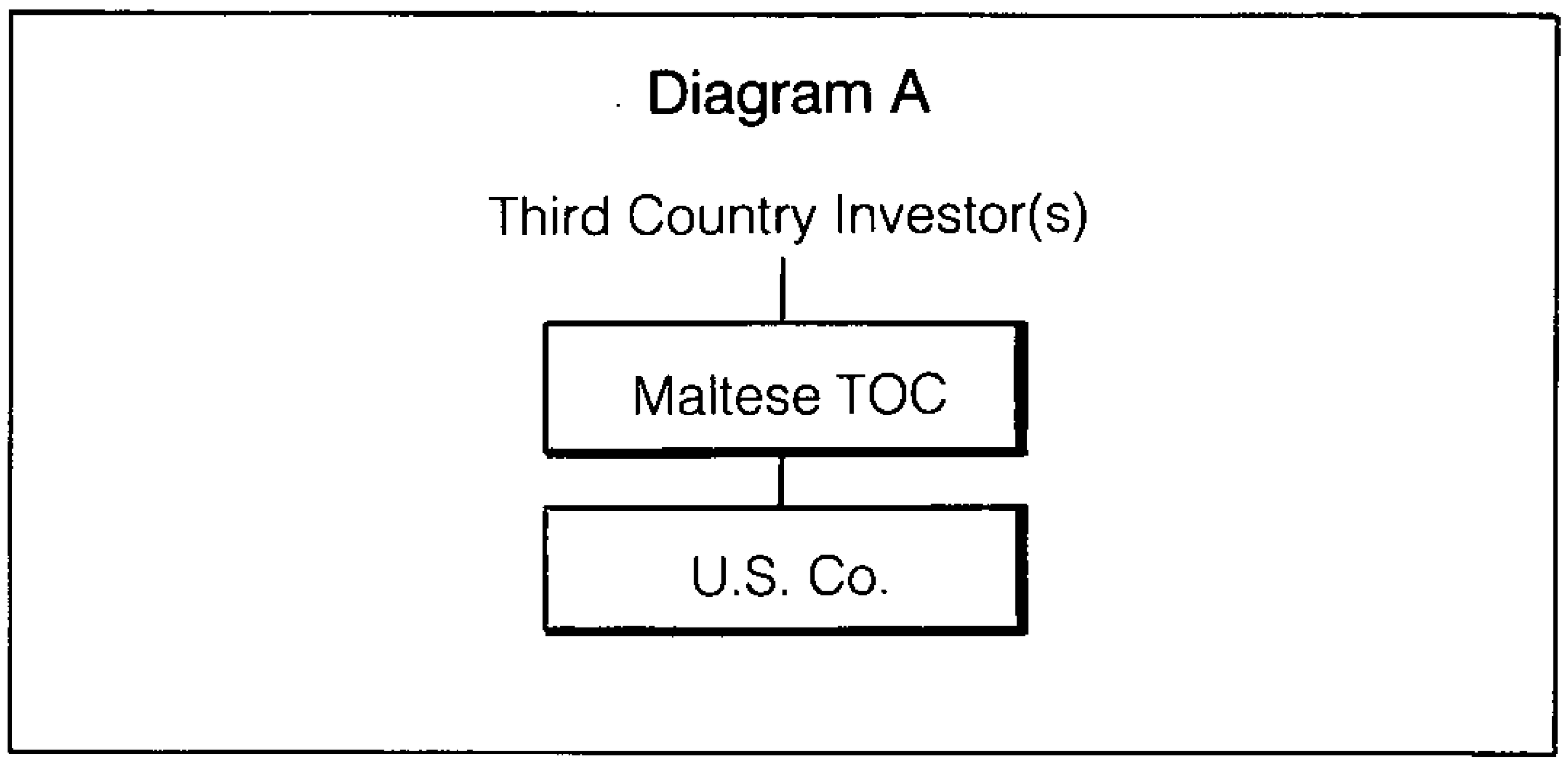

Diagram A

The U.S.–Malta tax treaty does contain an anti-avoidance provision designed to deny reduced withholding rates to investment companies and holding companies that are entitled to a special low tax rate on investment income, but the terms of this provision do not seem to cover Maltese TOCs.[14] Arguably, however, this anti-avoidance provision can reasonably be interpreted so as to deny reduced U.S. withholding tax rates to Maltese TOCs.

The issue can be avoided by means of a waiver of the five percent tax rate by the TOC, thereby leaving itself subject to the 35 percent rate applicable to onshore Maltese companies. Such a waiver is expressly provided for in the Maltese legislation.[15] The anti-avoidance provision should not apply to a TOC that is taxable at the rate generally paid by Maltese companies on dividends, interest and royalties, as well as other income.

Waiving the five percent tax rate would not affect the other tax benefits given to TOCs, such as the lack of any Maltese withholding taxes on dividends, interest or other payments by TOCs to non-residents; the self-assessment system; and the shifting of the burden of proof to the government.[16] Combined with the apparent ability of TOCs to erode their assessable income through deductible payments to related parties, these benefits would enable a TOC to earn and distribute income on a low tax basis in practice despite the 35 percent tax rate.

The Canada–Malta tax treaty contains a similar anti-avoidance provision, which can also be avoided by a waiver of the five percent rate.[17] Third country investors in Canada can still use the Canada–Netherlands treaty, but depending on the amount of Dutch tax that must be paid, the Maltese alternative may be attractive.

Of course if the use of Maltese TOCs to hold U.S. investments became widespread, the U.S. government would presumably take action of the sort that was taken in 1987 to stop foreign investors from taking advantage of the U.S.–Netherlands Antilles treaty. At present there does not appear to be any danger of that. However, it is worth noting that the U.K. tax authorities scheduled exploratory discussions in April 1991 to review the text of the U.K.–Malta tax treaty.[18]

The U.S.–Malta treaty also provides permanent establishment protection to a Maltese TOC with U.S. operations that might rise to the level of a U.S. trade or business for federal income tax purposes.[19] For example, a foreign trader may wish to sell goods to U.S. customers on a landed, duty-paid basis, which may involve limited but regular and continuous U.S. operations such as importation, storage and delivery of goods (see Diagram B). A Maltese TOC could make U.S. sales on this basis with minimal risk of becoming subject to U.S. tax on its income from the sales, because the U.S.–Malta treaty would prohibit U.S. taxation of the TOC's business profits unless such profits were attributable to a permanent establishment of the TOC in the United States.[20] However, aggressive planning would be required to avoid the U.S. branch profits tax in these circumstances because of the treaty override contained in the branch tax provisions.[21]

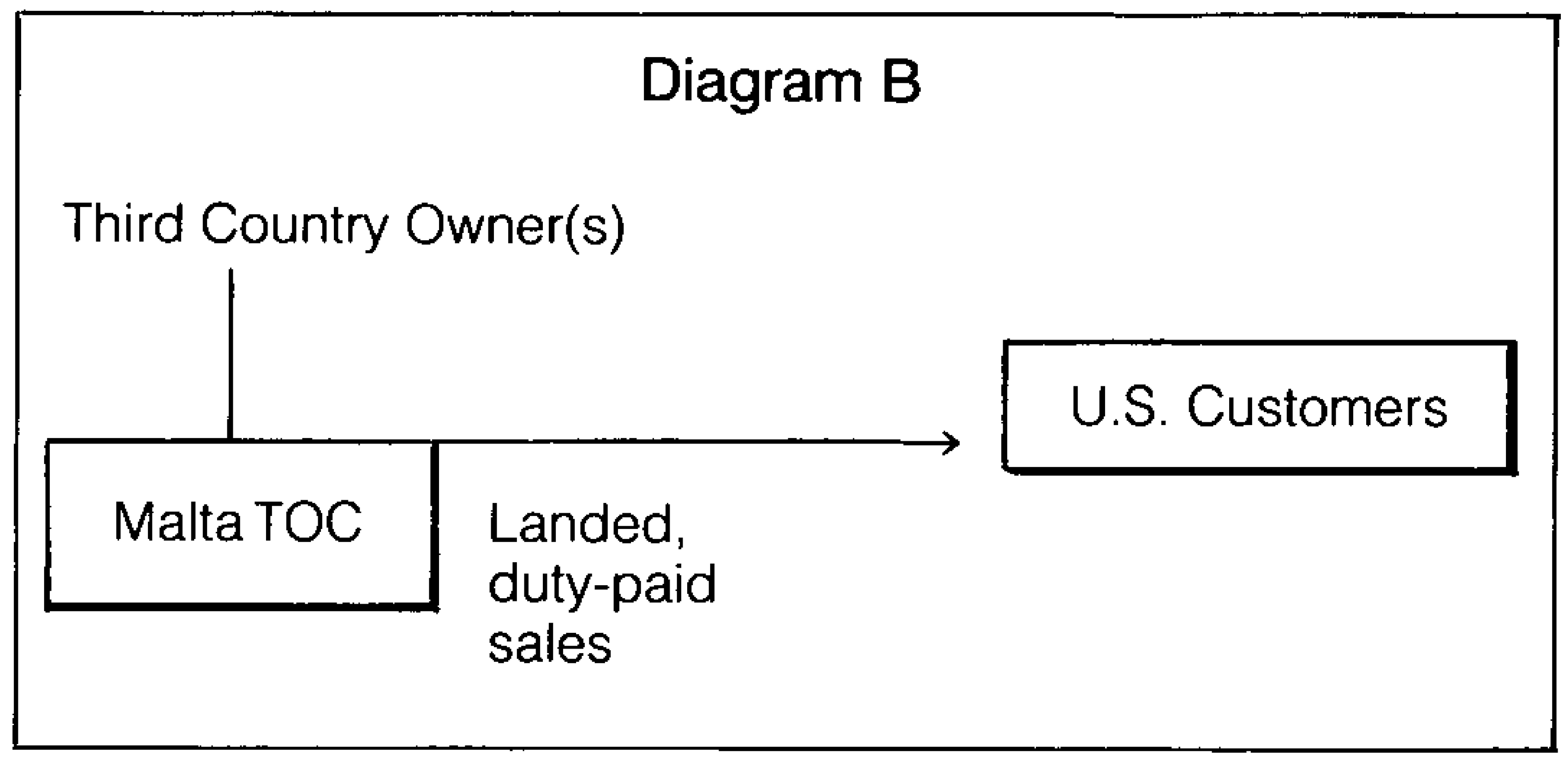

Diagram B

OTHER OPPORTUNITIES: EUROPEAN TREATIES

Malta has income tax treaties with Belgium, Denmark, the Federal Republic of Germany, France, Italy, the Netherlands and the United Kingdom, among others. As in the

12. Agreement between the Republic of Malta and the United States of America with respect to Taxes on Income ("U.S.–Malta Treaty"), Art. 10.
13. U.S.–Malta Treaty, Arts. 11 and 12.
14. U.S.–Malta Treaty, Art. 16. The relevant portion of Art. 16 is as follows:

> If 25% or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect ot dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on company business profits, then, notwithstanding the provisions of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties.

15. MIBAA Sec. 41.
16. See text at notes 6 and 8, *supra*.
17. Agreement between Canada and the Republic of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital, Art. 20(4).
18. 3 *Simon's Tax Intelligence* (17 January 1991), at 57.
19. U.S.–Malta Treaty, Arts. 5 and 7.
20. U.S.–Malta Treaty, Art. 7.
21. Internal Revenue Code, Sec. 884(e).

case of the U.S.–Malta treaty, these European treaties would generally enable a foreign investor to extract profits from European subsidiaries at reduced rates of tax through a Maltese TOC (see Diagram C).[22]

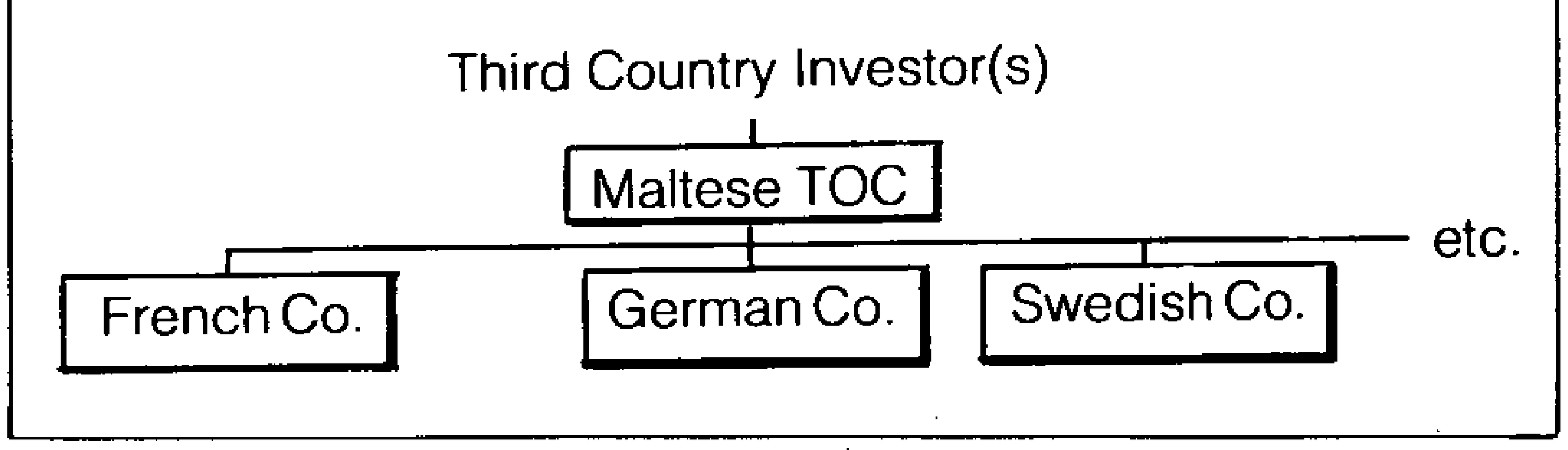

Diagram C

Moreover, to the extent that the effective rate of Maltese tax on the TOC can be kept below five percent, it may be more tax-efficient for non-treaty-qualified investors to use a Malta-Netherlands two-company "sandwich" structure rather than a Netherlands Antilles–Netherlands sandwich for inbound investment into countries such as Thailand and Indonesia (see Diagram D). The traditional Dutch sandwich involves a tax charge of about ten percent on dividends flowing through the structure (although maximizing debt capital can reduce the effective tax rate somewhat). Dividends paid by a Dutch company to a Maltese TOC owning at least ten percent of the Dutch payor are subject to a five percent withholding tax under the Netherlands–Malta treaty. If the effective Maltese tax on the dividend income is reduced in the manner noted earlier, the Dutch-Maltese sandwich structure will be highly tax-efficient.

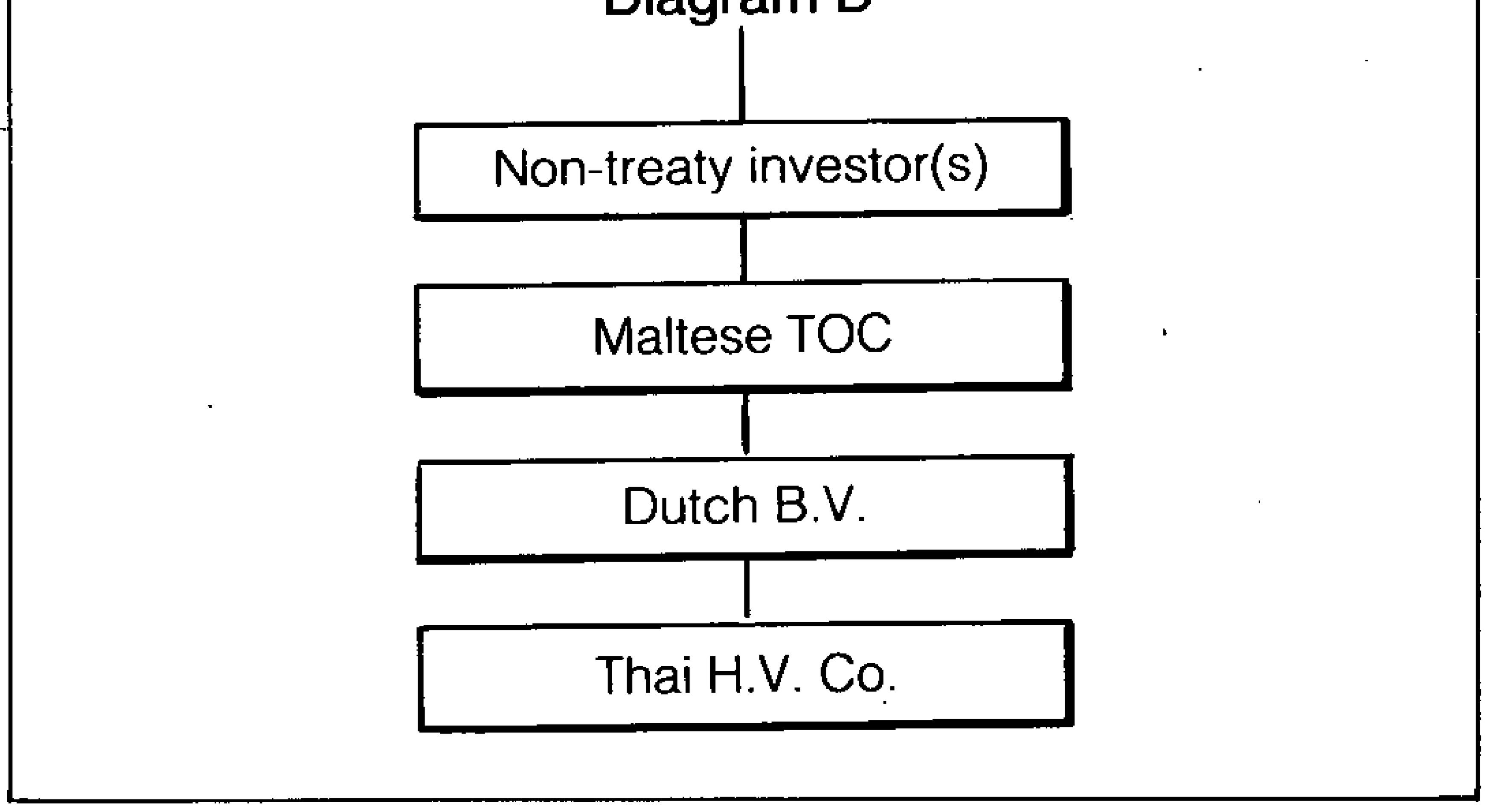

Diagram D

The same would appear to be true of other two-company holding structures with a treaty link, such as a Danish-Maltese sandwich. For example, if the United States renegotiated both the Netherlands–U.S. treaty and the Malta–U.S. treaty to prevent treaty shopping, a non-treaty-qualified investor could still use a Danish-Maltese sandwich to extract dividends and other payments from the United States in a tax-efficient manner (see Diagram E).[23]

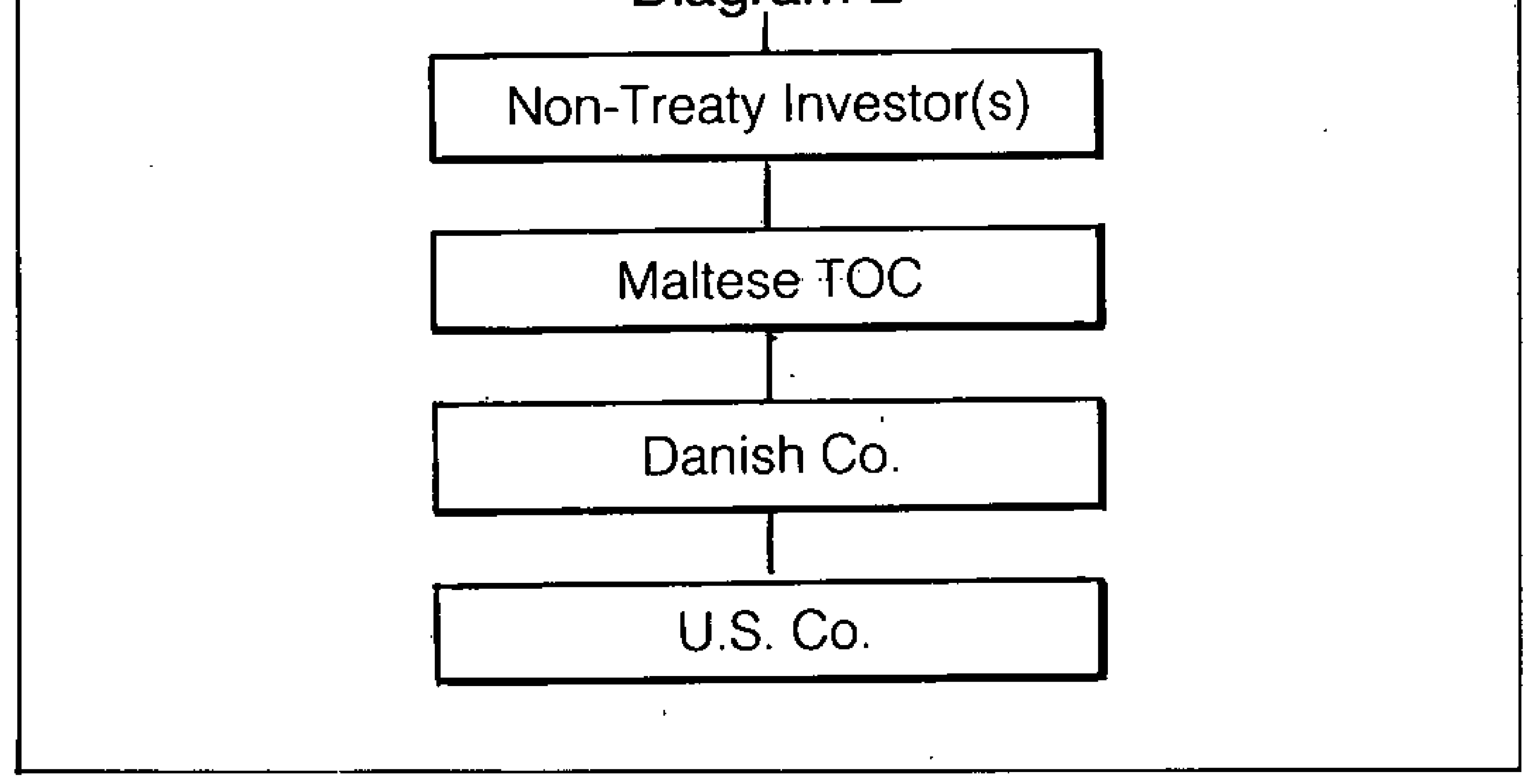

Diagram E

CONCLUSION

Most international tax practitioners have not yet begun to take advantage of the unusual opportunity afforded by Malta's offshore companies regime to combine treaty benefits with a low-tax environment. The current lack of awareness will undoubtedly change in the future as indefatigable global tax planners scour the map in pursuit of tax-efficient structures for the conduct of international business and investment.

22. For example, the France–Malta income tax treaty reduces French withholding tax on dividends paid by a French company to a Maltese resident to five percent (assuming a ten percent or greater shareholding).
23. In the early 1980s, the United States and Denmark negotiated a protocol to the U.S.–Denmark income tax treaty which included an anti-treaty shopping clause, but the protocol was never ratified by the U.S. Senate, due to a key senator's opposition to certain tax benefits for the oil industry.

INTERNATIONAL TAXATION AND INTERNATIONAL INVESTMENT FLOWS BETWEEN OECD AND NON-OECD COUNTRIES

Jeffrey Owens

Head of Fiscal Affairs Division, OECD

Taxation is generally recognized as one factor influencing international flows of capital, technology and other services. During recent years, major tax reforms have been implemented in almost all of the OECD countries and many non-OECD countries. Whilst the main thrust of the reforms is not difficult to identify – rate cutting and base widening being the norm – little has been said about the impact of tax reforms on investment to and from non-member countries. Similarly, little has been written on the extent to which recent tax reforms in OECD member countries may have influenced the systems of other countries.

Accordingly, the Committee on Fiscal Affairs in association with the OECD's Development Centre and the Fiscal Affairs Department at the International Monetary Fund decided to organize a symposium where the impact of taxation on international investment flows between member and non-member countries could be discussed. The Symposium was intended to complement the work done in the Economic and Social Council of the United Nations (ECOSOC) and such regional groupings as the Commonwealth Association of Tax Administrators (CATA), the Centre of Inter-American Tax Administrators (CIAT) and le Centre de Rencontres et d'Etudes des Dirigeants des Administrations Fiscales (CREDAF) and to promote a better understanding of the problems of tax policy and its implementation. This report provides a summary of the discussion.[1]

TAXATION AND INTERNATIONAL INVESTMENT FLOWS

In an ideal world, international investment would be taxed neither more nor less favourably than domestic investment, and flows of capital across frontiers would respond to differences in pre-tax rates of return. Unfortunately we do not live in an ideal world.

This raises the question of whether the tax differences will influence the international allocation of investment. Quantifying these distortions is virtually impossible. Non-tax factors like political stability, infrastructure, access to markets and profit potential probably play a more important role. Tax factors are, however, likely to influence these flows and sometimes can be the decisive factor in an investment decision. This explains the widespread use of fiscal incentives throughout the world.

Tax systems are often designed to encourage international investment flows, but they can also create tax obstacles that discourage inward investment. Three examples of such obstacles are:

- a tax code which is frequently changed or which is applied in a discriminatory fashion creates a climate which is not conducive to foreign investment;
- countries which ignore what may be called the "international rules of the game" will be at a competitive disadvantage in attracting investment;
- tax systems which lead to high rates of tax on the profits made from foreign investment discourage such investment.

These examples apply to OECD countries as well as to non-OECD countries.

DEVELOPING RULES TO COORDINATE TAX POLICIES

Tax policy coordination has probably lagged behind economic integration. This raises the question of whether there is a need for greater coordination and, if so, how this could be achieved.

The international dimension of tax policies has become increasingly important. For small and perhaps not so small open economies, one of the main constraints in designing new tax systems is the need to avoid getting too far out of line with major trading partners.

The first objective of international rules governing the taxation of international capital flows is to achieve neutrality and then to avoid both non-taxation and double taxation of income crossing frontiers. International rules also aim to provide an equitable division of the tax revenue from such flows between the country where the investment takes place and the country of the investor. Such rules are set out in both the 1977 OECD and 1980 U.N. Model Double Taxation Conventions. Guidelines are also provided in the 1979 OECD report on transfer pricing and multinational enterprises.[2]

Recent developments, however, suggest that such rules may no longer be sufficient and that coordination of tax policies may need to be improved. The liberalization of international capital flows and moves towards integrated capital markets may have increased the responsiveness of capital to differences in tax rates. This, in turn, may have increased the vulnerability of small open economies to tax competition. These trends – particularly the internationalization of financial markets – also provide greater opportunities for tax evasion and avoidance.

The increasing dominance of multinational enterprises in international trade and the increased integration of these companies also makes it difficult to share the tax base between the various countries in which a multinational enterprise operates.

1. A full report on the proceedings was published by the OECD in October 1990, under the title *Taxation and International Capital Flows.*
2. *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979).

If the need to improve coordination is accepted, what form should it take? Complete harmonization of tax regimes is an unrealistic approach since countries are not prepared to relinquish their sovereignty in tax matters. Leaving the market to force countries to coordinate changes to their tax systems is equally unrealistic; it would lead to ever-sharper reductions in tax rates and, consequently, large losses of tax revenue for all countries. There is therefore a need to explore how different tax systems can co-exist in a way which minimizes the distortion of international investment and savings patterns.

SUMMARY OF DISCUSSIONS

The following paragraphs provide a brief overview of the main themes discussed in the Symposium, highlighting differences between the experience of OECD and non-OECD countries, and areas of agreement and disagreement that emerged. As to the former, several participants submitted that it was an over-simplification to speak in too generalized a way of OECD and non-OECD or capital-exporting and capital-importing countries. Not only did both OECD and non-OECD countries differ considerably within each group, but all countries were both capital exporters and capital importers.

Both OECD and non-OECD countries have reduced marginal tax rates, broadened the tax base, reduced non-neutralities and simplified the tax system to the extent that this is possible. Two main questions discussed as regards the appropriateness of recent OECD reforms for non-OECD countries were the regressivity of VAT-type taxes, and the complexity imposed by the adoption of imputation systems. In respect of the VAT issue, it was argued that VAT-type taxes need not necessarily result in a regressive tax system, if introduced in conjunction with other legislative measures. As to the latter issue, the greater economic efficiency of imputation systems more than compensates for their complexity. Difference of opinion remained on both of these issues.

At a more general level it was recognized that there may be conflicts between the three objectives of economic efficiency, equity and simplicity and that trade-offs had to be sought. For example, one constraint on tax reform in both OECD and non-OECD countries is the complexity of transitional provisions which are necessary to prevent windfall gains or heavy losses for particular taxpayers.

The tax mix varies considerably among OECD countries, but in most of these countries income taxes and social security contributions provide the bulk of revenues, whereas most non-OECD countries rely more on taxes on goods and services. The general consensus was, however, that this difference is unlikely to change profoundly in the near future.

It was widely agreed that although tax considerations are only one of a number of factors taken into account in the investment decision, the tax reforms of the 1980s are likely to cause changes in investment flows. However, because these reforms are only just beginning to take full effect it has been impossible to obtain any reliable estimates of the impact of tax reform on international capital flows.

As evidenced by the growing network of tax treaties, bilateral double taxation conventions are generally considered to have a positive effect in encouraging international investment flows in creating certainty and stability for investors and reducing double taxation of profits. An additional advantage of tax treaties for tax administrations is that treaties provide a legal basis for exchanging information while protecting the confidentiality of taxpayers' affairs. Consensus was reached that whichever of the various model treaties (in particular the 1977 OECD Model and the 1980 U.N. Model) is adopted in particular bilateral relations, it is important to adhere to the general principles of that established model and it is better for the international investment climate for the parties to compromise on some sort of treaty rather than to have no treaty at all. Though this was the predominant view, representatives from certain non-OECD countries felt that tax treaties have very few advantages because non-tax factors overshadow tax considerations in the investment decision and concluding conventions may entail relinquishing much-needed tax revenues.

Tax incentives were described as inefficient, ineffective and unimportant as a means of attracting inward investment and as undesirable in adding to the overall complexity of the tax system. Nevertheless, non-OECD countries and some OECD countries continue to introduce new tax incentives and consider that these incentives should be recognized by tax sparing arrangements in tax treaties. Much of the discussion focused on designing tax incentives. No consensus emerged but there was general agreement that further study of this issue was necessary.

FUTURE COOPERATION BETWEEN OECD AND NON-OECD TAX EXPERTS

Participants at the meeting concluded that the Symposium provided a valuable contribution to improving cooperation between OECD and non-OECD countries and that there should be some follow-up to this first initiative. Whilst it was considered appropriate that this first meeting should have explored issues at the most general level, any future meeting should explore more technical issues in greater detail. It was agreed that informal contacts should be maintained with non-OECD participants, and with the Secretariats of other international and regional organizations working in the area of taxation and that the agenda for any further meetings would be established in cooperation with the ECOSOC group, other regional organizations invited to the Symposium, the International Monetary Fund and the OECD Development Centre.

PROPOSAL FOR A COUNCIL DECISION SETTING UP A PROGRAMME OF OPTIONS SPECIFIC TO THE REMOTE AND INSULAR NATURE OF MADEIRA AND THE AZORES (POSEIMA)

Commission of the European Communities

EXPLANATORY MEMORANDUM

1. PROBLEMS OF THE REMOTER REGIONS IN THE COMMUNITY

1. Some Member States of the Community include regions which do not form part of continental Europe (French overseas departments, Canary Islands, Azores and Madeira). In terms of their specific characteristics (remoteness, small size, island and/or isolated location, tropical products, deficient economic structures and low levels of development), these regions differ markedly from the rest of the Community.

2. The single market will throw up new opportunities for local businesses as controls are dismantled and competition injected into activities that suffer from the compartmentalization of national markets. But it will also represent a challenge for them because of their intrinsic handicaps, and this raises a number of questions for the Community, and in particular:

- What steps can be taken to ensure that these regions take advantage of the dynamic[s] of the Community-wide market despite the particular constraints which they face and which stem in particular from their remoteness and insularity?
- Will those specific constraints have to be remedied solely by applying the revised rules for the structural Funds or will special adjustments also have to be made in the way the common policies are implemented in these regions?

3. The Commission gave a general reply to these questions when it decided in 1987 to adopt a global approach to the problems of the remoter regions and to provide an appropriate framework for the application of the common policies in each of these regions.

4. As far as the French overseas departments are concerned, the Council adopted an appropriate framework for the application of the common policies (POSEIDOM)[1] in December 1989. The adjustments and measures envisaged are designed to mitigate the specific constraints they face while limiting the effects to the local economies.

5. Similarly, following the preliminary report it sent to the Spanish authorities[2] and the latter's reply, the Commission is presenting, at the same time as its proposal in respect of the Azores and Madeira, proposals in respect of the Canary Islands. These take the form of an action programme similar to POSEIDOM to be implemented after adjustment – by means of a proposed Council Regulation – of the arrangements applicable to the Canary Islands as agreed in the Act of Accession.[3]

1. Council Decision 89/688/EEC of 22 December 1989 setting up a programme of options specific to the remote and insular nature of the overseas departments, OJ L 399, 30.12.1989, p. 39.
2. Commission Report on the Canary Islands to be addressed to the Spanish authorities (SEC(90)83 final, 17 January 1990) sent for information to the Council and Parliament on 13 July 1990.
3. Proposal for a Council Regulation on the application of the provisions of Community law to the Canary Islands, and a proposal for a Council Decision setting up a programme of options specific to the remote and insular nature of the Canary Islands (POSEICAN) (COM(90)686).

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PROPOSAL FOR A COUNCIL DECISION setting up a programme of options specific to the remote and insular nature of Madeira and the Azores (POSEIMA)

2. THE SITUATION OF THE AZORES AND MADEIRA

2.1 THE SOCIO-ECONOMIC CONTEXT

6. The social and economic problems stemming from the remote island location of the Azores and Madeira are generally similar to those affecting the French overseas departments and the Canary Islands. Both these autonomous Portuguese regions permanently suffer from specific constraints whose cumulative effect places a heavy burden on economic and social life in the islands.

- *Their remote and insular nature:* Madeira is in an isolated position off the African coast almost 1,000 km from Lisbon. The Azores are one third of the way from Portugal to the American continent and, taking the average for the main islands, over 1,500 km from Lisbon. In addition to the distance from sources of supply and potential export markets, these regions are in the form of an archipelago. The nine islands of the Azores are spread over 600 km from east to west in three separate groups. The land area is 2,333 km^2 and the exclusive economic zone (EEZ) covers 938,000 km^2. Apart from several outlying barren islets, Madeira comprises only two inhabited islands, Madeira and Porto Santo, which are 40 km apart. This gives an EEZ of some 377,000 km^2 for a small land area of 798 km^2.
- *Geography and climate:* A volcanic escarpment which limits the utilized agricultural area and is specially vulnerable to natural disasters (earthquakes, cyclones and torrential rain).
- The *reduced dimension of the island economies,* which rules out economies of scale, and the *lack of exploitable raw materials,* which makes them dependent on the outside world, especially as regards energy and supplies of essential agricultural products.
- *Small size of agricultural holdings* (95% of farms in Madeira and 48.5% in the Azores have a surface area of less than 1 hectare). Agriculture concentrates on a few products, in particular bananas and wine in Madeira, and livestock production and dairy farming in the Azores.
- *Trade balance in structural deficit.*

7. These handicaps place the Azores and Madeira among the least favoured regions of the Community.[4] As such, they both qualify for the priority accorded to Objective 1 regions under the revised rules for the structural Funds.

2.2 THE STATUS OF THE AZORES AND MADEIRA IN THE COMMUNITY

8. The option taken up for the Azores and Madeira on accession was for the common policies to be applied in full, subject to the transitional period for Portugal and certain specific exceptions made in the Act of Accession and aimed at resolving certain problems peculiar to the two regions. These are:

- Article 309(d): price of milk in the Azores;
- Article 376: derogation from Article 60 of the ECSC Treaty for steel undertakings until 31 December 1992;
- Annex 1, at point V (system of VAT), in conjunction with Article 26: application of reduced rates under the Sixth VAT Directive; sea and air transport between the islands making up the Azores and Madeira and between those regions and the mainland deemed to be international transport;
- Annex II, at point 11.5: airports in the Azores;
- Article 377 allowing a derogation from Article 95 of the Treaty until 31 December 1992 with respect to excise duties on tobacco products manufactured in the Azores and Madeira.

9. In addition, a joint declaration concerning the economic and social development of the Azores and Madeira, annexed to the Act of Accession, recommends that the Community institutions devote special attention to the policies for developing the two regions, "the object of which is to overcome the handicaps of these regions, which arise from their geographical situation, far away from the mainland of Europe, their physical geographical features, the serious deficiency of infrastructures and their economic backwardness".

2.3 COMMUNITY SOLIDARITY SINCE ACCESSION

10. Community solidarity with the Azores and Madeira was evident in the granting of pre-accession aid, which allowed the two regions concerned to acquaint themselves with Community assistance mechanisms. As of the first year of accession, they received assistance under most of the Community structural instruments. (See Annex 2.1.)

11. Community solidarity towards the Azores and Madeira is being expressed more strongly today through assistance from the reformed structural Funds, with the two regions benefiting from the priority accorded to Objective 1 regions, in respect of which a major effort is being made to increase and concentrate Community resources. Today priority has been given effect by the adoption of specific programmes of operations (see Annex 2.2) following adoption of Portugal's Community support framework.

12. The efforts to promote development in the remoter regions, such as the Azores and Madeira, have been boosted by the adoption of a specific Community measure for these regions – the REGIS scheme[5] – which should in particular facilitate Community financing for extension of the runway at Funchal Airport (Madeira).

13. These major Community efforts in the structural field are a necessary prerequisite, but are insufficient to cope with all the problems of the remote islands making up the Azores and Madeira and enable them to catch up with economic and social development in the Community. The question is, should adjustments be made in the application of certain common policies or, at least, should special treatment be accorded to the Azores and Madeira to take account of their special characteristics in relation to the Community as a whole? Following the memorandums covering the problems and requests of the Azores and Madeira presented to the Commission in 1988, the latter prepared a factual report which was sent to the Portuguese authorities.[6] The report highlighted the potential benefits deriving from the application of common policies adapted to the situation

4. The basic statistics are set out in Annex 1.
5. OJ C 196, 4.8.1990, p. 15.
6. Commission report on the Azores and Madeira to be addressed to the Portuguese authorities (SEC(90)85, 17 January 1990); sent for information to Parliament and the Council on 13 July 1990.

in the Azores and Madeira, along the lines of the Community approach to remoter regions as first exemplified in the POSEIDOM programme adopted in 1989. In April 1990 the Portuguese authorities reacted positively to this approach while formulating certain additional requests.

3. APPLICATION OF COMMON POLICIES ADAPTED TO THE SPECIAL CONDITIONS OF MADEIRA AND THE AZORES: THE POSEIMA PROGRAMME

14. In view of the above, the Commission proposes that an appropriate framework be set up for the application of common policies in the Azores and Madeira. This approach should have a threefold aim:

- to allow the Azores and Madeira to play a full part in the dynamic[s] of the internal market by making the best possible use of existing Community policies and instruments;
- to acknowledge the region's special situation by taking into account in the application of the common policies their very distinctive natural conditions, where these conditions clearly mark the islands out from the rest of the Community;
- in doing so, to contribute to the economic and social development of the Azores and Madeira, by providing Community finance for the specific measures proposed.

The framework set up to permit the implementation of common policies should make it possible to implement provisions designed to take account of the special characteristics of the two regions without undermining the integrity and coherence of the Community legal order.

15. In line with the Community approach to the remoter regions, the Commission believes that such a framework should be given shape in an action programme known as POSEIMA (programme of options specific to the remote and insular nature of Madeira and the Azores). This multisectoral and coherent action programme should in principle be implemented by 31 December 1992 following adoption by the Council or the Commission, as appropriate, of the necessary legal instruments. With regard to specific constraints, of a permanent nature, which are a feature of these two regions, the period for the implementation of the proposed measures under POSEIMA should continue, if necessary, beyond the process of completing the internal market.

16. To ensure maximum effectiveness, the operations proposed under POSEIMA should be drafted, implemented, monitored and evaluated by the Commission in partnership with the national and regional authorities concerned.

17. With the same end in view, efforts will be made to ensure that POSEIMA operations and those conducted at national and local levels complement each other as far as possible. To achieve complementarity, the Member State and the regions concerned should take account of the specific measures contained in POSEIMA when drawing up future regional development plans. The Commission, for its part, will endeavour to ensure coherence between POSEIMA operations and assistance from the structural Funds and other Community financial instruments.

3.1 OPTIMUM UTILIZATION OF EXISTING POLICIES AND INSTRUMENTS

18. Community policies already include a number of instruments and programmes which could meet some of the specific requirements and constraints of the Azores and Madeira, mainly in the field of fisheries, energy, the environment, craft industries, and research and development. In partnership with the Member State and the two regions concerned, and in the framework of existing regulations, the Commission will ensure that optimum use is made of these instruments and programmes in the Azores and Madeira, particularly by facilitating their dissemination to these remote regions and developing appropriate technical assistance programmes.

19. With particular reference to the protection of the environment, the problems of the Azores and Madeira are exacerbated both by the geology and climate of the islands and by the fragility of their ecosystems. These problems are particularly significant because of the close ties between the environment and the various aspects of socio-economic development. While the Community's ENVIREG scheme to protect the environment might resolve some of the problems, it is clear that needs are still great, notably for the protection of coastal areas, soil and ecosystems. The Commission is therefore prepared to consider any specific requests made by the Portuguese authorities. Similarly, in view of the geological structure and the climate of the Azores and Madeira and the increased risk of natural disasters which results, the Commission is prepared to consider any specific requests made by the Portuguese authorities in connection with Community cooperation in civil protection matters, notably for training and exchanges of civil protection personnel and managers.

3.2 TAKING ACCOUNT OF THE SPECIAL CHARACTERISTICS OF MADEIRA AND THE AZORES IN APPLYING THE COMMON POLICIES

20. Generally speaking, the directives or other measures adopted with a view to establishing the internal market and implementing the other common policies could, when being drawn up or adopted, be scrutinized to determine whether their – as a rule, uniform – application should take into account the special characteristics of the Azores and Madeira, particularly in the fields of transport, taxation, social matters, research and technological development, and protection of the environment.

21. With particular respect to taxation, the principle underlying the Community approach to the remoter regions would permit special indirect taxation arrangements compatible with the rules of the Treaty, justified by the special location of these regions and capable of promoting their economic and social development:

- as regards VAT this would mean maintaining special arrangements for the Azores and Madeira in accordance with the Act of Accession. It would be possible, for instance, as part of the Council's work on removing tax frontiers in the Community, to allow modulations after 1992 of the type already applied to these two regions. In this connection the Commission has already proposed that sea and air transport between the islands making up the Azores and Madeira and between these islands and the mainland should continue to be treated as international transport after 1992;

- a special arrangement for excise duties on manufactured tobacco, spirits and other alcoholic beverages, and petroleum products after 31 December 1992 taking account of the problems of extreme remoteness will have to be incorporated into the general framework of the Commission's proposals on excise duties.

22. In applying the principle referred to in paragraph 20 to transport, particular account must be taken of the importance for the Azores and Madeira of access to regular means of transport at the lowest possible cost to alleviate the drawbacks of their remoteness and island location. Attention should focus in particular on the development of air transport, for which the most appropriate forms of liberalization should be worked out, notably under partnership arrangements, to enable many different airlines, especially regional airlines, to serve the islands in the interests of their development.

3.3 MEASURES DESIGNED TO MITIGATE THE EFFECTS OF THE EXCEPTIONAL GEOGRAPHICAL LOCATION

23. The geographical location of the two Portuguese autonomous regions in relation to the continental territory of the Community places serious constraints on trade between them and other parts of the Community. Community action is necessary to alleviate the impact of the additional costs of supply resulting from the remote and insular nature of the Azores and Madeira.

24. The object of such Community action is to maintain a reasonable standard of living in the Azores and Madeira while ensuring, by preserving competition, that traditional trade flows are not disrupted.

3.3.1 *Agricultural supplies*

25. In the case of essential agricultural products for consumption or processing in the Azores and Madeira (see Annex 3.1 and 3.3), the Community action in question would consist, within the limits of local market requirements and taking into account local production and traditional trade flows, in:

- exempting from levies and/or customs duties products originating in non-member countries;
- permitting, in parallel and in competition with products from non-member countries and on equivalent terms, the supply of Community products taken into intervention storage or available on the Community market.

26. The principles underlying the application of this system will be as follows:

- in order to ensure that these measures have an impact on the level of production costs and consumer prices, a system will have to be set up to monitor this impact up to the end-user stage;
- with respect to raw sugar supplies for the Azores, the system set out in paragraph 25 will be applicable until such time as local production of sugar beet is sufficient to satisfy local market needs and as long as the total volume of sugar refined in the Azores does not exceed 10,000 tonnes;
- with respect to supplies of compound feedingstuffs in Madeira, the system set out in paragraph 25 will be applied temporarily pending an increase in capacity and the modernization of the industry producing these feedingstuffs, subject to the limits of local market needs and taking account of local production. This measure could be applied for three marketing years for the products coming under CN Codes 2309 90 31, 33, 41, 43, 51 and 53.

27. In the Azores, for the purposes of genetic improvement, aid could be granted for the purchase of male breeding animals originating in the Community (beef breeds).

28. In Madeira, specific measures will be necessary to develop livestock farming for local market needs:

- aid for the purchase of breeding animals (cattle, pigs, chicks and hatching eggs) originating in the Community;
- on a temporary basis, limited to decreasing quantities pending the development of local production, exemption from levies and/or customs duties for the purchase of cattle for fattening originating in non-member countries; in the light of this exemption aid for the supply of Community products will be granted to facilitate the access of these products on equivalent conditions. After four years of application of the system, the situation would be reviewed.

29. For the production of liqueur wines in Madeira solely to satisfy local market needs, aid would be provided for the purchase of rectified concentrated musts in the Community, pending the result of a feasibility study on the construction of a wine alcohol distillery.

3.3.2 *Energy supplies*

30. Another drawback of the remote location of the Azores and Madeira is that they are very far from sources of supplies of refined petroleum products. This, together with their heavy reliance on imports of refined petroleum products to meet energy needs, means that supply costs in the Azores and Madeira are much higher than in the Community generally. At present these costs are borne by the regional budgets, which limits correspondingly their possibilities of action to promote economic and social development.

31. Given this exceptional situation, and without prejudice to various Community programmes currently in operation or being prepared (see Annex 4), the Commission believes it is appropriate to grant aid from the Community budget for a specified period to assist these regions to offset the high cost of oil imports. The following conditions would govern this aid:

- the extra costs to be offset would be those relating to the transport by sea of petroleum products between mainland Portugal (the reference point of departure being the nearest refinery, i.e. the Sines refinery) and the main depots on the islands, and between the main and the secondary depots on the other islands;
- the reference year for the calculation of Community aid will be 1989: account will be taken only of the costs of sea transport – and not the cost of storage and distribution on the island – on the basis of the quantities of petroleum products actually transported in 1989, the average transport costs by category of product in 1989 and the average ecu/escudo exchange rate in that year;
- aid will be granted for three years from 1 January 1991 up to 31 December 1993. During these three years,

annual Community aid will remain constant and equal to the extra cost of supplies, as defined above, in the reference year (1989);

- Community aid will be granted subject to the condition that over the same period the beneficiary regions devote at least 50% of the amount of Community aid to incentive programmes to promote investment in energy saving and the development of local, renewable energy sources to improve the situation of energy supply and demand on the islands. The regional authorities will present an annual report to the Commission to enable it to monitor observance of this condition.

3.3.3 *Special measures for free zones*

32. The Commission is aware that free zones can be an appreciable instrument of economic and social development in the remote island regions of the Azores and Madeira, and is keeping an open mind on the subject, particularly as regards State aid. Furthermore, an exception to the principle of Community preference to exempt inward processing operations from the economic conditions attaching to these arrangements would be appropriate in the case of the free zones in the two regions.

3.3.4 *Prices of steel products*

33. In view of the dependence of the Azores and Madeira on the outside world for supplies of steel products, it would be appropriate to extend for three years beyond 31 December 1992 the provisions concerning the pricing of steel products contained in Article 376 of the Act of Accession. The situation would have to be reviewed by the Commission in 1995.

3.4 MEASURES TO SUPPORT PRODUCTS OF THE AZORES AND MADEIRA

3.4.1 *Agricultural products*

3.4.1.1 *Products of Madeira*

34. Given the crucial importance of bananas to the economy of Madeira and with a Community market organization for bananas due to be established by 31 December 1992, steps should be taken to adopt structural measures without waiting for common rules to be adopted in that area; such measures could involve research, harvesting, presentation and processing, transport, storage, marketing and commercial promotion.

35. Community assistance would be given for the fruit and vegetable sector and the flowers and live plants sector (see Annex 3.2), as follows:

- temporary aid per hectare for programmes of measures carried out by producers and producer groups or organizations to diversify production and/or improve product quality; these programmes should serve to develop tropical products in particular. The aid would be increased in cases where the implementation of these programmes involves technical assistance measures;
- aid for the marketing of tropical products where the volume of trade does not exceed 3,000 tonnes for each product, under marketing season contracts between producers on Madeira and operators in other parts of the Community;
- the funding of an economic analysis and forward planning study of the processed fruit and vegetable sector (particularly tropical fruit and vegetables).

36. Other measures required to support local production on Madeira include (see Annex 3.2):

- specific aid per hectare for potato-growing, within the limits of the present areas under cultivation, irrespective of any measures which might be adopted in the context of a market organization for this product;
- as regards sugar cane:
  - specific aid per hectare for producers and producer groups or organizations growing sugar cane under a restructuring plan to be submitted by the Portuguese authorities; after five years this aid would be granted solely to producer groups or organizations;
  - aid for the direct processing of sugar cane into sugar syrup ("Mel de cana") or farm rum, where a minimum price is paid to the cane-grower;
- specific aid for grapes to be used in the making of quality wines psr, to be granted to producers and producer groups or organizations, subject to appropriate limits on the yield per hectare. Quantities delivered for distillation would not be taken into account. After five years this aid would be granted solely to producer groups or organizations;
- specific aid to support products of traditional stockfarming on Madeira and intended for local consumption (fresh milk and fresh meat);
- as regards animal and plant health, measures to safeguard Madeira from certain harmful diseases and organisms against which it is not yet protected, together with a Community financial contribution towards prevention or eradication programmes.

37. To encourage agricultural producers on Madeira to supply high-quality products and to promote the marketing of such products, the Community could finance the design and promotion of a logo.

38. The current legislation on agricultural structures may not take sufficient account of the special characteristics of agriculture on Madeira. Steps need to be taken to allow special exceptions to be made, on the basis of duly substantiated applications from the Portuguese authorities, to provisions restricting or preventing the granting of certain types of structural aid, with due account being taken of the measures already adopted to assist Portugal. New forms of structural assistance could also be envisaged within the framework of programmes to be submitted by the Portuguese authorities and could include:

- aid to improve and diversify production and to improve product quality, particularly in the case of wine, fruit and vegetables, flowers and live plants, animal products and forestry products.

3.4.1.2 *Products of the Azores*

39. Community assistance will be given for the fruit and vegetable sector and the flowers and live plants sector (see Annex 3.4), as follows:

- temporary aid per hectare for programmes of measures carried out by producers and producer groups or organizations to diversify production and/or improve product quality; these programmes should serve to develop tropical products in particular. The aid would be increased in cases where the implementation of these programmes involves technical assistance measures;

- aid for the marketing of tropical products where the volume of trade does not exceed 3,000 tonnes for each product, under marketing season contracts between producers in the Azores and operators established in other parts of the Community;
- the funding of an economic analysis and forward planning study of the processed fruit and vegetable sector (particularly tropical fruit and vegetables).

40. Other measures required to support local production include (see Annex 3.4):

- in the case of sugar beet:
  - flat-rate aid per hectare for the development of local production, subject to a limit on quantities corresponding to production of 10,000 tonnes of sugar;
  - specific aid for the processing of locally grown beet into white sugar, with a view to stabilizing supply costs;
- specific aid per hectare for the growing of seed potatoes (subject to a maximum of 200 hectares) and for the growing of chicory (subject to a maximum of 400 hectares);
- specific aid for the collection of tobacco and for the traditional local production of leaf tobacco, subject to maximum guaranteed quantities;
- temporary aid per hectare for the growing of vines to produce quality wines psr, to be granted to producers and producer groups or organizations pending the results of restructuring and subject to a maximum of 1,700 hectares;
- given the social importance of milk production in the Azores, particularly in the case of small producers, specific aid should be introduced to ensure the survival of traditional economic activities in this sector;
- specific additional aid for the fattening of adult male cattle, within the limits of traditional levels of production;
- as regards animal and plant health, measures to safeguard the Azores from certain harmful diseases and organisms against which they are not yet protected, together with a Community financial contribution towards prevention or eradication programmes.

41. To encourage agricultural producers in the Azores to supply high-quality products and to promote the marketing of such products, the Community could finance the design and promotion of a logo.

42. The current legislation on agricultural structures may not take sufficient account of the special characteristics of agriculture in the Azores. Steps need to be taken to allow special exceptions to be made, on the basis of duly substantiated applications from the Portuguese authorities, to provisions restricting or preventing the granting of certain types of structural aid, with due account being taken of the measures already adopted to assist Portugal. New forms of structural assistance could also be envisaged within the framework of programmes to be submitted by the Portuguese authorities:

- aid to improve and diversify production and to improve product quality, particularly in the case of milk, animal products, fruit and vegetables, flowers and live plants, wine and forestry products;
- aid to offset the additional cost of agricultural investments because of the need for protection against natural disasters and, where production has been diversified, aid for the establishment of a solidarity fund for the restoration of production potential damaged by natural disasters.

3.4.2 *Measures to assist craft industries*

43. In view of the considerable economic and social importance of craft industries in the regions concerned and given the traditional and highly localized nature of production, measures could be envisaged to assist small businesses in the fields of occupational training, access to new technology and the use of such technology, and access to new markets, where they are not covered by the Community support framework. These measures could include:

- specific information campaigns on Community training programmes;
- a feasibility study on a European apprenticeship system (training to qualify as a master craftsman);
- development of transnational pilot schemes to enable apprentices and craftsmen to take advantage of vocational training programmes in other Member States;
- launching of an advertising campaign to ensure that small businesses are fully informed of the opportunities to participate in technological programmes such as VALUE, CRAFT and LEADER or any new programme relevant to small businesses;
- encouragement for the introduction of trade directories or buyers' handbooks for the use of craftsmen and small businesses;
- improved access for firms and trade organizations to statistics on the quantitative and qualitative development of markets for craft products in the Member States;
- examination of the possibility of establishing an export credit and insurance system for craftsmen and small businesses.

44. Such projects must be selected, on the one hand, on a partnership basis in close collaboration with the regional and local authorities concerned and, on the other hand, be consistent with operations carried out in the two regions concerned under the Community support framework and with schemes implemented by the Commission in these regions and in other regions of the Community.

45. It is in any case necessary to mobilize small businesses in Madeira and the Azores so that they take advantage of the opportunities offered by the Community to improve their productivity and expand their outlets on the Community market. Similarly, they must be given easier access to the services of the Euro-Info-Centres already established on Madeira and the Azores so that they can make full use of the data available through these Centres. Another task will be to promote better use of the services of the BC-Net and the Business Cooperation Centre so that firms can cooperate across national frontiers.

3.5 FINANCING OF THE MEASURES PROVIDED FOR IN POSEIMA

46. The attached financial statement gives estimates of the cost of the various measures over an initial period of three years (1991-93).

47. Many agricultural measures provided for in POSEIMA will be financed by the EAGGF Guarantee Section.

48. The financing of measures relating to agricultural structures and of the specific aid for energy supplies and small businesses will depend, however, on the availability of resources in addition to those already agreed for the period up to 31 December 1993 in the Community support framework or currently under discussion for the REGIS scheme.

49. The question therefore arises of whether an overall budgetary framework should be set up to cover financial commitments under POSEIMA other than measures financed under the EAGGF Guarantee Section, and without prejudice to structural policy operations for the two regions.

50. If the Community measures to assist the remoter regions are to be fully consistent, this budgetary framework should also cover the funding of financial commitments which are not eligible under the EAGGF Guarantee Section and which appear in the action programmes for the other remoter regions – already adopted, in the case of the French overseas departments (POSEIDOM), or proposed, in the case of the Canary Islands (POSEICAN).

4. FINANCIAL STATEMENT

1. Measures to be financed by the EAGGF Guarantee Section
(Estimate)

– Maximum annual expenditure (2nd or 3rd year of application)	ECU 23 million

2. Measures to improve agricultural structures (1991-93)
(Estimate)

– Traditional products	
bananas	ECU 8 million
livestock products Azores	ECU 17 million
– Other products	ECU 9 million
– Natural disaster fund	ECU 6 million
Total – Agricultural structures 1991-93	ECU 40 million

3. Aid for energy supplies (1991-93)

Annual cost estimated at approx. ECU 8.6 million, i.e. for the three-year period 1991-93:	ECU 25.8 million

4. Measures to assist small businesses (1991-93)

Estimated cost for the three-year period 1991-93:	ECU 7 million
Total – Items 2, 3 and 4	ECU 71.8 million

ANNEX 1

AZORES AND MADEIRA: BASIC STATISTICS

INDICATOR	AZORES	MADEIRA	EUR 12	YEAR
Population (thousands)	253 (0.07%)	268 (0.08%)	324077 (= 100%)	1986
Pop. increase (% p.a.)	0.6	0.9	0.3	86/76
Area (thousand km²)	2.3 (0.1%)	0.8 (0.04%)	2254.6 (= 100%)	
Density (inh/km²)	112 (78.3%)	338 (236%)	143 (= 100%)	1986
EMPLOYMENT				
Unemployment rate (%)	3.1[1]	3.8[1]	10.2	1988
Agric./tot.emp. (%)	29.2	21.5	8.1	1986
Indust./tot.emp. (%)	22.6	34.2	33.7	1986
Services/tot. emp. (%)	48.2	44.3	57.7	1986
GDP				
Per capita GDP (ECU)	6620[2]	6620[2]	10324	AVE.84-86
Agric./tot. GDP (%)	30[3]	28[3]		
Indust./tot. GDP (%)	23[3]	18[3]		
Services/tot. GDP (%)	47[3]	55[3]		

NOTES

1. One reason for the low rates of unemployment is that large numbers of people have emigrated from the islands. There is in fact considerable underemployment in agriculture and small-scale industry (Madeira).
2. Since the data for the Azores and Madeira are not available, the figure given is the national average for Portugal. Per capita GDP in the Azores and Madeira is usually reckoned to be less than half this national average.
3. Estimates.

ANNEX 2

COMMUNITY STRUCTURAL AID FOR THE AZORES AND MADEIRA

1. *Period 1986-1989*

Transport infrastructures were one of the priority areas for Community aid to the Azores over the period 1986-89, reflecting the concerns of the regional government, one of whose main objectives was to equip each island with at least one port and one airport. Other priority areas for assistance to the region included: energy infrastructures (placing emphasis on alternative energy sources and facilitating regular supplies of energy throughout the region), medical infrastructures, support for tourism and productive activities, and vocational training. In addition to the assistance granted for individual projects, the region also benefits from the Community's STAR (telecommunications) and VALOREN (energy) programmes, from the national programme of Community interest in support of productive activity (PNICIAP) and from the PEDIP programme (with the exception of the SINPEDIP subprogramme).

In Madeira, assistance during the same period went primarily to transport infrastructures (40%), energy infrastructures (33%) and water-engineering infrastructures (15%). The main projects financed in the region include the ports of Porto Santo and Funchal, the Victoria power station, the hydroelectric power station at Calheta, the acquisition of a vessel for the Funchal/Porto Santo route, several water supply projects and a large number of roads. In addition to the assistance granted for individual projects, the region also benefits from the Community's STAR (telecommunications) and VALOREN (energy) programmes, from the national programme of Community interest in support of productive activity (PNICIAP) and from the PEDIP programme (with the exception of the SINPEDIP subprogramme).

The two autonomous regions are also eligible for various measures under the PEDAP (specific programme for the development of Portuguese agriculture) and for special arrangements that take account of their specific structural characteristics for the purposes of applying the Community Regulations on improving the efficiency of agricultural structures and on improving the conditions under which agricultural and fisheries products are processed and marketed.

Structural aid to the Azores, 1986-89

1. Community assistance (commitments) for the Azores[1]

ECU million

	1986	1987	1988	1989	Total
EAGGF (Guidance Section)[2] – Total	1.10	4.81	1.02	1.12	8.05
Reg 355/77 Proc/Mark Ag Prods	0.40	2.96	1.02	n.a.	4.38
Reg 4028/86 Restr fisheries[3]	0.70	1.85	8.00	1.12	3.67
ESF[4] – Total	0.00	2.33	4.23	0.00	6.56
Measures not broken down	0.00	2.33	4.23	0.00	6.56
ERDF – Total	29.80	29.71	18.19	n.a.	77.70
Infrastructure	29.80	29.71	18.19	n.a.	77.70
Total – Assistance	30.89	36.84	23.44	1.12	92.29

1. Excluding assistance for multiregional projects or programmes.
2. Direct and indirect measures that can be broken down by region.
3. Including Regulations Nos. 2992/81, 31/83 and 2908/83.
4. Before 1984, the bulk of ESF assistance could not be broken down by region.

2. Community loans to the Azores[5]

ECU million

	1986	1987	1988	1989	Total
EIB – Total	0.00	6.30	29.50	n.a.	35.80
Industry and services	0.00	0.00	0.00	n.a.	0.00
Energy	0.00	0.00	0.00	n.a.	0.00
Infrastructure	0.00	6.30	29.50	n.a.	35.80
Total – Loans	0.00	6.30	29.50	0.00	35.80

5. Excluding loans for multiregional projects or programmes.
* Partial/provisional.

Structural aid for Madeira over the period 1986-89

1. Community assistance (commitments) for Madeira[1]

ECU million

	1986	1987	1988	1989	Total
EAGGF (Guidance Section)[2] – Total	1.01	0.65	0.04	1.05	2.75
Reg 355/77 Proc/Mark Ag Prods	0.84	0.00	0.00	n.a.	0.86
Reg 4028/86 Restr fisheries[3]	0.15	0.65	0.04	1.05	1.29
ESF[4] – Total	0.00	2.39	3.14	0.17	5.70
Measures not broken down	0.00	2.39	3.14	0.17	5.70
ERDF – Total	20.19	26.34	19.17	n.a.	65.70
Infrastructure	20.19	26.09	18.06	n.a.	65.16
Studies	0.00	0.25	0.29	n.a.	0.59
Total – Assistance	21.20	29.38	22.35	1.22	74.15

1. Excluding assistance for multiregional projects or programmes.
2. Direct and indirect measures that can be broken down by region.
3. Including Regulations Nos. 2992/81, 31/83 and 2908/83.
4. Before 1984, the bulk of ESF assistance could not be broken down by region.
* Partial/provisional.

2. Community loans to Madeira[5]

ECU million

	1986	1987	1988	1989	Total
EIB – Total	29.10	20.70	0.00	n.a.	49.80
Industry and services	0.00	0.00	0.00	n.a.	0.00
Energy	29.10	0.00	0.00	n.a.	29.10
Infrastructure	0.00	20.70	0.00	n.a.	20.70
Global loans[6]	0.00	0.00	0.00	n.a.	0.00
Total – Loans	29.10	20.70	0.00	0.00	49.80

5. Excluding loans for multiregional projects or programmes.
6. Regional breakdown of allocations from global loans. *Source:* EIB Annual reports.
* Partial/provisional.

2. *Application of the reformed structural Funds in the Azores and Madeira*

Structural Fund operations for Madeira are shown in the table below concerning a multi-fund programme costing ECU 309 million with a Community contribution of ECU 218 million. This programme comprises the following eight subprogrammes:

1. Development of production structures
2. Tourism
3. Energy infrastructure
4. Transport infrastructure
5. Vocational training and utilization of human resources to best effect
6. Social strategy equipment (in the areas of education, health and vocational training)
7. Protection of the environment and town and country planning
8. Programme management and evaluation.

Structural Fund operations for the Azores are shown in the tables below. The first programme is the specific development programme for the autonomous region of the Azores (PEDRAA). Costing a total of ECU 304 million with a Community contribution of ECU 178 million, it is made up of the following four subprogrammes:

1. Basic infrastructure
2. Vocational training and support for production activity
3. Environment and quality of life
4. Implementation and monitoring.

The second programme is the national programme of Community interest (NPCI). The Community contribution is ECU 63 million out of a total cost of ECU 95 million.

The third operation is the purchase of three aircraft for the SATA airline, for which the Community will contribute ECU 19 million out of a total cost of ECU 38 million.

The Azores and Madeira would also be eligible for certain national measures in the Community support framework for Portugal (CIENCIA, PNICIAP, etc.).

Finally a number of Community schemes should also include the Azores and Madeira: ENVIREG, STRIDE, TELEMATIQUE, REGIS, LEADER, EUROFORM, NOW and HORIZON.

PNIC AÇORES – CUSTO TOTAL, DESPESA PÚBLICA E CONTRIBUIÇÃO FEDER

SUB-PROGRAMAS	Custo Total (Valor)	DESPESA PÚBLICA – REGIONAL – Valor	REGIONAL – % Despesa Pública	FEDER – Valor	FEDER – % Despesa Pública	TOTAL – Valor	TOTAL – % Custo Total	DESPESA PRIVADA – Valor	DESPESA PRIVADA – % Custo Total
S/P1 – Estruturas Físicas em sectores ou áreas envolventes ao sector turismo	8 899,0	3 218,5	36,2	5 680,5	63,8	8 899,0	100,0	–	–
1988	626,0	253,2	40,4	372,8	59,6	626,0	100,0	–	–
1989	3 708,0	1 357,0	36,6	2 351,0	63,4	3 708,0	100,0	–	–
1990	4 565,0	1 608,3	35,2	2 956,7	64,8	4 565,0	100,0	–	–
S/P2 – Melhoria e criação de estruturas físicas no sector turismo	7 872,0	2 405,9	30,6	5 464,2	69,4	7 870,1	100,0	1,9	...
1988	1 511,0	463,1	30,7	1 047,4	69,3	1 510,5	100,0	0,5	...
1989	3 137,0	965,0	30,8	2 171,4	69,2	3 136,4	100,0	0,6	...
1990	3 224,0	977,8	30,3	2 245,4	69,7	3 223,2	100,0	0,8	...
S/P3 – Organização	175,0	52,5	30,0	122,5	70,0	175,1	100,0	–	–
1988	17,0	5,1	30,0	11,9	70,0	17,0	100,0	–	–
1989	76,0	22,8	30,0	53,2	70,0	76,0	100,0	–	–
1990	82,0	24,6	30,0	57,4	70,0	82,0	100,0	–	–
S/P4 – Apoio ao investimento	693,0	207,9	30,0	485,1	70,0	693,0	100,0	–	–
1988	81,0	24,3	30,0	56,7	70,0	81,0	100,0	–	–
1989	225,9	67,8	30,0	158,1	70,0	225,9	100,0	–	–
1990	386,1	115,8	30,0	270,3	70,0	386,1	100,0	–	–
S/P5 – Promoção	596,0	178,8	30,0	417,2	70,0	596,0	100,0	–	–
1988	104,0	31,2	30,0	72,8	70,0	104,0	100,0	–	–
1989	217,0	65,1	30,0	151,9	70,0	217,0	100,0	–	–
1990	275,0	82,5	30,0	192,5	70,0	275,0	100,0	–	–
S/P6 – Execução e acompanhamento	80,0	24,0	30,0	56,0	70,0	80,0	100,0	–	–
1988	15,0	4,5	30,0	10,5	70,0	15,0	100,0	–	–
1989	28,0	8,4	30,0	19,6	70,0	28,0	100,0	–	–
1990	37,0	11,1	30,0	25,9	70,0	37,0	100,0	–	–
TOTAL PNIC AÇORES	18 315,0	6 087,6	33,2	12 225,5	66,8	18 313,1	100,0	1,9	...
1988	2 354,0	781,4	33,2	1 572,1	66,8	2 353,5	100,0	0,5	...
1989	7 392,0	2 486,2	33,6	4 905,2	66,4	7 391,4	100,0	0,6	...
1990	8 569,0	2 820,0	32,9	5 748,2	67,1	8 568,2	100,0	0.8	...

PROGRAMA OPERACIONAL PLURIFUNDOS DA REGIÃO AUTÓNOMA DA MADEIRA

SUBPROGRAMAS

(ECUs CONSTANTES 1989 x 1 000)

		DESPESA PÚBLICA													DESPESA PRIVADA	
	CUSTO TOTAL	TOTAL		APOIOS COMUNITÁRIOS						FINANCIAMENTO PÚBLICO						
			%	TOTAL	%	FEDER	FSE	FEOGA	OUTROS	TOTAL	%	ESTADO	REGIÃO	OUTRA	TOTAL	%
	1=2+15	2=4+10	3	4=6+7+8+9	5	6	7	8	9	10=12+13+14	11	12	13	14	15	16
Subprog. 1	67 402	65 280	97	43 484	67	43 484				21 796	33		9 764	12 032	2 122	3
Subprog. 2	38 760	38 760	100	29 070	75	29 070				9 690	25		9 690			
Subprog. 3	28 865	28 865	100	15 878	55	15 878				12 987	45			12 987		
Subprog. 4	70 502	69 244	98	52 193	75	52 193				17 051	25		17 051		1 258	2
Subprog. 5	39 521	38 772	98	27 118	70		27 118			11 654	30		11 654		749	2
Subprog. 6	41 136	41 136	100	30 851	75	30 851				10 285	25		10 285			
Subprog. 7	24 830	24 830	100	18 624	75	18 624				6 206	25		6 206			
Subprog. 8	2 374	2 374	100	1 781	75	899	882			593	25		593			
TOTAL	313 390	309 261	99	218 999	71	190 999	28 000			90 262	29		65 243	25 019	4 129	1

PROGRAMA OPERACIONAL: PEDRAA (Programa Específico de Desenvolvimento da Região Autónoma dos Açores)

SUBPROGRAMAS

(ECUs CONSTANTES 1989 x 1 000)

		DESPESA PÚBLICA										DESPESA PRIVADA	BEI
	CUSTO TOTAL	TOTAL	APOIOS COMUNITÁRIOS					FINANCIAMENTO PÚBLICO					
			TOTAL	FEDER	FSE	FEOGA	OUTROS	TOTAL	ESTADO	REGIÃO	OUTRA	TOTAL	
	1=2+12	2=3+8	3=4+5+6+7	4	5	6	7	8=9+10+11	9	10	11	12	13
Subprog. 1	168 163	168 163	105 125	105 125				63 038		63 038			
Subprog. 2	54 400	43 350	31 500	6 500	25 000			11 850		11 850		11 050	
Subprog. 3	79 950	79 950	39 975	39 975				39 975		39 975			
Subprog. 4	2 000	2 000	1 400	1 400				600		600			
TOTAL	304 513	293 463	178 000	153 000	25 000			115 463		115 463		11 050	80 000

Nota: Encontra-se negociado um empréstimo com o BEI, de aproximadamente 80 MECUs, que compreende alguns projectos incluídos neste PO.

ANNEX 3

1. AGRICULTURAL PRODUCTS COVERED BY THE MEASURES RELATING TO SUPPLIES ON MADEIRA

GENERAL PROVISIONS GOVERNING SUPPLIES

Cereals
Rice
Sugar
Vegetable oils
Beef/veal
Pigmeat
Milk and milk products

On a temporary basis

Compound feedingstuffs
Bovine animals for fattening
Seed potatoes

AID FOR THE PURCHASE OF COMMUNITY PRODUCTS

Breeding animals

Cattle
Pigs
Day-old chicks and eggs for hatching

Products for use in the manufacture of liqueur wines

Concentrated and rectified grape must
Wine alcohol (temporarily)

2. AGRICULTURAL PRODUCTS COVERED BY THE MEASURES TO ASSIST PRODUCTION ON MADEIRA

FRUIT, VEGETABLES, FLOWERS AND LIVE PLANTS

Tropical products

Sweet potatoes
Tropical fruit, including anonas, avocados, pineapples and papaws
Exotic plants and flowers

Other products

Non-tropical fruit
Potatoes
Vegetables other than potatoes

SUGAR CANE

VINEYARDS

3. AGRICULTURAL PRODUCTS COVERED BY THE MEASURES RELATING TO SUPPLIES IN THE AZORES

GENERAL MEASURES RELATING TO SUPPLIES

Cereals
Raw sugar

PURCHASE OF BREEDING ANIMALS

Cattle

4. AGRICULTURAL PRODUCTS COVERED BY THE MEASURES TO ASSIST PRODUCTION IN THE AZORES

FRUIT, VEGETABLES, FLOWERS AND LIVE PLANTS

Tropical products

Pineapples
Other fruit: avocados, anonas, passion fruit, mangoes etc.
Exotic plants and flowers

Other fruit and vegetables intended for the local market

Citrus fruit
Various fruit and vegetables

SUGAR BEET

SEED POTATOES, CHICORY AND TOBACCO

VINES

BEEF/VEAL

ANNEX 4

COMMUNITY AID TO THE AZORES AND MADEIRA IN THE ENERGY SECTOR

In addition to the specific aid for energy supplies which the Commission is proposing under the POSEIMA programme, the Community has provided and will continue to provide financial support for energy-related measures in the Azores and Madeira.

By means of the various Commission programmes which are currently in operation or being prepared, whether they are specific to the energy sector or of a more general nature, the Community is providing or could provide support for energy-related measures on both groups of islands, depending on the rules and priorities laid down for each programme.

The above-mentioned programmes include:

- the JOULE programme for research and development in the energy sector;
- regional and urban energy programmes;
- the THERMIE programme for the development or energy-related technologies;
- the SAVE programme to promote the efficient use of energy;
- the VALOREN programme for the exploitation of the Community's own energy potential;
- multifund operations programmes;
- the Community's REGIS scheme to assist the remoter regions.

Proposal for a
COUNCIL DECISION
setting up a programme of options specific to the remote and insular nature of Madeira and the Azores (POSEIMA)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to the Act of Accession of Spain and Portugal,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Economic and Social Committee,

Whereas the autonomous Portuguese regions of the Azores and Madeira belong politically and economically to the Community by virtue of the Act of Accession, which did, however, recognize some of their specific characteristics by allowing various isolated exceptions in the application of the common policies;

Whereas the Member States, in a joint declaration annexed to the Act of Accession, called on the Community institutions to devote special attention to the development policies of the two regions, "the object of which is to overcome the handicaps of these regions, which arise from their geographical situation, far away from the mainland of Europe, their physical geographical features, the serious deficiency of infrastructures and their economic backwardness";

Whereas the European Parliament, in its resolution of 14 April 1989 on Community programmes to help the Portuguese autonomous island regions[1], considered that in view of their island status and highly peripheral situation the Azores and Madeira deserve special treatment from the Community;

Whereas the Azores and Madeira suffer from a serious structural lack of development aggravated by a number of constraints (remoteness, isolation, small size, difficult terrain and climate) whose unchanging nature and combined impact have serious effects on their economic and social development and place them among the least-favoured regions of the Community; whereas these special constraints make it necessary to step up Community support in order to ensure that the Azores and Madeira are fully involved in the dynamic[s] of the internal market; whereas this Community support takes the form of operations under the reformed structural Funds (enjoying the priority given to the Objective 1 regions), but must also ensure that the special constraints affecting the Azores and Madeira are taken into account in the application of common policies, in accordance with the Community approach to the remoter regions, of which the adoption and implementation of the POSEIDOM programme for the French overseas departments is the first practical example;

Whereas an overall, multi-sector approach is necessary to allow for the special constraints on the Azores and Madeira in the application of common policies; whereas a coherent line must be taken as part of an overall action programme involving legislative measures and financial commitments;

Whereas, for the purposes of implementing this programme, the necessary legal acts will be adopted either by the Council or by the Commission, as appropriate, before 31 December 1992; whereas the application of certain measures in this programme could extend beyond the process of completing the internal market, given the permanent constraints which are a particular feature of the Azores and Madeira;

Whereas this programme must be based on the twofold principle that the Azores and Madeira form an integral part of the Community and that the regional reality deriving from their particular geographical situation must be recognized;

Whereas the measures contained in the programme must accordingly take into account the special characteristics and constraints of the Azores and Madeira without undermining the integrity and coherence of the Community legal order; whereas the economic effects of specific measures must therefore remain limited to the territory of the Azores and Madeira without affecting directly the functioning of the common market;

Whereas Community policies already provide many instruments and programmes which could deal with some of the specific problems and constraints of the Azores and Madeira, notably concerning fisheries, energy, environment, the craft industry and research and development; whereas steps should be taken to put these instruments and programmes to best use in the Azores and Madeira, especially by ensuring that they reach these remote regions and by developing appropriate technical assistance measures;

Whereas Community rules must take account of the specific nature of the Azores and Madeira and permit their economic and social development, particularly in those areas where the fragile nature of island territories is particularly acute, such as transport, taxation, the social sector, research and development, or the protection of the environment in view of the vulnerability of the Azores and Madeira to the risks of environmental or natural disasters;

Whereas, with respect to taxation, the special characteristics of the Azores and Madeira can be catered for by allowing special indirect taxation arrangements compatible with the rules of the Treaty and capable of promoting their economic and social development;

Whereas it is important to provide regular transport links at the lowest possible cost to alleviate the drawbacks of remoteness and the island location; whereas air transport is an instrument of regional development and the most appropriate forms of greater liberalization should be worked out, notably under partnership arrangements;

Whereas the exceptional geographical situation of the Azores and Madeira in relation to sources of supply for products used as inputs in certain food sectors, which are essential for current consumption or processing in the archipelago, entails costs that are a severe handicap for this area; whereas there is a need, in this connection, to make special arrangements for the supply of these products within the limits of market needs for the two regions and taking account of local production and traditional trade flows;

Whereas the extreme remoteness of the Azores and Madeira in relation to sources of supply of refined petroleum products, coupled with the heavy reliance on these products to meet energy needs and the compartmentalization of the market, means that supply costs in the Azores and Madeira are much higher than in mainland Portugal; whereas these costs are at present borne by the regional budgets, which limits correspondingly their capability for action to promote economic and social development; whereas these higher costs should be offset by temporary Community aid tied to the application by the two regions of incentive programmes to promote investment in energy saving and the development of

1. OJ No C 120, 16.5.1989, p. 321.

local, renewable energy sources to improve the energy supply and demand situation on the islands;

Whereas free zones can be an appreciable instrument of economic development in the remote island regions of the Azores and Madeira; whereas customs measures may be appropriate regarding the arrangements applicable to the free zones in the Azores and Madeira, in view of their special geographical situation;

Whereas, in view of the dependence of the Azores and Madeira on the outside world for supplies of steel products, it would be appropriate to take temporary measures, to extend beyond 31 December 1992 the provisions concerning the pricing of these products contained in Article 376 of the Act of Accession;

Whereas the special production conditions in the Azores and Madeira require that particular attention be paid to applying the common agricultural policy to this region; whereas appropriate measures are needed to assist the development of the fruit and vegetable and flowers and live plant sectors; whereas these measures will have to promote the growing of tropical products in particular; whereas special attention will have to be given to Madeira bananas in view of their crucial economic and social importance for the island and with due account for aspects relating to ecological balance and the countryside; whereas other market and structural measures will be required to support local products, especially for the milk sector in the Azores in view of the social importance for small producers;

Whereas, in view of the considerable social importance of maintaining craft activities in the two regions, specific Community measures should be taken to fit in with those already planned under the Community support framework; whereas these measures should aim at promoting vocational training, access to new technology and the use of such technology, and access to new markets;

Whereas the preparation, implementation, monitoring and evaluation of the measures provided for in this programme require a partnership between the Commission and the competent national and regional authorities; whereas this partnership must permit complementarity between the measures laid down in the programme and those applied at national and regional level;

Whereas Portugal and the region must take account of the measures and operations under this programme in drafting future regional development plans; whereas the Commission, within the scope of its powers, will take steps to ensure that this programme is consistent with the operations of the structural Funds and other Community financial instruments,

HAS DECIDED AS FOLLOWS:

Article 1

1. An action programme for Madeira and the Azores, known as POSEIMA (Programme of options specific to the remote and insular nature of Madeira and the Azores) and set out in the Annex, is hereby established. This programme shall cover legislative measures and financial commitments.

2. Within the context of the powers conferred upon it by the Treaty, the Council shall adopt the provisions necessary for the execution of this programme and invite the Commission to submit the relevant proposals as soon as possible.

Article 2

The financial resources required to implement the measures relating to agricultural structures appearing in this programme shall be determined in the annual budgetary procedures.

Article 3

This Decision shall take effect on ... 1991.

Article 4

This Decision shall be published in the Official Journal of the European Communities.

Done at Brussels,

For the Council
The President

ANNEX

PROGRAMME OF OPTIONS SPECIFIC TO THE REMOTE AND INSULAR NATURE OF MADEIRA AND THE AZORES (POSEIMA)

TITLE I

General principles

1. POSEIMA will be based on the twofold principle that Madeira and the Azores form an integral part of the Community and that the regional reality, characterized by the special features and constraints specific to the regions concerned as distinct from the Community as a whole, must be recognized.

2. Implementation of the measures and operations set out in the POSEIMA programme will in principle be carried out before 31 December 1992, through the adoption either by the Council or by the Commission, as appropriate, of the necessary legal acts, in accordance with the provisions and procedures laid down in the Treaty.

3.1. The POSEIMA programme will help attain the general aims of the Treaty by contributing to the achievement of the following specific objectives:

- better integration of Madeira and the Azores into the Community by establishing an appropriate framework for the application of common policies in this area;
- the full involvement of the Azores and Madeira in the dynamic[s] of the internal market by making optimum use of existing Community regulations and instruments;
- assisting the Azores and Madeira to catch up economically and socially, principally through Community financing of the specific measures contained in POSEIMA.

3.2. The Member State and the regions concerned will take into account the specific measures and operations contained in POSEIMA when drawing up future regional development plans. Within the scope of its powers, the Commission, for its part, will take steps to ensure that the operations conducted under POSEIMA are consistent with the operations of the structural Funds and other Community financial instruments.

3.3. The drafting, implementation, monitoring and evaluation of the operations and measures contained in POSEIMA will be carried out in partnership by the Commission and the competent national and regional authorities. Efforts will be made to ensure that POSEIMA operations and those conducted at national and regional levels complement each other as far as possible.

4. The measures and operations contained In POSEIMA should enable the specific nature and constraints of the Azores and

Madeira to be taken into account without undermining the integrity and coherence of the Community legal order.

TITLE II

Optimum use of existing policies and instruments

5. The Commission, in partnership with the Member State and the two regions concerned, and within the framework of the existing regulations, will endeavour to ensure that optimum use is made of existing Community instruments and programmes in the Azores and Madeira, in particular by developing appropriate technical assistance programmes.

TITLE III

Application of common policies in the Azores and Madeira

6. Directives or other measures adopted in connection with the internal market and other common policies will have to take account of the special characteristics of the Azores and Madeira and make their economic and social development possible, particularly in the fields of transport and taxation, social matters, research and technological development (without prejudice to the Community framework programme on this topic), and protection of the environment.

7.1. Due allowance will be made in the Community tax regulations for the special characteristics of the Azores and Madeira to admit an indirect taxation system specific to these regions, compatible with the rules of the Treaty and capable of promoting their economic and social development.

7.2. As regards VAT this means maintaining special arrangements for the Azores and Madeira in accordance with the Act of Accession.

7.3. A special arrangement for excise duties on manufactured tobacco, spirits and other alcoholic beverages, and petroleum products after 31 December 1992 taking account of the problems of extreme remoteness will have to be incorporated into the general framework of the Commission's proposals on excise duties.

8. The Community and the Member State will develop any actions designed to enable the many different Community airlines, particularly local airlines, to serve the Azores and Madeira in the interests of their development.

TITLE IV

Specific measures to mitigate the effects of the exceptional geographical situation

9.1. Within six months from the date on which this Decision takes effect, the Council or the Commission, as appropriate, will adopt the measures laid down in this article which are intended to alleviate the impact of the additional costs involved in maintaining supplies of agricultural products resulting from the remote and insular nature of the Azores and Madeira.

9.2. In the case of essential agricultural products for consumption or processing in the two regions, this Community action will consist, within the limits of local market requirements and taking into account local production and traditional trade flows, in:

- exempting from levies and/or customs duties products originating in non-member countries;
- permitting, in parallel and in competition with products from non-member countries and on equivalent terms, the supply of Community products taken into intervention storage or available on the Community market.

The principles underlying the application of this system will be as follows:

- in order to ensure that these measures have an impact on the level of production costs and consumer prices, a mechanism will have to be set up to monitor this impact up to the end-user stage;
- with respect to raw sugar supplies for the Azores, the system will be applicable until such time as local production of sugar beet is sufficient to satisfy local market needs and as long as the total volume of sugar refined in the Azores does not exceed 10,000 tonnes;
- with respect to supplies of compound feedingstuffs in Madeira, the system will be applied temporarily pending an increase in capacity and the modernization of the industry producing these feedingstuffs, subject to the limits of local market needs and taking account of local production. This measure could be applied for three marketing years for the products coming under CN Codes 2309 90 31, 33, 41, 43, 51 and 53.

9.3. In the Azores, for the purposes of genetic improvement, aid may be granted for the purchase of male breeding animals originating in the Community (beef breeds).

9.4. In Madeira, specific measures will be necessary to develop livestock farming for local market needs:

- aid for the purchase of breeding animals (cattle, pigs, chicks and hatching eggs) originating in the Community;
- on a temporary basis, limited to decreasing quantities pending the development of local production, exemption from levies and/or customs duties for the purchase of cattle for fattening originating in non-member countries; in the light of this exemption, aid for the supply of Community products will be granted to facilitate the access of these products on equivalent conditions. After four years of application of the system, the situation would be reviewed.

9.5. For the production of liqueur wines in Madeira solely to satisfy local market needs, aid will be provided for the purchase of rectified concentrated musts in the Community, pending the result of a feasibility study on the construction of a wine alcohol distillery.

10.1. In the course of 1991 specific Community aid to compensate for the extra cost of supplying oil to the Azores and Madeira will be introduced for a three-year period on the terms laid down in paragraphs 10.2 to 10.5.

10.2. The extra costs to be offset by this aid are those related to the transport by sea of petroleum products between the mainland and the main depots on the islands of the Azores and Madeira, and between the main depots and the secondary depots on the other islands.

10.3. The reference year for the calculation of Community aid will be 1989: account will be taken only of the costs of sea transport – and not of the cost of storage and distribution on the islands – on the basis of the quantities of petroleum products actually transported in 1989, the average transport costs by category of product in 1989 and the average ecu/escudo exchange rate in that year.

10.4. Aid will be granted for three years from 1 January 1991 up to 31 December 1993. During these three years, annual Community aid will remain constant and equal to the extra cost of supplies, as defined above, in the reference year (1989).

10.5. Community aid will be granted subject to the condition that over the same period the beneficiary regions devote at least 50% of the amount of Community aid to incentive programmes to promote investment in energy saving and the development of local, renewable energy sources to improve the situation of energy supply and demand on the islands. The regional authorities will present an annual report to the Commission to enable it to monitor observance of this condition.

11. Inward processing operations carried out in the Azores and Madeira free zones will not be subject to the economic conditions attaching to these arrangements.

12. The provisions concerning the pricing of steel products contained in Article 376 of the Act of Accession will be extended for three years beyond 31 December 1992. During the year preceding the expiry of this period the Commission will evaluate this measure and review the situation.

TITLE V

Specific measures to support products of Madeira and the Azores

13. In view of the economic and social importance of bananas for Madeira and the objective of a fair standard of living for producers, the Commission will, without waiting for the adoption of common rules, decide on structural action to assist this sector. With a view to improving the conditions of production and competition, such action will include measures concerning research, harvesting, presentation and processing, transport, storage, marketing and commercial promotion.

The Council, acting on a proposal from the Commission, will lay down provisions for bananas before 31 December 1992 with a view to the completion of the single market.

14.1. Within six months from the date on which this Decision takes effect the Council or the Commission, as appropriate, will adopt the measures referred to in this article.

14.2. Measures for the fruit and vegetable and live plants and flowers sectors in the Azores and Madeira may take the form of:
- temporary aid per hectare for programmes of measures carried out by producers and producer groups or organizations to diversify production and/or improve product quality; these programmes should serve to develop tropical products in particular. The aid may be increased in cases where the implementation of these programmes involves technical assistance measures;
- aid for the marketing of tropical products where the volume of trade does not exceed 3,000 tonnes for each product and for each of the two regions, under marketing season contracts between producers in these regions and operators in other parts of the Community;
- the funding of an economic analysis and forward planning study of the processed fruit and vegetable sector (particularly tropical fruit and vegetables).

14.3. Other measures to help support and develop local production on Madeira may take the form of:
- specific aid per hectare for potato-growing, within the limits of the present areas under cultivation, irrespective of any measures which might be adopted in the context of a market organization for this product;
- as regards sugar cane:
  - specific aid per hectare for producers and producer groups or organizations growing sugar cane under a restructuring plan to be submitted by the Portuguese authorities. After five years this aid may be granted solely to producer groups or organizations;
  - aid for the direct processing of sugar cane into sugar syrup ("Mel de cana") or farm rum, where a minimum price is paid to the cane-grower;
- specific aid for grapes to be used in the making of quality wines psr, to be granted to producers and producer groups or organizations, subject to appropriate limits on the yield per hectare. Quantities delivered for distillation will not be taken into account. After five years this aid will be granted solely to producer groups or organizations;
- specific aid to support products of traditional stockfarming on Madeira and intended for local consumption (fresh milk and fresh meat).

14.4. Other measures to help support local production in the Azores may take the form of:
- in the case of sugar beet:
  - flat-rate aid per hectare for the development of local production, subject to a limit on quantities corresponding to production of 10,000 tonnes of sugar;
  - specific aid for the processing of locally grown beet into white sugar, with a view to stabilizing supply costs;
- specific aid per hectare for the growing of seed potatoes (subject to a maximum of 200 hectares) and for the growing of chicory (subject to a maximum of 400 hectares);
- specific aid for the collection of tobacco and for the traditional local production of leaf tobacco, subject to maximum guaranteed quantities;
- temporary aid per hectare for the growing of vines to produce quality wines psr, to be granted to producers and producer groups or organizations pending the results of restructuring and subject to a maximum of 1,700 hectares;
- specific aid designed to ensure the survival of traditional economic activities in the milk sector;
- specific additional aid for the fattening of adult male cattle, within the limits of traditional levels of production.

14.5. As regards animal and plant health, appropriate measures will be taken to safeguard Madeira and the Azores from certain harmful diseases and organisms against which they are not yet protected. A Community financial contribution may also be made towards prevention or eradication programmes.

14.6. To encourage agricultural producers in the Azores to supply high-quality products and to promote the marketing of such products, the Community may finance the design and promotion of a logo for each of these regions.

14.7. Special exceptions may be made, on the basis of duly substantiated applications from the Portuguese authorities, to provisions restricting or preventing the granting of certain types of structural aid to reflect the special characteristics of agriculture in the Azores and Madeira, with due account being taken of the measures already adopted to assist Portugal.

14.8. New forms of structural assistance may also be envisaged within the framework of programmes to be submitted by the Portuguese authorities:

(a) Madeira:
- aids to improve and diversify production and to improve product quality, particularly in the case of wine, fruit and vegetables, flowers and live plants, animal products and forestry products;

(b) the Azores:
- aids to improve and diversify production and to improve product quality, particularly in the case of milk, animal products, fruit and vegetables, flowers and live plants, wine and forestry products;
- aid to offset the additional cost of agricultural investments because of the need for protection against natural disasters and, where production has been diversified, aid for the establishment of a solidarity fund for the restoration of production potential damaged by natural disasters.

15.1. Community measures will be introduced to assist small businesses in the Azores and Madeira in the fields of occupational training, access to new technology and the use of such technology, and access to new markets.

15.2. Such projects must be selected, on the one hand, on a partnership basis in close collaboration with the regional and local authorities concerned and, on the other hand, be consistent with the schemes implemented by the Commission in other regions of the Community.

15.3. The Commission and the Member State will introduce the necessary measures to improve the dissemination and accessibility of the programmes and networks available under the Community's enterprise policy, with a view to increasing the productivity of the craft sector in the Azores and Madeira and increasing their outlets on the Community market.

TITLE VI

Final provision

16. The Commission will report annually to the Council on progress in the implementation of the POSEIMA programme.

TAX POLICY FOR BULGARIA

Charles E. McLure, Jr.*

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I. INTRODUCTION: OBJECTIVES AND CONSTRAINTS

It is crucial that Bulgaria move as quickly as possible, consistent with the need to choose the correct system carefully, to introduce a modern tax system that will be conducive to fair and rapid economic growth. Failure to do this will aggravate both the fiscal problems of the state and macro-economic imbalance, leading to inflationary pressures. Privatization adds urgency to the problem because old methods of collecting taxes on the turnover and profits of captive state enterprises will no longer be available.

It is important that the contours of future tax policy – if not all the details – be established and announced as soon as possible in order to inform potential investors of the "rules of the game", since uncertainty will tend to suppress investment. Such rules should then not be changed in fundamental ways, except in extraordinary circumstances, in order to enforce the principle that tax liabilities are predictable in advance.

Finally, for political reasons it is important to establish correct policy "at the beginning". Massive changes are currently taking place in all aspects of the economic rules of the game; in the context of transition particular choices of tax rules have primarily prospective significance. But ten years from now business decisions will have been made on the basis of these rules and vested interests will have emerged. Once that happens it will be politically difficult to correct unwise choices in tax policy made today.

Bulgaria should resist the temptation to simply follow the well-worn tracks of tax policy in Western democracies and developing countries for several reasons. First, much of the tax policy followed throughout the rest of the world does not make much sense. Bulgaria should not make the same mistakes that have been made elsewhere. Second, social, economic and administrative conditions found in Bulgaria differ from conditions in both Western market economies and developing countries. Fiscal solutions should reflect these differences. In short, Bulgaria should re-examine the policies used elsewhere and consider alternatives more suited to its own needs and conditions.

Unfortunately, tax analysis and the determination of the best tax policy for any country cannot be made quickly. This is especially true in a country such as Bulgaria, where there has been a command economy, where the fundamental economic transformation that is occurring complicates policy analysis, where adequate data do not exist, where there is a scarcity of experts trained in tax policy analysis, and where language problems impede consultation and research by outside advisers. And yet, action must be taken quickly to avert short-term fiscal problems and establish the tax rules under which the game of business will be played. This poses the problem of how to choose short-term policies that will not be inconsistent with the long-term policies that will result from further analysis.

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* Senior Fellow, Hoover Institution, Stanford, California.

In designing a new tax policy for Bulgaria there are important objectives and constraints. First, tax policy should be conducive to capital formation; that is, it should encourage both domestic saving and investment by both Bulgarians and foreigners. The problem of ensuring that the tax climate is competitive with the tax climate of other countries emerging from socialism is discussed further below.

Second, tax policy should be economically neutral; that is, it should not discriminate in favour of certain economic activities and against others. This reflects a belief that under the proper circumstances free markets generally do fairly well in determining what should be produced, the best technology to use, how production should be organized (state enterprise, joint venture, stock company, etc.) and how it should be financed. This view takes as given the successful transition to a market economy that is relatively free of artificial state interference in such matters as pricing, financing, production decisions and resource allocation. It implies that the government generally would not use tax policy to pick "winners and losers", i.e. sectors to receive particularly generous treatment or (except in the case of charges intended to prevent environmental degradation) to be penalized.

A closely related issue that also has implications for fairness involves horizontal equity or equal treatment of equals. Income from various sources should be subject to similar tax treatment, both as a matter of neutrality and a matter of basic fairness. Moreover, alternative ways of organizing production (state enterprises, cooperatives, stock companies, joint ventures, private companies, etc.) should be subject to similar tax treatment, as should foreign and domestic investors. Preferential treatment of foreign investors creates incentives for Bulgarians to "launder" money and invest it under disguise of a foreign company; such treatment is also likely to generate ill-will based on envy.

Part of Bulgaria's legacy of socialism and central planning is the lack of an effective system of tax administration and compliance (which includes a lack of experience with Western accounting systems). This has three important implications. First, such administration should be improved significantly as soon as practical; this is likely to require substantial technical assistance.

Second, tax policy must be designed taking account of the present weakness of administration and compliance. Substantial reliance must be placed on withholding at source in order to minimize the number of tax returns that must be filed and processed. In many instances this will imply the choice of "rough justice" over "fine tuning" in the design of policy, that is, conceptually attractive provisions may need to be sacrificed to administrative reality. It is likely that the resulting system – while less attractive on paper – will be both more equitable and more neutral than one that aims at objectives that cannot be achieved. The third implication is the need to consider tax consequences in constructing accounting rules.

Like other countries newly emerging from socialism, Bulgaria is attempting to choose a system that encourages economic progress while protecting the economically weak and avoiding extreme differences in income. The objective of using progressive taxation to limit income inequality is problematical, since high tax rates stifle the work effort, saving, investment and risk taking that make economic progress occur. It is suggested, therefore, that tax rates be only mildly progressive and that punitive rates be avoided. The top rate should be no higher than 50 percent, and a rate much lower than that (e.g. in the range of 30-40 percent) would be preferable.

One of the most important features of the transition from central planning to a market economy is the opening of the economy to foreign trade and international capital flows. This has several implications for tax policy. Tax policy must not unduly hinder foreign investment. This suggests that much of the tax burden must fall on domestic consumption, rather than on income, since income taxes are more likely to deter foreign investment.

Income tax policy must be made with a view to what is being done in other countries. This includes both the tax treatment of income earned abroad by the home countries of foreign investors and the tax treatment of such income by other potential importers of capital, with whom Bulgaria competes for funds.

Since many home countries allow their residents credits for taxes paid to countries where income is earned, it is generally thought senseless for source countries not to impose taxes that can be fully credited. But the issue is more complicated than this. Not all countries tax foreign-source income (France does not), and some that do (e.g. Germany) allow tax sparing credits for taxes not paid because of investment incentives. In other countries – most notably the United States – many taxpayers are already paying more tax to foreign governments than can be credited at home. Even where this is not true, the deferral of tax until earnings are repatriated can create incentives similar to those facing investors from countries that do not tax foreign-source income. In any of these cases the potential investor, and not its government, actually feels the burden of source-country taxes. In such cases it is especially important to ensure that Bulgaria's tax system does not make it unattractive to foreign investors.

The remainder of this article provides a brief description of the key elements of the Bulgarian tax system (Section II), and then applies the principles outlined above to evaluate the value added tax (Section III), structural issues in the design of the individual income tax (Section IV), and five alternatives for the taxation of business income (Section V). Section VI addresses the special issue of the tax on wage increments. Section VII provides a summary and conclusions.

II. THE EXISTING TAX SYSTEM

The tax system of Bulgaria shares many features of tax systems found in other socialist countries of Eastern Europe. Roughly 22 percent of tax revenue is derived from turnover taxes and excises, 43 percent from income taxes on companies, especially state enterprises, 8 percent from income taxes on individuals, and 21 percent from social security contributions. This pattern differs markedly from that found in European members of the OECD: 32 percent from taxes on goods and services, 7 percent from corporate income taxes, 29 percent from individual income taxes, and 27 percent from social security contributions.[1]

The remainder of this section provides a thumbnail description of the basic features of the four most important taxes.[2]

1. These figures are from Owens (1990), at 37; they are for 1988.
2. This description draws on IBFD (1989) and interviews with officials of the Ministry of Finance. The description is inevitably somewhat sketchy in places, given the paucity of published material on the tax system, language problems and the brevity of field work in Bulgaria. Moreover, it describes only what is "on the books"; it makes no attempt to specify what actually happens. In particular, it does not address such questions as whether company taxes are negotiated after the fact and the efficacy of administration of the various taxes.

(The situation is changing so rapidly that it is difficult to provide a totally current description. What follows describes the situation prevailing in August 1990, as well as some changes made since then (and a few made earlier). This description provides a useful historical starting place for a discussion on tax reform in Bulgaria.)

A. *Turnover taxes, customs and excises*

Until recently turnover taxes in Bulgaria were calculated, as in other centrally planned economies, as the difference between producer prices and retail prices, net of wholesale and retail trade margins. (Where this difference is negative a subsidy rather than a tax occurs.) Tax naturally represents widely differing fractions of the retail (or wholesale) prices of various goods and services in such a system. Indeed, before 1988 there were more than 20,000 such implicit turnover tax rates in Bulgaria. Since tax liability is determined by subtraction, rather than by multiplication of a rate times a base, it makes little sense even to speak of either the tax base or the tax rate, and taxes do not have the distributive and allocative effects usually attributed to them in the Western public finance literature.[3] Once Bulgaria moves to a market economy, it will not be administratively feasible or economically desirable to continue this system.

In 1988 initial steps were taken to convert to a Western system of indirect taxation. Excise taxes on several commonly excisable items (alcoholic beverages, tobacco products, matches, coffee, petroleum products and certain luxury goods) have been split off from turnover taxes. Except for those on petroleum products, excises are calculated at ad valorem rates applied to retail sales – ranging from 24 to 80 percent.

For purposes of the turnover tax, products have been placed into 45 groups, based on the ratio of retail prices (net of trade margins) to wholesale prices; the implicit tax rates range from 5 to 70 percent, with an average effective rate of 25 percent. Sales of intermediate goods, capital goods and exports are tax-exempt.

The tax is still calculated as a residual, but there are plans to shift on 1 September 1990 to a system of taxes collected at the manufacturer's level but based on retail prices (most of which will still be set centrally); this system will have explicit ad valorem rates of 10 and 20 percent. There has been talk of shifting to a standard credit-method VAT of the type levied in the European Community at the beginning of 1991, but this timetable is unrealistic. Under the prospective VAT, some goods will be exempt and others will be taxed at rates of 10 and 20 percent. The timing and success of this change will depend on both the completion of price liberalization and the establishment of the requisite administrative capabilities. (In the absence of price liberalization VAT simply acts as a profits tax, unless there is an explicit policy of allowing the tax to be passed through in the form of higher prices.)

Bulgaria makes virtually no use of explicit customs duties. Less than two percent of total tax revenue comes from this source. Rather, "price differences" representing the (positive and negative) differences between the administratively determined wholesale prices of imports and their import prices, calculated at the official exchange rate, serve as taxes and subsidies on imports.

B. *Profits taxes on companies*

The profits tax is levied on the "balance sheet profits" of all juridical entities, including state enterprises, cooperatives, stock companies, limited liability companies and joint ventures. This definition of profits allows no deduction for several important types of expenses, including interest on short-term and investment credit, insurance, management salaries, and bonuses for workers; nor can taxable profits be reduced by losses in excess of planned norms. Since January 1989 depreciation allowances calculated on a straight-line basis are allowed. The allowance for any one year may be increased by 50 percent, but total allowances claimed cannot exceed the cost of assets. Profits derived from participation in other enterprises are excluded from taxable profits. Although most subsidies are included in balance sheet receipts, those granted after the fact to state enterprises making losses are not.

The standard rate of profits tax is 62 percent (the 50 percent state profits tax, a 10 percent municipal levy and a 2 percent tax earmarked for the Irrigation Fund). A 5 percent tax is also levied on profits allocated to the Development and Technical Renovation Fund, which includes accumulated depreciation. Exceptions to the basic 50 percent rate include 10 percent for agriculture (reduced from 20 percent in April 1990), 25 percent for tourism and 30 percent for joint ventures with more than 20 percent foreign participation. Losses can be carried forward five years, and a five-year tax holiday is provided for firms engaged in "high technology".

A reduction of the basic rate to 45 percent is being considered; it would be applied to the profits of all but the smallest enterprises. Of this, 20 percent (9 percent of profits) would go to municipal governments. The tax would be based on income reported for financial accounting purposes, less "tax reliefs" for certain activities but increased by certain disallowed expenses such as high representation expenses.

C. *Individual income taxes*

Bulgaria does not have a global individual income tax system, despite having what is called The Law for General Income Tax. Rather, it relies on a group of three schedular taxes, each with its own base and progressive rate schedule.

1. Wage and salaries tax

The tax on wages and salaries is levied on an individual basis and is withheld by employing enterprises. It is based on monthly remuneration, excluding certain bonuses and social welfare payments. There are no personal exemptions for the taxpayer, spouse or dependents, and no deductions for personal expenditures, but an amount equal to the monthly minimum wage (currently 165 Lv. per month) is exempt from tax.[4] Tax is levied at graduated marginal rates that range from 12 to 14 percent. This top rate is reached at a monthly income of 400 Lv., which is about 150 percent of the average wage of 260 Lv. However, there is a 30 percent marginal rate in the income range immediately above the minimum wage; this was recently reduced from 80 percent.

3. For further elaboration, see Gray (1990). See Holzman (1954) for the classic description of the type of tax systems in Soviet-style centrally planned economies.

4. It is useful to know the hard currency equivalent of these figures. Unfortunately, in a system with an over-valued exchange rate (or multiple rates) it makes no sense to use (one of) the official rate(s). At the time this was written in August 1990 the black market rate was roughly 15 leva to the dollar. In March 1991 the newly legal free market rate stood at about this level. Even the use of this figure for conversion is improper, since so many prices were artificially depressed.

This description of the tax on wages and salary income gives an incomplete picture. Wages and salaries are highly compressed, creating the equivalent of a 100 percent marginal tax rate over much of the income distribution.

2. Tax on income of authors, scholars, artists, etc.

Payments to authors, scholars, artists, musicians, journalists, etc. over and above their normal salary and other remuneration are subject to a progressive rate schedule based on annual income of this type. The rate schedule, which is applied on an individual basis, begins with a marginal rate of 4 percent (on annual income up to 240 Lv.) and reaches a maximum marginal rate of 50 percent (on income in excess of 40,000 Lv.). There are no personal exemptions and no itemized deductions, although an amount equal to the minimum wage is exempt for those with no other source of income.

3. Tax on income from private business and liberal professions

Various types of income not consisting of either wages and salaries or fees, and thus not subject to the two taxes previously described, are subject to the third schedular income tax. These include income from private business and the practice of liberal professions, as well as dividends and participation in the profits of cooperatives. The bottom of the progressive rate schedule (including the exempt amount) is identical to that for the tax on wages and salaries (converted to an annual basis), but progression extends beyond an annual income of 4,800 Lv. to reach a maximum rate of 85 percent on income above 70,000 Lv.[5] Unlike the other two taxes, this one is levied on a household basis; i.e. all the income of various members of the household is aggregated for purposes of applying the progressive rate schedule. Deductions are allowed for certain expenses incurred in earning income, but there are no personal exemptions or personal deductions.

4. The proposal for a new global system

Plans are underway to introduce a new global income tax. The system would be based on taxation of individuals, though perhaps with allowance for the number of children. There would be no itemized deductions, but an amount based on the annualized minimum wage would be exempt. Marginal rates of 20 to 40 percent (on annual income above 48,000 Lv.) would be applied to income above that level.

D. *Social security contributions*

A tax of 30 percent of nominal wages and salaries (20 percent in the case of payments to foreign citizens by joint ventures) is collected for the provision of pensions and other social security payments.

E. *Other miscellaneous provisions*

Bulgaria also has a number of other taxes that do not yield major amounts of revenue. Particularly noteworthy are the progressive tax on increases in average gross salaries, various property taxes, gift and inheritance taxes and motor vehicle taxes.

F. *Summary evaluation*

By any reasonable standard the Bulgarian tax system is extremely complex and (in the absence of central planning) distortionary; it is not suited to a market economy. Major reform is needed to create a system that will be simpler and more consistent with greater reliance on market forces. Such reform must include tax administration (including computerization) and the development of tax statistics, as well as tax policy. It is important to begin at once on a two-pronged effort that introduces short-term reforms quickly, while laying the groundwork for more fundamental reforms of tax policy and administration to be undertaken over the next several years. The following sections provide some guidelines for this effort. They discuss the VAT, the individual income tax, the company income tax and the tax on wage increments.

III. VAT: THE NEW REVENUE WORKHORSE

Bulgaria currently relies heavily on the turnover tax. Turnover taxes in socialist countries with centrally planned economies differ considerably from those in market economies.[6] Essentially these taxes represent a "wedge" calculated as the difference between producer prices and retail prices, net of wholesale and retail margins. Thus they are the residual in the calculation, rather than a predetermined ad valorem rate or monetary quantity per unit of output or sales (as in the case of specific excises). By the very nature of the calculation, there are hundreds, or even thousands, of different implicit tax rates. Even so, they do little to affect resource allocation, which is largely determined by the plan, or income distribution, which is determined by the wages and prices set by the planners. As reform occurs and taxation takes on a new character the continuation of this practice of utilizing highly differentiated rates will cause serious resource allocation problems and inequities. Moreover, administration will become a nightmare, because of the need to draw distinctions between activities subject to different tax rates. It is thus highly desirable that Bulgaria move to a modern sales tax system with only a few rates as soon as possible, especially since the sales tax is likely to become the most important source of public revenue.[7]

Several sales tax systems should be ruled out at once, except as interim measures. These include the type of multistage turnover tax utilized in much of Europe before the adoption of VAT as the norm. Such taxes distort resource allocation and create incentives for vertical integration. Single stage sales taxes levied before the retail level should probably also be avoided, because of their administrative and economic defects. It may, however, be necessary to employ such taxes as interim measures, and this issue is discussed below. This leaves a retail sales tax and a VAT as the most appropriate long-term options for consideration.

The retail sales tax seems quite inappropriate for Bulgaria, despite its theoretical advantages under some circumstances. If all retail distribution were to remain the monopoly of state enterprises, a retail tax could be adminis-

5. Income from the rental of residential property is subject to a separate rate schedule with rates ranging from 9 percent on income up to 200 Lv. to 81 percent on income in excess of 7,000 Lv.
6. For this reason I avoid the use of the term in describing gross receipts taxes, also commonly called turnover taxes in Western literature.
7. One qualification must be made to this statement. The Simplified Alternative Tax discussed in Section V as an alternative to the income taxes resembles both an income tax and a subtraction method VAT; this is shown in McLure (1990c). It is not clear that it makes sense for a country to spread its administrative resources thin by having both a VAT and the SAT. If, however, Bulgaria aspires to join the EC it has no choice but to have a credit-method VAT. Thus the SAT might substitute for the income taxes, but not for the VAT, as well.

tered fairly easily and would be relatively neutral. In fact, it is likely that retail trade will flourish in numerous small privately or cooperatively owned businesses, none of which has any prior experience as sales taxpayers. Thus a retail sales tax would be virtually impossible to administer effectively for many years.

The most appropriate sales tax alternative is the credit-method VAT employed in the European Community (EC). This is especially true if Bulgaria aspires eventually to join the EC. Much of its revenue would be collected either before the retail stage or from large retailers, and there are ways – none of them very good – to approximate taxation through the retail stage for small traders. The "paper trail" of invoices inherent in the commonly used credit method of implementing the VAT gives that method important administrative advantages. For this reason, for economic reasons, and because Bulgaria may eventually wish to join the EC, no other method of implementing a VAT should be considered.

Important issues remain to be addressed. These involve the use of exemptions and/or zero-rating to avoid tax on basic necessities and products thought to have high social value, the choice of tax rates and the tax treatment of particular sectors (finance, housing, farming, second-hand goods, small business, etc.) These deserve more attention than is possible here.[8] Another issue warranting further study is the desirability of extending the tax to the retail level immediately, rather than initially limiting it to a pre-retail stage (manufacturing or wholesaling) and then extending it as experience is gained. This depends crucially on the development of the capacity of the tax administration and taxpayers to deal with a retail level tax.

The above discussion leaves unanswered one of the most pressing questions of all – how to finance the government during the period before introduction of a full-fledged VAT. This question has no easy answer, but it seems appropriate to rely on an old-fashioned gross receipts tax, despite the well-known defects mentioned above. Provision can, however, be made for the use of rudimentary methods of exemption and crediting for taxes on purchases to avoid much of the multiple taxation for which these taxes are notorious. In addition, further revenues may be available from excises; this also deserves further study. Finally, it is worth emphasizing that there is presumably an enormous potential to reduce the drain on the budget represented by subsidies. These are both planned subsidies, such as those implicit in prices set below opportunity costs, and unplanned subsidies given to cover losses of unprofitable firms.[9]

IV. STRUCTURAL ISSUES IN THE INDIVIDUAL INCOME TAX

If Bulgaria is to move to a modern system of income taxation, a number of issues in the design of the individual income tax must be addressed. These include the role of withholding, the extent to which schedular taxation is to be continued, the choice of taxpaying unit (individual, household, etc.), the availability of personal exemptions, the advisability of itemized deductions for personal expenditures, the relationship to the taxation of enterprises, the rate structure and the indexation of nominal amounts. These issues are addressed briefly in this section.

A guiding principle in the discussion that follows is that simplicity is an extremely important goal, especially in the next few years, when administrative capability will be weak. Fine-tuning can be added once the administrative capability has been developed to deal with greater complexity. It would be a serious mistake to jeopardize both revenues and the appearance of fairness by imposing a complicated system that cannot be implemented effectively.

A. *The role of withholding*

Bulgaria lacks the tax administration necessary to deal with a system in which annual returns are filed by most recipients of income. Nor do most income recipients have the experience with income tax returns necessary for the introduction of a system of annual filing. Finally, for historical reasons taxpayers have good cause not to be enthusiastic about reporting details of their financial situation to a strong tax administration that may have the power of economic life or death over them. It thus seems extremely important to construct a system in which most taxpayers do not file returns.[10] (Obviously those in business for themselves will be required to file returns on which income is calculated.) This is one of the cardinal principles guiding the discussion that follows. As tax administration is improved and as experience is gained – and as trust in the government increases – more complex provisions intended to fine-tune tax liabilities can be added to the system, if thought appropriate.

B. *Schedular taxation*

The existence of schedular taxation – taxing different types of income under different rate schedules, rather than lumping all income together and taxing this "global" income under a single schedule – is commonly thought to be inappropriate in a modern tax system. The reasoning is that equity and neutrality demand equal treatment of income from all sources under a global income tax. There are, however, reasons to question this attitude, which is based on a somewhat naive view of what is feasible. First, it simply may be difficult to tax all income accurately; this is especially true in a country with a weak tax administration. However, it is inherently difficult to measure some types of income accurately; this is the case especially with fringe benefits and income from business and capital.[11] In such circumstances it may be appropriate to treat different types of income differently for administrative reasons. For example, under certain circumstances withholding taxes on wages and salaries and on interest income may appropriately be final taxes, rather than tentative taxes to be offset against global liability. Similarly, it may be appropriate to disallow business deductions for the cost of providing certain fringe benefits, instead of attempting to value the benefits and attribute them to individual employees.

Second, if some sources of income are not taxed, either as a matter of policy or as a result of administrative difficulties, it makes little sense to allow the expenses of earning non-taxable income to be deducted against otherwise taxable income. The United States in its 1986 tax reform introduced schedular elements into its ostensibly global income tax for this reason.[12]

8. See, however, McLure (1987).
9. It is often difficult to know which prices are being subsidized, relative to opportunity costs, because of the pervasiveness of the system of artificial prices. Petroleum products provide an important exception; since they are imported, their opportunity cost in hard currency is quite clear. The problem is knowing the exchange rate to use in converting this price into local currency.
10. McLure and Pardo (1991) report on Colombia's shift toward a system that requires fewer taxpayers to file returns after years of attempting to implement an ambitious system of self-assessment.
11. See McLure (1988) and (1990a).
12. For further discussion, see McLure (1988).

Finally, there are well-defined systems of taxation that rely on a schedular approach for some of their advantages over alternative structures. One such approach (the Simplified Alternative Tax or SAT) is described in Section V. It distinguishes between income of individuals derived from wages, salaries and pensions, and income from business sources. Whereas the former is (or can be) subject to graduated rates, the latter is taxed at a flat rate (presumably the top rate applied to the income of individuals). Moreover, while personal exemptions and itemized deductions may be allowed in calculating the tax on individuals, they are not allowed for the business tax. The SAT takes this approach to simplify tax administration, at the cost of not having a global income tax levied at a single set of rates on all income.

The following evaluation of the situation in Bulgaria seems appropriate. If the SAT is chosen, its schedular elements should be accepted as one of its inherent strengths. If it is rejected in favour of a traditional income tax, a more global approach would presumably be appropriate, yet several caveats are in order. First, it will probably be appropriate to tolerate schedular elements in the short term, given the lack of an adequate system of tax administration; for example, schedular withholding taxes might be levied on interest and dividends. This issue is related to the role of withholding, addressed above. Second, even in the long term there may be good reasons not to move to a fully global system. This deserves further consideration.

C. *The taxpaying unit*

Individual income taxes can be based on separate taxation of individuals, on joint returns of married couples, and on more complicated systems such as the French "quotient" system. For several reasons separate filing seems most appropriate for Bulgaria. First, that is the traditional approach in Bulgaria. (Of course, one must ask whether this practice reflects society's attitudes toward the proper definition of the taxpaying unit or a choice made by the previous totalitarian regime.) Second, separate filing is simpler and facilitates accurate collection of exact amounts due through withholding, without resort to annual returns. Third, separate filing generally is more conducive to work effort by second wage eaners in a given household.

D. *Personal exemptions*

It is common to allow deductions or credits based on the number of dependents (and perhaps their relationship to the taxpayer) in order to reflect differences in ability to pay based on family size and composition. It can be presumed that this should be a long-term goal in Bulgaria. Whether this should be done in the short term is less clear, since such provisions considerably complicate administration and withholding.[13]

E. *Itemized deductions*

The individual income taxes of most countries include itemized deductions for various personal expenditures. These include deductions and/or credits for such expenditures as educational and medical expenses, mortgage interest payments, charitable contributions, residential rent, insurance and taxes of subnational governments. While some of these can be justified (e.g. charitable contributions), most cannot be. Moreover, they seriously complicate compliance and administration, they make it virtually impossible to have a system in which withholding accurately discharges tax liabilities, without the need for annual returns, and they create opportunities for abuse. It is thus proposed that, at least initially (and perhaps in the long term, pending further analysis), Bulgaria should allow no such deductions.[14]

F. *The relationship to the taxation of enterprises*

It is commonly agreed that it is desirable to avoid double taxation of company income distributed as dividends; this is achieved through the complete "integration" of the individual and company income taxes or the provision of dividend relief.[15] It has also generally been agreed that it would be impossible to implement complete integration, under which corporations are treated like partnerships (no taxation at the corporate level; attribution of all corporate income to shareholders for tax purposes).

There are several ways in which relief from double taxation of dividends can be achieved. Conceptually proper methods include the withholding or imputation method (the gross-up and credit method) commonly used in Europe, the split-rate system utilized in Germany (in conjunction with the imputation method) and the deduction for dividends paid method, which was recommended in the U.S. Treasury Department's 1984 tax reform proposals to President Reagan but rejected by Congress. Another approach which is conceptually defective, but administratively simpler, is the exemption of dividends from shareholder taxation. This approach, which effectively subjects all dividends to the corporate rate, instead of the marginal tax rate of shareholders, was recently adopted by Colombia.

While a definitive choice between these methods requires further analysis, it appears that because of its greater simplicity the dividends paid deduction may be the most appropriate of the conventional methods for Bulgaria to use in the context of a conventional income tax. The Colombian approach probably would not be appropriate for Bulgaria, since privatization is likely to produce widespread ownership of shares by persons in different marginal tax rate brackets. By comparison, in Colombia, the ownership of wealth is so concentrated that virtually all recipients of dividends are – or should be – subject to the top marginal rate, which is equal to the corporate rate. Under the SAT examined in the next section the issue of integration does not arise.

G. *The rate schedule*

If a traditional global income tax is adopted, it will be appropriate to have a unified rate schedule for the taxation of most income. If a schedular approach (including the SAT) is adopted, then a unified schedule for the taxation of labour income, and perhaps most other income, is appropriate. The question, then, is how progressive this schedule should be.

The individual rate schedules found in the current tax system of Bulgaria appear to vary considerably in their extent of progressivity. The apparent progressivity of the wage and salary tax is quite limited, with a range of rates of only 12 to 14 percent. On the other hand, the other two schedules

13. Colombia eliminated such exemptions in its 1986 reforms in recognition of this; see McLure and Pardo (1991).

14. Again, Colombia abolished most of its deductions and credits for personal expenditures in its 1986 reforms; see McLure and Pardo (1991). The United States also cut back on the availability of itemized deductions in 1986.

15. For a complete discussion, see McLure (1979).

exhibit a substantial amount of graduation, with top rates of 50 percent and 80 percent. In fact, this difference is almost certainly overstated, because the compression of wages under central planning acts as a surrogate for very progressive taxation of wages and salaries (essentially a 100 percent marginal tax rate). In short, the present system of wage compression and explicit taxation of non- wage income is extremely progressive.

The move to a market economy will result in an end to wage compression and its replacement with explicit taxation of income. Whether the extreme progression described above should be continued, but applied to all income, depends on the relative weight to be given to competing objectives. Graduated rates reduce income differences. Bulgaria's socialist history suggests that this may be an important objective. The relative equality of the existing distribution of wealth may, however, reduce the importance of this goal. Nor do revenue considerations necessarily require high rates. Increases in tax rates often do not raise as much revenue as expected (and rate reductions do not lose as much). People respond to higher rates by working, saving and investing less, by evading or avoiding taxes, and by generally being less efficient. Even if this is not true, in most countries there simply is not enough income subject to the top marginal rates for highly progressive rates to yield much revenue.

Incentive effects and simplification also favour rate schedules with much less progression and relatively low top rates. The tax reform movement that has been sweeping the world in recent years has emphasized simplicity and incentives over income redistribution.[16] On balance this seems the best policy for Bulgaria. Marginal rates in excess of 50 percent should definitely be avoided, and a top rate well below that – perhaps in the range of 30-40 percent – would be desirable. Finally, the top individual rate should be approximately equal to the company rate. Of course, rates this low are feasible only if the government cuts spending drastically, restricting it only to the levels appropriate for the supply of public goods and the social safety net.

H. *Indexation of nominal amounts*

If the rate schedule contains bracket limits that are fixed in nominal (monetary) amounts, inflation will push taxpayers with a given real income into increasingly higher tax brackets.[17] Such "bracket creep" does not matter so long as the graduation of rates is insignificant, as is the case for the wage and salaries tax. But once wage compression is eliminated and replaced by explicit progressivity, bracket creep will have undesirable effects. It will make the redistributive effect of taxes depend on inflation, instead of explicit policy decisions; inflation will raise taxes and increase disincentives; and it will increase the government's command over resources, without an explicit policy decision that this is appropriate.

These effects can easily be avoided by indexing amounts fixed in nominal value in the tax law. (Thus if there are personal exemptions, they can be indexed, as well as tax brackets.) This is easily done annually when rate schedules, tax forms and instructions are printed; the administrative burden on taxpayers and employers is minimal.

V. FIVE ALTERNATIVES FOR BUSINESS TAXATION

There is little disagreement that a tax on business profits should be an important component of the new tax system. What has not received adequate attention is the design of a business income tax that is appropriate for Bulgaria. This section describes and evaluates five generic business tax policies Bulgaria might consider:
- a comprehensive tax on all income, with few deviations of taxable income from real economic income (the broad-based real income tax);
- a less ambitious system that does not attempt inflation adjustment (the broad-based nominal income tax);
- an income tax that allows numerous exemptions, investment allowances, differential rates and other tax preferences for particular activities (the "Swiss cheese" income tax);
- a system that provides uniformly available incentives for capital formation and is simpler than the other three, i.e. the SAT; and
- a hybrid combining features of the nominal income tax and the SAT.

It argues that the SAT may be the most appropriate for the particular circumstances facing Bulgaria – and indeed for other socialist countries in transition from central planning – and that the hybrid may be a reasonable fall- back position.

A. *The broad-based real income tax*

The key characteristic of the broad-based real income tax is the definition of the tax base to conform as closely as possible to real economic income. Such a definition of the tax base assures that the tax is both fair and neutral (at least as far as its treatment of various economic activities is concerned). Thus it provides a good benchmark against which to measure the other alternatives to be presented below. It also gives the largest possible tax base, consistent with the need to avoid taxing more than 100 percent of income (or taxing some income more than once), and thus the lowest possible rates. Finally, such a tax is consistent with the international norm of taxing income. This facilitates the conclusion of tax treaties and assures that the tax is almost certainly creditable in the home countries of foreign investors that allow foreign tax credits.

In order to tax real economic income, it is necessary to allow deductions for real economic depreciation (and similar forms of amortization of capital expenses), to allow a deduction for real interest expense, to tax real interest income and real capital gains and to provide for integration of the individual and business income taxes. This immediately raises several difficulties. First, it is very difficult to know the rate at which economic depreciation occurs. If depreciation for tax purposes differs from economic depreciation, income from all activities will not be taxed equally, and resource allocation will be distorted.[18] Though perhaps the most im-

16. See the papers in Boskin and McLure (1990). Owens (1990), at 42 reports the dramatic reductions in tax rates in OECD countries between 1986 and 1990.

17. Inflation also erodes the value of other provisions fixed in nominal terms, such as floors and limits on itemized deductions. This can be problematical, if such nominal amounts have been set sensibly. Otherwise, they can have either positive or negative effects. This issue is not pursued further here, given the suggestion that Bulgaria should not make much use of itemized deductions.

18. One commonly used way to express this is to say that the marginal effective tax rate (METR) is not the same for all investments. The METR measures the percentage reduction in before-tax rate of return resulting from taxation, considering depreciation allowances, investment incentives, deductions for interest expense, and inflation, as well as statutory rates. METRs can be negative, or they can exceed 100 percent. If METRs applied to income from various alternatives are not similar, resource allocation is distorted. See McLure, *et al.* (1990), chapter 9 or Zodrow and McLure (1988).

portant, depreciation is only one of many timing issues – questions of when income should be recognized for tax purposes and when deductions should be allowed.[19] To the extent timing issues are not handled satisfactorily, distortions, inequities and opportunities for abuse occur. Second, the integration of individual and business income taxes is complicated.[20]

Finally the notion of taxing economic income makes sense only if there is no inflation or if the measurement of income is adjusted for inflation.[21] (It is important to note that this is *not* the kind of inflation adjustment of nominal amounts described in Section IV above.) If inflation occurs and there is no inflation adjustment in the measurement of income, tax is paid on interest income and capital gains that are not real, deduction is allowed for "interest expense" that is really repayment of principal and depreciation allowances and deductions for cost of goods sold from inventories do not cover the real cost of the dissipation of assets. The result is mismeasurement of income and either misallocation of resources (if inflation is expected), inequities (if it is not) or both. While inflation adjustment is conceptually correct, it is complicated and thus administratively difficult.

Without major exceptions the advanced Western countries use income taxes based on nominal values. This reflects their relatively low rates of inflation. By comparison many high-inflation countries of Latin America, and some with relatively moderate inflation, have inflation-adjusted tax systems.

The broad-based income tax also has an important economic disadvantage, especially for a small open economy seeking saving, investment and economic growth; it discourages saving and it may discourage foreign investment. As suggested in Section I, the latter effect depends in part on the tax situation of potential foreign investors (residents of countries with territorial systems; residents of countries with worldwide systems and tax sparing; residents of countries with worldwide systems, without excess foreign tax credits; residents of countries with worldwide systems, with excess foreign tax credits). For example, following the 1986 U.S. tax reform many American multinational corporations have excess foreign tax credits. This implies that countries seeking American investment must be careful not to impose taxes appreciably higher than those in other countries competing for investment flows. Investors from other countries may face quite different choices.

B. *The broad-based nominal income tax*

Inflation adjustment of the base for the taxation of income from business and capital is inevitably very complex. Whether it should be adopted depends crucially on the rate of inflation that is expected to prevail and the administrative and compliance capacity of taxpayers and the fiscal authorities. This conceptually attractive system may not be feasible in Bulgaria for the foreseeable future, no matter what the inflation rate.

The preferred fall-back position in an income tax context would be an income tax based on nominal historical values. Thus there would be no inflation adjustment of depreciation (and similar allowances), inventories, capital gains, or interest income and expense.

As indicated earlier, such a system would create distortions and/or inequities in an inflationary world, but not in a world of stable prices (except to the extent that taxable income deviated from economic income, for example, because timing issues are handled badly). However, it would avoid the burdens of administration and compliance mentioned above.

The failure to provide inflation adjustment in the measurement of income represents a significant compromise with conceptual purity in favour of administrative feasibility. Though not implied by the title of this approach, other compromises might be made in dealing with timing issues for similar reasons. Some issues might initially be handled in simple ways, even at the risk of economic distortions and inequities, and some may not even be addressed, leaving taxpayers considerable latitude to interpret the law as it suits them. It seems almost inevitable, however, that eventually such systems will need to be modified in ways that make them more complex, in order to remove the anomalies, which will become increasingly troublesome.

Thus, for example, current deductions might initially be allowed for expenses incurred in projects lasting several years, even though income is recognized only when the project is completed. Eventually, as the economy becomes more complex and taxpayers become more sophisticated, this liberal treatment will need to be changed in order to avoid inequities, distortions and opportunities for abuse.

C. *The "Swiss cheese" income tax*

Most income taxes levied throughout the world, by both developed and developing countries, depart significantly from either model of comprehensive income taxation just described. It appears that several of the countries making the transition from socialism to market economies are also adopting tax systems that are far from comprehensive and rational. Hungary, for example, has allowed so many deviations from economic income in defining its tax base (and in allowing unjustified tax credits) that its system deserves to be called a "Swiss cheese income tax". In Bulgaria this phenomenon is manifested in proposals for tax holidays.

The enactment of departures from economic income is not hard to understand. Some activity is thought to be particularly deserving of public support and is thus given a tax incentive such as an investment allowance, accelerated depreciation, a preferential rate or a tax holiday. Accelerated depreciation and investment allowances are sometimes advocated as a way to offset the effects of inflation without introducing an explicit system of inflation adjustment, which is inevitably complicated.

This approach to tax policy calls for several comments. First, the attempt to pick "winners and losers", like central planning, places faith in bureaucrats and politicians, instead of market forces. There is little reason to believe that such faith is merited; certainly the experience of Eastern bloc countries under central planning does not inspire much confidence. To the extent that preferential treatment is not justified, economic resources are misallocated to low-productivity uses.

Second, because of the reduction in the tax base, tax rates must be higher than under a comprehensive income tax. This has adverse incentive effects on work effort, saving, investment and risk-taking. Moreover, high rates exaggerate the adverse effects of any distortions and inequities in the definition of taxable income.

19. For further discussion, see McLure (1988) and (1990a).
20. For details and discussion of integration schemes, see McLure (1979).
21. The benefits and difficulties of inflation adjustment are discussed further in McLure *et al.* (1990), chapter 7.

Third, preferential treatment of various sectors and activities gives rise to complexity and to opportunities for abuse that can be prevented only by the investment of scarce administrative resources. For example, tax holidays for certain sectors or activities create problems of definition of eligible activities and problems of transfer pricing for sales of inputs and outputs between related companies engaged in both taxable and exempt activities. Holidays limited to foreign investors create the opportunity for residents to send money out of the country and bring it back disguised as foreign investment.

Fourth, the existence of tax preferences creates an impression of inequity that undermines taxpayer morale – something that is likely to be a scarce and valuable commodity in a country with well-justified skepticism about government. This impression of inequity is, of course, often founded in fact.

Fifth, tax preferences complicate the integration of the individual and business taxes. It is generally thought desirable not to give relief for company taxes not actually paid. Thus most countries that provide dividend relief have fairly complex schemes to limit relief to the amount of company taxes paid.

Sixth, the ad hoc adjustments for inflation provided by such techniques as accelerated depreciation and preferential treatment of capital gains are correct for only one rate of inflation. At any other rate they are too generous or not generous enough.

Ultimately, there is little to recommend this approach to the taxation of business income. There has recently been a worldwide movement to eliminate many of the gaps in the measurement of income, replacing them with lower tax rates.[22] Either the comprehensive income tax – even the one based on nominal values, the SAT, or the hybrid is likely to be preferable. This is especially true (except for the nominal income tax) in an inflationary environment.

D. *The SAT*

There is a fourth alternative that deserves serious consideration by any country making the transition from socialism, for it is arguably especially appropriate for such countries.[23] Although this system has not been adopted by any country, it has been receiving increasing attention by tax specialists.[24] This approach, called the SAT, is both simpler (because it avoids issues of timing and inflation adjustment) and more neutral than either of the other two alternatives. It provides generalized incentives for saving and investment, and therefore avoids the need to pick winners and losers. Finally, it requires somewhat less change from the present tax system of Bulgaria than would any of the other alternatives.

The basic features and administrative advantages of the system are relatively simple. There would be two essentially separate taxes, an individual tax on wages, salaries and pensions, and a business tax on (taxable) non-labour income. Capital gains of individuals would be exempt. This schedular approach is consistent with current Bulgarian practice.

The wage and salary tax presumably would be (but need not be) levied at graduated rates and would be collected primarily through withholding. Whether the filing of annual returns would be necessary depends on how the questions concerning joint versus individual filing, personal exemptions and itemized deductions raised in Section IV are answered. As emphasized there, it will be important for administrative reasons to answer these questions in ways that avoid requiring most taxpayers to file returns, at least initially.

The business tax would apply to all forms of businesses, including businesses conducted by individuals. It would be levied at a flat rate, presumably the highest rate applied to the income of individuals. There would be no personal exemptions or itemized deductions. Owners of small businesses could avail themselves of the advantages of lower individual rates by paying themselves salaries that would be deductible by the business and taxable under the individual tax.

Immediate expensing (first-year write-off) of investments, rather than depreciation, would be allowed. This avoids timing issues, such as the need to determine useful lives and depreciation rates of assets and the need for inventory accounting. Moreover, it eliminates the need to adjust depreciation allowances and inventories for inflation. Neither interest income nor dividends would be subject to tax, and neither interest expenses nor dividends would be deductible. The administrative difficulty of taxing interest income and dividends would thus be avoided. There would be no need to distinguish between interest expense (commonly deductible under an income tax) and the payment of dividends (commonly not deductible under an income tax). There is no need for inflation adjustment of interest payments and receipts to convert them to real figures, as under a true income tax. Again, this treatment is much simpler than that under the standard income tax. Moreover, it is generally consistent with the treatment of interest income and expense under the current income tax law of Bulgaria.

The economic features of this system deserve special attention. Expensing is (under certain admittedly special circumstances) equivalent to the exemption of the return to investment.[25] This can be seen by considering an investment by a taxpayer subject to a tax rate of 40 percent. When an investment of 100 Lv. is undertaken, the net cost to the investor is only 60 Lv., due to the tax saving of 40 Lv. resulting from expensing. If the investment yields 10 percent or 10 Lv. before tax, the government takes 40 percent of the yield, or 4 Lv., and the investor 60 percent, or 6 Lv. Since the investor's after-tax rate of return of 10 percent (the return of 6 Lv. on "own" investment of 60 Lv.) is the same as in the absence of tax, the marginal effective tax rate on this investment is exactly zero. In essence, the government is a silent partner in the investment.[26] (If the return had been 15 percent because of an element of monopoly profit, the same conclusion would hold; the investor's net of tax return would be 9 Lv. on an investment of 60 Lv., for a rate of return of 15 percent.) This provides a powerful and attractive incentive for saving and investment.

The SAT avoids the need to pick winners and losers by extending equally favourable treatment to all investments. SAT is neutral in its effects on investments in various sectors.

22. See the papers in Boskin and McLure (1990), especially Whalley (1990a), and Whalley (1990b).
23. This section is based on McLure (1990c) and (1991). For more details of the operation of the system, see Zodrow and McLure (1988), McLure *et al.* (1990), chapter 9, or McLure and Zodrow (1990).
24. See U.S. Department of the Treasury (1977), Institute for Fiscal Studies (1978), Hall and Rabushka (1983) and (1985), Bradford (1986), McLure (1988), McLure *et al.* (1990), chapter 9, McLure and Zodrow (1990), and Zodrow and McLure (1988).
25. For further exposition of these points, see McLure (1990c), McLure *et al.* (1990), chapter 9, McLure and Zodrow (1990), and Zodrow and McLure (1988).
26. For further discussion, see McLure (1990c).

The SAT does raise some issues of concern. First, because of expensing, the tax raises less revenue (with a given set of tax rates) than does an income tax that allows only depreciation allowances. This can be an especially important concern in the short term in a country such as Bulgaria that faces serious budget problems.

Second, the implicit exemption of the return to capital – and the explicit exemption in the case of interest and dividends – may be troublesome in a society that until recently has been hostile to private ownership of capital and that has favoured a very egalitarian distribution of income. There are several answers to this concern. There is general agreement that the country needs increased saving and investment. A system that provides incentives for all saving and investment would appear to be preferable to one that provides incentives on a selective basis. Moreover, compared to the situation in Western capitalist societies, in which the ownership of wealth is quite concentrated, the exemption of the return to capital seems to be far less objectionable in a society in which wealth is currently rather equally distributed and in which, provided privatization occurs carefully and fairly, most citizens will have more or less equal access to, and shares in, formerly state-owned property.[27]

Third, due to expensing of investment, tax losses will be much more common than under an income tax. These should be carried forward, probably with interest. This adds an unwelcome element of complexity to the SAT, but far less than that found in a conventional income tax. Moreover, it should be recognized that tax holidays and other selective methods of providing tax incentives also create complexity.

A further concern involves the question of whether the United States and other countries with "residence cum credit" systems would allow foreign tax credits for the SAT. The fear is that otherwise U.S. investors would be discouraged from investing in Bulgaria. The answer to this question is, unfortunately, unclear, since no country has ever enacted the SAT. It is worth noting, however, that the importance of the question for U.S. firms can easily be overstated. At present the majority of foreign income of U.S. multinational corporations is received by firms that are in an excess foreign tax credit position. For them it makes little practical difference whether Bulgaria imposes a creditable income tax or a non-creditable tax of another kind; in fact, neither would be credited.[28] On the other hand, creditability may have symbolic significance beyond its direct importance. These issues deserve further study.

There may be some concern that the cost of foreign debt capital would be increased to unacceptable levels especially if the tax were not creditable and interest expense were not deductible.[29] In addition, the non-deductibility of interest is the primary potential stumbling block to the creditability of the tax. There would probably be ways to structure the treatment of interest expense that would simultaneously avoid an unacceptable increase in the cost of capital, assure creditability, and yet retain most of the simplicity features of the tax treatment of interest. The simplest is the hybrid approach described below. This issue also deserves further study.

Transition has proven somewhat of a bogey man for Western countries thinking about adopting the SAT or other consumption-based direct taxes. The problems include how to treat interest on outstanding debt and depreciation on existing assets in order to avoid windfall gains and losses. These problems appear to be less important in Bulgaria than in Western economies. First, the bulk of any windfalls would be experienced by state-owned enterprises, rather than by private firms. Second, any problems caused by transition to the SAT are likely to pale beside the basic problems of transition from socialism to a free market economy. Finally, transition of some type will occur, whether to the SAT or to a conventional income tax; the problems encountered along the two roads are not likely to be very different.

One must be wary about proposing that any country introduce the SAT, instead of the traditional income tax, in either its comprehensive form or the "Swiss cheese" form. Being a pioneer in the fiscal area, like many other spheres, can be risky.[30] Certainly, this should not be done without further analysis of the particular situation of Bulgaria, including transition issues. But this is an option that clearly deserves consideration.

E. *A hybrid system*

The non-deductibility of interest was identified as a potential source of difficulty in the SAT. It may raise the cost of foreign debt capital to unacceptable levels and jeopardize foreign tax credits. An alternative that retains some – but not all – of the advantages of the SAT is a hybrid that allows expensing of capital investments, as under the SAT, but treats interest income and expense as under the income tax.[31] To simplify matters and achieve neutrality toward financial decisions, dividends should also be deductible and taxable.

This approach avoids the timing and inflation-adjustment difficulties of the income tax for capital investment, but not for interest. (Ideally interest would be subject to inflation adjustment, but it need not be. The effects of this decision are indicated in Part A of this section.) Like the SAT, it would be more conducive to saving than the income tax. It would generally be neutral in its treatment of alternative investments, unlike the Swiss-cheese approach. (The marginal effective tax rates on debt-financed investment and on equity investment would depend on the relative tax rates paid by borrowers and lenders and by enterprises and shareholders.) Finally, because of the deduction of interest, losses would be much more common than under the SAT.

F. *Summary evaluation*

The primary characteristics, advantages and disadvantages of the five types of business taxation considered in this section are summarized in Table I. It is no simple matter to choose between the alternatives for the taxation of business income described above. It does, however, seem possible to provide the following rough ranking, based on the considerations discussed above (summarized in parentheses):

27. This depends on the details of how privatization is achieved, a topic beyond the scope of this paper; see, however, McLure (in process).
28. For further analysis, see McLure *et al.* (1990), chapter 9, and McLure (1990, b).
29. See McLure *et al.* (1990), chapter 9. The SAT treatment of interest income – exemption – could not be imposed on the home countries of lenders, except by treaty. Thus the combination of non-deductibility of interest expense by the source country and taxation by the home country of lenders may be more onerous than either standard income tax treatment of international capital flows (deductibility in the source country and taxation in the home country) or SAT treatment of domestic debt capital (non-deductibility and exemption).
30. For a discussion of the possible reasons underlying Colombia's decision not to adopt the SAT, see McLure *et al.* (1990), chapter 11.
31. This is the approach advocated by Sinn (1987). Note, however, that he favours source-based taxation of interest.

TABLE I

SUMMARY EVALUATION OF ALTERNATIVES

	Comprehensive Income Tax		Swiss Cheese Income Tax	SAT	Hybrid
	Real	Nominal			
Provision					
1. Capital Goods	Real Depreciation	Nominal Depreciation	Accelerated Depreciation	Expensing	Expensing
2. Interest Taxation/Deduction	Real	Nominal	Nominal	None	Real or Nominal
3. Dividends Taxation/Deduction	Integration	Integration	Integration	None	Integration
Criterion					
1. Administrative Problems					
a. Timing	Yes	Yes	Yes	No	Interest-Yes Depreciation-No
b. Inflation Adjustment	Yes	No	No	No	Yes (?)
2. Neutrality					
a. Saving/Investment	No	No	No	Yes	Yes (?)
b. Sectors	Yes	?	No	Yes	Yes
3. Short run Revenue Loss	No	No	Yes	Yes	Yes
4. Foreign Tax Credit	Yes	Yes	Yes	?	Yes
5. METR	Statutory	?	?	0	approximately 0
Bottom Line	Too complex	Must appropriate income tax	Too many problems	Simplest & best	Next best
Rank	5	3	4	1	2

(1) SAT (administrative and economic advantages; chief concerns: short-term revenues, foreign tax credits and foreign investment).
(2) Hybrid (similar to SAT, but clearly creditable; more complicated than SAT).
(3) Nominal income tax (complex, due to timing issues; vulnerable to inflation).
(4) Swiss cheese income tax (avoids inflation adjustment; involves picking winners and losers, opportunities for abuse, inequities, economic distortions, and administrative costs).
(5) Comprehensive real income tax (conceptually attractive, but administratively difficult).

These alternatives deserve further analysis in order to confirm this ranking.

VI. THE TAX ON WAGE INCREMENTS

The tax on increases in wage payments deserves special comment, even though it is not a major source of revenue.

Social ownership, combined with inadequate incentive systems for management, creates almost irresistible tendencies for wage increases that are greater than are thought socially desirable and acceptable. The problem is aggravated by labour management, in which labour can demand the dismissal of management that fails to accede to wage demands. In essence, labour has one of the important attributes of ownership (residual claim to the assets of the firm via higher wages), without others (the ability to sell these claims to assets or pass them on to heirs). Because of the perverse incentives created, labour management can lead to decapitalization of the firm via excessive wages.[32] The tax on wage increments is intended to restore some semblance of responsibility to the setting of wages, by making high wage increases financially unattractive.

The tax on wage increments is a poor substitute for the proper solution to this problem – a hard budget constraint for state enterprises or privatization, combined with elimination of labour management. Unless structured very carefully, the tax on wage increments discourages wage increases that reflect greater productivity and effort, as well as unjustified wage increases. Without eliminating labour management, the effects described in the previous paragraph can be avoided only through elaborate provisions that create the kind of unmanageable information and monitoring problems for which command economies are notorious. By comparison, the elimination of labour management would remove a feature of the system that guarantees undesirable incentives for management. This, plus either a hard budget constraint or privatization, would make the tax on wage increments largely unnecessary.

32. There will be a tendency for wages to be set equal to average revenue product, rather than marginal revenue product.

VII. SUMMARY AND CONCLUSIONS

The Bulgarian tax system is not suited to a free market economy. For reasons of revenue, equity and economic neutrality it is important to move quickly to a more appropriate system. Unfortunately, Bulgaria also presently lacks the capacity in tax administration and taxpayer compliance to implement many of the taxes that might otherwise be appropriate. Thus it is important both to improve tax administration and to design tax policies with administrative limitations in mind. It may be necessary to utilize tax policies in the short term that would not be totally appropriate in the long term. At the same time, it is important to choose short-term policies that are generally consistent with desirable long-term policies.

In the long term the Bulgarian tax system should include a VAT, probably modeled after those of the EC, and a tax (or taxes) on the income of individuals and enterprises; the latter might be a consumption-based system of direct taxation such as the SAT, rather than a conventional income tax. In the short term, until the administrative capacity to deal with the VAT is established, it will be necessary to rely on some sort of turnover tax.

The individual income tax should be designed initially with an eye towards administrative simplicity; refinements can be made at a later time when the capacity to deal with them has improved. Thus, at least for now, the tax should continue to be based on the income of individuals, rather than that of couples or families, it should rely heavily on withholding, it should allow no personal exemptions or itemized deductions, and schedular elements should be tolerated. The rate schedule should show only mild progressivity, reaching a maximum of no more than 50 percent; a top rate well below that would be desirable. The individual and company taxes should be integrated via a company deduction for dividends paid (except in the case of the SAT which exempts dividends from individual taxation).

Five alternatives for the taxation of business are discussed. The broad-based tax on real income is arguably most attractive from a conceptual point of view, but probably not feasible, because of the difficulty of adjusting the measurement of income for inflation. A similar tax based on nominal income is more appropriate, given Bulgaria's capacity for tax administration, despite its vulnerability to inflation. A tax with generous investment allowances and/or tax holidays – a "Swiss cheese" income tax – should be avoided, despite its use in some other countries emerging from socialism. It involves the picking of "winners and losers" in a manner reminiscent of central planning, rather than reliance on market forces; it creates inequities and the appearance of favouritism; and it opens avenues for abuse that can be prevented – if at all – through the waste of scarce administrative resources.

An alternative that appears to be more appropriate for Bulgaria is the SAT, a scheme under which all investments are deducted immediately (rather than depreciated) and neither interest nor dividends are taxable or deductible. This approach avoids the administrative difficulties inherent in income taxation created by so-called timing issues (e.g. setting the rate of depreciation and accounting for depreciation and inventories) and by inflation adjustment. In addition, by providing a uniform incentive for all investment, it avoids the need for the government to pick "winners and losers". Its primary drawbacks are smaller revenues, especially in early years, and the risk that some capital exporting countries may not allow foreign tax credits for it. The second of these problems is avoided under a hybrid approach that provides expensing, but treats interest and dividends as under the income tax. This latter approach rivals the SAT as the most attractive business tax option for Bulgaria.

The combination of social ownership and labour management leads to wage increases that may be unjustified and unrealistic. Labour management is particularly pernicious, because it provides strong incentives for management to go along with labour demands for higher wages. One often proposed remedy, the taxation of excessive wage increments has the disadvantage of discouraging the payment of higher wages where justified by greater effort and productivity. Without labour management and public ownership there is relatively little need for this tax. Even privatization and a move to free markets will not eliminate this problem unless labour management is eliminated.

Whatever system is chosen, it cannot be implemented immediately. Technical assistance will be required in several areas. These include the design of a more detailed long-term policy, the design of a short-term strategy that is consistent with long-term objectives, improvement of tax administration, computerization, and data collection and analysis. All these measures should begin at once, but with recognition that they will not be completed soon. The improvement of tax administration and computerization, in particular, are likely to require the investment of considerable resources over a period of several years.

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Euroforum, Frankrijklei 16, 2000 Antwerpen, Belgium. Tel.: 03/226.21.80; Fax: 03/226.21.75.

JUNE 1991

Taxation of Branches and Subsidiaries. Brussels, 3-4 June (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium. Tel.: 32/2/516.19.11; Fax: 32/2/513.71.08.

Leasing Taxation Conference. Dublin, 6-7 June (English):
Pet O'Brien, Tax Partner, KPMG Stokes Kennedy Crowley, 1, Stokes Place, St. Stephen's Green, Dublin 2, Ireland.

IFA BENELUX CONFERENCE 1991. Maastricht, 7-8 June (Dutch, French):
Nederlandse Vereniging voor Internationaal Belastingrecht, p/a INTERCENA, Postbus 20111, 1000 HC Amsterdam, The Netherlands.

Holding Structuren, Fiscale maatregelen door de EG. De Moeder-Dochter Richtlijn en de Fusierichtlijn. Zaventem, 12 June (Dutch):
Euroforum, Frankrijklei 16, 2000 Antwerpen, Belgium. Tel.: 03/226.21.80; Fax: 03/226.21.75.

The Use of International Finance Centres and Tax Havens; Sixth Annual Conference. Geneva, 13-14 June (English):
Legal Studies & Services Limited, IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: (44) 71 236 4080; Fax: (44) 71 489 0849.

Omzet- en Overdrachtsbelasting bij Transacties in het Onroerend Goed. Arnhem, 14 June (Dutch):
Studiecentrum voor Bedrijf en Overheid, Antwoordnummer 10041, 5600 VB Eindhoven, The Netherlands. Tel.: 040-608888; Fax: 040-460405.

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Internationale Steuertagung. Zürich, 27-28 June (English):
Zentrum für Unternehmungsführung AG, Im Park 4, CH-8800 Thalwil, Switzerland, Tel.: 01/720 88 88; Fax: 01/720 08 88.

International Conference on Property Taxation and its Interaction with Land Policy. Cambridge, Massachusetts, 22-26 September; Technical Workshop 27-28 September (English):
Lincoln Institute of Land Policy, Attn.: Mrs. Ann Long, Registrar, 26 Trowbridge Street, Cambridge, MA 02138 U.S.A. Tel.: 617-661-3016; Fax: 617-661-6596.

SEPTEMBER 1991

I.T.P.A. Monte-Carlo Workshop. Monte-Carlo, 23-24 September (English):
Ms. Elisabeth Husband, I.T.P.A., Membership and Conference Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1991 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Complete up-to-date reference work containing consolidated annotated text of the most important Hong Kong tax legislation in force as of 1 January 1990. The handbook also includes all Inland Revenue Departmental Interpretation and Practice Notes and headnotes of all the major published Inland Revenue Board of Review Decisions and Hong Kong Tax cases, which are fully cross-referenced to the legislation itself.
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NEWS

BRITISH BRANCH

The topic for the March meeting was "Harmonisation of Direct Tax in Europe", with guest speaker Mr. Michael Whitear, Senior Tax Manager, British Petroleum Plc. The focus of the meeting was to examine the impact of the recent EC Directives on businesses operating in Europe.

DUTCH BRANCH

An IFA Benelux Conference will be held on 7 and 8 June in the MECC Congress Centre in Maastricht.

Subjects to be discussed include:
(1) development of fiscal regulations in the Benelux countries with respect to the EC Directives on parent/subsidiary relationships;
(2) the views of the Benelux countries with respect to recent international developments, in particular limitation of the application of treaties, treaty override and super royalty provisions;
(3) special fiscal regimes in the Benelux countries, such as coordination centres, cost plus rulings, etc.

A programme for accompanying persons will be arranged; and a dinner will be held on Friday evening for participants and accompanying persons. The conference fee is 220 Dfl. for participants and 155 Dfl. for accompanying persons. For more information please contact:
Mr. Mark Doets
c/o Loyens & Volkmaars
P.O. Box 71170
1008 BD Amsterdam
Tel. (020) 647 14 16
Fax (020) 643 53 96

HONG KONG BRANCH
Ian Harris, Secretary

An active discussion took place at the first meeting of the branch this year on the question as to whether Hong Kong should enter into tax treaties with its major trading and investment partners. The debate has been growing over the past year in Hong Kong and it has now been elevated to the political scene with questions being asked in the Legislative Council of Hong Kong. Those in favour of Hong Kong developing a treaty network point to the example of Singapore, which has a tax system similar to Hong Kong's and which has entered into some 25 tax treaties. Although Hong Kong has no withholding tax on interest or dividends and the withholding tax on royalties is only 1.65 percent, it is considered by some that certain countries would be interested in entering into a tax treaty as Hong Kong is becoming a capital-exporting nation, yet is discouraged from making direct investments due to the substantial withholding taxes on interest and dividends in the major target countries. It has also been suggested that Hong Kong's role as a major financial centre for the Asia-Pacific Region would be enhanced if there was a tax treaty network so that interest going to Hong Kong would be free of withholding tax or taxed at a substantially reduced rate. A further argument by those in favour of a treaty network is that it would encourage further political recognition of Hong Kong, which is facing transition to a Special Administrative Region of the People's Republic of China (PRC) in 1997.

Those opposed to the introduction of tax treaties in Hong Kong point to the fact that Hong Kong would have very little to offer the treaty partner other than an exchange of information clause. In the context of Hong Kong's traditional attitude towards secrecy this is likely to be a very controversial issue. It has been pointed out that in most treaties exchange of information is restricted to that information actually in the possession of the Revenue authority, which in the context of Hong Kong is limited because of the schedular and territorial system of taxation in Hong Kong, and in consequence few, if any, countries are likely to be interested in granting treaty benefits to Hong Kong.

The view of the majority of members present at the Hong Kong branch meeting was that any real advantages in a treaty network for Hong Kong is unlikely. Certainly it would appear that the Hong Kong government has not made any commitment to consider a treaty or a series of treaties, although it is not unlikely that exploratory talks – perhaps on an informal basis – may take place with one or more jurisdictions in order to ascertain whether there is any common ground. In this connection it should be noted that the basic law of Hong Kong, which forms the constitution of Hong Kong from 1 July 1997, provides that the Special Administrative Region will be independent of the PRC in its tax affairs; clearly in this respect Hong Kong will be able to have treaties separate from those in force between the PRC and its own treaty partners.

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First published in 1946, the *Bulletin* aims to report on matters of importance to the international tax community and to provide a forum for discussion of worldwide developments in tax policy, law and reform. The *Bulletin* is the official journal of the International Fiscal Association and publishes the reports of its national branches.

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Professor Nooteboom retires as Chairman and John Avery Jones appointed Chairman of the Board of Trustees of the International Bureau of Fiscal Documentation.

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John F. Due and Francis Greany

A value added tax went into effect in Trinidad and Tobago on 1 January 1990. In spite of certain problems, the tax has been relatively successful. Development of the tax proceeded in several phases, including a review of he existing system, formulation of preliminary recommendations, development of analytical models an finally the drafting of legislation. Professor Due and Mr. Greany provide a historical context for the development of the VAT in this Caribbean nation.

CANADA: INCENTIVES FOR INTERNATIONAL SHIPPING CORPORATIONS 269

Allan R. Lanthier

International shipping groups headquarted in Canada have, for several years, been encouraging the Canadian Department of Finance to introduce some type of alleviating measures. In February 1991 the government announced a proposed amendment to the Canadian Income Tax Act, the purpose of which is to clarify the Canadian tax status of foreign-incorporated, international shipping corporations having ownership and management activities in Canada. This article examines the proposal and points out some of the technical uncertainties and deficiencies which should be addressed before the legislation is finalized. The author concludes that if appropriate revisions to the amendment are not made certain taxpayers will be forced to maintain management and operational personnel offshore, while others will be confronted with the difficult choice of deciding whether or not to rely on administrative positions and pronouncements of the assessing branch of Revenue Canada.

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Abe I. Greenbaum

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HONG KONG: 1991/92 BUDGET AND LONG-TERM FINANCIAL STRATEGY 303 *Dr. Tang Shu-hung*

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CONTRIBUTION OF ARTICLES TO THE *BULLETIN*

We welcome the submission of articles which are of interest to tax professionals, executives and scholars to be considered for publication. The author should ensure that the significance of the contribution will also be apparent to an international readership.

The editor will consider for publication manuscripts by contributors from any country. Manuscripts will be subject to a review procedure and accepted manuscripts will be edited to improve the general effectiveness of communication.

Manuscripts should be submitted, together with a covering letter, to the Editor. At the time the manuscript is submitted, written assurance must be given that the article has not been published, submitted or accepted elsewhere. The author will be notified of acceptance, rejection or need for revision within 8 weeks.

Manuscripts may range from 3,000 to 10,000 words, approximately 10-24 typed pages. Diskettes 5.25 inch (Word Perfect) welcome!

The author should submit biographical data, including his or her current affiliation.

Professor Nooteboom

Retires as Chairman of the Board of Trustees of the International Bureau of Fiscal Documentation

After a ten-year term of office, Professor Adriaan Nooteboom retired as chairman of the IBFD's Board of Trustees at the end of the annual meeting on 17 May 1991. Professor Nooteboom will continue his association with the Bureau as a member of the Board.

During his chairmanship the IBFD developed into a major research organisation, publishing house and educational centre in the field of international taxation.

In 1981 the research staff consisted of nine associates; at the moment 40 lawyers and economists from 17 countries work at the IBFD. In 1981 14 major (loose-leaf) books were on the market; by the end of 1991 35 titles (databases and loose-leaf books) will be available.

Major achievements in this period were the organisation of East-West Tax Conferences, the founding of the International Tax Academy and its important educational work in Central and Eastern Europe, the restructuring of the IBFD into a research foundation and a publishing house (IBFD Publications B.V.), the move to a modern head office and important legislative work and assistance for various countries.

With his enthusiasm Professor Nooteboom was the ideal chairman during this transitional period in the life of the IBFD.

Professor Nooteboom is a former Parliamentary State Secretary for Finance and is Professor of Tax Law at the State University of Groningen. He is also an attorney at law and tax counsel (Nootéboom c.s. at Dordrecht).

Professor Nooteboom has always played an important role in the International Fiscal Association and has been chairman of the Netherlands branch of IFA for many years.

John Avery Jones

Appointed Chairman of the Board of Trustees of the International Bureau of Fiscal Documentation

John Avery Jones CBE MA LLM FTII, senior partner of Speechly Bircham and a leading international tax expert, has been appointed Chairman of the Board of Trustees of the International Bureau of Fiscal Documentation in Amsterdam. He succeeds Professor Adriaan Nooteboom who retired as Chairman after 10 years in that office. It is the first time in the IBFD's history of over 50 years that a person from outside the Netherlands has been chosen to fill this position.

Mr. Avery Jones has a varied and distinguished career in the world of taxation. His legal career spans 25 years in practice for the firm of which he is now the senior partner. He has been a member of the Meade Committee on the Structure and Reform of Direct Taxation (1975 to 1977) and the Keith Committee on the Enforcement Powers of the Revenue Departments (1980 to 1984). He was President of the Institute of Taxation (1980 to 1982) and Chairman of the Law Society's Revenue Committee (1983 to 1990).

He is currently Visiting Professor at the London School of Economics, Chairman of the British Branch of the International Fiscal Association, member of the International Fiscal Association's Executive Committee, council member of the Institute of Fiscal Studies, joint editor of the British Tax Review (since 1974), consulting editor of the VAT Encyclopaedia and a member of the editorial board of Simon's Taxes. He has written numerous articles and lectured extensively on U.K. and international taxation.

The IBFD is pleased to welcome its new Chairman whose experience and advice will be most valuable to the organisation.

TRINIDAD AND TOBAGO:
THE DEVELOPMENT OF A VALUE ADDED TAX

John F. Due and Francis Greaney

With independence and the formation in 1973 of CARICOM (the Caribbean Common Market), the tax structures of Commonwealth Caribbean countries, particularly the four major ones (Trinidad, Jamaica, Barbados and Guyana) had many features in common: unusually high dependence on income taxation, with steeply rising marginal rates; a uniform (with minor exceptions) external tariff which the countries could not unilaterally raise under the terms of the CARICOM agreement; and traditional excises applying only to domestic production.[1] Relative yields from customs were less than in many developing countries and fell as a result of the establishment of CARICOM, as intra-CARICOM trade was not subject. The countries such as Guyana, whose own tariffs were higher than that of CARICOM, suffered additional loss of revenue.

John F. Due is Professor of Economics Emeritus at the University of Illinois at Urbana-Champaign, *Francis Greaney* is Manager, Policy Economics Group, KPMG, Peat Marwick, Washington, D.C.

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As a consequence of these circumstances, all of the countries turned to additional tax sources, but not initially to general sales taxes with more or less uniform rates. Instead they imposed a number of special levies on various commodities, called purchase taxes in Trinidad and Tobago, consumption taxes in the other three countries. The Guyana levy covered virtually all commodities and thus was in a sense a manufacturers sales tax, with widely different rates, a total of 27. The other three countries gradually extended the coverage of their consumption or purchase taxes until these taxes likewise had wide but not general coverage and the taxes were levied by specified goods. They also had other special levies on various services. Jamaica imposed a so-called retail sales tax, which was not such a tax in any usual sense of the term. The consumption or purchase taxes were applied to both imported and domestic goods, unlike the excises, but with minor exceptions were confined domestically to the manufacturing sector.

By the 1970s, some attention was given in the CARICOM countries to conversion of the rather complex systems into a more general sales tax. As early as 1974, for example, Guyana developed under the initiative of Inland Revenue Commissioner Devonish, with UNDP aid, a plan for a value added type sales tax to replace the consumption tax, but no action was taken. In Jamaica attention was given to reform of the consumption and related taxes in 1973,[2] and subsequently on several occasions in the 1970s and 1980s. Finally, in 1984-85 a detailed plan for a new value added tax in Jamaica was developed with the assistance of the Metropolitan Studies Program of Syracuse University.[3] Various objections and a change in government resulted in delay of implementation until 1991. Barbados imposed a retail sales tax in 1975, but with a change in Government repealed it in 1976.

DEVELOPMENT OF INTEREST IN TRINIDAD

As long as Trinidad had substantial oil revenue, it was less concerned about modification of the indirect tax structure to increase revenue from this source. But with the decline in world oil prices, the Government turned increased attention to the question. In the budget speech of 1983, the Prime Minister and Minister of Finance stated, "We have been giving consideration for some time to the introduction of a general sales tax. I am advised that there are numerous problems in the administration of such a tax. I therefore propose to seek the assistance of the International Monetary Fund as to the form which would be most appropriate in our circumstances." This request resulted in a report by the IMF entitled *Trinidad and Tobago: Sales Tax and Other Options of Indirect Tax Reform* (18 May 1983). No immediate action was taken on this report however, because it recommended a sales tax to be imposed at the manufacturers' level and the existing purchase tax was already being imposed on the wholesale value of goods.

1. The experience is described by Roy Gobin, "An Analysis of the System of Sales Taxation in the Caribbean Common Market", 2 *Public Finance,* (1980), at 270-88, and the following articles in the *Bulletin for International Fiscal Documentation:* "The System of Indirect Taxation in the Caribbean Common Market", Vol. 33 (June/July 1979), at 252-257 and "A Survey and Analysis of the Tax System in the Caribbean Common Market", Vol. 33 (October 1979), at 445-455.
2. A report, "Indirect Taxation for Jamaica", was prepared by Professor Charles McLure, Jr. for the taxation division of the Ministry of Finance of Jamaica, 24 August 1973.
3. Richard Bird and Mathias Bourgeois, *General Consumption Tax,* Staff Pair # 29, Jamaica Tax Structure Examination Project, Metropolitan Studies Program, Syracuse University and Board of Revenue, Government of Jamaica, Syracuse and Kingston, May 1986.

In 1986 in the budget speech, the Prime Minister indicated that changes in the purchase tax represented movement toward a full implementation of a general sales tax. The Acting Permanent Secretary of Finance requested that the Board of Inland Revenue ("BIR") develop a proposal for a general retail sales tax, and to this end the BIR appointed a committee headed by Mrs. Michal Christian, Assistant Commissioner of Inland Revenue, to prepare such a plan. During 1986, the Committee held a number of meetings, gathered relevant information and prepared a report. The Committee concluded that with a retail sales tax, which was emphasized, a rate of 21 percent would be required to raise the same revenue as the purchase taxes, which had relatively high rates. A 40 percent rate would be required if food were exempt.[4] If various service sectors were included, the necessary rates would be 13 percent (food taxed) and 19 percent (food exempt). The Committee did not regard a tax with such rates as feasible, given rates in other countries, and sought to avoid multiple rates, which would allow a lower basic rate.

PRELIMINARY ACTION

In its 1988 budget speech, the Government announced that it had established a Tax Performance Committee in 1987 with Mr. Steve Ferguson as Chairman, to further consider plans for a general sales tax, and it indicated that a sales tax would be introduced in 1988. The establishment of a tax committee, comprised of representatives from labour, business and the Government, to examine the tax system and recommend changes to the Government was not a new precedent. This approach had often been taken in the past, with formal committees established in 1967, 1981 and 1986 to review the tax system and recommend reforms. The terms of reference of the Tax Performance Committee were not limited to the indirect tax system, but rather included an examination of the entire system of taxation.

In early 1988, the business community was responsible for bringing to Trinidad Mr. R. Watson of Price Waterhouse and Co. (U.K.), an expert on VAT operations in the United Kingdom, for discussions about the feasibility of a VAT. Following a meeting on 16 January 1988 attended by Mr. Watson, representatives of the private sector and the Government, a draft report on the introduction of a value added tax was prepared by a committee headed by Mr. Ferguson.[5] This brief report considered the relative merits of a retail sales tax and a VAT and indicated that the business community favoured the value added tax form. A schedule of work to be done was set up, with the hope that the tax could be introduced 1 January 1989, and steps in the operation of the tax were outlined. The needed educational programme was noted. The report favoured administration by Inland Revenue rather than Customs and Excise. Emphasis was placed upon the need for simplicity and for care in designing the new tax.

In May of 1988 the Policy Economics Group of KPMG Peat Marwick formally entered into an agreement with the Government of Trinidad and Tobago to assist the Tax Performance Committee and the Ministry of Finance in developing a comprehensive Tax Reform Programme. A scope of work of the Policy Economics Group was divided into three phases.

Phase I of the study included two principal components:

(1) a review of the current tax system covering indirect taxes, individual income tax, corporate income tax, petroleum taxes and tax administration; and
(2) the development of preliminary recommendations for directions for reform.

Particular emphasis was to be placed on:

(a) simplifying and expanding the system of indirect taxes;
(b) improving the structure of the individual income tax with special attention paid to the equity of the system; and
(c) reforming the corporate income tax to broaden the base and lower the tax rate to improve the environment for economic growth.

Phase II focused on the development of analytical models to assist the analysis of the entire tax system. Three microsimulation models were developed for the individual income tax, the corporate income tax and the system of indirect taxation. These models, based on detailed tax and economic data, were designed to estimate the revenue and distributional effects of proposed changes in the tax system. These models provided the Government and the Tax Performance Committee, for the first time, with a reliable means of quantifying the effects of proposed tax changes.

Phase III called for developing specific recommendations for a comprehensive Tax Reform Programme along with a detailed plan for implementing the reform programme.

The aim was to have a final report of the overall tax revision programme completed by the end of 1988, together with a detailed implementation plan.

For purposes of the project, a team was assembled by Peat Marwick, and the members visited Trinidad on various occasions in 1988 and 1989. The team worked closely with the Tax Performance Committee, Inland Revenue, Customs and Excise and other Government agencies and private sector firms. Throughout the course of their work, the team held a series of discussions concerning their findings and recommendations with the Tax Performance Committee and the Government. To assist in the work of the tax reform team, a specially appointed technical committee was formed. This Committee included representatives from the Ministry of Finance, the Board of Inland Revenue, Customs and Excise and the Central Statistical Office. Of great benefit was the assignment of two Government staff persons to assist the members of the team working on indirect taxes.[6]

ANALYSIS OF THE EXISTING INDIRECT TAX SYSTEM

The first step on the part of those members of the team who were involved with policy on indirect taxes was a detailed review of the existing indirect structure and administration. This work, primarily in April 1988, resulted in completion of *Indirect Taxation in Trinidad and Tobago: Initial Report* (12 May 1988). This report was combined with analysis of

4. *Report of the General Sales Tax Committee* by its Chairman, Mrs. Michal Christian to Mr. Randolph Kong, Chairman, Board of Inland Revenue, 17 September 1986.
5. *Draft Report on the Introduction of a Value Added Tax* (1988).
6. The authors would like to express particular appreciation to these persons: Mr. T. Boodoosingh of the Budget Office and Mr. Ken Superville, Superintendent of Enforcement for Customs and Excise, and to Mrs. Michal Christian, VAT Commissioner, for their assistance. Appreciation is also expressed to the Board of Inland Revenue and its staff, and the staff of Customs and Excise, the VAT Administration Centre, and a number of other government departments, as well as the Tax Performance Committee and private sector firms and associations, and to Professor Carl Shoup for his comments on the manuscript.

other aspects of the tax system and presented to the Tax Performance Committee and the Ministry of Finance in a formal presentation of 1 June 1988 as well as in a written report entitled *Draft Phase I Report: Initial Overview of the Trinidad and Tobago Tax System.* Feedback on the directions for change was received from the Ministry and the Committee and the team sharpened its focus in developing more specific recommendations concerning the design of a tax reform programme for Trinidad and Tobago.

Indirect taxes in total yielded about 32 percent of total tax revenue. Of this total percentage, import duties plus a stamp tax on imports, purchase taxes on various goods applying to both imports and domestic production and excises (applying only to domestic production) each yielded about 8 percent, or 24 in total of the 32 percent. As of 1988, there were four ad valorem rates of purchase tax (20, 40, 60 and 85 percent), plus specific rates on tobacco products. Tax applied to importation and to sale by manufacturers. The total purchase tax coverage was broad, only a few basic necessities being excluded plus various inputs of industry. Over one third of the purchase tax revenue was obtained from alcoholic beverages, tobacco products, food and soft drinks, and building materials. The purchase tax did not apply to services. There were about 600 active manufacturers paying tax. The tax was administered by Customs and Excise.

While the tax had some desirable characteristics, there were serious limitations. In summary: the designation of taxable items by tariff number resulted in unnecessary restriction of coverage. The relatively high rate (40 percent on many commodities) inevitably resulted in misclassification and adverse economic effects. While relatively few inputs in production were taxed, there was no general rule for excluding them, resulting in some cascading and restricting the ability to extend the coverage of the tax to goods used both as production inputs and for consumption. The levies did not constitute a broad-based sales tax.

There were serious inadequacies in administrative requirements, particularly the lack of penalties for failure to file and pay. There was no trained audit staff. Failure to cover any of the distribution sector restricted potential revenue. Overall, the purchase tax was unnecessarily complex, restricted in scope, and applied unusually high rates on many transactions. Compliance requirements were inadequate.

In the excise field, petroleum products had become the major revenue source, yielding two thirds of the total excise revenue. Excises applied only to domestic production under traditional British Commonwealth practice, and all had specific rates.

In addition there were several special levies on sales of motor vehicles, on hotels and on telephone and electric service.

The overall evaluation was that the indirect tax system was in urgent need of revision to lessen complexity, broaden the scope, reduce the number of separate taxes, introduce computerization, establish an audit programme, improve equity and buoyancy of revenue, end adverse economic effects and strengthen administration.

7. The experience is reviewed in the paper by Mrs. Michal Y. Christian, "VAT: The Trinidad and Tobago Experience", a paper presented to the Caribbean Community Secretariat's Seminar on Value Added Tax; Barbados, 18-22 June 1990.

DEVELOPMENT OF PROPOSALS FOR CHANGE[7]

The basic proposal of the report prepared by the team was for the establishment of a general sales tax, merging in the existing levies (except customs), with the proposed title of General Indirect Consumption Tax. A review of alternative forms of general indirect taxes was presented. The value added technique was recommended, but the need for further review was necessary before making the key decision on the extent to which the tax should go forward beyond the manufacturing sector. Other issues to be resolved, such as exemptions, taxation of services, choice of single vs. multiple rates, choice of the tax rate, exclusion of small firms and location of administration, were noted, and a list of steps to be taken in the development of the tax presented.

Further work in May and June 1988 resulted in the preparation of a Supplement to the initial report. A substantial portion was devoted to the question of the extent to which the tax should be extended forward to the retail sector. Consultation with various trade and industry groups, three major firms involved in importing, manufacturing, wholesale distribution and retailing (Neal and Massy, McEnearney Alstons and T. Geddes Grant), the Chamber of Commerce and other business groups, plus data from the Central Statistical Office, led to the recommendation that the scope of the value added tax not be defined in terms of sector (manufacturing, wholesale, retail), but in terms of size of establishment. Given the complexities in the distribution system, many firms were carrying on business in several sectors, and the inevitable influence of the sector approach would encourage firms to shift functions forward beyond the point of impact of the tax. The decision was partly influenced by the high literacy rate of the country and the adequacy of record systems; the same reasoning does not necessarily apply to other developing countries.

In the process of these investigations, substantial support was found in the business community for increased reliance on indirect taxation, and choice of the value added approach, primarily for enforcement reasons. Unlike many countries, such as Australia and New Zealand, there was no sharp division in the business community on the preferable form of the tax.

Several major issues remained, particularly the treatment of agriculture, the selection of the threshold figure above which registration, collection and payment of tax would be required, exemptions and zero rating, and a number of more specific issues. Further investigation by the team and discussions with various persons involved in the private sector, ministries, the Agricultural Development Bank and faculty at the University of the West Indies, St. Augustine, facilitated making recommendations on these issues.

In July of 1988, Peat Marwick completed *Indirect Taxation in Trinidad and Tobago: Second Report,* incorporating the various recommendations, noting remaining issues and making a number of more specific recommendations:

(1) The threshold figure would be TT$ 50,000 (about US$ 12,500).
(2) Tax credit would be allowed registered firms on all business inputs.
(3) Exclusion from tax should be limited to a very small number of unprocessed foodstuffs and a few other commodities. This recommendation was based in part upon household budget studies.
(4) Taxation of all services was not recommended for equity and operational reasons; services considered suitable for taxation were listed.

(5) A single rate for the value added tax was strongly recommended. Only the excises (except a few minor ones) and one special levy would be retained, a simplified ad valorem rate tax on sales of motor vehicles.
(6) Administration would be placed with Inland Revenue because of the importance of audit and the need for integrating to some degree value added and income tax audit.
(7) Farmers in general would not be registered for the tax but major farm inputs would be zero-rated.

This report was supplemented with additional analysis of the revenue and distributional effects of the current tax system and proposed changes to the system. This analysis was undertaken by the development of a computer-based Indirect Tax Model designed specifically to analyse the revenue and distributional effects of alternative tax policies.

The recommendations developed in the report on indirect taxes, along with recommendations on direct taxes, were formally presented to both the Cabinet and the Tax Performance Committee in separate meetings held on 7 and 8 September 1988. While the recommendations were fairly well received, both the Government and the Tax Performance Committee offered numerous comments and alternative proposals, which were in turn analysed by the Peat Marwick team. Throughout the entire process a heavy emphasis was placed on the quantitative analysis of the tax reform proposals. This analysis was made possible through the application of computerized microsimulation models developed by Peat Marwick for the Ministry of Finance and the Tax Performance Committee. This emphasis served to focus on developing a sound tax reform programme that met not only the structural objectives of good tax policy but also satisfied the revenue and distributional goals of the Government.

The results of these analyses and the incorporation of appropriate modifications to the proposed tax reform programme were presented to the Government and the Tax Performance Committee on 17 October 1988.

THE FINAL REPORT AND PLANS FOR IMPLEMENTATION

The revised Tax Reform Programme, including reforms to both direct and indirect taxes, was presented to the Government by Peat Marwick in a formal report entitled *Tax Reform Programme for Trinidad and Tobago Final Report* (December 1988), which covered the other taxes as well. While primarily presenting the recommendations of the previous reports, this report contained a major addition, proposing a rate of 18 percent. This figure was based upon estimates of revenue necessary to make up that lost from the repeal of the purchase taxes and some special levies (but not the excises). The consulting firm also prepared a *Proposed Programme for Implementation of a Value Added Tax in Trinidad and Tobago,* dated 10 January 1989, which defined in detail the responsibilities of the consultants and the Government and outlined the steps to be taken in 1989 so that the tax could be operational 1 January 1990, the date indicated in the 1989 budget message. The Programme provided a detailed month-by-month statement of the objectives to be attained in four areas: Policy and Planning; Organizational Analysis; Staffing and Training; Computerization.

The Tax Reform Programme was formally announced in the Minister of Finance's budget speech in December 1988 and a Provisional Collection of Taxes Order was issued to effect the changes. The majority of the income tax reforms took effect in January 1989.

To facilitate the implementation of the VAT programme, Peat Marwick brought in experienced tax administrators from the United Kingdom and New Zealand to assist in policy decisions, framing of legislation, training and personnel to work with the Port of Spain office of Peat Marwick to complete the computerization programme. A detailed checklist of issues on which decisions had to be made was developed, and discussed at length among persons on the consulting team, Government officials and the Tax Performance Committee.

A VAT Implementation Team was appointed by the Ministry of Finance to carry out the implementation programme for the VAT. This team was drawn from the Board of Inland Revenue and Customs and Excise and included an Assistant Commissioner of Inland Revenue and designated head of the VAT office, a tax lawyer, a tax officer, a tax training specialist, a computer systems analyst, and a Customs and Excise tax officer. Members were assigned specific responsibilities in their area of expertise. The group met frequently to formulate key policy and administrative recommendations for the Government.

Weekly status meetings were held with the VAT Implementation Team to review the accomplishments of the previous week, to plan activities for the following week and to address any problems that arose. Periodic status meetings were held with the Tax Performance Committee and the Minister of Finance to review and discuss detailed policy and administrative recommendations. Substantial progress was made in implementation of the plans for the tax. The checklist of unresolved issues was reviewed and decisions made – in the end by Inland Revenue and the Ministry – on almost all issues, though some new ones appeared later. In the process, the Government made the decision to call the tax the value added tax in lieu of general consumption tax (as in Jamaica) or goods and services tax (New Zealand and Canada). It is not feasible to list all of the issues, but their general nature can be summarized briefly:

(1) final decision on services: specified or all services except those specifically excluded;
(2) restrictions on credits for tax on business inputs;
(3) exclusions: zero-rating vs. exemption treatment of food, medicine, clothing, etc.;
(4) actual coverage of the services category;
(5) special rules on imports; zero-rating of exports;
(6) sales to and by Government and various organizations;
(7) sales of used goods;
(8) tax treatment of farming, fishing;
(9) exact rules on small firms;
(10) rate structure: single vs. multiple;
(11) rate level;
(12) quotation of tax; tax invoices;
(13) elements in taxable price;
(14) time of tax liability;
(15) building construction, rentals, sale of buildings;
(16) allowance of refund of excess input tax credits.

There were likewise a number of issues relating to operation of the tax, legal aspects and operating procedures, on which decisions were made as noted below.

FINAL DECISIONS

The period between March and July 1989 involved intensive work on all aspects of the tax, preparatory to the introduction of legislation in the summer period. Major aspects included:

(1) Final decisions on policy issues, which produced the contents of the legislation subsequently drafted, as noted below. This involved cooperative effort between the consulting team and the VAT Implementation Team. In addition, the Tax Performance Committee and the Minister of Finance were involved in discussions concerning the major VAT policy issues.

(2) The selection of a director of the VAT Office and recruiting of personnel. Mrs. Michal Christian, Assistant Commissioner of Inland Revenue, a certified accountant and a graduate of the Mona (Jamaica) Campus of the University of the West Indies, was named VAT Commissioner and added to the Board of Inland Revenue. She had been involved in consideration of a general sales tax over a period of several years. The VAT Administration Centre, as it came to be called, proceeded to recruit personnel, largely from Inland Revenue, but some from the outside.

(3) Training: an extensive programme was introduced in training persons in VAT operations.

(4) Development of the computer system, assisted by personnel of the Port of Spain office of Peat Marwick, technical consultants from outside the country, and personnel within the Government.

(5) Establishment of an informational and educational programme, with guidance from a person from the New Zealand administration and the contracting of a local advertising firm.

A number of key decisions were made about the operation of the tax at this period; major ones can be summarized:

(1) The tax would be administered by a separate unit in Inland Revenue with its own enforcement and audit staff, rather than under a functional system, under which audit, enforcement and other activities would be administered by units involved with all taxes. It was universally agreed that the tax should be handled by Inland Revenue, not by Customs and Excise, a decision the latter concurred in.

(2) Three local offices, in Port of Spain, San Fernando and Tobago, were established.

(3) A bi-monthly system of returns was established, with one half of the firms filing in each two-month period.

THE SECOND PHASE

The policy discussions and decisions resulted in two documents, *The Design of a Value Added Tax for Trinidad and Tobago* and a White Paper on *Tax Reform for Trinidad and Tobago: the Second Phase*. The former presented in some detail the structure and operation of the proposed VAT including the following:

(1) a rate between 15 percent and 20 percent would be used, with a single rate to avoid operational complications;
(2) the threshold for small businesses was raised to TT$ 75,000;
(3) specified services would be included in the tax; financial, insurance and professional services would not be taxed;
(4) zero-rating would be limited to exports and a few basic foods and medicines subject to prescription.

Late in March the recommendations were presented by the consulting team to the Minister, the Permanent Secretary and the Tax Performance Committee, and with minor exceptions the recommendations were accepted, approved by Cabinet and served as the basis for ultimate drafting of the legislation.

Because the implementation activity had been delayed more than a month in getting underway, every effort was made in the late spring of 1989 to speed up the process so the legislation could be approved in mid-summer. The checklist for policy issues was replaced by a statement of proposed decisions on the tax, and this aided the preparation by the Legal Counsel, in cooperation with consultants, of the statement on which the draft of legislation would be prepared.

DRAFTING

The actual drafting of the legislation was undertaken by the Chief Parliamentary Counsel. Drafting was completed in July, and a number of meetings were held between members of the consulting team and the Minister and the Permanent Secretary. Several major decisions were made by the Government.

- A rate of 15 percent was made possible, in lieu of the original 18 percent proposal, by an expansion of the base and the maintenance of the same level of taxation on traditional excise tax goods.
- The threshold annual sales figure for registration of firms was raised to TT$ 120,000 (about US$ 30,000).
- Crude oil and natural gas were zero-rated to avoid liquidity problems in the petroleum industry. Natural gas is used solely by industry; there was basically no revenue effect of the change.
- Decision was made to tax real property contractor services, but not the sale of newly constructed buildings. Since this change reduced the tax on new housing (many small contractors would be below the threshold), an initial provision for a refund of tax on new housing was eliminated.

Subsequently, as a result of debate in Parliament change was made to tax all services except those exempted.

The legislation, the passage of which required a three-fifths majority of all members, was passed by the House on 18 August, and by the Senate on 8 September.

By no means were all the issues resolved, however. In subsequent meetings between the VAT officials and the consultants decisions were made, although issues continued to arise through 1990.

With the enactment of the legislation, increased stress was placed on preparing booklets and other instructional materials for the business community and the public, and substantial newspaper and television publicity was provided, using the services of an advertising firm. The Minister of Finance himself travelled throughout the country giving presentations to various community and business groups explaining the objectives of the overall Tax Reform Programme, its anticipated revenue and distributional effects and many of the specifics on the structure and operation of the VAT. Again, the overriding theme was that the VAT must be viewed as part of the overall Tax Reform Programme which was designed to provide a stable basis for economic growth.

Persons were available in the three local offices to provide information. Forms for registration were prepared and distributed and tax return forms developed. Recruitment and training continued. Even in mid-October 1989, there were still many questions. Registration was required by 31 October.

RESPONSE TO THE TAX AND CRITICISMS

No new tax is ever popular – but on the whole the tax was relatively well received. The business community favoured it – unlike the reaction in many countries – partly because the tax would allow reduction in income taxes, partly because of the unsatisfactory nature of existing indirect taxes. Cooperation between the Government and the business community obviously facilitated a favourable reaction. The downturn in the economy and the sincere desire of both business and Government to take possibly difficult actions for the good of the country as a whole played an important role in reaching consensus on the appropriate tax reform programme.

Inevitably the opposition in Parliament criticized the new tax, primarily on the basis that the shift to VAT reduced the income tax and luxury spending tax burdens on the higher income groups, and increased the burden on the lower and middle income groups. The Government did make a strong effort to minimize the burden on the poor, but some shifting between upper and middle income groups was inevitable, given the general objectives of the overall tax reform. Furthermore, there had undoubtedly been considerable evasion or avoidance of income taxes in the higher levels. Those objecting to shifting the burden to the poor advanced arguments for excluding all medicines, not merely prescription ones, from the tax, and for excluding books, or at least text books. But driven by important revenue goals and with special attention paid to the distributional effects of the tax system, the Government held to several politically difficult decisions concerning the appropriate coverage of the VAT. The Government also committed itself to increase the funding of certain transfer programmes, such as old age pensions, food subsidies and public assistance, aimed at assisting low income and elderly persons.

In everyday discussions, much of the criticism was against the 15 percent rate; 10 percent was often mentioned as a reasonable figure. But the purchase taxes being removed had rates higher than 15. The rate level was largely dictated by the revenue needs and the desire to shift relative reliance to indirect taxes from direct taxes.

Concern was expressed about inflationary effects of the tax and fear that the tax would be added to prices without downward adjustments reflecting the elimination of the purchase taxes. There was concern that small firms would adjust prices upward by the amount of the tax rate applied to sales even though they were only taxed on inputs. The criticisms involved a good bit of outright misinformation – the argument, for example, that registered firms would shift forward the taxes on their inputs even though these amounts were deductible against tax due on sales.

Persons involved with certain activities were fearful of adverse effects. Promoters of various Carnival activities were afraid that they would have to pay tax on goods purchased in 1989 for delivery in 1990 at Carnival time (this potential problem was alleviated by the introduction of transitional provisions). The hotel industry was concerned that the 15 percent tax on hotel charges was out of line with taxes in neighbouring countries – thus checking the tourist trade that the country is seeking to develop. However, the evidence showed that the major impediments to the development of the tourist industry related more to infrastructure and marketing decisions, including the quality, availability and accessibility of resort hotels, than to the rates of the current hotels. Farm groups sought zero-rating of additional farm inputs.

There was concern over lack of clarity in defining zero-rated commodities and various taxable services – a problem gradually lessened by interpretations issued. But questions continue to arise about the meaning of unprocessed food. The issue of taxing second-hand goods has not been resolved.

There was concern about firms advertising to buy early to avoid the tax (ignoring the fact the purchase taxes would come off), and after the tax became effective, advertising claims by firms that they were not shifting the tax to the consumer.

THE EXPERIENCE WITH OPERATION: 1990

As scheduled, the tax went into effect 1 January 1990. By June 1990, revenues were comparable to those anticipated; the estimates were reasonably accurate. As of December 1990, there were 9,688 registered firms, somewhat lower than the original estimates. Of these, 66 percent were in the Port of Spain district, 31 percent in San Fernando, 3 percent in Tobago. During the initial registration period, 52,144 registration packets had been mailed out, the mailing list based on a number of sources of potential taxpaying firms. Many of these names were duplicates and a significant number of firms had previously gone out of business but had never been removed from the various registers. 15,929 of the applications were completed and returned to the VAT Centre by 10 October 1989. Of these 6,343 were found to have sufficient sales to be subject. Of the remainder, 17,104 were returned as duplicate, unclaimed, out of business, etc.; 18,478 never responded; 633 were returned incomplete.

By 12 December 1989, 8,215 registrations were complete; by 8 August 1990 the number of registrants was 9,729, by December, 9,688. The figure of population divided by the number of registered firms, 127, compares favourably with other similar countries; it is unlikely that the number is substantially less than should be expected.

The non-filing or delinquency rate – the number of registered firms not filing – was initially very high; it had fallen to 25 percent by the bi-monthly period ending 25 May 1990, but was still 24 percent in November 1990. Roughly one half of these delinquencies were cleared a month later.

By January 1991, the chief deficiency was the failure of the computer system to perform all desired functions. There were delays in developing the computer system along the way, and for reasons by no means obvious the completed system was inadequate. The most serious failure was the inability of the system to ascertain non-filers and prepare a list and notices for mailing.

This was being done manually; the department had responded quickly to develop a substitute approach. Ultimately, the system should be brought into full operation. Meanwhile the delinquency rate remains relatively high.

The audit programme was underway by mid-1990, but it is not adequately staffed. As of January 1991 there were 12 auditors assigned to refunds and 11 to payable accounts, but of this total only about one half are available the entire year, because of training and illness. In the ten months (March – December 1990), there were 193 audits of refund cases, 119 of payable cases; but the number was much lower in the last five months of the year than in earlier months.

The budget estimate of revenue from the tax for the calendar year 1990 was TT$ 863 million. The actual yield, after refunds, was TT$ 899,744,336. The gross yield was TT$ 1,213,137,631 of which TT$ 581,660,679 (48 percent) was collected at customs, TT$ 630,043,831 on domestic sales (52 percent) and a negligible TT$ 1,431,121 from Government departments. The total figure of refunds for input tax credit was TT$ 313,393,296, or 26 percent of the gross yield.

For the 1991 budget year, the tax is expected to yield 25 percent of total tax revenue.

The general situation after a year of operation was reasonably satisfactory. The VAT department has effective leadership and a number of competent persons, a potentially good computer system, excellent physical quarters and the support of the top level of Government. The overall programme of development of the tax proved to be satisfactory; there were some difficulties, as is almost inevitable. There were considerable delays in getting human and physical resources, much of the delay in staffing the VAT office caused by the rigidness of public service administration regulations and procedures. As in many countries, both developed and developing, more importance is placed on seniority than capability. However, the VAT office as a whole was successful in obtaining exceptionally capable personnel. The whole operation fell several months behind schedule, in terms of staffing, training and development of legislation, and many basic policy decisions were made relatively late, thus affecting both information for the public and training. The difficulties with the computer system should have been avoidable. Striking a balance between authoritative leadership and committee decision making is always difficult, and it may be argued that too much emphasis was placed on the committee approach, in terms of utilization of time. But these features should not be exaggerated; the tax did go into operation on schedule, and without serious difficulties, although the delinquency rate is still excessive and the audit programme is inadequate.

The Act, as enacted in September 1989, proved for the most part to be satisfactory, but changes soon became necessary. Several were made in December 1989, most minor, but some of substance; baby formulas and baby milk substitutes were zero-rated, for example, and travel between Trinidad and Tobago zero-rated instead of being exempted. Changes were made in early 1990 to allow simplified tax invoices, and during the spring a number of rather detailed changes were developed, primarily to the schedules, to clarify the meaning of various categories. Clarifying zero-rated goods, such as unprocessed food and exempt services, in a workable manner is a serious problem in any value added tax. Other provisions of the Act could be questioned; for example, the various alternative "schemes" for simplified accounting for tax, which had their genesis in the U.K. VAT and are themselves complicated and may be regarded as unnecessary.

Because firms had the choice of quoting the tax separately or quoting tax-included prices, some confusion arose. This again was the result of the compromise between the U.K. and New Zealand approaches to VAT. Typically prices were readjusted to a tax-included basis, some stores closing down for one or two days to make the changes. These firms were fearful of confusion at the tax register if the tax were added separately.

Data on price increases showed that the price of goods subject to tax rose between 5 and 11 percent between December 1989 and January 1990, while the price of non-taxed goods rose by only 2 percent. Even by April 1990, none of the commodity groups had risen in price by as much as 15 percent, an indication that some downward adjustments were made for the repeal of purchase taxes. The year of 1989 had been one of relative price stability; the tax was not introduced in a strongly inflationary period.

While refunds are being paid, there is some complaint about delay.

SUMMARY OF THE TAX AS OF 1990

The major features of the tax as introduced and modified slightly in 1990 are as follows:

Nature: The tax is a value added levy of the usual tax credit or invoice form. The tax applies to importation and domestic sales. Credit is allowed for tax paid on inputs for business use by registered firms, without exception. The tax extends through the retail level, although small firms in all sectors are free of the requirement to register, collect and remit tax. They pay tax on their purchases and are not eligible for input tax credit.

Coverage: The tax applies to all sales of goods and to all services, except as otherwise specified.

The sale of land and buildings is not included in the scope of the tax, although rental of business property is taxable. Commodities specifically excluded from application of the tax are zero-rated; thus tax does not apply to the sales of the goods, and sellers receive input tax credit for tax paid on inputs to produce them.

Zero-rating is restricted, compared to many sales taxes, being limited to:
(a) unprocessed food, and a few basic processed foods, such as flour, bread, milk and margarine;
(b) medicines of a type sold by prescription;
(c) live animals, livestock feed, seed, fertilizer, farm machinery;
(d) water sold through pipes;
(e) exports and certain export-related activities;
(f) natural gas and crude oil;
(g) veterinary and pest control services.

Specified services are exempted and thus, while not subject to tax, suppliers do not receive input tax credits. The principal exempt services are:
(a) medical, dental, hospital and other health-related services;
(b) most education;
(c) rental of residential property;
(d) bus and taxi services; postal services;
(e) real estate brokerage, insurance, banking, stock brokerage.

Small firms: The threshold for registration of firms is set at TT$ 120,000 (about US$ 30,000) annual sales. This figure appears to be satisfactory. Voluntary registration is permitted for firms under the threshold in certain important industries, such as farming and manufacturing.

Operations: Returns and payment are required on a bimonthly basis, due by the 25th of the following month.

Tax invoices are required, with a simplified form for use by gas stations, car parks and supermarkets. Firms have the choice of quoting the tax separately from the price or quoting tax-inclusive prices, although the latter is increasingly common.

The tax is administered by the Value Added Tax Centre of Inland Revenue, under the VAT Commissioner, who is a member of the Board of Inland Revenue.

REASONS FOR THE SUCCESS OF THE INTRODUCTION OF THE TAX

Despite problems, such as with the computer system, the overall introduction of the tax has been successful. There are several reasons that can be given:

(1) The careful planning that went into the development of the tax structure and administration. A heavy emphasis was placed on the quantitative analysis of the proposed changes.

(2) The close cooperation between business and Government from the beginning of consideration of the tax. This cooperation was facilitated by the formation and participation of the Tax Performance Committee in the development and review of the VAT proposals.

(3) The extensive publicity programme to acquaint the public and taxpaying firms with the operation of the tax.

(4) The introduction of the tax in conjunction with repeal of the purchase taxes and significant reduction in income tax rates.

(5) The selection of competent persons in key positions. The VAT Implementation Team appointed by the Minister included some of the most capable and hard-working members of the Board of Inland Revenue.

APPENDIX

SOME SUGGESTIONS RELATING TO THE INTRODUCTION OF A VALUE ADDED TAX BASED ON THE EXPERIENCE IN TRINIDAD AND TOBAGO

The introduction of the VAT in the context of an overall Tax Reform Programme enabled the Government to formulate a consistent set of policies with the appropriate mix of winners and losers. The reduction in income tax rates greatly facilitated the introduction of the VAT by providing the benefit of lowering or eliminating income taxes for the lower-middle income classes; and increasing benefits to the poor lessened complaints of burden on these persons.

The following suggestions are offered for other countries considering a VAT, based on the experience in Trinidad and Tobago:

(1) If at all possible, the rate should be kept down to 10 percent when the tax is introduced. Much of the complaint in Trinidad was against the 15 percent rate.

(2) If the tax is to yield substantial revenue at a tolerable rate, it is imperative that most food be taxable.

(3) Delineation of exempt from taxable food is difficult in a workable and acceptable fashion; unprocessed food, plus a few other items such as milk and bread, was the approach used in Trinidad, and this seems to be accepted although there are definitional problems, especially regarding what constitutes processing. This approach provides adequate protection to the lowest income group while maintaining a broad base and lower rate by taxing processed foods, much of which is consumed by middle and high income families.

(4) If services are to be taxed, it appears desirable to tax all services other than those exempted or zero-rated, in the interest of simplicity. It is desirable to include types of services rendered mainly to business firms (which is highly undesirable in a usual sales tax), given the political repercussions of not doing so, and the fact that most business firms will be able to obtain input tax credit for the tax on these services.

(5) Studies in many countries have demonstrated the difficulties of applying a VAT to financial and insurance services, and it is better not to attempt to do so; the concept of value added is not clearly definable in these fields. Taxation of rentals of non-transient housing is not feasible because of the consequent discrimination against the tenant compared to the homeowner.

(6) It is important to accept the use of zero-rating rather than exemption for categories designed to be free of tax; otherwise the major inputs used to produce the exempt goods must be exempted also. Exemption is desirable when there is justification for not taxing the item, but it is considered appropriate for some tax burden to rest on the purchasers of it.

(7) Registration of all farmers is clearly not feasible in terms of compliance and enforcement. Accordingly major farm inputs – fertilizer, feed, seed, livestock, farm machinery – should be zero-rated, but not hand tools and items also widely used for non-farm use, such as batteries for farm and other tractors.

(8) One of the most confusing issues in Trinidad was the question of how firms should indicate tax to customers. Clear instructions regarding policies are necessary for the firms. There is merit in a requirement for separate quotation, in the belief that this facilitates exact and uniform shifting, as is intended, but the tax-included approach appears simpler.

(9) A major issue is the criterion for excluding small firms from the registration requirement. The aim is to draw the line at the level above which most firms have records sufficient to ensure control of the tax. This figure cannot be determined scientifically, but must be based on the views of persons familiar with the business community, particularly retailing and craft production.

(10) A major issue relates to allowing credit for previous consumption or purchase taxes on stocks of goods on hand when the tax is introduced. No allowance was given in Trinidad, primarily because of the drastic effects doing so would have on revenue in the first year of operation. Allowance in other countries has had disastrous effects on revenue.

(11) Use of consultants from countries using the VAT obviously has merit. They bring a significant amount of experience to the task at hand. However, one must take care to understand the background, experiences and points of view of the consultants. Advisors with experience in a number of countries are usually preferable to ones with experience limited to one country. VAT advisors whose background is in Customs and Excise, such as in the United Kingdom, will have a different approach from those whose background is in Inland Revenue, such as in New Zealand.

(12) There are a number of issues that must be resolved, many often escaping attention when the tax is first considered. For example:
   (a) Are hotel service charges to be included in the taxable charge for hotels?
   (b) How are transient rentals, usually taxed, to be delineated from permanent housing, which is usually not taxed?
   (c) What sort of invoices must registered firms give to customers, showing tax paid? These must not be too complex, as many taxable purchases by registered firms will be small in amount.

(d) If fertilizer and seed are to be exempt for farm use, how about small packages sold primarily at retail for non-farm use? Attempts to make the latter taxable in Trinidad were not successful for operational reasons.
(e) Are trade-in allowances to be deductible from the taxable price? If not, are the subsequent sales of goods taken in as trade-ins to be taxable?
(f) Are sales of second-hand goods to be taxable?
(g) What is the appropriate treatment of real property construction for business purposes? For residential construction?

(13) Implementation Schedule: An initial study of the tax structure and operation, computer facilities, etc., will require roughly six months. Then six months are needed from the completion of this study until basic decisions on tax reform are made, and at least an additional six months until implementation. Thus 18 months from the beginning is a minimum time; 2 years is more realistic. Once these decisions are made, several aspects require careful planning and scheduling:

(a) *Staffing:* If a new tax such as a VAT is to be introduced, it is important to acquire staff immediately, particularly a suitable director of the new tax, which typically should be located in Inland Revenue.

(b) *Training:* One possibility is to send for two months two key persons to a country using a VAT to become well acquainted with the tax and its operation. New Zealand is one of the best places to send persons; the Republic of Ireland is another as is Canada, once its new value added tax is in operation for a time. These persons will then direct the training of other personnel when they return. The alternative is to bring a person familiar with the VAT from another country to direct the training. This person must be selected with great care.

(c) *Public Information:* Publicity for the change must be developed early and made generally available. In this field both New Zealand and Trinidad have done very well. Both the public and the taxpaying firms need to be instructed about the new tax.

(d) *Computer Systems:* The development of a new computer system is a major effort and can be a lengthy process in itself. It includes requirements analysis, system design, hardware and software procurement (often done through competitive bidding), software development, testing, installation, documentation and training, and each step can give rise to substantial delays. The use of advanced software tools and languages and the initial temptation to be too ambitious in the initial design resulted in a delay in delivering a fully operational computer system prior to the effective date of the VAT. However, the use of modern database management software allowed the flexibility to develop isolated applications to address the major needs of the VAT administration, particularly carrying out the important function of taxpayer registration on a timely basis.

(e) *Legislation:* Early enactment of the new Act is necessary. Plans should be made early for regulations and for instructional booklets. Use can be made of other Acts but adapted to circumstances in the country.

CANADA:

INCENTIVES FOR INTERNATIONAL SHIPPING CORPORATIONS

Allan R. Lanthier

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Mr. Lanthier is a senior tax partner with Ernst & Young in Montreal. He is a member of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, a contributor to "Income Taxation in Canada" (Prentice-Hall), and a frequent speaker and author on international taxation matters. He has lectured on taxation and advanced taxation at McGill University and Concordia University, Montreal, and is a director of the Canadian Society for International Maritime Centres.

I. INTRODUCTION

On 20 February 1991 the Canadian federal government announced a proposed amendment to the Canadian Income Tax Act[1] which is intended to clarify the Canadian tax status of foreign-incorporated, international shipping corporations having ownership and management activities in Canada. The purpose of the proposed amendment is twofold. First, to encourage international shipping groups which are presently operating out of other jurisdictions such as Hong Kong and considering relocation, to view Canada as the jurisdiction of choice. Second, to persuade those international shipping groups which are already operating out of Canada to retain operational and management personnel in Canada rather than transferring personnel offshore. The Canadian federal government has, quite rightly, been widely praised by the Canadian shipping community for setting forth a very clear and positive policy direction. Unfortunately, the technical wording of the present draft amendment is such that it may not allow the government's policy objective to be achieved and, as outlined below, unless further amendments to the Act are introduced, many in the international shipping community may ultimately conclude that they must remain (or relocate) offshore.

By way of a short background, Canada relies heavily on exports as a source of employment and economic growth, and international shipping has always been inextricably linked with this foreign trade.[2] Shipping played a critical role in the early economic development of Canada. Its abundance of timber produced rapid expansion in the Canadian shipbuilding industry in the 18th century, as well as providing a ready source of cargo for export. By 1878, the Canadian merchant fleet comprised close to 7,200 vessels, ranking fourth in the world. However, as steel began to rapidly replace wood in the shipbuilding industry in the late 1800s, Canada's dominate position began to decline. While the conditions which allowed Canada to reach a privileged position in international shipping in the days of sail will never return, several factors – Canada's early history, the continuing importance of foreign trade to the Canadian economy and a Great Lakes fleet which prospered following the opening of the St. Lawrence Seaway in 1959 – have contributed to the ongoing presence in Canada of a strong and sophisticated marine industry, including ship ownership, management, chartering and brokerage, shipping agencies, ship chandlery, freight forwarding and marine insurance. It is against this background of existing infrastructure and expertise that the proposed amendment to the Act has been released.

II. GENERAL CANADIAN RULES RELATED TO TAXATION OF INTERNATIONAL SHIPPING INCOME

A. *Residents of Canada*

Corporations resident in Canada are taxable on their worldwide income, subject to possible credit for foreign taxes where business is carried on in whole or in part outside Canada.[3] All corporations formed in Canada after 26 April 1965 are deemed to be resident in Canada. Beyond the foregoing deeming provision, corporations formed outside Canada are generally considered to be resident in Canada if their "central management and control" is exercised in Canada. It is this concept of "central management and control" which has to date induced Canadian international shipping groups to relocate senior management personnel outside Canada and has inhibited other international shipping groups from relocating to Canada.

1. RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended (herein referred to as "the Act").
2. Several of the comments in this paragraph have been extracted from "Task Force on Deep-Sea Shipping: Report to the Minister of Transport", Transport Canada (Ottawa: Minister of Supply and Services, 1985).
3. Subsec. 2(1) of the Act.

B. *Non-residents of Canada*

Non-resident corporations are, as a general rule, subject to tax in Canada on income derived from a business carried on in Canada and on capital gains realized on the disposition of "taxable Canadian property", as defined.[4] However, relief from taxation may be available, either under the reciprocal relief provision in the Act related to international shipping[5] or under the terms of an applicable tax treaty.

Under the reciprocal relief provision, the income of a non-resident from the operation of a ship in "international traffic", as defined, is exempt from Canadian tax if the country where that person resides grants "substantially similar relief" to a person resident in Canada. It is understood that corporations resident in countries which do not impose an income tax qualify for the exemption, in the same manner as corporations resident in countries which do impose such a tax, but then provide relief in respect of international traffic either by domestic tax legislation or by tax treaty. As described further below, however, one of the problems with Canada's reciprocal relief provision is the fact that a number of sources of income which form an integral part of the business of many international shipping groups (including revenue from bareboat charters and capital gains on the disposition of vessels) may fall outside the concept of the phrase "income from the operation of a ship", which is used in the provision.

C. *The foreign affiliate system*

The existing Canadian rules which apply in respect of active business income earned by non-resident subsidiaries or affiliates of Canadian corporations are, with some exceptions, relatively favourable.[6] A Canadian-based group which carries on business operations through foreign subsidiaries of a Canadian parent company may be exempt from Canadian tax when the income is earned by the foreign subsidiaries. In addition, under the Canadian foreign affiliate system, the parent company may be eligible for full or partial exemption when such earnings are repatriated to Canada as dividend payments.[7] In particular, a Canadian corporate shareholder which receives dividends out of "exempt surplus" of a foreign affiliate will normally be entitled to a 100 percent dividend-received deduction, regardless of the underlying level of foreign taxes applicable to the earnings out of which the dividends are paid or whether any taxes at all were imposed by the foreign jurisdiction. Exempt surplus generally includes after-tax business income earned by a foreign affiliate resident in a country listed in Regulation 5907(11) to the Act (generally, countries with which Canada has either concluded an international tax convention or initiated negotiations to this end) and, in addition, carrying on business in a listed country or in Canada. Notwithstanding the "exempt surplus" system, interest expense incurred by a Canadian company on indebtedness which has been used to purchase or finance its foreign affiliates is generally deductible for Canadian tax purposes.

III. TAX EXPOSURE UNDER PRESENT CANADIAN RULES

The present Canadian rules related to the taxation of international shipping income can, in theory, provide a relatively favourable tax result. For example, an international shipping group could form a Canadian holding company (Canco), which would incorporate one or more international shipping corporations operating either leased or owned vessels in an international shipping business using management personnel located in Canada. If the structure was not challenged by the Canadian revenue authorities, the result would be that most of the income earned by the offshore operating subsidiary should be exempt from Canadian tax when earned, either under the reciprocal relief provision in the Act or possibly under the provisions of one of Canada's tax treaties. Further, the income would be exempt from Canadian tax when received by Canco as dividends, while any interest expense incurred by Canco related to financing the offshore operating subsidiaries would be deductible against other sources of income.

There are, however, fundamental problems with the above structure. As noted earlier, corporations formed under the laws of a foreign jurisdiction are considered to be resident in Canada if their "central management and control" is exercised in Canada. If such a corporation was found, on the facts, to be resident in Canada, the reciprocal relief provision in the Act (applicable only to non-residents of Canada) would not be available. Similarly, the provisions of tax treaties to which Canada is a party would often not apply. The location of central management and control is generally considered to be the jurisdiction in which the board of directors exercises its responsibility. While the location of day-to-day management of a foreign corporation's business does not normally, in and of itself, determine the residency of the corporation, prudent tax planning dictates that foreign corporations seeking to retain their bona fide non-resident status for Canadian tax purposes (including foreign subsidiaries of Canadian parents) ensure that senior management is located offshore and that day-to-day management of the company's affairs is not exercised in Canada. It is this concern which has forced management and operational personnel of Canadian international shipping groups to locate offshore and has inhibited the relocation of other shipping groups to Canada. It is also this concern which the proposed amendment now attempts to address.

IV. PROPOSED AMENDMENT TO THE ACT

The Canadian federal government has proposed that, effective for taxation years commencing after 28 February 1991, a corporation formed under the laws of a country other than Canada shall, where the corporation satisfies certain tests related to its activities in international shipping, be deemed to be resident in the country of incorporation and not resident in Canada. Where the qualifying tests are met, application of the proposed amendment will mean that the long-standing test of "central management and control" will no longer apply to foreign international shipping corporations (hereinafter referred to as "FISCs"). Thus, a corporation formed outside Canada and carrying on qualifying international shipping operations could employ all of its management personnel in Canada and also have its board of directors exercise its responsibility in Canada, without being considered to be a resident of Canada. This new deeming

4. Subsec. 2(3) of the Act. While an additional "branch tax" may also apply under Part XIV of the Act in certain circumstances, this tax does not apply to a non-resident corporation whose principal business is the transportation of persons or goods.
5. Para. 81(1)(c) of the Act.
6. For an outline of these rules, see Allan R. Lanthier, "Canada: The 1982 Changes to the Taxation of International Income", 37 *Bulletin for International Fiscal Documentation* (April 1982), at 171. Note, however, that these rules, as well as the rules related to the deductibility of interest, are currently under study by the Canadian Department of Finance.
7. Subsec. 113(1) of the Act.

provision, when combined with the exemption for income from certain international shipping operations, either under the reciprocal relief provision in the Act or under one of Canada's existing tax treaties, is intended to provide exemption from Canadian tax.

To qualify under the proposed amendment, all or substantially all of the FISC's activities throughout a taxation year must consist of the operation of ships used by the corporation primarily in its business of transporting passengers or goods in "international traffic", as defined, and all or substantially all of the FISC's gross revenue for the year must be from that business. The government's intention is that the relieving provision will only apply to deep-sea and international shipping and will generally not apply in respect of trading on the Great Lakes or the St. Lawrence Seaway. Qualifying "international traffic" for purposes of the proposed amendment will therefore generally exclude voyages within the Great Lakes and the St. Lawrence Seaway.[8]

V. UNCERTAINTIES AND PITFALLS IN THE PROPOSED AMENDMENT

The concerns outlined in this section assume that international shipping groups, in relocating to (or remaining in) Canada, would incorporate a FISC in an appropriate foreign jurisdiction and that the FISC would carry on business through an establishment in Canada, directly employing all management and operational personnel. The alternative of using a separate, Canadian-incorporated management or service corporation providing commercial and technical ship management out of Canada to a FISC in consideration for a fee, is discussed in Section VI; however, as described in that section, this approach also has its pitfalls.

A. *"All or substantially all" tests*

There are a number of problems and concerns with the "all or substantially all" tests as presently formulated in the proposed amendment. A corporation must meet two tests: the "all or substantially all of activities" test, and the "all or substantially all of gross revenue" test. While the concept of "all or substantially all of gross revenue" is relatively objective, there is great uncertainty as to how a corporation would ever provide a measurement related to "all or substantially all of its activities". For example, the activities test could conceivably refer to relative port-call-tonnage, number of voyages, time of all employees of the corporation, time of senior management, and or any number of other criteria or combinations of criteria. The author respectfully submits that the concept is so amorphous as to render it virtually incomprehensible and that reliance on an "all or substantially all of gross revenue" test would (perhaps in combination with an "assets or property" test) be more appropriate. Deleting the "all or substantially all of activities" test would also eliminate the problem that, under the existing proposal, this test must be met "throughout a taxation year", so that even a short period of "tainted activities" (or perhaps even inactivity) during a taxation year could conceivably be sufficient to disqualify a FISC.

There are also problems with the "all or substantially all of gross revenue" test. Firstly, while the general administrative position of the Canadian revenue authorities is that "all or substantially all" means at least 90 percent, certain jurisprudence suggests that the test may in fact be significantly more stringent.[9] Substituting a specific 90 percent factor for a general phrase such as "all or substantially all" would provide much greater certainty on this point. Secondly, it is far from clear whether certain types of income will qualify under the "all or substantially all of gross revenue" test. For example, income from management or stevedoring services in respect of vessels owned by other corporations (whether related or unrelated to the FISC) would not appear to be qualifying income for purposes of the gross revenue test.[10] Also, it is uncertain whether incidental or ancillary income (e.g. fees for port handling charges, etc.) would qualify as gross revenue from an otherwise qualifying international shipping business.

B. *Dispositions of vessels*

Conspicuously absent from the federal government's initiative are any provisions to deal with capital gains or recaptured capital allowances which may arise on the disposition of vessels used in a qualifying business. While proceeds of vessel disposals do not form part of "gross revenue", as defined in the Act (and therefore would not result in a corporation failing to qualify as a FISC), non-resident corporations are, as noted earlier, taxable not only on income from carrying on a business in Canada but also on capital gains realized on the sale of "taxable Canadian property", which may include a ship used in carrying on business in Canada.[11] The reciprocal relief provision in the Act is restricted to income of a non-resident from the operation of ships in international traffic – wording which does not appear to be broad enough to encompass capital gains from vessel dispositions.

Given that vessel dispositions are an inevitable and ongoing part of the business of many international shipping groups, it is unclear whether such groups would relocate to Canada unless appropriate revisions are made to the reciprocal relief provision in the Act so that (consistent, for example, with

8. The proposed amendment is as follows: "Section 250 of the Income Tax Act is amended by adding thereto the following subsection:
(6) For the purposes of this Act, a corporation that was incorporated or otherwise formed under the laws of a country other than Canada or of a state, province or other political subdivision of that country shall, where
(a) all or substantially all of the corporation's activities throughout a taxation year consist of the operation of ships that are used by the corporation primarily in its business of transporting passengers or goods in international traffic (determined on the assumption that the corporation is non-resident and that, except where paragraph (c) of the definition "international traffic" in subsection 248(1) applies, any port or other place on the Great Lakes or Saint Lawrence Seaway is in Canada),
(b) all or substantially all of the corporation's gross revenue for the year is from that business, and
(c) the corporation has not been granted articles of continuance in Canada before the end of the year,
be deemed to be resident in that country throughout the year and not to be resident in Canada at any time in the year."
9. See, for example, *Douglas Wood v. MNR*, 87 DTC 312 (Tax Court of Canada), where the Court concluded that, in the context of para. 115(1)(f) of the Act, the description advanced by counsel for the Minister ("small, unrelated amounts, such as interest, etc.") came much closer to the description "substantially all" than did the Minister's policy of 90 percent.
10. See in this regard *Furness, Withy & Company Limited v. MNR*, 66 DTC 5358 (Exchequer Court of Canada), subsequently affirmed by the Supreme Court of Canada (68 DTC 5033).
11. While one could argue that a vessel used by a FISC in international traffic, which does not call on Canadian ports, does not constitute an asset used in "carrying on a business in Canada", it is unclear whether this view would be sustained. Also, while there may be stronger arguments where all management and operational personnel are placed in a separate corporation which renders services to the FISC for a fee, this type of arrangement would be subject to the concerns referred to below in Section VI of this article.

Canada's own income tax treaty with the United States) the provision also exempts gains from such dispositions.

As is the case with revenue from charter-parties (discussed below), possible Canadian taxation of capital gains on vessel dispositions is not a concern under existing structures, where senior management personnel have specifically been relocated (or left) offshore to ensure that the foreign corporation retains bona fide non-resident status and stays outside the Canadian jurisdiction. Rather, potential Canadian taxation only becomes an issue should a group reorganize or relocate to Canada (in accordance with the federal government's initiative) to carry on business as a FISC, in which case one must rely on the reciprocal relief provision in the Act (or on one of Canada's tax treaties) to provide specific exemption.[12]

C. *Time, voyage and bareboat charters*

In addition to the above-noted concerns, there remain a number of fundamental questions in respect of the treatment of charter-parties under the proposed regime.

In order to qualify as a FISC, a corporation's business must consist of "the operation of ships that are used by the corporation primarily in its business of transporting passengers or goods in international traffic". This would seem to include the operation of a vessel, whether the FISC has title or merely disponent ownership under a lease or bareboat charter (it is understood that officials at the Canadian Department of Finance are in agreement with this view). A FISC may then exploit its vessels (whether owned or leased by it) in any one of several ways – contracts of affreightment, time or voyage charters, bareboat charters, etc. However, based on the existing wording, it is uncertain which of these activities will, in fact, be considered to be qualifying activities, whether for purposes of qualifying as a FISC under the proposed amendment or for purposes of qualifying for exemption under the reciprocal relief provision in the Act.

It is understood from informal discussions with officials at the Canadian Department of Finance that the new regime is intended to apply to gross revenue received from time or voyage charters, in addition to revenue received under contracts of affreightment, but is not to extend to vessels operated under a dry lease, demise or bareboat charter. While the intention may be that gross revenue from time or voyage charters will qualify, the requirement in the proposed amendment that the vessels be used "by the corporation" may, in fact, imply a more narrow reading and certain jurisprudence[13] would indicate that such revenue may not qualify. While Finance officials have indicated that the proposed amendment related to qualification as a FISC will be revised to delete the offending words "by the corporation", it is not entirely certain, even with this change, whether income from time or voyage charters will qualify either for purposes of qualification as a FISC or as revenue eligible under the reciprocal relief provision in the Act. Somewhat more certain, but even more problematic, is the fact that revenue from bareboat charters is not intended to qualify for either purpose, so that entering into such charter-parties would result in the imposition of Canadian tax under the proposed regime.[14] If the proposed amendment is to be effective in attracting and or retaining international shipping ownership and management activities in Canada, it is respectfully suggested that the type of wording used in analogous provisions of tax legislation in other countries[15] should be introduced, specifically providing that income from time, voyage and bareboat charters will all qualify, both for purposes of the definition of a FISC and the reciprocal relief provision in the Act.

D. *Failing to qualify in a particular year*

One of the reasons that it is, in the author's view, critical that the Canadian Department of Finance address and clarify the types of uncertainties and pitfalls noted above is the substantial jeopardy that a FISC would face if it inadvertently failed to meet the qualifying tests in one particular year.

For example, assume that a FISC is formed under the laws of a country other than Canada, that it carries on a qualifying international shipping business and that all operational personnel, as well as the exercise of responsibility by the corporation's directors, are in Canada. Absent the proposed amendment, the FISC would, as a question of fact, be resident in Canada. Should the FISC inadvertently fail to meet the qualifying tests in year 2 (but qualify in other years), it would face the following consequences:

- At the end of year 1, Canadian-resident shareholders of the FISC would, further to a specific anti-avoidance provision related to the deliberate repatriation of foreign affiliates to Canada, be immediately taxable on any "taxable surplus" existing at that time in the FISC.[16]
- The FISC would be taxable in Canada on its worldwide income during year 2.
- In year 3, the FISC would have requalified, and accordingly would have ceased to be a resident of Canada.

The general Canadian rules which apply whenever a taxpayer gives up residence in Canada would therefore apply and, subject to certain exceptions and elective provisions, the FISC would be deemed to have disposed of capital property (other than "taxable Canadian property") for proceeds of disposition equal to the fair market value of the assets at the beginning of year 3, thereby subjecting the FISC to possible Canadian capital gains taxation.

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12. Recaptured capital allowances are also problematic. Again, this type of income would presumably not be considered income from the "operation" of a ship, as required by the reciprocal relief provision in para. 81 (1)(c) of the Act. There are, however, additional issues to be considered related to capital allowances. Firstly, Regulation 1102(3) to the Act provides, in general terms, that where a taxpayer is a non-resident, the classes of property eligible for capital allowances are deemed not to include property that is situated outside Canada. While this provision may be appropriate in respect of immovable property, its impact on a vessel, which may enter Canada from time to time in the course of an international shipping business, is somewhat obscure. Secondly, even in those circumstances where a vessel was considered to be eligible for capital allowances, the claiming of such allowances is permissive, and one would not normally expect a FISC to claim capital allowances if it was satisfied that all of its income qualified for exemption under the reciprocal relief provision. However, in those circumstances (presumably unusual) where capital allowances have been claimed, the interaction of subsecs. 13(7) and 13(9) of the Act may, in fact, result in deemed dispositions at fair market value (and possible realization of recaptured capital allowances which, again, are not exempt under the reciprocal relief provision) at any time that the proportion of use of a vessel in Canada changes.
13. See *Furness, Withy & Company Limited v. MNR, supra* note 10; see also *MNR v. Hollinger North Shore Exploration Company Limited,* 63 DTC 1031 (Supreme Court of Canada).
14. Note that, in the most adverse circumstances, Regulation 1102(3) to the Act (*supra* note 12) may require that income from bareboat charters subject to Canadian tax be computed without deductions for capital allowances.
15. See, for example, Secs. 883 and 872(b)(5) of the U.S. Internal Revenue Code.
16. Subsec. 48(5) of the Act and Regulation 5907(13). While these provisions would also provide for a disposition of certain capital property by the FISC for proceeds equal to fair market value and immediate taxation to any Canadian shareholders in respect of any additional taxable surplus thus created, this rule does not apply to "taxable Canadian property" which, subject to comments above, could conceivably include many of the assets, including vessels, used by the FISC in carrying on business from Canada.

The type of double jeopardy noted above should be a clear signal to the Canadian Department of Finance that the applicable rules should be revised so that they are as objective and clear as possible. It should be noted that this type of jeopardy generally does not apply where, under the current regime, international shipping groups relocate or maintain senior management personnel offshore to ensure bona fide non-resident status.

E. *Payment of dividends to Canada*

As if there were not enough uncertainties and pitfalls to contend with under the proposed regime, when international shipping income is earned by a FISC further problems will arise whenever the FISC makes dividend payments to its Canadian-resident shareholders.

As described above, a Canadian corporate shareholder which receives dividends out of "exempt surplus" of the foreign affiliate will normally be entitled to a 100 percent dividend-received deduction, regardless of the underlying level of foreign taxes applicable to the earnings out of which the dividends are paid.[17] Exempt surplus includes after-tax business income earned by a foreign affiliate, provided the affiliate is:

(a) resident in a country listed in Regulation 5907(11) to the Act (generally, countries with which Canada has either concluded an international tax convention or initiated negotiations to this end);[18] and
(b) carrying on business through a permanent establishment in a listed country or carrying on business in Canada, to the extent any income therefrom is subject to tax under the Act.

With respect to the test in (b) above, the reciprocal relief provision in the Act provides that qualifying income from international traffic "shall not be included in computing the income of a taxpayer". It therefore appears that international shipping groups which relocate their senior management and operational personnel to Canada and carry on business in Canada as a FISC in accordance with the proposed regime will find that dividends received are not out of "exempt surplus" as defined (due to the fact that the income earned in Canada was not subject to tax under the Act). As is the case with many of the uncertainties and pitfalls noted in this article, the problem represents a significant impediment but is, at the same time, comparatively easy to correct. In this case, the offending regulation[19] could be revised so that a "permanent establishment" test would apply to businesses carried on both in listed countries and in Canada.

F. *Federal capital tax*

In addition to normal income tax potentially payable under Part I of the Act, resident or non-resident corporations may be subject to a separate (non- deductible) federal capital tax under Part 1.3 of the Act ("Tax on Large Corporations"). The tax is applied at a rate equal to 0.2 percent of a corporation's taxable capital employed in Canada (as defined), less an annual capital deduction of C$ 10 million (which must be shared between related companies in a group).

While a non-resident corporation carrying on business through a permanent establishment in Canada is liable for the capital tax, a proposed amendment to the Act introduced as part of an omnibus set of draft "technical amendments"[20] proposes that ships operated by a corporation in international traffic, or personal property used in its business of transporting persons or goods in international traffic, will be excluded from the base for the federal capital tax, provided the country in which the corporation is resident imposes neither a capital tax on similar assets nor a tax on the income of the operation of ships in international traffic. Any foreign capital or income tax, no matter how small, would, however, be sufficient to disqualify a FISC from the special exemption.

G. *Reorganization of existing Canadian shipping groups*

While the proposed amendment should, if appropriately revised, be an important incentive in attracting international shipping groups to Canada which are presently operating from other jurisdictions, Canadian shipping groups which have been operating in Canada for some years may, somewhat ironically, find it more difficult to reorganize their operations so as to take advantage of the proposed amendment. This is due to the fact that shipping groups which are presently located outside Canada will, in many situations, be able to reorganize their corporate structure appropriately, without potentially adverse consequences in their home country, and subsequently transfer the operations to Canada. An existing Canadian-resident corporation may, on the other hand, have to deal with certain reorganization steps, including vessel transfers, assignment of charter-parties and freight contracts, etc., which are subject to fair market value provisions in the Act; no specific provision has been included in the proposed amendment to allow such reorganizations to proceed on a non-recognition basis.

H. *Provincial tax considerations*

Provincial income taxes are significant in Canada and, in addition, are non-deductible for Canadian federal income tax purposes. The rates of provincial income tax vary from 6 percent to 17 percent, depending on the province of residence, and in the majority of provinces are 15 percent or higher. Many provinces also impose their own capital tax. While the province of British Columbia worked on behalf of securing the proposed amendment and clearly supports its introduction, the position of other provinces vis-à-vis both provincial income and capital taxes has yet to be ascertained.

VI. POSSIBLE STRUCTURES UNDER THE NEW REGIME

A. *Use of management or service corporations*

It has been suggested that many of the uncertainties and pitfalls noted in this article could be avoided by the separation of ownership (or leasing in) of vessels from commercial

17. At the same time, deductions or credits are not available in respect of underlying foreign taxes applicable to the earnings out of which the dividends were paid or any foreign withholding taxes which may apply on payment of the dividends.
18. The FISC will, provided it meets the qualifying test in the proposed amendment, be deemed for purposes of the Act to be resident in its country of incorporation. However, Canada is not itself a listed country under Regulation 5907(11) and, as a question of fact, the FISC would (absent the deeming provision) be a resident of Canada. The question that arises, therefore, is whether the proposed amendment will also apply for purposes of the foreign affiliate regulations. Based, inter alia, on Secs. 14 and 15 of the Canadian Interpretation Act, it appears that the deeming provision will apply for purposes of the foreign affiliate regulations and again it is understood from discussions with officials at the Department of Finance that they share this view.
19. Regulation 5906 to the Act.
20. Draft Amendments to the Income Tax Act and Related Statutes were issued by the Minister of Finance on 18 February 1991, further to an earlier draft originally issued on 13 July 1990.

and technical ship management. This would be accomplished by using at least two separate corporations – firstly, a management or service corporation formed in Canada which would employ all management and operational personnel, and secondly, a FISC formed under the laws of a country other than Canada, which would own or lease the vessels used in the group's international shipping business. The management or service corporation would provide all commercial and technical ship management to the FISC in consideration for a fee. While the management or service corporation would be resident in Canada and subject to normal rates of federal income and capital tax, one would argue that the amounts subject to tax could be kept to a manageable level, while the FISC would remain outside the Canadian tax jurisdiction.

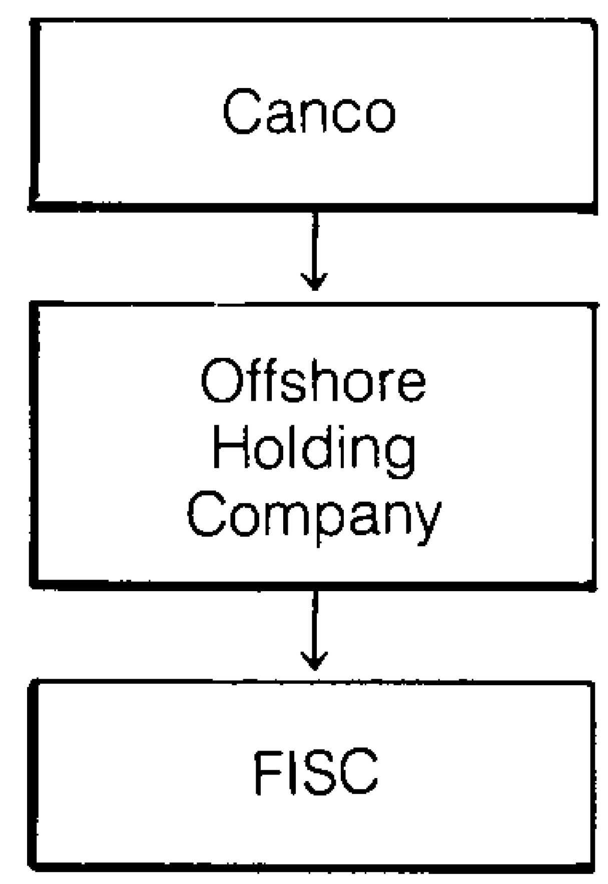
There are, unfortunately, significant concerns that prevail under this approach. Firstly, while one can argue that the FISC is not "carrying on business in Canada" under this arrangement, and is therefore outside the Canadian tax jurisdiction altogether (without the need to revert to the reciprocal relief provision in the Act to obtain exemption), there is some doubt whether this position would be sustained. Even if it was, however, one must still meet the tests in the proposed amendment to qualify as a FISC and revenue from bareboat charters will, for example, not qualify for this purpose.

Perhaps the most important concern, however, is the application of the related party transfer pricing provision in the Act[21] and the potential impact thereof on the quantum of the fee to be earned by the management or service company. The relevant provision provides that any fee for such services must be the amount that would have been reasonable in the circumstances had the parties been dealing at arm's length. There are no accompanying regulations to the foregoing provision and there has been little Canadian jurisprudence which would be of assistance in interpreting the rule. The Canadian assessing branch has, however, issued an Information Circular, which sets outs its administrative approach in the international transfer pricing area.[22] While the Circular takes a somewhat ambivalent approach to the use of functional analysis (essentially suggesting that it should be used as an aid but not as a specific pricing method), the position of the assessing branch in many situations in the past (including situations involving the international shipping industry) has been that a "reasonable" fee in these situations must take into account the worldwide profits of all companies in a multinational group and must be commensurate with the efforts made by personnel located and employed in Canada (including efforts in respect of the acquisition and financing of assets used in the business) relative to efforts of personnel located offshore. If anything, the emphasis on this type of economic approach may well increase as Canada is forced to reply to transfer pricing initiatives in other jurisdictions, particularly the United States,[23] in an effort to protect its own revenue base.

B. *Operating directly from Canada*

Having regard to the types of concerns noted above in respect of the use of management and service corporations, it is the author's view that many international shipping groups will only respond to the recent Canadian initiatives if additional technical changes are made to the Act. The revisions, while critical, would be relatively simple. For example, qualifying revenue, for purposes of both the proposed amendment with respect to qualification as a FISC and the reciprocal relief provision in the Act, would specifically include revenue from bareboat charters and proceeds on vessel disposals. Secondly, a simple amendment would be made to the Canadian foreign affiliate regulations to ensure that income of a FISC retained its status as "exempt surplus" for Canadian tax purposes. Finally, the proposed exemption from federal capital tax might be revised somewhat so that, rather than this exemption being dependent on the quantum of capital or income tax imposed by a foreign country, a qualifying FISC would be added to the list of corporations which are already entirely exempt from the tax.[24]

Assuming that the above changes were to be made (and while the most effective structure for any particular international shipping group will depend on its specific facts and method of operations), one tax-effective structure would be as follows:



In the above structure, a Canadian holding company (Canco) incorporates an offshore holding company which, in turn incorporates one or more FISCs.

While beyond the scope of this article, an offshore holding company serves various purposes under the Canadian tax system, including effective dividend management, facilitating the tax-efficient financing of international operations and allowing access to the "excluded property" rules which form part of the Canadian foreign affiliate legislation.[25] The FISC would be incorporated in a country listed in Regulation 5907(11) to the Act, so that income earned from its active shipping operations would form part of exempt surplus for Canadian tax purposes. All of the directors of the FISC could be residents of Canada and all directors' meetings could take place in Canada. In addition, and more importantly, all management and operational personnel would be employed by the FISC but could be physically located in Canada. While the individuals would themselves be subject to Canadian tax, the FISC would be exempt by virtue of the reciprocal relief provision in the Act.

With proper planning, it should be possible to form the FISC in a jurisdiction which will impose a low or nil domestic rate of tax on the earnings in question and on dividend distributions out of the earnings and have minimal, if any, restrictions on the nationality of crews. With respect to

21. Subsec. 69(3) of the Act.
22. Information Circular 87-2 issued in February 1987; these types of views and pronouncements do not have the force of law, although the Canadian courts have, at times, referred to such documents as external aids.
23. See in particular the Study of Intercompany Pricing (the White Paper) released by the U.S. Treasury on 19 October 1988.
24. Subsec. 181.1(3) of the Act.
25. For a detailed review and discussion of these concepts, see Allan R. Lanthier, "Foreign Holding Companies and Finance Vehicles: An Update", in Report of Proceedings of the 42d Tax Conference, 1990 Conference Report (Toronto, Canadian Tax Foundation, not yet published).

international shipping groups contemplating a relocation to Canada, it should be noted that this type of structure could be set up without an actual change of residency of the shareholders of Canco and a subsequent immigration of the shareholders to Canada would not have any adverse Canadian tax consequences.

VII. CONCLUSION

International shipping groups headquartered in Canada have, for several years, been encouraging the Canadian Department of Finance to introduce some type of alleviating measure. While this article has pointed out some of the uncertainties and deficiencies in technical aspects which should be addressed before the legislation is finalized, the government's policy initiative is both positive and welcome; if certain technical revisions are made, the initiative should, without question, result in the retention of senior and experienced international shipping personnel in Canada, as well as encouraging other international shipping groups to relocate to this country. If appropriate revisions are not made, however, certain taxpayers will be forced to maintain management and operational personnel offshore (thereby continuing to avoid the Canadian tax jurisdiction altogether), while others (depending on the specific nature of their trading operations) will be faced with the difficult choice of deciding whether or not to rely on administrative positions or pronouncements of the assessing branch of Revenue Canada in respect of contentious issues – positions or pronouncements which are subject to change and which have not always been accepted by the Courts.

THE CANADIAN GOODS AND SERVICES TAX

AN OVERVIEW

Abe I. Greenbaum*

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I. INTRODUCTION

At midnight, 1 January 1991, Canadians became subject to a federal goods and services tax ("GST"). This article discusses the predecessor legislation and explains why the GST was introduced in Canada, as well offers a brief history of the introduction of the legislation and its passage through Parliament. The structural features of the legislation, its application and administration are then outlined. As the GST Act consists of 335 sections and countless subsections, no attempt is made to deal comprehensively and exhaustively with the legislation. Rather the aim of this article is to highlight the key legislative and structural features and make the occasional comment on policy issues.

II. HISTORY

The goods and services tax originated in June 1987, when Michael Wilson, the Minister of Finance for Canada, tabled a White Paper on Tax Reform which proposed replacement of the existing federal manufacturers' sales tax (discussed below) with a multi-stage goods and services tax, or value added tax as it is commonly known.

In the April 1989 budget, the Minister of Finance announced the Government's intention to introduce the GST. On 8 August 1989 the Minister issued a technical paper and the House of Commons Finance Committee held public hearings in September and October of 1989. Some of the suggestions of the Committee after its consultations were incorporated in Bill C-62, which was introduced in the House of Commons on 24 January 1990. Bill C-62 is entitled: "An Act to Amend the Excise Tax Act, the Criminal Code, the Customs Act, the Customs Tariff, the Excise Act, the Income Tax Act, the Statistics Act and the Tax Court of Canada Act".[1]

The passage of the GST Bill was not as smooth as it could have been. Despite vocal opposition in the Lower House, the substantial majority held by the Progressive Conservative Party in the Commons ensured passage of the Bill on 10 April 1990. Passage through the Senate caused considerable "excitement" (a term not normally associated with the Canadian Senate).

In Canadian federal politics, passage by the House of Commons is usually the end of the story. After passage, the legislation then proceeds to the Senate. The Senate, which is a patronage appointed body, its members enjoying tenure to the age of 75 and generous pensions, normally "rubber stamp" any Bill passed in the Commons.[2] When the GST Bill arrived at the Senate, the Senate was populated with a majority of opposition Liberal Party members. They threatened to make the passage of the GST through the upper house a very difficult and painful experience. So began eight months of Senators engaging in various procedural tactics aimed at delaying the Bill. The Liberal Senators effectively stalled the Bill in the Senate. The Prime Minister, Brian Mulroney, worried about the consequences of the Bill being held in limbo by the Senate beyond the proposed implementation date, sought to end the deadlock by eliminating the majority held by the Liberals in the Senate. To do this, he invoked Section 26 of the *Constitution Act,* 1867[3], a provision that had not previously been used in the 123-year history of the Constitution.

* B.A. (Tor.), LL.B. (Osgoode), LL.M. (Labour) (NYU), LL.M. (NYU); Lecturer in Taxation Law, Deakin University, Australia.

I would like to thank the Canadian Tax Foundation for their kind assistance in providing me with office facilities and access to their excellent tax library while in Toronto. Their kind help is greatly appreciated.

1. For the sake of brevity, the legislation will hereafter be referred to as the GST Act.
2. After the Bill is passed in the Senate it receives Royal Assent.
3. Previously known as the British North America Act, 1867 (U.K.).

Section 26 provides for the appointment of four or eight additional members to the Senate beyond the normal complement of 104. The Prime Minister asked the Queen to direct the appointment of eight Senators. She obliged.[4] These appointments tilted the majority in favour of the governing party. After several months of acrimonious debate, as well as a filibuster[5] in December, the Senate finally approved the GST at 6:05 p.m. Thursday, 13 December 1990. Fifty-five Senators voted in favour of the legislation as compared to 49 who voted against it.

Royal Assent did not proceed, either, according to its normal course. The Liberals in the Senate, through procedural delays, made it impossible for the legislation to be signed into law on Friday, 15 December 1990.[6] The GST was ultimately signed into law on Monday, 17 December 1990, two weeks prior to its implementation date.[7] Bill C-62 was named The Goods and Services Tax Act.

Throughout the time that the legislation was before Parliament, the Government engaged in an information (some would say propaganda) campaign[8] to explain to the public what the GST was, how it would operate and how wonderful it would be.

III. WHY WAS A GST INTRODUCED IN CANADA?

Canada has had a manufacturers sales tax ("MST") for almost 70 years. The MST was a tax applied at the wholesale level on manufactured goods. The tax was levied on the manufacturer's selling price of domestic goods and on the duty-paid value of imported manufactured goods. There were four rates of tax, ranging from 9 percent to 19 percent. The Government decided to eliminate the MST. The GST was introduced as the tax to collect the revenue that otherwise would have been collected under the MST.

The MST, originally implemented in the 1920s, was the subject of increasing criticism from both the private and public sectors. This criticism has dated back as far as the 1967 *Report of the Royal Commission on Taxation* (the Carter Commission). Problems with the MST, described by the Minister of Finance, included:[9]

1. *Cascading Effect* – As the tax is levied on a broad range of inputs (manufactured components) and then again on the finished manufactured item, there is "tax cascading", that is, a tax being imposed on an item whose value has already been inflated by a previously imposed tax. Tax cascading inflates the ultimate price paid by the consumer for goods.

2. *Damages Exports* – The MST is imposed at the manufacturing level which is an additional cost factor for exported goods. This makes them more expensive in relation to international competing products.

3. *Encourages Imports* – The MST applies to imports on the duty-paid value of the item. This does not include the costs of marketing and distribution of the goods. Marketing and distribution is often a very large component of the cost of manufactured goods, particularly in a nation like Canada which is so large and sparsely populated. Since the MST on imported manufactured goods is paid on a smaller base amount, imported goods have a competitive advantage over a domestic manufacturer.

4. *Distortions in the Allocation of Resources* – Under the MST regime, manufacturers would seek to shift whatever activities they could beyond the point of taxation (the manufacturing stage). As such, the MST would not be levied on the full wholesale price of the goods. This process of arranging business activities to avoid the MST leads to an inefficient allocation of resources. Decisions are not being made for reasons of business efficiency, but rather to minimize MST. Further, those companies unable or unwilling to order their affairs to reduce their MST liability would be at a competitive disadvantage to those who had done so.

5. *Narrow Tax Base* – About one third of goods and services are directly subject to the MST. Of those goods subject to the MST, tobacco, alcohol, automobiles, auto parts and fuels represent 16 percent of all consumer expenditures and yield one third of all MST collected. This makes the MST very narrowly based. The narrow base is in part a reflection of the shift in the economy since the introduction of the MST. In the 1920s, two thirds of consumer consumption was of manufactured goods. Now two thirds of expenditure is on services. This shift represented a huge untapped reservoir of federal tax revenue.

6. *Excessive Complexity* – The MST had four rates of tax applicable depending on the category of product. There were also a great number of exceptions. For the 75,000 firms covered by the MST, there were over 22,000 special arrangements and administrative interpretations governing the tax.

7. *Distortion of Consumer Choices* – Since the mark-up from wholesale to retail level varies greatly from industry to industry and product to product, the MST component of the final retail price, expressed as a percentage of the total, will vary greatly. As the MST is levied at the wholesale level, the consumer is unable to ascertain how much of the price he is paying for a good is MST, how much is the wholesale price component and how much is retail mark-up. This makes an informed consumer choice of which product to purchase impossible.[10]

It is clear from the range and gravity of the problems associated with the MST that something had to be done to deal with its inadequacies. The means employed by the Government was to eliminate the MST.

The question then arose, what would be done to raise the CAN$ 19 billion per annum in revenue previously collected

4. Included in the number appointed to the Senate was a former provincial Premier who left office because of political scandals and who was being investigated by the police on allegations of political corruption. This same person underwent a political conversion having prior to his appointment been opposed to the GST. He suddenly and miraculously became a supporter of the GST when he was appointed to the Upper House.

5. Certain of the Senators spoke uninterrupted for more than 24 hours as part of the filibuster. Eventually, the newly-created majority Progressive Conservative Senators introduced and passed a cloture motion to curtail debate and call the question.

6. The Liberal Senators kept debate going in the Senate until the House adjourned for the day so that the approved Bill could not be returned to the House and given to the Governor General.

7. The legislation was not signed by the Governor General. It was signed instead by a Puisne Justice of the Supreme Court of Canada, acting on behalf of the Governor General.

8. Included in this campaign was the establishment of a "consumer hotline". The theory was that consumers would call up and get information on how the GST would affect them. In practice the telephone service was mainly used by lawyers and accountants. They were constantly frustrated by the poor quality of information and confused responses they were receiving. This was not surprising in light of the fact that the persons answering the calls were generally university students who were given a manual and an index and no further training to answer the inquiries.

9. Minister of Finance, "Goods and Services Tax Technical Paper", (Ottawa: Ministry of Finance, August 1989), at 4-6.

10. As will be noted below, due to the lack of uniform price-marking under the GST, it will be very difficult for consumers to comparison shop under the new legislation as well.

through the MST? The Government chose to replace the MST with a flat rate, broadly based GST.

IV. STRUCTURE OF THE GST

A GST is a multi-level tax which is exacted at each stage of production and distribution culminating in the ultimate purchase of the product or service by the consumer. Tax is not paid on the full value of the item at every stage of the process (which would create an attractive tax windfall for the Government). Instead there is a tax credit system which permits all persons except the end-purchaser to receive a credit for all GST paid by them on purchases that they have made. This in effect means that at each stage of production, the net GST payable represents the tax on the "value added" to the goods processed or distributed or the services rendered.

The seller of a product or service pays GST on the acquisition of any inputs needed (paper clips, pens, legal fees) to operate his business. When he sells his product or service he collects GST on the now enhanced value. The amount the seller remits to Revenue Canada is the difference between the amount of GST collected and the amount he already paid. The amount collected by the seller is offset by the amount he already paid because of the existence of the "input tax credit". In effect the credit operates to ensure that only the end consumer of the product or service pays GST. All persons prior to the final consumer in the production chain receive a full credit for the GST already paid by them. This can be illustrated by the following example:

The Sale of a Dishwashing Machine

Process /Transaction	Purchase	Sale	GST	Inp. Tax Credit	Net Tax
Mine extracts ore	N/A				
sells ore		$ 100	$ 7	N/A	$ 7
Steelmaker smelts ore and makes steel	$ 100 (+$ 7 GST)				
sells steel		$ 300	$ 21	$ 7	$ 14
Manufacturer makes dishwasher	$ 300 (+$ 21 GST)				
sells machine		$ 400	$ 28	$ 21	$ 7
Retailer sells machine	$ 400 (+$ 28 GST)				
sells to consumer		$ 600	$ 42	$ 28	$ 14
Consumer	$ 600 (+$ 42 GST)				net tax $ 42

At each stage of the process the taxpayer receives an input tax credit equal to the amount of GST paid on the acquisition of the input used in producing the product or service. The net effect is that any GST liability the taxpayer had is completely offset by the credit. In the example, the manufacturer purchased $ 300 worth of steel. In addition to the $ 300 paid, he paid $ 21 in GST (which the steel maker collected). He uses the $ 300 worth of steel to make a dishwasher which he sells to the retailer for $ 400. He collects not only the $ 400 but $ 28 in GST. He receives a credit of $ 21 for the GST already paid and he remits $ 7 in GST to Revenue Canada. Therefore, the manufacturer is not out of pocket at all for the GST paid previously by him. The $ 7 represents the $ 100 value added that the manufacturer contributed in making the item. When the retailer sells the machine for $ 600, he collects $ 42 of GST from the consumer. The retailer is entitled to a $ 28 credit for the GST already paid so he remits $ 14 to the Government. When all of the net amounts remitted to the Government at each stage are totalled, the sum remitted is $ 42. This represents 7 percent of the total retail cost of the dishwashing machine. Through the input credit system, liability for the GST is passed down from transaction to transaction until it reaches the consumer. The final consumer of the goods or services bears the full GST burden, since he is not eligible for any credit.

The four rates in the MST were replaced with a flat rate of seven percent. This rate was lowered from the original proposal of nine percent. Many commentators are of the view that once the system is under way, it will not be long before the rate is increased.[11] The revenue stakes are very high; it is estimated that for every one percent that the GST rate is raised, an additional $ 3 billion is collected in tax.[12]

V. APPLICATION OF THE GST

A. *General*

Although the GST has greatly expanded the tax base from that of the MST, the Government did not maintain the purity of philosophy of having a universal flat rate GST. The GST does not apply to all goods and services consumed in Canada.[13] There are two categories of exemption: (1) "zero-rated" or tax free and (2) "tax exempt". In neither case is GST charged on the sale of the product or service. The input tax credit, however, may not be claimed in relation to the supply of exempt goods and services.

B. *Taxable goods and services*

The legislation starts, theoretically, as a universal goods and services tax. Rather than creating an exhaustive list of those goods and services which are taxable, the legislation provides that if the goods or services are not exempt or zero-rated, they are taxable.

C. *Zero-rated*

Examples of "zero-rated" goods and services include:
- basic groceries;
- prescription drugs;
- medical devices, e.g. prostheses, wheelchairs, etc.;
- agriculture and fishing;
- exports;

11. The Government could argue that an increase is justified because the rate of GST in Canada is relatively low in comparison to other nations. The 7% rate may appear to be relatively low when viewed superficially; however, the reality is quite different. Most nations which levy higher GSTs have a unitary system of government and therefore only one level of government is imposing a sales tax. Canada, on the other hand, is a federation. Nine of the ten provinces collect retail sales tax, with rates ranging from 6% to 12%. This makes the tax burden on the consumer as high as 19.84%, when the cascading effect is taken into account.
12. The total annual tax revenue collected by the Federal Government is approximately $ 100 billion.
13. Departure from a comprehensive tax is an example of political reality interfering with economic and tax policy.

- travel services. Travel out of the country is generally zero-rated;[14]
- transportation services, such as international freight, other than courier services competing with the postal service;
- municipal transit services;
- [services provided by] international organizations and officials;
- some financial services, such as certain services to non-residents and the supply of precious metals.

Of the zero-rated categories, many have very complex rules for determining what will be included in the category. For example, one of the areas of zero-rating with the largest impact on the general public is the category "basic groceries". What are basic groceries? The term is not defined in the legislation. Instead the legislation lists in Schedule VI, Part III, those foods that do not fall within the category. The list of excluded foods and beverages is extensive. Generally the distinction can be drawn on the basis of those foods that are made for preparation and consumption at home and those that are already prepared and ready to eat. Problems arise with such a differentiation as to where the line should be drawn. For instance, a case arose in the United Kingdom under similar rules, where a baker made and sold meat pies. Non-sweet bakery goods are typically characterized as groceries but the Inland Revenue decided that the pies were subject to VAT since they were hot, take-away food. The baker argued that they were groceries. He added that the pies happened to be hot when they came out of the oven but then were cooling down awaiting purchase. The fact that the pies might be warm if purchased soon after they were taken out of the oven should not cause the pies to cease to be considered groceries.[15] The compromise reached was that the VAT applied to the sale of pies until 2:30 in the afternoon. After that time it was deemed that the pies could not be take-away food and were therefore groceries.

It is hoped that such rules do not develop in Canada, although it appears that these hopes have already been dashed. For example, donuts, an important staple food of many Canadians, are subject to the GST unless they are purchased in quantities of greater than five and not consumed on the premises where they were purchased. It would therefore be important for the person who has a hankering for donuts not to open the box and take one out until outside the view of the vendor. Would the purchaser be exempt from the GST if he bought seven donuts and began to eat one before he left the shop? The legislation is unclear on the point. Further, will special regulations have to be promulgated to govern the purchase of the tiny donuts sold in quantities in excess of six, by many vendors. Six of these mini-donuts may have a mass equal to one or two regular donuts. Should they be exempt? At the other end of the baked confection spectrum, some cookie shops sell huge cookies (30 cm in diameter) that have a mass equal to more than a dozen cookies. How should this one cookie be treated by the GST?

There are numerous other anomalies in the basic groceries category. For example, packaging,[16] nutritional value[17] and where the groceries are purchased[18] often produce strange results.

Another category where absurd results are likely to arise is agriculture and fishing. Exempt from GST are livestock, poultry, bees and various agricultural products in their natural harvested state, with only a minimum of processing. For example, wool that has not been processed beyond being washed is exempt. Taxable agricultural items include trees and flowers, wood, animal hides or fur and horses. Why is a horse taxable but a cow or bee not? Why is the final product of wheat growing zero-rated but flowers and trees grown for harvest taxed?

D. *Exempt*

Exempt supplies are outlined under Schedule V, which is divided into eight parts:

1. *Real property*
Resale of houses and residential rents are exempt. All other property transactions are taxable.

2. *Health care services*
Included in the exemption are the provision of hospital and nursing home care, medical and dental services and the services of other health practitioners, such as osteopaths and chiropodists. Also exempted are services supplied under a provincial health insurance scheme.

3. *Educational services*
Most such services are exempt. Not exempt are courses taken for enjoyment that do not lead to obtaining a diploma or degree.

4. *Child care and personal care services*

5. *Legal aid services*
The services rendered by a lawyer and billed to legal aid are taxable but under Section 258 the legal aid authority is eligible for a rebate of the full tax paid.[19]

6. *Services supplied by public service bodies*
This includes Government, non-profit organizations and charities. The exemption only applies to the extent that these entities operate on a non-commercial basis.[20]

7. *Financial services*
Most financial services provided to Canadian resident customers are exempt.

8. *Ferry, road and bridge tolls*
The tolls are exempt regardless of whether the service is public or privately owned or operated.

It should be emphasized at the outset that "tax-exempt" is a misnomer. Although the supplier does not charge tax on the sale of his goods or services, he may not claim input tax

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14. The air transport tax still applies to flights leaving Canada. The amount of the tax has been raised from $ 19 to $ 40 per ticket. Travel agent services are zero-rated if the work relates to zero-rated (overseas) travel.
15. Many pies were sold at midday while still warm and consumed by customers soon thereafter. Other pies were taken home at the end of day and rewarmed.
16. Single servings of puddings, yoghurt or beverages are taxable under the GST. Unflavoured milk, or those foods or beverages packaged specifically for consumption by babies are zero-rated. When those taxable products are sold in packages of four they are also zero-rated.
17. The legislative draftsmen appear to have made nutritional value judgements in determining what foods would be subject to the GST. It is not surprising that alcoholic beverages are taxed, but so are non-alcoholic malt beverages. In fact, all carbonated beverages are taxed, as are all non-carbonated fruit beverages with less than 25% fruit juice content. The Government is also concerned about hypertension. Salted nuts and seeds are taxed, but the non-salted version of the same product is zero-rated.
18. All foods sold in vending machines are subject to GST even if they would have been zero-rated if purchased in a shop.
19. Query why the tax is charged in the first place if it is just remitted back to the legal aid authority.
20. Where the public service body operates on a commercial basis they will generally be fully taxable. They will also be eligible for the input tax credit.

credits. As a result, the previously paid unrebated GST will then be imputed in the price of the goods or services.

E. *Overview*

The question that must be asked is, what is the policy justification for the existence of three categories of supplies? What characteristics do zero-rated supplies have that tax-exempt ones lack and alternatively, what characteristics do exempt supplies have that fully taxed supplies lack? Is there a thought-out tax policy underlying this complex structure? Or is this "crazy quilt" the result of some lobby groups being more successful in obtaining preferential tax treatment than others? In view of the alterations to the legislation that have already taken place and those which are planned to take place (see below), the latter interpretation is most likely to be correct.

Not only do these exclusions require the legislation to be considerably more complicated than if it were comprehensive and uniform, the curious rules of what is and what is not taxable will cause distortions in the economy. The farmer may switch crops or change the manner in which he operates to take advantage of zero-rating. Whenever there is a GST that is not comprehensive or where it applies more than one rate, there will be business decisions made by taxpayers because of GST considerations rather than on the basis of what is economically optimal.

VI. TAX CREDITS AND REBATES

The GST Act offers a variety of credits and rebates to taxpayers. These are made available to deal with perceived and actual unfairness in the application of the legislation or to correct distortions in the economy caused by the GST.

A. *Lower income credit*

When introducing the GST, the Government had no choice but to recognize the regressive nature of such a tax. All broadly based consumption taxes are regressive because lower income persons must spend all of their disposable income merely to secure the necessities of subsistence. As one becomes more affluent, a progressively smaller proportion of disposable income is spent to meet the taxpayer's needs. As such, the low income taxpayer will pay proportionately more of his total income in GST than the more affluent taxpayer.[21]

In response to this obvious inequity, the Government decided to introduce a tax credit to ameliorate the additional burden of the tax on the low income populace.[22] The August 1989 paper released by the Minister of Finance outlined the structure of a refundable GST credit. It was asserted in the paper that:

> [O]nce the GST is in place, the federal tax system will be more progressive and lower and modest income Canadians will be better off. This will be achieved through the implementation of a new refundable GST Credit.[23]

1. Application

The credit is similar to the refundable federal sales tax credit, which it replaces. The GST credit is calculated on the basis of the individual's tax return and is based on the income and family details of the taxpayer for the prior year. The credit will be received in quarterly instalments, paid in advance (July, October, January and April). The first payment was made in December 1990, immediately prior to the implementation of the legislation, so that those persons requiring the credit would be in receipt of the credit in advance of having to pay the GST.

The refundable GST credit is found in the amendments to the Income Tax Act, specifically Section 122.5(3). Eligible adults receive a credit of $ 190. A credit of $ 100 per child is also available. In addition, a single parent may claim an adult credit for one child. Single individuals or single parents who maintain their own household will receive a credit of two percent of their taxable income in excess of the minimum income tax threshold ($ 6,169 in the 1990 year of income), to a maximum of $ 100.

As the GST credit is designed to assist lower income taxpayers, the credit phases out as income rises. The GST credit begins to reduce as the taxpayer's gross family income exceeds $ 24,800 (in 1990). The credit then is reduced by $ 5 for every $ 100 of family income that exceeds this threshold amount. In the case of the single parent, the credit would be eliminated when the total family income exceeded $ 34,400. The middle income family will continue to be adversely affected by the regressivity of the GST.

2. Overview

The apparently boundless generosity of the Government is questioned when the quantum of credits initially proposed is compared with that which was ultimately introduced into law. The adult credit proposed was $ 275, and the child credit was $ 100. Single parents could claim a $ 275 credit for one of their children. There was also an additional credit of up to $ 140 for eligible persons.[24] In the ensuing months, the Minister was persuaded to reduce the GST rate from nine percent to seven percent. In doing so, he was faced with a dilemma: How should the projected shortfall in revenue be met? In a large part, this was made up by making the refundable GST credit less generous and more difficult to obtain.

The effect of the changes to the credit is that the single parent, who under the original proposal could have received as much as $ 690, will now receive $ 480.[25]

This 30 percent reduction is only part of the story in relation to how the lower income sectors of the public will be affected. More insidious than the reduction in the credit is the manner in which the credit is affected by inflation. Inflation will progressively erode the GST credit until it is available to considerably fewer persons. For those still eligible, the credit will be worth considerably less in constant dollar terms. The partial indexation of the GST credit is its most disturbing characteristic.[26] The income threshold for reduc-

21. The lowest income families will pay 7.1% of their total income on GST, whereas the richest families will spend 3.1% on the GST. See Neil Brooks, "Searching For An Alternative To The GST", working paper for The Institute for Research on Public Policy (February 1990), at 29.
22. Observing what has happened to the original low income credit proposal and the reason for its change, speaks volumes about the actual attitude of the Government *vis-à-vis* the poor and the GST. See discussion in text.
23. See *supra* note 9.
24. Under this proposal, a single taxpayer could receive as much as a $ 415 credit representing the amount of tax payable on $ 4,611.11 consumption (assuming a 9% GST, as was the case at that time). A single parent with one child could have received a $ 690 credit (equal to the GST on $ 7,666.67 consumption).
25. This figure assumes that the single parent has one child, maintains his own household and is eligible for the full $ 100 additional credit.
26. Indexation of credits and deductions is found in Sec. 117.1 of the Income Tax Act. Indexation for all deductions and credits is 3% less than the rate of inflation.

tion of the credit is indexed for inflation, less three percent. It has been estimated by the National Council of Welfare that within two years of commencement of operation of the GST, 100,000 families will lose the credit and this number will have increased to 700,000 by the fifth anniversary of the GST. This drop-out rate is not the result of anticipated prosperity among the underprivileged classes in Canada. It is attributable solely to inflationary increases to income outstripping the indexation of the income threshold for receiving the credit.[27]

A further problem with the GST credit is that it is inadequate in quantum. For example, the conventional family of two parents and two children would receive up to $ 580 as a GST credit. This represents the GST paid on $ 8,285.71 of taxable consumption. Since the low income family will be spending all of its disposable income, it will spend considerably more than $ 8,285.71. Any taxable spending by the family beyond this figure will result in the family being out of pocket for GST paid. Since the family is spending 100 percent of its disposable income on necessities, any amounts spent on GST will mean less money will be available to acquire the necessities of life. Higher income families will also be paying GST; however, they will be paying the tax out of discretionary spending money or money that would otherwise be saved. Although it is questionable whether the larger credit was adequate to deal with the negative economic consequences for the lower income taxpayer, it is clear that the reduced credit is of even less assistance in offsetting the regressivity of the GST.

B. *New housing rebate*

Another credit that has been portrayed by the Government as an attempt to further assist the lower income taxpayer is the GST rebate on new housing. The rebate is more accurately described as a governmental response to complaints by the construction industry that the GST exemption on the resale of houses placed them at a great economic disadvantage when attempting to compete in the marketplace with existing housing stock.

1. Application

The rebate is equal to 36 percent of GST paid on new houses, up to a maximum of $ 8,750. The maximum rebate is reached when a house costs $ 347,222.28. The rebate only applies to the purchase of the primary residence of the taxpayer. The rebate begins to be phased out at $ 350,000 and is eliminated when the price of the house reaches $ 450,000. The formula for determining the amount of rebate for houses costing in excess of $ 350,000 is:

$$\$\ 8{,}750 \times \frac{\$\ 450{,}000 - \text{purchase price}}{\$\ 100{,}000}$$

In other words, for every $ 1,000 over $ 350,000 the house costs, the rebate is reduced by one percent.

2. Overview

Does the rebate offer the intended relief to the builder or the buyer? First, since the rebate is only for 36 percent of GST paid, the consumer will still be 64 percent worse off for GST paid on a new house as compared to a tax-exempt resale. It is unknown how this difference will be addressed in the marketplace. Second, the amount of the upper threshold can be questioned. The $ 350,000 limit in some localities in Canada would embrace virtually all new housing stock being constructed. In Toronto, however,[28] little would be available under this threshold figure.

The Government argued that it was seeking to assist the lower income taxpayer through the new house GST rebate. It is interesting to note, however, that under the original August 1989 proposal, the rebate was to represent 50 percent of GST paid, up to a maximum of $ 13,950 (9 percent on $ 310,000). At $ 350,000, the rebate would begin to phase out until it was eliminated at $ 400,000. This rebate was more generous; however, it still did not fully address the market pressure on builders of new houses who will have to collect partial GST as compared to resold houses which are GST-exempt.

Further, one can question this additional complication to an already complex law. These additional provisions would be unnecessary had the Government not exempted from tax the resale of houses. Had all houses been subject to the GST, there would be no market distortions necessitating compensation to the new house industry in the form of the new house credit.

C. *Public service body rebate*

Most public sector services are GST-exempt. This means that GST may not be charged for their supply, which in light of the basic goods and services being provided is not surprising. What is surprising, as well as disturbing, is that these important social services, such as meals on wheels, homemaker services and municipal transit, are exempt rather than zero-rated. Since they are exempt, the public service body ("PSB") is not eligible for an input tax credit for any GST paid by them in the course of providing the services and goods. To provide relief for the lack of input tax credits, rebates have been made available under the legislation to compensate for some of the tax paid by PSBs.

The rebate percentage depends on the type of PSB involved. The rates are as follows:

– charity or qualified non-profit organization and not a selected public service body	50%
– hospital authority	83%
– school authority	68%
– university or public college	67%
– municipality	57.14%

A university will be eligible for a rebate representing 67 percent of the GST paid on inputs, while a secondary school will receive a rebate of 68 percent. One can only be very curious as to the basis upon which these rebate percentages were derived.[29] Particularly curious is the municipal rebate of 57.14 percent – why not 57.0 percent or 57.15 percent?

It seems incongruous that public services provided by PSBs would be categorized as exempt and that only partial compensation for GST paid on inputs would be made. These are activities which the Government considers socially useful and the Government is saved from providing the service directly. Entities purely motivated by profit are eligible for full input tax credits. Why are charities and other PSBs, engaging in socially useful activity, not eligible for the full input tax credit? Had the Government been sincere about encouraging these public and quasi-public activities, it would have zero-rated them so that the full amount of GST paid on inputs would be credited.

As with any GST-exempt activity, the amount of GST which

27. See Brooks, *supra* note 21, at 21.
28. This would be particularly true prior to the recent recession-related market adjustment.
29. Did the Minister of Finance throw darts at a board to ascertain the appropriate rebate percentage or was a less scientific method used?

is not rebated to the PSB will have to be passed on or absorbed by the taxpayer. In the case of PSBs this means that either the client group will have to pay more for the services they are provided (something which most can ill afford) or, more likely, the PSB will have to reduce services offered.

VII. ADMINISTRATION OF THE GST

A. *Registration*

1. Application

The responsibility for collection of the GST lies with the supplier of the product or service. The GST Act establishes a system of registration of suppliers with Revenue Canada. Registration is required by all forms of legal person or entity engaged in commercial activity. "Commercial activity" is defined broadly and includes a business or an adventure in the nature of trade,[30] but does not include the making of an exempt supply, activity engaged in without reasonable expectation of profit or performance of any duty or activity in relation to employment.

The registration requirement is comprehensive in scope. As such, there was a concern that the administrative burden of complying with the GST could be too much for some businesses. As a response to that concern, an exception from registration exists for small suppliers.[31] A "small supplier", briefly stated, is one that receives less than $ 30,000 per annum of revenue from the supply of taxable goods and services. Sales of capital property are excluded from the calculation of the revenue threshold. Persons who are not registered do not need to collect the GST. They are, however, ineligible for the input tax credit.[32] Small suppliers may voluntarily register if they wish. If so, they will be required to collect and remit the GST and they will be eligible for the input tax credit.[33]

One problem with exempting certain suppliers from the requirement of collecting GST is that a business may exploit the seven percent market advantage in not collecting the GST in order to pass on the cost saving to the public. This is particularly likely to occur if the business does not pay a great deal of GST on inputs. Customers will be attracted to these retailers who offer "no GST" prices. The exception has created an unfair market advantage for certain businesses.[34]

This market advantage could be indefinite for those who engage in business on a casual or part-time basis. Those persons, since they work only part-time, regardless of how successful, will not exceed the $ 30,000 level since the threshold is calculated on an annual basis.[35] As such, the exemption creates an incentive for persons to work on a casual or part-time basis and take advantage of the $ 30,000 annual threshold.

An example of the problem of non-uniform registration and collection requirements, in practice, is the taxi industry. Days after the GST became law, the Government announced certain "technical" amendments to the law. One of these was to provide that all taxi drivers would have to register for the GST, regardless of income level. The Government took this action in response to lobbying by the taxi owner associations. They were concerned that only some drivers would collect the GST (full-time drivers) while others would not (part-timers, who comprise a large proportion of drivers). The lack of uniformity in collection would cause a great deal of confusion. Secondly, potential passengers, it was feared, would go from car to car in a taxi rank asking whether the driver collects GST or not, and so affect the earning ability of some drivers. Thirdly, and of greater concern to the owners and Government, was that it would be increasingly difficult to monitor how much money drivers were in fact collecting in fares and GST. The only solution to these problems was to require uniform registration and collection.

The other concern for the administration of the legislation is that the supplier may not register for the GST, but collect it nevertheless and not remit the money to Revenue Canada. This would provide a seven percent windfall to the supplier (albeit as money taken under false pretences). There are quasi-criminal and civil provisions to deal with such a situation. Money collected by the supplier under the GST is considered under Section 313(1) of the GST Act to be a debt due to Her Majesty in Right of Canada. As such, a civil action to recover taxes collected is facilitated. Further, the offences subdivision of the GST mandates monetary penalties as well as imprisonment where a person evades the remittance of tax.[36]

A further problem is enforcement, or detection of non-compliance. How will Revenue Canada cope with supervising GST compliance for small suppliers if they are not uniformly required to be registered? Will the consumer be forced to become a volunteer Revenue Canada inspector, asking the retailer to show him his GST registration before payment? Or will the ubiquitous "VAT man" arise in Canada? Enforcement would be considerably facilitated if the requirements of registration, collection and remittance of GST were uniformly applied to all persons supplying goods and services. As will be outlined below, the administrative requirements for reporting and remittance of taxes are far less onerous for the smaller supplier. That being the case, there is no strong rationale for not requiring all to register for the tax.

B. *Tax invoices*

An important component of the GST legislation is the tax invoice rules. Tax invoices are essential for taxpayers seeking input credits. The tax invoice is the manner by which the

30. For example, an isolated transaction.
31. GST Act Sec. 148.
32. Others not required to register include "a person whose only commercial activity is making supplies of real property by way of sale other than in the course of business". There is no explanation in any of the government memoranda as to what this means. Presumably it is an exemption from registration for persons who sell a property used in their business or profession, but are not normally engaged in the business of selling property. Also not required to register are non-residents of Canada who do not carry on business in Canada. Although these groups are not required to register they may wish to do so in order to claim the input tax credit.
33. In addition to being eligible for the input tax credit, a taxpayer may wish to register so as to give the impression that he is successful.
34. Many of these businesses would soon, as a result of their market advantage, exceed the $ 30,000 threshold and no longer be exempt from registration. The question is, once they have exceeded the threshold will they register, as required under the Act, or continue business as usual? The lack of uniform registration rules will make supervision of registration by Revenue Canada very difficult.
35. In the United Kingdom the annual threshold is higher; however, there is a pro-rated quarterly threshold as well. As a result, part-time and casual businesses are more likely to exceed the threshold figure.
36. Tax evaders may be charged under summary conviction process and fined a penalty equal to 50% to 200% of the tax owing, to a maximum of $ 25,000. In addition, or as an alternative to the fine, the taxpayer may be subject to imprisonment of up to two years (Sec. 327(1)). If the Attorney General decides to proceed by way of indictment, the fine would be 100% to 200% and the prison term could be up to five years in length.

taxpayer provides substantiation that he has paid GST for the inputs used in supplying his goods or services.

1. Application

The legislation establishes three levels of detail for documentation to be supplied for tax invoices depending on the value of the transaction. If the value of the purchase is less than $ 30, the receipt need only identify the vendor, the date of the transaction and the amount of money the item cost. It is not necessary to state if the item was GST taxable or not.[37] For purchases valued from $ 30 to $ 150, the invoice must, in addition to the information required above, state the amount of GST charged, or whether the GST was included in the price of the item, and the GST registration number of the supplier. For purchases over $ 150, the purchaser's name must also be included on the invoice and there must be a description of the goods or services supplied as well as an outline of the terms of sale.

2. Overview

This three-level documentation system will cause confusion. It would simplify matters for the supplier if there was only one method to remember. The cost of the confusion is not offset by possible enforcement gains.

The documentation associated with the $ 30 to $ 150 purchases includes all of the information that Revenue Canada needs for substantiation of the input credit. Anything more or less is either surplus or insufficient for Government purposes. At the least, it would promote simplicity of administration if a single documentation requirement were adopted. It would also increase efficiency of enforcement. Why have inspectors investigating compliance with forms when they could be checking more important areas?

C. *Collection and remittance of tax*

Central to the administration of the GST (or any other tax) is the completion of returns and remittance of the tax owed to the tax office. The legislation imposes different rules depending on the size of the business. Taxpayers supplying in excess of $ 6 million per annum of taxable or zero-rated supplies must file monthly returns. If the taxpayer supplies less than $ 6 million per annum but more than $ 500,000, he must make quarterly filings. If supply is less than $ 500,000, then filing may be done on an annual basis.

The GST return, simply stated, is a report of the GST collected by the supplier, less GST paid for supplies (input tax credit). Where there is a positive balance, that amount represents tax still owing, a negative balance means that a refund is due.

For those making monthly or quarterly filings, the return and the remittance of tax is due one month after the completion of the reporting period. For those making annual filings, the return is due within three months of the end of the reporting period. Tax is, however, remitted on a quarterly basis, unless the tax owing is less than $ 1,000 per annum where it may be remitted annually.[38] For those taxpayers who are tardy, interest is owed from the first day the remittance is due. For those taxpayers receiving a refund, Revenue Canada is obliged to pay interest on the refund 21 days after a correct and complete return is filed with them.

1. Accounting rules

In a further attempt to simplify reporting for smaller businesses, some abbreviated accounting methods have been introduced. These are: (1) Quick Method, (2) Streamlined Method One and (3) Streamlined Method Two.[39]

The "Quick Method",[40] provides that in the case of certain businesses, a predetermined percentage of total sales will be used to determine the GST payable, rather than tracking GST collected and paid. For example, although seven percent will still be collected on taxable transactions, groceries and convenience stores with annual sales of $ 500,000 or less, and more than 50 percent of sales being basic groceries (zero-rated), have the option of paying a flat one percent of total sales. The Government is assuming that in such businesses, GST collected will exceed GST paid on inputs by an amount equal to approximately one percent of sales. If the taxpayer has made a capital acquisition (plant and equipment) he may deduct GST paid for it from the amount of GST owing under the flat rate calculation. Groceries and convenience stores with 25 to 50 percent basic groceries sales may remit 1.75 percent of total sales. Retailers and wholesalers with sales of $ 200,000 or less may remit three percent of total sales. In all other cases, where total sales do not exceed $ 200,000, the supplier may remit five percent of total sales.[41]

This short-cut leaves wide scope for certain taxpayers to derive considerable advantage by applying the "Quick Method".[42] In the most extreme case, the grocery selling 50 percent zero-rated and 50 percent taxed goods with sales of $ 500,000, would collect $ 17,500 in GST. The amount owed under the "Quick Method" is $ 5,000. As long as GST on inputs is less than $ 12,500, the grocer will receive a windfall. The burden of this windfall is fully borne by the consumer, since the grocer has collected the seven percent GST under the premise that it would be remitted, in full, to Revenue Canada. The consumer will likely pay a second time for this abbreviated accounting rule. As less revenue will be collected by Revenue Canada, the Government will have to make up the shortfall by raising the GST rate or increasing other taxes.

Retailers with annual sales of $ 2 million or less[43] who sell a combination of taxable and zero-rated basic groceries, and include the GST in the price of those goods, may elect to use one of two "streamlined" accounting methods.[44] The choice as between the two methods is up to the taxpayer. The first method involves taking the total value of the taxable goods for resale and applying an average mark-up to establish the estimated value the goods will have when they are retailed. The seven percent GST is applied to the estimated retail revenue, which provides an estimate of GST to be collected on sales. The amount of GST already paid by the retailer for the goods (input tax credit) is then subtracted from the estimate of GST to be collected. The net amount is the GST payable. For example, assume the retailer purchases $ 10,000 of taxable goods for resale. The average mark-up is 50 percent, which means that the goods will be sold for $ 15,000. The GST that will be collected on $ 15,000

37. A further documentation problem in policing the small supplier and ensuring that they remit all GST collected.
38. Sec. 237(3).
39. Goods and Services Tax Regulation, SOR 91-51, 18 December 1990.
40. *Id.*, at Part IV.
41. SOR 91-51, Sec. 15(5).
42. With any legislative short-cut to full accounting which utilizes an arbitrary multiplication factor there is considerable opportunity for the taxpayer to have a tax windfall.
43. In 1991 the threshold limit will be $ 8 million, and in 1992 it will be $ 6 million.
44. SOR 91-51, 18 December 1990, Parts I and II.

is $ 1,050. GST of $ 700 (7 percent of $ 10,000) has already been paid by the retailer for the stock; therefore $ 350 is owed to Revenue Canada under this method.

The second method is used where the taxpayer has sales of zero-rated groceries in addition to taxable goods. The method establishes a four-stage process. The first stage is determining the amount of zero-rated groceries purchased by the supplier during the quarter and multiplying that figure by the legislatively prescribed mark-up.[45] Stage two involves deducting the marked-up figure from total sales for the quarter, yielding a sum representing sales of taxable goods. In stage three the GST payable on sales is calculated by multiplying the amount derived in stage two by a factor of 7/107. In stage 4, the GST payable on sales is reduced by the GST already paid on supplies (input tax credit). The net amount, if positive, is the GST payable for the quarter.

The three abbreviated accounting methods relieve the small and medium-size business of much of the administrative difficulties of accounting for the GST. This is not without cost. As mentioned above, there will be a reduction in revenue collected and this will have to be paid by someone. When, and if, all businesses have computerized cash registers which can instantly calculate GST payable and track inventory, such accounting rules will be unnecessary.

2. Pricing and the consumer

One of the points that the Government has emphasized in promoting the GST is that it is a visible tax, unlike the manufacturers sales tax it replaces, which was hidden in the price of the goods. The author questions whether the taxpayer is any happier about paying a tax that is obvious. Although the Government promotes the GST as a visible tax, the reality is not so clear. The purchase of items valued under $ 30 does not require the GST component of the price be listed on the invoice. More important for the consumer is that there is no uniform rule as to whether prices on shop shelves will be GST-included or not. This makes comparison shopping impossible without having a calculator handy to apply a factor of 100/107 to GST-included goods to determine the pre-GST price and conversely multiplying pre-GST prices by 1.07 to determine the price including GST. If the aim of the GST was to assist the consumer, the Government has failed dismally.

VIII. THE GST AND PROVINCIAL SALES TAX

Under the GST, the supplier/retailer will be collecting, reporting and remitting the GST. Further, in nine of the ten provinces, the retailer will collect a provincial retail sales tax (PST). There are a number of difficulties that arise as a result of an additional sales tax being imposed by another level of government.

One politically controversial issue that has arisen is whether the provinces will levy their sales tax, based on the retail price of the product, before or after GST is applied. The choice made by the provincial government has a substantial impact on sales tax revenue as the tax base is instantly increased by seven percent if the GST-added retail price is used as the base.[46] Most provinces have recognized this tax bonanza and all but four will apply their sales tax to the price of goods inclusive of GST.[47] For instance, when the 12 percent PST in the province of Newfoundland is applied to the GST-inclusive price of goods, a $ 100 item becomes subject to a total of $ 19.84 sales taxes. 19.84 percent is collected rather than the 19 percent that would be collected if the taxes had been collected in parallel.

A further complication arises with the two levels of sales tax because the items taxable under the GST are not necessarily the same as those taxed under the PST. Alternatively, items that may be exempt from PST in one jurisdiction may be taxed in another.

Furthermore, provincial reporting and remittance rules, as well as accounting standards, differ from province to province and all of these differ from the federal rules under the GST. The existence of 11 sets of rules will necessitate different books being maintained for each level of government, in each jurisdiction in which the business operates. This will be a considerable administrative hardship for businesses, particularly for businesses which operate in several provinces.

In response to this concern, and as a means of greatly expanding their PST base, the province of Quebec has been the first to move towards "harmonizing" its PST with the GST. PSTs have a much narrower base, only certain goods are taxed and services are not taxed at all. The effect of the harmonization is that the PST will soon be collected on the same broad range of goods and services as the GST. This will mean a considerable increase in tax revenue to the province as well as a greatly increased tax burden for the consumer. Saskatchewan and Newfoundland are also contemplating similar harmonization. It is strange that the provinces have been so quiet about this federal incursion into the previously provincial-held domain of sales taxes. The reason for this lack of jurisdictional fighting is probably that the provinces recognize that the broadly based GST gives them an opportunity, under the guise of harmonization and simplification of the law, to greatly increase their tax revenue.

IX. CONCLUSION

The MST had long outlived its usefulness. It caused massive distortions in the economy and had too narrow a base. It had to be repealed. The Government decided that the revenue that otherwise would have been collected under the MST would now be replaced by the GST.

If the GST was to be an improvement on the MST, it should have been applied as a universal, single-rate tax. Each of the deviations from this ideal have caused market distortions which have led to the introduction of ever more complex rebate, credit and exclusion provisions.

Even if a GST, in its pure form, were introduced, there is nothing inherent in it that makes it a valuable addition to the Canadian tax mix. Introducing a GST has meant incurring huge administrative costs, setting up a new bureaucratic infrastructure to collect the tax as well as imposing substantial compliance costs on the taxpayers. Why did the Government decide to introduce the GST?

It could be asserted that the Government recognizes that once the infrastructure is in place, increasing the GST rate will be an easy and attractive means of quickly building up government revenue. The Canadian Government is pre-

45. The mark-up for businesses with sales of $ 2 million or less is 25%. For larger businesses, eligible to use the streamlined method only during the 1991-1992 transitional period, the mark-up is 20%. See SOR 91-51, Sec. 7(2).
46. The cost to the consumer is also considerably increased.
47. The provinces located west of the Ottawa River (Ontario, Manitoba, Saskatchewan and British Columbia) have decided to apply their PSTs on the same base as the GST and thereby avoid the cascading effect.

sently facing record high deficits as well as a crippling debt load. It is doubtless pleased to have an additional revenue source, albeit a cumbersome and regressive one. How long will it be before the rate is restored to the original proposal of nine percent or increased beyond that figure? It will be impossible to keep the GST from having an increasingly important role in the tax mix.

If the goal of Government is to progressively tax increases in economic power, it makes more sense to make up the shortfall in revenue from the former MST by increasing the income tax rates and perhaps combining that with the reintroduction of a wealth tax or succession duties. Increasing revenue by these means would have saved the Government the cost of establishing a new bureaucratic structure and saved taxpayers considerable money in compliance costs.

The GST Act and its regulations are unnecessarily complex, confusing and regressive. The Canadian tax system would have been much better off without their introduction.

PACIFIC REGION CONFERENCE

Susan M. Lyons and Nicholas C. Webb

The first Pacific Region Conference, sponsored by the U.S. branch of IFA, was held in Maui, Hawaii, 22-24 May 1991. The conference was attended by some 90 participants, including government officials from the United States, Japan and Korea. Conference participants also included representatives of companies, law and accounting firms and academics. The programme consisted of five topics which were tackled by panels of experts. The following subjects were discussed: Panel I, "Taxation of Doing Business in and with a Participating Country, including Acquisitions"; Panel II, "Cost Sharing and Transfer Pricing"; Panel III, "Enforcement"; Panel IV, "Inpatriate Taxation"; and Panel V, "Tax Accounting, Periods and Methods".

The conference opened with a statement by Mr. Joseph Guttentag of Gaikokuho Jimu Bengoshi Jimusho and the President of the U.S. IFA, Mr. Daniel Lundy. The keynote speaker was the highly distinguished author and commentator, Kevin Phillips, whose most recent book, *The Politics of Rich and Poor: Wealth and the Electorate in the Reagan Aftermath,* is a best seller.

The theme of the keynote speech was the likelihood of a worldwide shift, as the 1990s progress, away from the conservatism in economics and tax policy which characterized the 1980s. Noting the similarity which existed in that decade between the taxation and monetary policies of the United States and the other "G7" nations, and in particular the common tendency towards privatization, the speaker painted a global picture of collaboration between states sharing an aggressively conservative, economics-driven ideology. Mr. Phillips feels that in the 1990s the picture is changing. A shared conservatism among the G7 nations is unlikely with the result that there will be less cooperation in economics and trade and monetary policy. He detects the signs of change in the growing belief that economic globalism has gone too far, in the emergence of a new economic nationalism – or at least continentalism – in North America and in the mounting pressure in the United States to raise the rate of tax on top-bracket income earners. Mr. Phillips drew support for his thesis from an extensive comparison of the last ten years to earlier boom periods of which high debt, low inflation and low taxes were also features. Because the Federal Reserve now provides a safety net he does not, however, believe that the current economic downturn portends the kind of dramatic collapse which followed previous boom periods.

Panel I was comprised of representatives from Canada, Japan, Korea, Malaysia, Hong Kong, the United States, Australia, New Zealand and Mexico. Generally each panelist outlined the basic elements of his country's taxation system. However, aspects peculiar to each system and recent legislative changes were also highlighted.

The Canadian representative and panel chairman, Mr. Larry James, of Peat Marwick Thorne, focused on Canada's desire to attract foreign investment; for example by its recent legislation on international financial centres (IFC) and the international shipping legislation. The IFC legislation is designed to encourage financial institutions to relocate in Vancouver, a city which is well situated with regard to time zones, and the shipping legislation offers incentives for shipping companies to take up residence in Canada.

The expert from Japan, Mr. Takashi Kuboi, KPMG Peat Marwick, addressed what he described as "hate taxes".

Mr. Ian Harris, of the Hong Kong & Shanghai Banking Corporation, spoke on the investment climate in Hong Kong particularly with reference to the post-1997 era. He expressed the general view that Hong Kong's status is uncertain at best despite assurances from the PRC that the policy of "one country/two systems" will be adhered to. Questions arise, however, as to how the basic law will be interpreted. Mr. Harris conceded that the uncertainty over Hong Kong's future has spurred a mass exodus of middle level executives. Nevertheless, he concluded his presentation on an optimistic note and encouraged investment in Hong Kong.

The U.S. panelist, Mr. Roger Epstein of Cades, Schutte, Fleming & Wright, observed that tax disincentives currently outweigh incentives in the United States. Doing business in the United States has become dramatically different in recent years. The IRS perceives that foreigners do not pay tax commensurate with the income generated so the emphasis has shifted to avoiding second and third tier taxes.

The first luncheon speaker was Mr. Charles Triplett, Associate Chief Counsel of the IRS. The theme of Mr. Triplett's talk was the anticipated trends of the 1990s and on into the 21st century. He identified two main areas for consideration: legislative activity and administrative guidance. It is expected that there will be a respite from the flurry of legislative activity which we witnessed in the 1980s. Areas of potential change, however, include simplification of the foreign tax credit, VAT and integration. Mr. Triplett noted that one big question remains unresolved: how to finance the changes? In the area of administrative guidance, a plethora of regulations and rulings are imminent, i.e. the Section 6038A regulations (information reporting by foreign owned subsidiaries in the United States) and Section 163J regulations. The advance pricing agreement is on everyone's mind at the moment and a concerted attempt is being made to develop a workable procedure. However, the issues are rancorous and vast sums of money are involved.

Panel II, chaired by Mr. Toshio Miyatake of Adachi, Henderson, Miyatake & Fujita, was divided into a general discussion on cost sharing and transfer pricing and a discussion which addressed specific issues. During the general discussion, each panelist highlighted the most salient features and/or problem areas of his respective system.

Mr. Yuji Gomi of Chuo Coopers & Lybrand, Japan emphasized the recent proposals designed to bolster transfer pricing provisions. More emphasis will be placed on the administration of transfer pricing examinations. Mr. Ian Harris succinctly stated that transfer pricing is not an issue in Hong Kong.

Mr. Yong-Kyun Kim stressed that the focus in Korea was on inbound rather than outbound investment issues. The situation in New Zealand, according to Ms. Susan Glazebrook of Simpson Grierson Butler White, is that there is only a general transfer pricing provision with no regulations to back it up. The Revenue, however, is becoming more aggressive in the transfer pricing area. Mr. Alain Ahkong of Pioneer Associates explained that currently Singapore does not have any specific transfer pricing legislation but rather relies on anti-avoidance provisions. Singapore, which hosts a large manufacturing and service sector, offers a generous incentive regime. As more and more companies emerge from tax holiday periods the issue of transfer pricing will become more acute. These companies may be facing intense scrutiny by the tax administration in the future. Mr. David Berenson of Ernst & Young in Washington, D.C. outlined four stages of a transfer pricing situation: advance planning, IRS examination, competent authority mechanism and litigation.

On a more specific level, five topics were singled out for further discussion: advance determination rulings, cost sharing agreements, the three method versus the four method approach to computing an arm's length price, competent authority procedure and the collection of data. Each panelist touched on sensitive areas as regards the above topics, and Mr. Triplett responded to several of the panelists' comments. The interaction between the panelists, delegates and government officials resulted in an informative exchange of ideas on how their respective countries handle the particularly rancorous issues involved in transfer pricing.

Panel III on the subject of enforcement was chaired by Geoffrey Harley of Russell, McVeagh, McKenzie, Bartlett and Co., New Zealand. The opening speaker was Lance Heenan, of the same firm. Mr. Heenan underlined the importance of the approach taken by the authorities to the questions of enforcement as well as that of the law itself. He traced the development of New Zealand's enforcement machinery which took its impetus from the avoidance schemes devised in response to the high tax rates of the early 1980s and illustrated how recent years have seen the adoption of a more aggressive approach by the authorities. This has encompassed the introduction of a comprehensive international tax regime and criminal penalties for tax evasion and what the speaker characterized as "overuse" of New Zealand's general anti-avoidance provision. Mr. Heenan concluded on a note of cautious optimism, commending the progress that has been made on the relationship between the Inland Revenue Department and practitioners and the replacement of specific loophole-closing sections with comprehensive provisions.

Mr. Anthony Au-Yeung, Commissioner of Inland Revenue for Hong Kong, emphasized the heavy reliance which that country places on voluntary compliance. He noted that because the tax system is essentially simple, because tax rates are low and because Hong Kong employs a source basis of taxation and is therefore not interested in ex-Hong Kong transactions, compliance procedures are relatively straightforward. The remainder of the Commissioner's contribution was taken up with a review of registration procedures, matters connected with returns, the fairly extensive powers of the authorities to obtain information from third parties and the rules, which generally follow U.K. practice, on obtaining search warrants.

Mr. Yuko Miyazaki of Nagashima and Ohno highlighted two peculiar aspects of the Japanese system – the extensive scope of withholding taxes and the role of tax audits. More than 70 percent of Japan's individual income tax haul is collected by way of withholding taxes, only 8 million out of 38 million taxpayers completing returns. The highly efficient withholding tax regime applies to four categories of income – the remuneration of professionals, salary income, asset-based income and payments to non-residents. Audits also play an important part in Japan's enforcement machinery with coverage, particularly by the investigation division, being relatively high. Tax audits are conducted on a basis which requires "voluntary" taxpayer compliance – there is a general lack of direct enforcement procedures, but non-compliance may be penalized.

Mr. Woo Taik Kim of Kim and Chang opened with the provocative reflection that the underlying assumption with regard to enforcement procedures in Korea is that "government action is reasonable". He assured delegates, however, that with the intensification of cross-border activities, the climate is changing. Mr. Woo outlined the five steps in the Korean income tax process, namely filing, audit, assessment, collection and appeal and described the authorities' "almost unlimited" powers in relation to obtaining information from third parties. He also touched on the important Real Name Law of 1982 which, though generally preventing banks from disclosing information without consent of the customer, allows them to disclose information if requested to do so by the tax authorities.

Mr. Michael Abrutyn of Cole, Corette & Abrutyn showed how in the United States enforcement policy is very much influenced by statistical studies which recently have generally led to an increasing focus on inbound investment. Specifically he predicted that studies revealing the amount of money leaving the United States as interest (which is free of withholding tax) are likely to lead the IRS to concentrate on the question of whether such outgoing interest is really a return on equity. The speaker explained how the IRS has reorganized to deal with international avoidance referring to the controversial Coordinated Examination Program and discussed the recent amendment to the foreign record-keeping sections and the proposed regulations on the types of records to be maintained as well as the exchange of information article in U.S. tax treaties.

Mr. Cho Joong-Hyung, Deputy Commissioner for International Taxation, Korea, and Wednesday's lunchtime speaker, addressed delegates on the problems of interpreting double taxation agreements. Mr. Cho placed these problems in the context of Korea's increasing economic dependence on international trade and the growing complexities of arrangements providing for the transfer of technology and services. Korea has 29 double taxation agreements, with four more soon to be signed, and introduced transfer pricing legislation in 1989. The Deputy Commissioner focused on three areas which give rise to special problems in interpreting treaties – the question of what constitutes a permanent establishment, the difficulties in determining the proportion of income attributable to a domestic source and the issue of apportioning head office expenses. He concluded with the suggestions that exchange of information agreements should be encouraged and that tax authorities must be quick to inform treaty partners when new legislation with a bearing on international matters is introduced.

The most striking feature of *Panel IV* was its focus on the human aspects of taxation. Mr. Paul Ellard of Ernst & Young, Singapore opened the panel with the bold remark that tax is part of culture shock. He stressed that even though no vast sums of money are usually involved, inpatriate taxation is an important and intricate area because it directly affects human beings. He stressed the importance of advance planning for inpatriates – an obvious way to avoid troubles down the road. Mr. Ellard noted that the Singapore government uses selective tax holidays as a way to filter immigration. A trade off is necessary in order to obtain exemptions, i.e. Singapore will require some economic value – generally in the areas of high technology, fabrication or commitment of resources. The remainder of the speaker's presentation was taken up with an overview of Singapore's individual taxation regime, including the central provident fund, estate duty, and the need for a tax clearance certificate before departing the country. Mr. Ellard concluded by proclaiming that Singapore is "a great place to live".

Mr. Ian Harris took his cue from Mr. Ellard – Hong Kong is also a great place to live. Hong Kong is a source-based taxing jurisdiction so if an individual has a foreign employer, he is only subject to Hong Kong tax on income relating to services rendered in Hong Kong. Unlike Singapore there is no central provident fund. Mr. Harris explained Hong Kong offers a generous fringe benefits package which has recently become the focus of some controversy. As in Singapore it is necessary to obtain a tax clearance certificate before departure.

Mr. Masatami Otsuka of Jones, Day, Reavis & Pogue took a more pragmatic approach to inpatriate taxation under the Japanese system. Mr. Guttentag's recent transfer to Japan and Mr. Otsuka's recent transfer to the United States provided an authentic (and amusing) frame of reference from which to explain the convoluted system of taxing residents and non-residents. Both groups are subdivided into two categories: residents are divided into permanent residents and non-permanent residents, and non-residents can be those with a permanent establishment in Japan and those without. The remainder of Mr. Otsuka's contribution was taken up with a discussion on the estate and gift tax aspects.

Again focusing on the human element of inpatriate taxation, Mr. Sanford Goldberg of Roberts & Holland highlighted various facets of the U.S. system which apply to inpatriates. He concluded his presentation with the suggestion that engaging in some estate planning before moving to the United States will avoid estate taxes.

Panel V on "Tax accounting, periods and methods" was introduced by Mr. Frank Walsh, Executive Director, IFA, USA branch. Under the chairmanship of Mr. Robert Oser of Price Waterhouse, Sydney, the session took a somewhat different format to the other panels with the panelists tackling the subject from three different angles – time/value of money, tax versus financial accounting and accruals versus cash accounting.

Mr. Oser stressed the importance of time/value of money considerations in a climate of high inflation and high interest rates and noted that governments are taking an increasing interest in the timing of tax liabilities. Turning to the Australian experience he explained how high inflation has led to the production of artificial budget surpluses by means of accelerated tax collection, with no change in the actual tax rates. This process is exemplified in the Australian reform of superannuation fund taxation with a 30 percent tax on withdrawals being replaced by a 15 percent tax on withdrawals with 15 percent shifted up front by way of a tax collected when contributions are paid into the fund. A second example is the change in the collection procedure from a quarterly to a 28-day system.

The selection of Mr. Koichi Uno of Arthur Andersen and Co., Tokyo, to deal with the topic of tax versus financial accounting was especially felicitous as Japan takes a unique approach to this issue. As Mr. Uno explained, companies must compute tax liabilities on the basis of the financial statement presented at the shareholders' meeting, what is known as the "book and tax compliance requirement". The speaker observed that this requirement has a number of interesting aspects, among them that corporate taxpayers do not have the freedom to show their results on the basis of their own judgement, that tax law is generally written to take account of general accounting principles and that the tax authorities can rely to a degree on financial statements because these have been approved by shareholders.

Professor Walter O'Connor of Fordham University emphasized that although the central issue when considering cash versus accrual accounting methods is essentially basic – that is "can cash be saved by accelerating deductions and/or deferring income?" – it is extremely important to be aware of the particular approach taken to the subject by the legislation of the country concerned. In the United States, the speaker noted, the tendency is for tax laws to prevent the deferral of income and to defer deductions. The United States has "all events" and "economic performance" tests for deductions which sometimes produce the strange result that an accruals deduction cannot be taken until the bill is paid. Professor O'Connor concluded by making the interesting point that while the United States currently only allows one reserve (namely for depreciation) other countries are generally much more generous in allowing reserves. The effect of this is that even though a U.S. parent may have foreign subsidiaries in higher tax jurisdictions, it will not generally have an excess of foreign tax credits.

The final luncheon speaker was Mr. Tasuku Honjo, Director of the Examination Division of the National Tax Administration (NTA) in Japan, who spoke on administrative and legislative developments with respect to transfer pricing in Japan. He provided an inside look at the composition and administrative procedures of the NTA.

The combination of dynamic speakers from private practice as well as from governments produced the recipe for a highly successful Pacific Region Conference. It is to be hoped that this success will lead to the organization of similar conferences on a regular basis.

INTERNATIONAL: APPLICATION OF THE LOMÉ IV CONVENTION TO SERVICES AND THE POTENTIAL OPPORTUNITIES FOR THE BARBADOS INTERNATIONAL FINANCIAL SECTOR

Bruce Zagaris*

I. INTRODUCTION

On 15 December 1989 68 African, Caribbean and Pacific States ("ACP States") and the 12 Member States of the European Economic Community ("EC") signed in Lomé, Togo, the Lomé IV Convention ("Lomé IV"). Ratification will be complete when all 12 EC members have notified their ratifications[1] and when two thirds of the ACP States have done so.[2] Although completion of the ratification procedure may be expected by the middle of this year, the individual ACP States are progressing through preliminary procedural steps concerning project identification.

The agreement has a ten-year duration, which began on 1 March 1990. It covers all forms of development aid: preferential access to the Community market, the financing of projects by the European Development Fund, the stabilization of export earnings and the mining system.

Innovative aspects are the common institutions, the common Council of Ministers, the Joint Assembly and the Committee of Ambassadors, which are designed to ensure that the system operates on an egalitarian basis. The regional character of the Agreement between the EC and the ACP States, especially when contrasted with the bilateral nature of counterpart regimes such as the Caribbean Basin Initiative ("CBI"), provides a useful guarantee against any risk of domination.

Another positive feature is the adoption of a five-year financial package that allows estimates vital to sustained development efforts to be made, and enables the planning of development assistance programmes over a reasonable time period.

This article discusses the application of Lomé IV to services and the opportunities for the Barbados international financial services sector. Prior to discussing the provisions of the Convention that apply to services, the structure and main features of the Convention will be outlined; financing will then be discussed. Finally, some potential applications to the Barbados services sector will be proffered.

In the wake of CARICOM's efforts towards accelerated integration and the recent regional economic conference, Lomé IV provides an excellent opportunity to rethink the role of Barbados in the future of the region. Many of the new opportunities for financial and technical assistance and even for straight trade and business deals will only occur if Barbados is part of a regional mechanism. As a prefatory remark, Lomé IV enables Barbados to mine a relatively successful regional integration organization for ideas, assistance and business. While this article deals with the international financial sector, the need for intellectual leadership in forging a correct path in CARICOM's attempted accelerated integration should not be lost. The historical role of Barbados in Caribbean regional integration, its unique geographical and political circumstances and its dependence on CARICOM's success provide additional impetus for Barbadian intellectuals and business people to study the EC, foster links, experiment with some of its models and become knowledgeable about the EC and the parts of its system and regional integration theory that may apply to the Caribbean and CARICOM. To this end, course instruction in Barbados on the EC and CARICOM should be a priority matter. Indeed, unless Caribbean professionals, business persons and general public are educated in the intricacies of both Barbadian and other integration movements and alternatives, they will not follow the agreements and may even develop a cynicism about the importance of such agreements.

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III. SUMMARY AND CONCLUSION

Appendix – A Proposal for the Establishment of a Caribbean Institute of International Services (CIIS)

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* Of counsel, Oppenheimer Wolff & Donnelly, Washington, D.C.; Lecturer, Faculty of Law, University of the West Indies, 1977-78. The author is grateful for the assistance of his colleague Bruce McCrae and paralegal U. Scott-Larsen, both in the Brussels office of Oppenheimer Wolff & Donnelly.

1. At present my best information is that 10 EC members have notified their ratification.
2. Barbados gave notice of its ratification on 2 October 1990.

Although this article primarily concerns the narrow subject of the application of Lomé IV to the international financial sector, Barbados should increasingly seek to broaden its horizon for business, political, cultural and other ties beyond its traditional relationships. The politics and business developments in the post-technelectric age are dynamic and require an ability to diversify a country's business partners and its skills. Fortunately, the conclusion (or agreement to do the same in the case of Sweden) during the last year of Barbados' treaties with three Nordic countries and its substantial negotiation of a treaty with Germany evidence some momentum in the pursuit of European strategy in the international financial sector. While Lomé IV provides some new opportunities, investment missions by Barbados to the Nordic countries and vice versa will help develop the momentum to capitalize on the treaties with the three Nordic countries.

A. *Overview of coverage and main areas of cooperation*

To put the services component of Lomé IV in its proper perspective requires a sketch of the main areas of coverage and primary developments and innovations in the Convention.

1. Environment

Priority is given to environmental protection and conservation of natural resources to achieve conditions for sustainable and balanced development.[3] In particular, priority is accorded to the following:

- a preventive approach aimed at avoiding harmful effects on the environment resulting from any programme or operation;
- a systematic approach that will ensure ecological viability at all stages, from identification to implementation; and
- a trans-sectoral approach that considers not only the direct, but also the indirect consequences of the operations undertaken.[4]

Special provisions deal with control of the international movements of hazardous waste, radioactive waste[5] and the safe use of pesticides and other chemical products.[6]

This provides an opportunity for CARICOM and Barbados to obtain technical assistance and funding in achieving some of the goals of the Port of Spain Accord on the Management and Conservation of the Caribbean Environment.[7] In particular, the emphasis in Lomé IV on the environment can assist in the achievement of Barbados' national priorities and programmes on the environment, such as the formulation of a national conservation strategy, the protection of important natural habitats and coastal conservation protection.[8] One clear area of the services sector to which environmental protection is connected is nature tourism.[9]

An example of the upgrading of a unique natural spot[10] that has been heralded by nature tourist critics is Andromeda Gardens.[11]

2. Agricultural cooperation and food security

The Convention provides for agricultural cooperation, food security, and rural development and devotes attention to the key role of women in the development and preservation of ecological balances.[12] An entire title is devoted to fisheries development.[13]

3. Development of services

Lomé IV expands the provisions on services. The Convention provides for services that support economic development and contain expanded provisions on tourism, communications and information technology (discussed below).

4. Industrial development

Specific provisions on enterprise development enable the Convention to better assist the development priorities of the ACP States in industrial development, manufacturing and processing.[14]

5. Cultural and social cooperation

The section on cultural and social cooperation (discussed in more detail below) has been expanded to cover new items, such as nutrition, population and demography. The provisions on health and the role of women in development have been strengthened.[15]

6. Regional cooperation

Regional cooperation has been strengthened in order to assist regional economic integration. The themes of functional cooperation have been extended and opportunities for cooperation between the ACP States and the overseas countries and territories are highlighted.[16]

B. *Finance*

One positive feature of the Lomé Convention is that, unlike other counterpart preferential programmes (i.e. the CBI and CARICOM), it did not unilaterally emanate from the donor with a term of between one to four years, depending on the life of the governing party or other short-term political circumstances, but rather resulted from negotiations by the donor and donee countries and has a long-term framework.

1. Terms of financing

Except for the funds managed by the European Investment Bank, all financing under Lomé IV will be in the form of grants. The use of the Bank's own resources will include a higher subsidy of four percent and the interest rate charged to the borrower will be between three percent and six percent. The interest rate on risk capital is limited to three percent and exchange rate risks will, under certain conditions, be partially borne by the EC.

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3. Lomé IV Convention, Art. 6.
4. *Id.*, at Art. 35.
5. *Id.*, at Art. 40.
6. *Id.*, at Art. 40.
7. The Port of Spain Accord on the Management and Conservation of the Caribbean Environment, Port of Spain, Trinidad and Tobago, 31 May – 2 June 1989, CARICOM, *Proceedings of the First CARICOM Ministerial Conference on the Environment* vii-ix (1989).
8. *Id.*, paper by the Barbados representative, the Hon. N.K. Simmons, Minister of Employment, Labour Relations and Community Development at the 1989 Trinidad Conference, at 30-31.
9. Boo, E., *Ecotourism: The Potential and Pitfalls* (1990).
10. See "Andromeda Gardens", a brochure published by Andromeda Gardens.
11. See Deitz, "A Rare Garden in Barbados", The New York Times (17 February 1991), at 16.
12. Lomé IV Convention, Title II, Arts. 42-57.
13. *Id.*, at Title II, Arts. 58-68.
14. *Id.*, at Title V, Arts. 77-98.
15. *Id.*, at Title XI, Arts. 139-155.
16. *Id.*, at Title XII, Arts. 156-66.

2. Structural adjustment support

Lomé IV, for the first time in the history of the Convention, provides structural adjustment support, which will occur after a joint assessment by the EC and the country concerned.

3. Debt

Lomé IV provides for technical assistance for debt management and, through structural adjustment support, correcting the imbalances that cause indebtedness. The operation of Stabex and Sysmin,[17] which are themselves unique, are further liberalized.

4. Investment promotion, financing and support

The Convention obligates the EC to promote European private investment in the ACP States by organizing discussions between any interested ACP State and potential investors on the legal and financial framework that ACP States might offer to investors; and encouraging the flow of information on investment opportunities by organizing investment promotion meetings, providing periodic information on existing financial or other specialized institutions, their facilities and conditions; and creating or strengthening the ACP States' capacity to improve the quality of feasibility studies and the preparation of projects.[18]

The signatory countries have agreed to study the main clauses of a standard investment protection agreement with a view to 61 further discussions in the joint institutions on providing investment protection.[19]

To attain the goals of promoting private investment and realizing its multiplying effect, the Bank and/or the Commission agree to participate by providing financial assistance, including equity participation, technical assistance, advisory services and information and coordination services.[20]

5. Development financing cooperation

The Convention, in providing for technical cooperation, contains implementation procedures for programming, with greater importance attached to monitoring and evaluation.

C. *Trade and commodities*

1. Trade arrangements

(a) *Basic principles*

Although the underlying principles of the trade arrangements are unchanged, some rules of general scope have been adjusted to better respond to the ACP concerns. The machinery for taking safeguard measures is now the subject of a protocol.

(b) *Access of agricultural products*

The arrangements for access of agricultural products have been improved considerably for some 40 products. The concessions offered by the EC provide, depending on the case, for a total dismantling of present customs duties, or a reduction in duties or levies applicable to imports of quantities that in most cases exceed the export capacity of the ACP States as a whole.

(c) *Protocols*

Protocols have been concluded on exports of beef, veal and rum (phasing out Member States shares of the tariff quota for the ("CACP") countries with the new protocol providing for a rapid increase in the quota for 1993 and its abolition after 1995) and for bananas.

(d) *Rules of origin*

The rules of origin have been simplified. A single list of exceptions, based on the new customs nomenclature (the Harmonized System) has replaced the "negative" and "positive" lists of Lomé III. The requirement concerning the degree of processing or working has been made more flexible by doubling the margin of tolerance for non-originating inputs (ten percent), abolishing the double-threshold rule for a number of products and lowering the percentage of value added required for others.

(e) *Trade in services*

A chapter on trade in services provides for negotiations on more detailed provisions when the outcome of the Uruguay Round is known.

2. Commodities

A Commodities Committee will be established to review on a regular basis the application of the Convention to commodities and deal with international cooperation issues. The Convention emphasizes the need to reduce the dependence of the ACP States' economies on unprocessed products through diversification and support for processing, marketing, distribution and transport activities, while simultaneously improving the competitive position of the ACP States' products on international markets.

3. An improved Stabex

The Stabex system has been improved by enlarging the risk covered to new products, lowering dependency thresholds to five percent in most cases and one percent in the case of the least-developed, landlocked and island countries, increasing the financial allocation, and so forth.

4. Sysmin

The special facility for mining produces (sysmin) has been improved. Sysmin operations are possible where an ACP State's export earnings suffer substantially as a result of disruption, without the viability of the mining sector necessarily being affected. Sysmin will facilitate preventive operations and diversification.

II. COOPERATION IN SERVICES

A. *Objectives and principles of cooperation*

The purpose of inclusion of cooperation in developing services is to support the efforts of the ACP States such as

17. STABEX (Stabilization of Export Earnings) is a system operating within the framework of Lomé to guarantee the stabilization of export earnings derived by ACP States from agricultural commodities to the EC and, exceptionally, other destinations. Funds are allocated to sectors recording loss of earnings occasioned by fluctuations in price or quartity of exports.
SYSMIN is a special financing facility established within the framework of Lomé for those ACP States whose mining sectors are important to their economies. The funds are used to safeguard mining production and export sectors by implementing measures to alleviate the economic consequences of decline in production or export capacity and/or export earnings occasioned by economic or technological changes.
18. Lomé IV Convention, Title XII, Art. 259.
19. *Id.*, at Art. 261.
20. *Id.*, at Art. 267.

Barbados to provide services with a view to improving the operation of their economies, relieving balance of payment constraints and stimulating the process of regional integration.[21] In particular, a goal is to assist countries such as Barbados to diversify the range and increase the value and volume of their trade in goods and services.[22] Another goal is to assist ACP States to increase their collective capacity by means of greater economic integration and consolidation of functional cooperation or cooperation on specific themes.[23] A specific goal is to stimulate enterprise development through the encouragement of investment in services with a view to creating employment, generating and distributing revenue and facilitating the transfer and adaptation of technology to specific ACP needs.[24] To derive maximum benefit from national or regional tourism and to improve the participation of ACP States in world tourism is still another specific goal.[25] Clear goals are the establishment of transport and communications networks, assistance to informatics and telematics systems' need for development, acceleration of vocational training activities and the transfer of know-how for services activities.[26]

Because of the broad range of services and their unequal contribution to development, in order to maximize the impact of EC aid on the development of ACP States, particular attention will be given to services in the following areas:
- services that support economic development (e.g. international financial sector services);
- tourism; and
- transport, communications and information technology.[27]

To implement cooperation in services, the EC will help implement programmes, projects and operations submitted to it on the initiative of the ACP States.[28]

B. *Services that support economic development*

The Convention calls for cooperation in services that support economic development with priority given to services that support foreign trade, services required by the business sector and services that support regional integration.[29]

Attention is devoted to the improvement of infrastructure for services that support external trade, such as strengthening external trade statistics, automation of customs procedures, port and airport management and the establishment of closer links between the various protagonists in trade, including exporters, trade financing bodies, customs and central banks.[30] The Convention aims to specifically promote trade-oriented services,[31] and to develop other external trade-linked services, such as trade financing, clearing and payment facilities and access to information networks.[32] Under the Convention, attention should be paid to strengthening the capacity of ACP States such as Barbados in financial services, to technical assistance for developing insurance and credit institutions in the field of trade development and to promotion.[33]

C. *International financial services*

The specific call for strengthening financial services, such as insurance and credit institutions in trade development and promotion, seems tailor-made for Barbados and other jurisdictions with an international financial sector. The role of its international financial sector is growing, but is still in a comparatively early stage of development. The provisions of Lomé IV relating to economic support and services do not discuss in detail the application to the international financial sector (as for instance the tourism and informatics provisions specify). Hence, more creativity is required in applying the provisions to the Barbados and the Caribbean situation.

As a relatively new player in the world's international financial sector, Barbados will have to continue to devote resources towards research and development, surveying the international financial sector markets around the world and designing a strategy that can take advantage of market trends for international financial sector services. Depending on its assessment of the world markets, its own advantages, the competition and its limited resources, Barbados will have to continue to identify and design new products and directions. The identification of new directions and products includes conceptualization of specific activities, refining the ideas to suit the Barbados environment, possibly testing the market by further discussion at international tax meetings, and finally deciding on adoption of a financial product and its conceptualization.

Following conceptualization, the implementation phase must be undertaken. This may include, inter alia, the preparation of legislation and statutory instruments, negotiating treaties and the interaction required at the various levels of the executive and legislative branches of government. During this phase the private sector is often called upon to provide opinions and support for the concepts, constitutional and legal questions, economic aspects and inevitably, political aspects.

Coinciding and following the implementation stage is the marketing of the new directions and products both internally (in Barbados) and externally. The internal approach cannot be under-emphasized since in a small island country the professionals should be the persons to market the policy abroad and to develop the know-how to successfully (i.e. efficiently and economically) establish new vehicles once new clients ripen from the new products. Some of the marketing and support must come from the few entities that the Barbados Government has abroad, such as the Embassies, the Industrial Development Corporation ("IDC"), and the private sector groups (e.g. Business Friends of Barbados).

In today's world, marketing may come in many forms: coverage of low-tax jurisdictions and financial products in sophisticated international tax books; various types of comprehensive and abbreviated brochures on a jurisdiction; newsletters on a jurisdiction prepared by law and accounting firms, a governmental entity,[34] and other private sector groups; booths and receptions at key international seminars; holding regional and international seminars in Barbados; making videos on the international financial sector and incorporating the international financial services sector into the economic development videos that the IDC (or the tourism videos that the Board of Tourism) prepares.

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21. *Id.*, at Art. 114.
22. *Id.*, at Art. 114(3).
23. *Id.*, at Art. 114(3).
24. *Id.*, at Art. 114(3).
25. *Id.*
26. *Id.*
27. *Id.*, at Art. 115.
28. *Id.*, at Art. 115(2).
29. *Id.*, at Art. 117.
30. *Id.*, at Art. 118(i).
31. *Id.*, at Art. 118(ii).
32. *Id.*, at Art. 118(ii).
33. *Id.*, at Art. 119(iii).
34. For instance, the Bahamas recently established a Financial Services Secretariat, which has hired a public relations firm to publish a newsletter on its international financial sector.

An issue that all governments (not just those in the Caribbean) face is the extent to which foreign service personnel will devote time to commerce. The allocation of such limited resources will necessarily come at the expense of more traditional work, such as consular work, attending meetings of regional organizations and so forth. Foreign service officials must be well educated about the international financial sector if they are to understand and actively market an opportunity for a shared foreign sales corporation ("FSC"), and exempt insurance company, or a potential tax treaty partner. Some governments believe that commerce is important enough to have a foreign commercial service. Governments also believe that a given sector, such as tourism, is important enough that they have foreign service officials that only market tourism. There is no more important issue than the issue of devoting sufficient resources to training government officials on the international financial sector. Appropriately, the budget speech of last year addressed this precise issue.

To the extent that small governments have insufficient numbers of foreign servants to train on the international financial sector, they can support regional training programmes; e.g. through the Institute of International Relations at St. Augustine and new courses at the University of the West Indies ("UWI") at Cave Hill, and elsewhere. Most important, this is where the University of the West Indies Distance Education System ("UWIDITE"), the long- distance teaching satellite of UWI, may be useful, i.e. to provide background and continuing education courses to foreign service officers on international tax, the international financial sector, the role of tax treaties and various financial products. These courses can be delivered in person and made accessible by video with course material.

In the implementation phase the new directions and products will need reassessment, refinement in design and marketing, and potential additional adjustments. The potential linkages with other aspects of the economy, especially the service sector, should be considered and refined.

All of these elements of the international financial sector require organization and allocation of resources. All of the phases can include many components. Lomé IV provides support insofar as they are services in support of economic development and/or involve linkage with other services covered by the Convention. To the extent the services involve *regional* activities, the limited resources of the European Development Fund ("EDF") will fulfil the goal of regional integration and benefit the most people. That is, many regional projects that are conducted in Barbados and for which Barbadians can benefit will qualify for assistance by the EDF under Lomé IV whereas individual Barbados projects may not qualify.

The human resource development component of the international financial sector is vital. In this context it will be essential for the Caribbean, and Barbados in particular, to transcend the gap between university education and continuing education. By forging new links and cooperation between universities in the region and professionals, the international financial sector will be able to accomplish many of the activities that necessarily must be undertaken. Appendix I sets forth a skeleton concept for a proposed Caribbean Institute of International Services. The concept can be implemented in part through other organizations as well as the ones suggested.

D. *Tourism*

An enlightened feature of Lomé has been the explicit recognition and assistance given to tourism and the meaningful amount of financial assistance given to a broad range of activities.[35] The Convention calls for taking measures at all levels, from the identification of the tourist product to the marketing and promotion stage. The goal is to derive maximum benefit from tourism in view of its impact on economic development and to devote particular attention to the need to integrate tourism into the social, cultural and economic life of the people.[36]

From the very beginning the Caribbean tourism sector has received funding under the Lomé Conventions. Substantial investment has occurred in a wide range of public infrastructure such as airport facilities, utilities, scenic roads and hotel training schools. In addition, the European Investment Bank has financed tourism enterprises. At the regional level, comprehensive support programmes focusing on tourism development, marketing and related activities were implemented under Lomé I and II which amounted to more than 9 million ECU. Funds under Lomé III aided tourism development of the national individual programmes of several Caribbean ACP States. The Lomé III Caribbean regional programme allocated approximately 17 million ECU to tourism and trade, supplemented by other resources. The activities financed have included an accommodation sector training programme combining core training at the Bahamas Hotel Training College with decentralized skills tuition provided by an itinerant team of experts. The Caribbean programme is also financing tourism-related transport infrastructure with the construction of Bequia Airport (St. Vincent and the Grenadines) and studies of the improvement of airports on Beef Island (British Virgin Islands) and Nevis.[37]

Tourism development is directed at the definition, adaptation and development of appropriate policies and should be based on four components:

- human resources and institutional development;
- product development;
- market development; and
- research and information.[38]

Lomé IV does not establish a new framework for cooperation, but it does set forth substantial adaptation and innovation in areas which complement the tourism sector and which, in themselves, are principal areas of cooperation:

- the development of services;
- environmental cooperation; agricultural cooperation;
- cultural and social cooperation; industrial development; and
- regional cooperation.[39]

The effort to link the services sector (and the international financial sector) to the dynamic growth of tourism is the engine of hope for the application of Lomé IV to international financial services.

35. In contrast, for six years the U.S. Government refused to allow the U.S. Travel and Tourism Agency ("USTTA") to even participate in low-level technical assistance and to complete a report on Caribbean tourism. The reason was that at the time the Reagan Administration was threatening to abolish the USTTA, and members of Congress from tourism states responded by directing the Administration not to use any money whatsoever for any project outside the domestic United States.
36. Lomé IV Convention, Title XII, Art. 121.
37. Barrett, "EEC-Caribbean Cooperation on Tourism", No. 122 *The Courier* (July/August 1990), at 80.
38. See also the discussion about strategic tourism planning in Peterson, "Tourism: Planning, Promotion and Marketing", No. 122 *The Courier* (July/August 1990), at 56-57.
39. Lee, "The tourism sector and Lomé IV", No. 122 *The Courier* (July/August 1990), at 61-63.

Human resource and institutional development include developing professional management in specific skills and continuous training at appropriate levels in the private and public sectors to ensure adequate planning and development. The establishment and strengthening of tourism promotion centres, education and training for specific segments of the population and public/private sector organizations active in the tourism sector should be elements of the human resources and institutional development goal. Finally, intra-ACP State cooperation and exchanges in the fields of training, technical assistance and the development of institutions are included. Because of the edge Barbados already has in education and human resource development and because of the presence in Barbados of, inter alia, the Caribbean Tourism Organization ("CTO"), the University of the West Indies and the Caribbean Development Bank, Barbados can and should play a leadership role in regional human resource and institutional development.

In the human resource area, the EC has been funding the regional hotel training programme, which will establish comprehensive, region-wide hotel training standards. In addition the EC is financing a study on public-sector needs.[40]

Product development is the key for Barbados. Currently, other competing tourism jurisdictions have leaped ahead of Barbados in developing market segmentation. The traditional Caribbean market for sun and surf and honeymoons is declining.[41] Such traditional Caribbean products are quickly losing ground to adventure and nature tourism, cultural tourism, sports tourism and combinations of business and tourism. To survive, let alone prosper, in the new tourism market will require refining markets and properly refocusing tourism products.[42] In the context of Lomé IV, the EC Commission is prepared to finance appropriate experts to develop packages with European trade.[43]

The Convention calls for assistance in the identification of the tourism product, development of non-traditional and new tourism products, adaptation of existing products including the preservation and development of cultural heritage, ecological and environmental aspects, management, protection and conservation of flora and fauna, historical,[44] social and other natural assets, and the development of ancillary services. As a traditional Caribbean destination, Barbados must be aware of the fragility of its product and take urgent measures to address issues of pollution and land use. Careful attention must be paid to its infrastructure in order to preserve environmental standards both for commercial reasons as well as for the sake of aesthetics. For instance, the Mediterranean and more recently the North Sea have experienced a regression in their tourism due to pollution. The EC and Lomé offer excellent opportunities to develop environmental projects linked to tourism, culture and sports.[45]

Tourism has and can continue to contribute significantly to the development of arts and crafts, conservation and architecture.[46] For instance, the restoration of the Careenage Buildings and traditional architecture in Barbados, Old San Juan in Puerto Rico, the Gingerbread Houses in Haiti, Brimstone Hill in St. Kitts, and other historic forts throughout the Caribbean have all been tourism-inspired. Similarly, tourism has influenced governments in the Caribbean to clean up and beautify the airports, entrance and exit roads, and other public areas; and to identify unique natural areas, establishing national parks therein and upgrading botanical gardens.[47] Tourism can also have a negative effect on the environment. Examples may be inadequate environmental and infrastructure to sustain increased loads on unique and fragile resources. These effects must be identified and minimized ahead of time.[48]

Product development also embraces promotion of private investment in the tourism industry of ACP States, including the creation of joint ventures. It also includes the provision of technical assistance for the hotel industry and production of cultural crafts for the tourism market.[49]

A project now under way is linking cooperatives between the Caribbean and the EC since a recent study has revealed enormous potential in cooperative joint ventures in the tourism area.[50]

Under the Convention market development is a clear objective. It includes helping to define and execute objects and market development plans at national, sub-regional, regional and international levels. It includes providing support for ACP States' efforts to gain access to services for the tourism industry such as central reservation systems and air traffic control and security systems.[51] In this respect, the EC has been imploring CARICOM and specifically the CTO to develop a proposal for a central reservation system to be funded by the EC.[52]

The Convention also calls for marketing and promotional measures and materials in the framework of integrated market development plans and programmes with a view to improved market penetration, aimed at the main generators of tourism in traditional and non-traditional markets.[53] Marketing would also be directed at specific activities such as participation in specialized trade events, such as fairs, production of quality literature, films and marketing aids.[54] Developing additional videos on Barbados or a segment on historical Barbados, and effectively distributing them would be within marketing and promotional measures. A marketing mechanism for the U.S. market would be to target convention and incentive travel groups, indicating to them that as a signatory to the tax information exchange agreement ("TIRA"), business meetings and conventions in Barbados are more easily deductible than other destinations in the region.

40. Speech of Gabriel P. Lee, Deputy Division Chief, Division for Development of Trade and Services, Directorate-General for Development, Commission of the European Communities, to CTO, January 1990, at 2.
41. *Id.*, at 3.
42. *Id.*
43. *Id.*, at 4.
44. The recent growth in the historical heritage of Barbados can be seen in books such as Nutt, M., Exploring Historical Barbados (1981) and two videos, entitled "Treasures of Barbados (CBS-TV series, October-December, 1986).
45. Lee, *supra* note 40, at 2.
46. See, e.g. Zagaris and Emery, "Tourism: The Orphan of Caribbean Programs", *Journal of Travel Research* (1988), at 24-28.
47. Holder, "Overcoming the Socio-cultural and Environmental Impacts of Tourism – the Verdict for the Caribbean", No. 122 *The Courier* (July/August 1990), at 64-65.
48. Jackson, "Links between Tourism, Agriculture and the Environment", No. 122 *The Courier* (July/August 1990), at 66-67; Holder, "Far Greater Dependence on Tourism Likely", No. 122 *The Courier* (July/August 1990), at 74-79.
49. Lomé IV Convention, Title XII, Art. 122(b).
50. ILO Caribbean Office, Port of Spain, "Trade between Caribbean and European Cooperatives", No. 125 *The Courier* (January/February 1991), at 19-20.
51. Lomé IV Convention, Art. 122(c).
52. Unpublished speech of Gabriel Lee, Dep. Div. Chief, Division for Development of Trade and Services, Directorate-Gen. for Development, Commission of the European Communities, CTO Meeting, January 1990, at 5.
53. One way to actively market tourist products is to undertake formal marketing arrangements with the United States, Puerto Rico and other complementary destinations. See, e.g., Zagaris, *supra* note 46.
54. Lomé IV Convention, Art. 122(c).

According to tourism experts, unfortunately, in Europe, Barbados and the rest of the Caribbean has limited tourism marketing. Tourism boards are either non-existent or are perceived, with market exceptions, as not meeting the requirements of the trade. There is an absence of an organized private-sector presence in the market which is showing steady growth in long-haul traffic.[55]

The EC is investigating the potential for a programme offering traineeships to enable Caribbean nations to acquire the in-depth operational market knowledge required to be able to operate marketing programmes. The EC proposes tailored diploma courses in European specialist institutions, together with in-service training stints with leading tour operators and carriers and also with established national tourism offices. In this connection, the EC Commission is also considering an educational programme for European retailers to improve its knowledge of the Caribbean and its products.[56]

The Lomé IV Convention calls for research and development, such as improving tourism information and collecting, analysing, disseminating and utilizing statistical data. It calls for research and information on the assessment of the socio-economic impact of tourism on the economies of ACP States with particular emphasis on the development of linkages to other sectors in ACP States and regions such as food production, construction, technology and management.[57] Recent studies have pointed to this requirement and the need for a comprehensive tourism policy that is both multi-disciplinary and cross-sectoral.

E. *Communication, informatics and transport*

The Convention aims to strengthen cooperation in transport by developing road transport, railways, port installations and shipping, transport by domestic waterways and air transport.[58] Cooperation in communications is aimed at the development of postal services and telecommunications, including radio communications and informatics.[59] Among the purposes of the joint effort are:
- establishing conditions fostering the movement of goods, services and persons at national, regional and international levels;
- providing, rehabilitating, maintaining and operating efficiently cost-effective systems serving the requirements of social and economic development that are adjusted to the needs of users and to the overall economic situation of all States concerned; and
- greater compatibility of transport and communications systems.[60]

With respect to shipping services, the objective of cooperation in the field is to ensure harmonious development of efficient and reliable shipping services on economically satisfactory terms by facilitating the active participation of all parties according to the principle of unrestricted access to the trade on a commercial basis.[61] The Convention provides for devoting special attention to effective development of efficient and reliable shipping services in the ACP States.[62] It may be possible to combine the provisions on development of shipping services, services that support economic development, and investment promotion to obtain technical assistance and financing for further refinement and expansion of the exempt shipping act into a more sophisticated open maritime registry.

Cooperation in the communications industry requires that particular attention is paid to technological development in supporting ACP States' efforts to establish and develop effective systems. This includes studies and programmes on satellite communication, where this is justified by operational considerations, especially at regional and subregional levels.[63]

Cooperation in information technology aims at developing the ACP States' information technology and telematics capacity by offering countries that want to give high priority to this sector support for their efforts to acquire and instal information technology systems, the development of efficient telematic networks, including international financial information, the production of computer components and software in the ACP States, and their participation in international activities in the field of data processing and the publication of books and reviews.[64]

The use of Barbados by R.R. Donnelly & Co. in its publishing endeavours and the recent need to triple its space for these activities two years after establishing a satellite printing facility indicates the potential for growth in the informatics sector, from data processing to the higher end of communications technology and education in the new information age.[65] Similarly, the opening on 21 August 1989 by Caribbean Data Services of a new insurance claims data processing centre that will eventually employ 500 Barbadians demonstrates the utility of targeting data processing.[66] Other fora in the regions have been examining the theme of Caribbean media and telecommunications in the information age.[67]

Several areas of linkage between telecommunications and the services sector make leadership by Barbados important. For the international financial sector, almost all transactions are conducted by fax, wire and interlinked computers, whether the communicators are accountants, lawyers, bankers, insurance agents, etc. Barbados must be at the forefront of technological developments if it will efficiently and economically interact with the rest of the world.

Similarly, as mentioned above, the utility, and necessity, especially by small and medium-size hoteliers, of an electronic and internationally linked reservation system is an illustration of the application of telecommunications to tourism. Other applications are the use of computers in airports, hotels, restaurants and other key spots for communication to tourists about potential markets and events during a visit to Barbados. Other large hotels in the Caribbean use these machines to lure tourists to selected tourist attractions.

The importance of telecommunications in education in the Caribbean cannot be underestimated.[68] The UWIDITE for higher education has been successful. However, the government and private-sector initiatives in such a system have been quite limited, leaving the initiative largely to UWI and

55. Lee, *supra* note 52, at 3.
56. *Id.*, at 4.
57. Lomé IV Convention, Art. 122(d).
58. *Id.*, at Art. 123(1).
59. *Id.*, at Art. 132(2).
60. *Id.*, at Art. 123(3).
61. *Id.*, at Art. 126.
62. *Id.*, at Art. 129.
63. *Id.*, at Art. 132(1).
64. *Id.*, at Art. 133.
65. See "R.R. Donnelly Expands in Barbados", *Barbados Business Report* (Barbados IDC Fall 1989).
66. For addition background, see "CDS Opens Second Facility", *Barbados Business Report* 2 (Barbados IDC, Fall 1989).
67. Basdeo, S., *Caribbean Media and Telecommunication in the Information Age* (Inprint Caribbean, 1989).
68. For a discussion of education and information in the region, see Parris, "Education and Information", 89 *Trinicom* (1989), at 58.

its relatively inadequate resources. The use of telecommunications as a means for educating has substantial potential, especially television and radio communications for education at the primary or high school levels, for upgrading literacy in the communities of the Caribbean and linking literacy to economic development (particularly in relation to innovation).[69]

Perhaps the international financial sector could provide leadership by having groups pool resources. For instance, if there is a useful video or cassette of an international tax programme, the IFA branch, the bar and accountants associations could purchase such videos and make them available for rental, so that practitioners and policy makers would have access to the latest information.

Tele-conferencing provides dynamic potential for facilitating decision-making in the private and public sectors. Because of the physical separation of jurisdiction in the Caribbean and the cost and inconvenience of constantly attending meetings, tele-conferencing has special meaning and utility in the Caribbean.

Additional advances that have business and international financial sector application include electronic mail, computer conferencing and bulletin boards. These electronic messages will allow subscribers at diverse locations to share ideas and information and to participate in projects and conferences, thereby minimizing the need for personal meetings. A Caribbean Paging Service would enable a person travelling throughout the Caribbean to be contacted. The establishment of data bases containing general and specific information about the region, such as products of the international financial sector, tourism information informatics, culture and the like would be advisable both for intra and extra-regional markets. Initially, the region could have and support such services. If a potential investor in Asia is looking for a trust regime, he must start from scratch and may choose among Guernsey, Gibraltar, the Bahamas and Barbados. However, if a regional organization such as CARICOM, with funding from the European Development Bank and the Caribbean Development Bank, had a data base on the international financial sector, the Asian investor would have instant access to secondary and primary source material and might well choose either the Bahamas or Barbados. Another service is the provision of Cellular Radio and Maritime Satellite facilities that will serve to improve and expand telecommunications services to cruise ships and other maritime vessels. Indeed these facilities would assist an open maritime registry.[70]

F. *Cultural cooperation*

An entire title of the Convention is devoted to cultural and social cooperation. In particular, the signatory parties agree to encourage cooperation through operations fostering the recognition of the cultural identities of ACP citizens, which are part of their histories and value systems, and foster the reciprocal cultural enrichment of the ACP citizens and those of the EC. It calls for mechanisms to promote cultural identities to preserve and enhance cultural heritage, the production and dissemination of cultural products and services, highly representative cultural events and support for information and communications media.[71]

Support will be provided for action taken by the ACP States to safeguard and promote their cultural heritage, notably through the establishment of cultural data banks and sound-recording libraries for the collection of oral traditions and the enhancement of such traditions. Support will also be given to conserve historical and cultural monuments and promote traditional architecture.[72]

Significant opportunities exist in Barbados to take advantage of the provisions to further develop national organizations, such as the Barbados Museum and the National Trust and to establish a national art gallery. The most effective projects will be combined with regional cultural projects, taking into account the need for donors to utilize funds for multiple donees simultaneously and the interest of many foreigners in multi-cultural experiences. Linkage can and should be made to cultural tourism.[73]

The rising interest in visiting the plantation "great houses", such as Villa Nova, St. Nicholas Abbey and the Sunbury House, as well as Codrington College, the synagogue and the Bush Hill House, can be capitalized by additional marketing and linking such cultural tourism to its counterparts in other Caribbean islands (i.e. Grenada, St. Lucia, and the French and Dutch Antilles).[74]

Cooperation will support ACP events and exchanges (e.g. CARIFESTA), as well as those jointly organized by ACP States and EC member states in particularly significant cultural spheres such as the promotion of cultural identities and international dialogue.[75]

Indeed, an enormous untapped market exists in the supposed off season in the Caribbean for historical and cultural tourists. By offering courses on the Caribbean and the Americas (e.g. at the UWI, which has a substantial amount of unused space in the summer) to Europeans and North Americans, combined with travel in Barbados and the Caribbean, educated and potentially influential persons will obtain educational credits and return to their home country with a knowledge that they can turn into political support and perhaps business.[76] The European tourist is very sophisticated and quite interested in combining travel with history, culture and nature.

Post-colonial societies in the Caribbean must nurture the cultural dimension of development as a prerequisite to economic and political independence.[77] The failure to quickly rediscover and stimulate lost folk heritage may result in its permanent loss. Some of the ritual dances, music and other performing arts are best suited to, and should only be performed in, their natural environment.

Other forms of culture may have a more commercial value. Some traditional arts can be performed before local audiences, acquainting people with their own historical past at little cost. Some can be presented to visiting tourists. The development of more indigenous visual and performing arts

69. Lewis, "Regional Cooperation", 89 *Trincom* (1989), at 63.
70. For additional background on these services, see Forde, "The Information Explosion", 89 *Trincom* (1989), at 13, 15.
71. Lomé IV Convention, Title XII, Art. 145.
72. *Id.*, at Art. 146.
73. For an example of marketing historical tourism, a further segment of cultural tourism, see Barbados Board of Tourism, "Island of Barbados Rich in History and Legends".
74. Already the Barbados Board of Tourism is promoting these types of tours. See, e.g., Barbados Board of Tourism, "Caribbean Celebration 1990 Architecture, Monuments Provide Visitors with Photo Opportunities"; "Milestones Along the Bajan Way – A Concise Guide to the Historic and Cultural Attraction of Barbados".
75. Lomé IV Convention, Title XII, Art. 148.
76. See, e.g., discussion of programmes in Zagaris and Emery, *supra* note 46.
77. For an excellent discussion of the problem of cultural development in the Caribbean, from which some of the ideas for this section are derived, see Nettleford, *Caribbean Cultural Identity: the Case of Jamaica* (1979).

linked to Barbadian history will complement efforts to preserve oral tradition, develop cultural pride and enhance cultural activities for tourists. Dinner/drama productions such as "1627 and All That" and "Barbados" should be complemented by other shows. For instance, "Crop Over" serves the purpose of reacquainting Barbadians with their past and stimulating the development of calypso music. Further development and refinement of the number and quality of these productions will help develop market segmentation for the sophisticated cultural tourist.

Whenever possible, such productions should be performed abroad. Unless efforts are taken to stimulate and recognize indigenous culture forms, the tendency by some to prioritize Eurocentric culture will predominate. Attention to the cultural dimension of development is imperative in a small island with a plantocracy legacy surrounded by cable television, BBC news and the bright lights of Miami and Caracas.

Cooperation projects aimed at developing ACP States' cultural productions or co-productions and their distribution will be designed as components of an integrated programme or as specific projects. Cooperation will be directed at encouraging the distribution of the ACP States' cultural goods and services that are highly representative of their cultural identities in the ACP countries and the EC. Where cultural items are produced for the market, their production and distribution will be eligible for assistance provided under industrial cooperation and trade promotion.[78]

Under the Convention cooperation in the area of information and communications will be directed towards increasing, by appropriate means, the ACP States' ability to contribute actively to the international flow of information, communications and knowledge. In this connection the Convention will support the establishment and strengthening of national, regional and inter-regional communications media and infrastructure. It will support better informing the people of the ACP States to assist them in mastering their own development through cultural, economic or social projects or programmes making wise use of communications systems and taking account of traditional communications techniques.[79]

A national, and even regional, policy is required to achieve institutional rationalization and sophistication so that the instruments of cultural action can be effectively mobilized. Examples include cultural training institutions, libraries and archives, museums, exhibition facilities, such as theatres and galleries, research facilities, dissemination mechanisms, such as publications, festivals, videos, colloquia, radio and television.

A useful initiative under the Lomé Convention could be to develop national and regional information systems, especially since they can be the engine to socio-political as well as economic development. Establishing and perfecting a degree programme in Mass Communications at the UWI and upgrading the skills by media professionals have been, and should continue to be, a vital component of such a regional and national information policy. The existence of strong national and regional bodies on media policy to advise governments on media development in the context of overall national development will assist governments in future planning.

Cultural development can be financed through charitable contributions, voluntary organization, receipts from admission for performances and earnings derived from marketing cassettes and videos in and out of the region. Professionals should form organizations to help cultural development. A number of organizations in other Caribbean countries, such as Jamaica, or even in the United States, can serve as prototypes.[80]

In most urban areas in the United States, trade associations are formed by musicians. The Washington Area Music Association ("WAMA"), for instance, is organized and run by music industry people, with the idea that a collective organization will more effectively promote the group's services than the individuals acting alone. WAMA holds a yearly awards banquet to recognize outstanding performances in the various music categories. It also assists musicians and the music industry with a variety of other needs. WAMA publishes a newsletter reporting on all the members' activities. The newsletter is distributed nationwide so that the industry executives in other geographical areas will know of developments in the Washington music industry.

WAMA also sponsors showcases of local talent for record-industry executives from New York, Nashville and Los Angeles. This idea in particular would be conducive to the Caribbean music industry. WAPA provides legal services to indigent artists and new record companies through its affiliate, the Washington Lawyers for the Arts (WALA). Similar organizations are formed for visual artists and for drama and dance professionals.

Caribbean professionals must tailor their organizations to meet local needs. Professionals in the private and public sectors should consider organizational structure and experiment with new organizations to stimulate cultural development. Some organizations can be based on a national and regional context. Some visual and performing artists may want to have only one umbrella organization. If the individual activities (i.e. drama, crafts, dance) gain enough momentum, they can organize their own groups. Caribbean artists and supporters of culture should contact their counterparts within and outside the region for support and assistance.

The linkage with tourism would enable Barbados, independently and with other countries, to host cultural tourism, in which tourists could study in Barbados various aspects of regional culture. Some of the study would be at the UWI, and could consist of lectures, seeing videos, reading music history, attending calypso competitions, musical dramas, having a tour of the recording studios and hopefully watching and listening to ancestral music patterns. Such study-tourism could be offered to music programmes, but also to music clubs and the vast market of Caribbean music in Europe and the United States. These tours and this type of linkage among service activities is envisaged by Lomé IV.

G. *Human resource enhancement*

The Convention calls for cooperation to enhance the value of human resources in the context of integrated and coordinated programmes, through operations embracing education and training, research, science and technology, participation by the population, the role of women, health and nutrition, and population and demography.[81]

Training operations will take the form of integrated programmes aimed at well-defined objectives, either in a given

78. Lomé IV Convention, Title XII, Art. 147.
79. *Id.*, at Art. 149.
80. For additional discussion of potential ways to support cultural development in the Caribbean, see Zagaris, "Economic Development and Diversification in the Caribbean", *Trade Winds* (September 1988), at 27-28.
81. Lomé IV Convention, Title XII, Art. 150.

sector (e.g. services) or as part of a more general framework. They will take account of each country's institutional situation and social and cultural values.[82]

The education and training operations will, as a matter of priority, be undertaken in the recipient ACP State or region.[83]

To meet the immediate and foreseeable education and training needs, cooperation will support the ACP States' efforts to establish and expand training and educational institutions, particularly those of a regional nature (e.g. the UWI). They will assist in restructuring their educational establishments and systems, update curricula, methods and technology employed and reform their basic education institutions and systems, in particular by providing overall primary education coverage and adjusting imported systems as well as building them into development strategies. They will inform and make the population aware of progress in science and technology at an early age and at all stages of education and emphasize curricula that incorporate science, technology and practical applications of knowledge geared to job prospects, while taking account of traditional techniques. The programmes should stimulate training of instructors, education planners and specialists in educational technology. Cooperation will assist to initiate associations, exchanges and transfer of information and technology between universities and institutions of higher education in the ACP States and in the Community.[84]

The Convention provides for the conducting of research programmes primarily in the ACP States' national or regional framework. They must take account of the needs and living conditions of the people concerned, especially the rural population.[85]

Research programmes must support development in priority areas and should comprise, inter alia: the establishment or strengthening of basic or applied research institutes; the promotion of local technology and the selection of imported technology and its adaptation to the specific needs of the ACP States; improvement of scientific and technical information and documentation to ensure the better dissemination of research trends and findings, via networks at national, subregional, regional and inter-regional levels and between ACP States and the Community; and making research findings accessible to the general public.[86]

A mechanism by which Barbados can best take advantage of the diverse services provisions in the Lomé IV Convention, simultaneously assisting itself and the region, is the establishment and development of a Caribbean Institute for Services. This Institute would have a particularly strong component on financial services within which tax policy would be strong. The Institute would be connected with an established regional institution, including the UWI. It could utilize its Extramural Departments to provide programmes throughout the Caribbean. While it would offer diploma programmes, it would also serve as a research and development arm. It would hold seminars and sponsor research and internships by bright students. It would recognize and honour students and professionals who, through their hard work and excellence, make outstanding contributions to national and regional tax policy. It would hold specialist programmes and invite, when needed, experts extraregionally. The Institute would have the goal of involving the mass of the citizens in the shaping and implementation of tax policy. In that way, taxi drivers, maids, retail clerks, civil servants and grammar school teachers, among others, would understand better the purposes and activities of the international financial sector and its contribution to the employment and revenue of the country. Only by involving the masses in tax and other service policies can professionals and Government hope to have their support in taking and financing initiatives. The Institute should have a conference arm. Its newsletter would inform and solicit ideas from persons worldwide. The proposal for the Institute is contained in the Appendix to this article.

A Caribbean Institute of Services would also look at services, such as tourism and travel, culture and computer-based industries. It would focus especially on developing linkages between industries nationally, regionally and extraregionally. By exporting music and other culture, Barbadians can earn foreign exchange while simultaneously promoting tourism and the international financial sector. The Institute would also have links with its counterpart organizations.

Interested organizations, such as the Barbados branch of the IFA, the Barbados Chamber of Commerce, the Caribbean Association of Industry and Commerce, the UWI and the Caribbean Law Institute, can and should play a leadership role in facilitating the discussions and the establishment of an Institute. In a democratic and free enterprise society, a significant share of the burden of research and development, marketing and education of the general public must rest with the private sector if it is to succeed. Professionals in the Barbados international financial and services sector generally must come forward and forge a new frontier in the nation's and region's international financial sector.

H. *Regional cooperation*

Regional cooperation is important, partly because the limited resources for financing requires that the most effective use be made of those resources and often assistance to a regional donee will be the most efficient use of limited funds. Furthermore, in relation to many of its neighbours, Barbados is considered a most developed country and hence allocated a smaller portion of development projects.

Under the Convention the EC must support the ACP States' efforts through regional cooperation and integration to promote long-term collective and self-reliant, self-sustained and integrated social, cultural and economic development and greater regional self-sufficiency.[87] The EC agrees to assist within the framework of the major regional cooperation and integration objectives which the ACP States have established or will establish for themselves at a regional, inter-regional and international level.[88] In particular, to promote and strengthen the ACP States' collective capabilities, the EC must provide effective aid enabling the ACP States to strengthen regional economic integration and consolidate cooperation of a functional type or on specific themes mentioned in the Convention.[89]

The regional cooperation which the Convention will support will cover operations agreed on between two or more ACP States (i.e. Barbados and the Dominican Republic); one or more ACP States and one or more neighbouring non-ACP States, countries or territories (i.e. Barbados and Surinam); one or more ACP States and one or more overseas ter-

82. *Id.*, at Art. 151(2).
83. *Id.*, at Art. 151(4).
84. *Id.*, at Art. 151(5).
85. *Id.*, at Art. 152(3).
86. *Id.*, at Art. 152(3).
87. *Id.*, at Art. 156(1).
88. *Id.*, at Art. 156(2).
89. *Id.*, at Art. 156(3).

ritories or departments (i.e. Barbados and Martinique or Curaçao); two or more regional bodies of which ACP States are members (i.e. CARICOM and OECS and/or CARICOM and the Andean States); one or more ACP States and regional bodies of which ACP States are members (i.e. Barbados and CARICOM and/or Barbados and the CTO and/or the UWI).

In supporting regional cooperation, particular attention should be paid to, inter alia: evaluation and utilization of existing and potentially dynamic activities in complementary sectors (i.e. developing linkages in services or between services and non-services); maximization of the use of ACP human resources as well as the optimum and judicious exploration, conservation, processing and exploitation of ACP natural resources; acceleration of economic diversification to simulate complementary production and intensification of cooperation and development within and between ACP regions; and strengthening a network of relations among individual countries or groups of countries that have common characteristics, affinities and problems in order to solve such problems.[90]

A broad scope for assistance to regional cooperation is set out, which includes preservation and improvement of the environment, especially programmes to combat erosion, deforestation, coastal deterioration, the consequences of large-scale marine pollution; transport and communication; development and expansion of trade; support, at the request of the ACP States concerned, for operation and structures that promote the coordination of sectoral policies and structural adjustment efforts; education and training, research, informatics, management, information and communication; the establishment and strengthening of training and research institutions and technical bodies responsible for technology exchanges and cooperation among universities; other services, including tourism; and cultural and social cooperation activities.[91]

Under the Convention regional organizations that have a mandate for certain activities must play an important role in the design and implementation of regional programmes.[92] Such organizations may participate in the programming exercise and in the implementation and management of regional programmes and projects.[93]

I. *Financing service projects*

Among the objectives of development finance cooperation in Lomé are: to support and promote the efforts of ACP States to achieve long-term, self-determined, self-reliant and self-sustained integrated social, cultural and economic development, on the basis of mutual interest and in a spirit of interdependence; to assist in raising the standard of living; contribute to the development of the abilities of the ACP States to innovate, adapt and transform technology; provide support for and promote the optimal development of human resources in the ACP States; to find new approaches to direct private investment promotion in ACP States; and[94] support the development of a health, prosperous and dynamic ACP private sector and encourage domestic and foreign private investment flows into the productive sectors in the ACP States.

The principles on which development finance cooperation is available under the Lomé Convention is that it should be implemented on the basis of and be consistent with the development objectives, strategies and priorities established by the ACP States, at both national and regional levels with due regard to the respective geographical, social and cultural characteristics; be provided on very highly concessional terms; and ensure that resource flows are more predictable. The projects should strengthen and utilize, as much as possible, the ACP States' human resources and existing administrative structures, and be flexible and appropriate to the situation in each ACP State as well as adapted to the specific nature of the project or programme concerned.[95]

The guidelines direct that among the responsibilities of the ACP States are: defining the objectives and priorities on which the indicative programmes are based; choosing projects and programmes; preparing and presenting the dossiers of projects and programmes; preparing, negotiating and concluding contracts; implementing and managing projects and programmes; and maintaining projects and programmes.[96]

The scope of financing under the Convention will cover: sectoral programmes; technical cooperation programmes; and recurrent costs (including current administrative, operating, and maintenance costs, both local and foreign) of new, ongoing and completed projects and programmes.[97] Of the total amount of 12,000 million ECU (EDF + EDB), 1.2 million ECU is set aside for regional cooperation and 4,965 million ECU is set aside for national programmes.[98]

The sectors of financial intervention include: artistic activities and tourism; economic and social infrastructure; structural improvement of the productive sectors of the economy; preservation and protection of the environment; education and training programmes; marketing and trade promotion; support to national and regional development banks and financial institutions; transport and communications; development and optimal utilization of human resources; improvement of social and cultural infrastructure and services; and assisting ACP and ACP-EEC professional and business organizations with the aim of improving production and marketing of products of external markets; and investment promotion and support measures.[99]

The entities or bodies that are eligible for financial support under the Lomé Convention include: ACP States; regional or interstate bodies to which one or more ACP States belong and which are authorized by those States; and joint bodies established by the ACP States and the EC to pursue certain specific objectives.[100] Subject to the agreement of the ACP State or States concerned, also eligible for financial support are the following groups: national and/or regional public or semi-public agencies, departments or local authorities of the ACP States and especially their financial institutions and development banks; companies and firms of ACP States; enterprises of an EC member state to enable them, in addition to their own contribution, to undertake productive projects in the territory of an ACP State; award holders and trainees; ACP as well as EC local communities, nongovernmental organizations and teaching and research institutions to enable them to undertake economic, cultural,

90. *Id.*, at Art. 158(1).
91. *Id.*, at Art. 159.
92. *Id.*, at Art. 161(1).
93. *Id.*, at Art. 161(2).
94. *Id.*, at Art. 220.
95. *Id.*, at Art. 221.
96. *Id.*, at Art. 222(2).
97. *Id.*, at Art. 224.
98. Newsletter of the Delegation of the European Communities in Trinidad and Tobago and in Barbados, *Europe and the Caribbean* (October 1990), at 7.
99. Lomé IV Convention, Title XII, Art. 229.
100. *Id.*, at Art. 230(1).

social and educational projects and programmes in the ACP States in the framework of decentralized cooperation.[101]

The overall amount of the EC's financial assistance is set forth in the Financial Protocol to the Lomé Convention.[102]

One of the principal mechanisms for direct support to business under the Lomé IV Convention is the Centre for the Development of Industry ("CDI"). Its principal function is "to help establish and strengthen industrial enterprises in the ACP States, especially by encouraging joint initiatives by economic operations of the ERC and the ACP States".[103] CDI will receive 60 mecu under Lomé IV: one half to cover operating costs and one half for studies and technical assistance. CDI will assist potential investors by providing project identification, substantiation and selection; project promotion; feasibility studies; rehabilitation, expansion and diversification of existing industries; industrial training; marketing assistance; implementation assistance; adapted technologies; and information service. Barbados and the ACP countries may want to broaden the scope of the CDI's mandate, so that it covers services.

The projects or programmes can be financed by grant or by risk capital from the EDF, or by loans from the Bank's own resources, or jointly by the ACP State or States concerned and the EC by reference to the level of development, the geographical situation and economic and financial circumstances of these States; the nature of the project or programme, its economic and financial return as well as its social and cultural impact; and in the case of loans, to facts guaranteeing their servicing.[104]

The Convention also allows for participation in the form of loans or equity. Loans are to bear a concessional rate of interest of less than three percent.[105]

J. *Implementation*

Prior to implementation of individual projects under Lomé IV, several procedural steps must be completed.

A decision must be taken concerning the *financial allocation* to individual ACP States.[106] This decision will set forth the global amount of funds that each ACP State may receive from the Seventh EDF (1990-95). This step was completed at the end of 1990.

Another requirement is that each ACP State's *indicative programme* must be prepared. Each ACP State identifies the major sectors in which EDF funding is desired, in the form of grants, risk capital (involving the EIB), or structural adjustment. Indicative programmes are prepared by the ACP national authority, in cooperation with the EC. Barbados is in the final stages of its indicative programme. It may be signed in early April.

An additional step is the *financial proposal*, the detailed identification of individual projects within the broad sectors. It is prepared in cooperation between the individual ACP State and the EC Commission. The financing proposal is submitted to the EC (responsible Commission services) for review. It is then transmitted to the EDF Committee for an opinion and then again to the Commission for approval. Once approved/signed by the Commission, the ACP State must sign the financing proposal. The financial proposal may take as long as six months or more.

The final step is the preparation and conclusion of a *financing agreement* ("*primary commitment*"). It constitutes a commitment of funds to the agreed projects, signed by both the EC and ACP State. Each primary commitment may contain several individual project contracts, which will be covered by *"secondary commitments"*, pursuant to which funds may be released.

In theory, no project/service contract can be tendered for and/or concluded before the financing agreement has been signed. Sometimes, however, tenders may precede the signature of the agreement. The financing proposal and financing agreement steps cannot be initiated before ratification of Lomé IV. If the projected timetable is followed for the ratification of Lomé IV, it should be ratified by mid-1991. Thereafter, some financing agreements may be ready by the end of 1991.

III. SUMMARY AND CONCLUSION

Lomé IV provides unprecedented recognition of the services sector. The wide eligibility of entities or bodies for financial support under the Lomé Convention should encourage professionals to actively pursue projects. Do not wait for the EC, the Government or some other authority to knock on the door and show you how to become involved. Instead, professionals engaged in the services sector and especially in international financial services should prioritize some projects, meet with interested persons and organizations, including local and other potentially interested regional intergovernmental organizations, and propose projects. For instance, inquire about the eligibility of entities in Barbados that have been designated by the Government for financial assistance. Much of the development of infrastructure, human resource development, marketing, research and development can and should be the role of the private sector. Strong and prosperous private sectors must invest in their future and must have a vision if they are to continue to be competitive, refining existing products while developing new ones.

The private sector must have a vision that enables it to overcome the traditionally insular perspective of an island economy. The private sector must reach out from within the interested professionals (i.e. attorneys, accountants, bankers, travel agents and business persons). Barbadians will need to be clever enough in their vision, organization and drive to develop organizations and programmes that are on the cutting edge of the international financial sector. Barbados is competing with some very mature international financial sectors. It competes in some sectors with the United Kingdom, the Netherlands and Switzerland. It also competes with other Caribbean jurisdictions, such as the Bahamas, the Cayman Islands, Netherlands Antilles and Antigua. Many of the potential competitors to a professional, whether it be another professional in Barbados or another jurisdiction, can also be a source of knowledge, a link to business and an ally in shaping strategy.

To survive and even to prosper will require dedicated and committed professionals to step up and invest their time and resources, even when it may not pay immediate returns. It will require smooth working relationships between the private sector and the Government. I can tell you from firsthand knowledge that in some of the Caribbean jurisdictions, there is a vibrant private-public sector working relationship that enables those jurisdictions to identify opportunities, debate and discus them, prepare legislation, enact

101. *Id.*, at Art. 230(2).
102. *Id.*, at Art. 231.
103. *Id.*, at Art. 89.
104. *Id.*, at Art. 233(1).
105. *Id.*, at Art. 234(1).
106. *Id.*, at Art. 281.

and market them. In some of the jurisdictions the whole process takes only 12 to 18 months. Unless competitors can be matched or outwitted, Barbadians will have to be content with capitalizing only on ideas that no one else wants to handle. During the last ten years positive efforts have occurred to develop a more active, searching private sector. For instance, the number of Barbadians participating in foreign programmes on the international financial sector, writing articles and proposing ideas to the Government indicate that the private sector increasingly is becoming involved in the international financial sector.

My sense is that more can and needs to be done on the grass roots level if success is to be achieved in mobilizing the required political support to commit resources to develop the international financial sector. Many Barbadians do not know the linkage between the international financial sector and other service and even non-service sectors. In some cases unless the private sector takes advantage of the opportunities to develop them, the case for the international financial sector cannot be made. In other cases the linkage is already present, but the private sector merely must communicate effectively to the grass roots. By involving itself in educating high school and university students, offering prizes for essays and work on the international financial sector, providing internships for graduates and students, leadership in human resource development will be provided and simultaneously the subjects deserving recognition will be highlighted which will make young people take notice.

APPENDIX

A Proposal for the Establishment of a Caribbean Institute of International Services (CIIS)

By Bruce Zagaris

The proposed establishment of a Caribbean Institute of International Services is designed to meet the terms of the Lomé IV Convention on services. It is designed to enable Barbados and two other Caribbean Governments to apply for funding with the European Development Fund.

I. OVERALL FOCUS OF THE CARIBBEAN INSTITUTE ON INTERNATIONAL SERVICES

The Institute would improve the opportunities and capabilities of participating Caribbean countries at a national, regional and subregional level to increase and diversify the range and increase the value and volume of their trade in services and, wherever possible, the linkages with other economic sectors at the national, regional and subregional levels. The Institute would be directed to increase their collective capacity of providing services and linkage within the services sector and between the service and non-service sector by means of greater economic integration and consolidation of functional cooperation. The Institute would stimulate enterprise development, notably by examining ideas to stimulate local, regional and extraregional investment in services, for the purpose of creating employment and generating and facilitating the transfer and adaptation of technology to specific needs of the participating Caribbean countries. The Institute would help participating countries and the region derive maximum benefit from the subsectors embraced by the Institute. In particular, the Institute would address the establishment of the transport and communications networks and informatics and telematics systems needed for their development. The Institute would also assist in the establishment of training activities and transfer of know-how in view of the determining role of human resources in the development of services. The Institute would also serve to inform the general public of the role of the service sector generally and in particular of the various subsectors, so that the general public can participate in some of the benefits, understand the benefits and linkages of services and provide support in the operation and development of services.

The potential subsectors and fields embraced by the Institute are the following. Initially the Institute can begin with a few and add new ones thereafter. It would seek to develop links with counterpart organizations, such as the Graduate Institute of European Studies in Geneva, the International Tax Academy of the International Bureau of Fiscal Documentation in Amsterdam, the Applied Services Economics Centre in Geneva.

The Institute would have several means of communication. It would distribute a bi-annual newsletter to individuals and organizations interested in regional services.

It would establish a Caribbean Services Forum ("CSF"), which would be a network of professionals, public servants and academics interested in the services field and would bring them together in an annual meeting dealing with all aspects of regional services research.

It would establish the Caribbean Applied Services Economics Centre ("CASEC"), which would organize conferences to the economic and business aspects of services.

Through its interaction with the University of the West Indies and the Caribbean Law Institute, it would hold courses, conduct and disseminate research on the law of services, especially within and outside the region.

II. CARIBBEAN APPLIED SERVICES ECONOMICS CENTRE ("CASEC")

CASEC would emulate the Applied Services Economics Centre in Geneva. It would also seek to work closely with ASEC. CASEC would be a consortium of consultants, researchers and practitioners in the field of services in the Caribbean. It would advise on services issues, conduct studies in a wide range of service sectors, and operate as a forum for discussion issues. The forum would facilitate and promote research, discussion and innovation among entrepreneurs, national governments, international organizations, students and experts, including extraregional experts by applying practical experience and research results to problems in services development. In this connection CASEC would have the goal of becoming a clearinghouse for documentation and expertise in this field.

CASEC would have the perspective that services are increasingly responsible for national and international economics and trade. CASEC would identify the challenges, opportunities and risks associated with services growth and development. The governing board of CASEC would include prominent professionals involved in diverse services and with specific expertise in areas such as banking and insurance, telecommunications and informatics, transportation and services in components manufacturing processes.

Emulating ASEC, CASEC would seek to respond to requirements of business, governmental and international organizations. It would work closely with the Caribbean Association of Industry and Commerce ("CAIC"), the national Chambers of Commerce in the Caribbean, leading trade associations in the region, national governments and international organizations, especially CARICOM and the Caribbean Development Bank. CASEC would have the following four main lines:

1. *Consultancy and Specialized Research:* CASEC would keep a library and would seek to cooperate through inter-library loan with the other leading libraries in Barbados, including UWI (a U.N. depository), the Caribbean Development Bank ("CDB"), the University of the West Indies (UWI) Law Library, and so forth. It would also maintain a list of consultants and senior researchers available to undertake projects in many service fields, such as insurance, banking, telecommunications, informatics and transportation.

2. *Organizing Meetings and Conferences:* CASEC would assist in organizing and holding specialized meetings and conferences on a variety of topics and conduct a forum for business-oriented discussion of service issues. It would utilize the UWIDITE programme so that all UWI campuses through the Extramural Departments can broadcast the conferences and programmes.

3. *Conducting Multi-client Studies:* CASEC would support and extend into other areas experience with multi-client studies such as telecommunications trade projects (e.g. establishing a regional television association analogous the Caribbean Area News Agency ("CANA")).

4. *Specialized Newsletter on Services:* CASEC would assist business and governmental organizations by informing them of ongoing developments affecting various services fields through a Services Trade Newsletter.

III. INTERNATIONAL FINANCIAL SERVICES

A major component of the Institute would be international financial services.

An important aspect would be offshore financial services of the type that Caribbean jurisdictions are offering. For instance, the Institute would cover: international tax planning (i.e. tax policy and administration, tax policy and economic integration, international enforcement aspects of international tax law); international insurance; international trade services relating to international tax planning and operations (i.e. marketing, distribution centres, incentives to attract trade services); transportation (i.e. shipping, foreign flag jurisdictions, offshore air registries); international banking (i.e. merchant banking, letters of credit, comparative offshore banking regimes, private international banking and foreign trusts); international investment services (i.e. the role of national development banks, regional private banks such as the Caribbean Financial Services Corporation, project development financing, incentives for investment and the role of bilateral investment treaties); and the role and types of private banking.

Courses, research and training on international financial services would also be provided, particularly their interaction with the offshore financing sector. Among the courses offered would be: the international monetary framework (i.e. the international monetary system, national exchange control systems, the nature of monetary risks in international business and coping with monetary risks in international business transactions); the international financial framework (i.e. multinational banks and international finance, the World Bank Group, regional development institutions, other public financial institutions, and public financial institutions and international business transactions); and international borrowing (i.e. the management of external debt, sources of funds, selected financing techniques, negotiating and structuring loan agreements, and loan renegotiation).

IV. INTERNATIONAL TOURISM AND TRAVEL

A useful model for this part of the Institute is the Tourism Administration course of the George Washington University, from which this discussion borrows heavily. For this curriculum, a student would take certain core courses, such as: economic and socio-cultural and environmental aspects of tourism; administration of travel and tourism services; travel and tourism research; and systems analysis of tourism services.[107]

A student would then concentrate in more targeted and directed tourism studies. These could include: tourism development; planning for tourism; tourism policy analysis; and tourism marketing. In addition, the student should undertake research and undergo practical training in the form of an internship.

Interested students could concentrate on particular types of tourism, such as ecotourism, culture and tourism, tourism and the environment, and study tours.

Some of the courses and research could be undertaken in conjunction with Caribbean organizations, such as the Caribbean Tourism Research Centre, the Caribbean Hotel Organization, and the Caribbean Tourism Association.

The tourism curriculum would also communicate basic information on tourism policy to the general public and would provide introductory tourism courses for the general public.

A course would be held at UWI Law Faculty on legal aspects of travel and tourism. It would discuss: national laws in the Caribbean, and international law on travel and tourism (i.e. bilateral tourism agreements, the services round of negotiations in the GATT and the tourism subsector components, treatment of tourism in the Lomé IV Convention, and programmes of intergovernmental organizations. The tourism component of the Institute would also promote the study of legal aspects of Caribbean tourism and would disseminate the results of its research in the form of brochures and books for both attorneys and non-lawyers.

V. COMPUTER-BASED INDUSTRIES

The computer-based industries programme would offer courses on an industry overview. It would discuss the changing profile of the informatics markets in developed countries. Among the topics of discussion would be: advancements in data communications; reliance on information systems as a strategic asset; migration from centralized to decentralized system architecture; integration of new technologies in the workplace; and growing pains-market needs and trends in the next few years.

The curriculum would also utilize case studies of the U.S. and European market needs as opportunities for the Caribbean and the evolving data entry industry. In particular, the case study would consider: the migration from key entry into "information capture"; information capture requirements and how to build a full-scale operation; and leveraging local resources for cost/effective data entry operations (i.e. infrastructure and trained labour pool).

The curriculum would consider issues for developing the informatics sector. In particular, it would look at: providers of telecommunications services; conditions of service; regulatory framework (local and U.S.); employment profile; foreign debt – earnings and balance of payment effect; demand for tele-communication services in the Caribbean; and the macro-economic impact.

The curriculum would seek internships for students, both regionally and intraregionally. It would also consider strategies for staying ahead with changes in the U.S. and European markets. In particular, it would consider: investment climate; maximizing local input; changes in local regulations and their effects on the local

107. As a fellow of the Tourism Policy Forum of George Washington University Tourism and Travel Program, I am aware of its interest and work in the Caribbean and Barbados as well as its interest in strengthening its cooperative efforts.

industry; infrastructure; and effective marketing, a global perspective.

The computer-based industries component would provide a course on the law concerning computer-based industries, such as the protection of data bases, piracy, international trade of computers (hardware and software), licensing, etc.

The curriculum would utilize and develop materials and themes from the two programmes on Caribbean communications held in Trinidad in January 1989 and 1990. These programmes considered the role and future strategies for Caribbean communications in development.

VI. VISUAL AND PERFORMING ARTS

The Institute would have a component on visual and performing arts and its linkages with other international services. The goal would be to increase the export of visual and performing arts and culture generally. The role of culture in tourism would be considered with attention to increasing the amount and quality of culture for tourists.

HONG KONG: 1991/92 BUDGET AND LONG-TERM FINANCIAL STRATEGY

Dr. Tang Shu-hung
Head, Department of Economics,
Hong Kong Baptist College

On 6 March 1991 the Hong Kong Financial Secretary, Sir Piers Jacobs, presented the 1991/92 financial budget. Reaction to the new budget was mixed: the business and industrial communities welcomed the budget since it did not increase the corporate tax rate, while the general public condemned it because the small surplus budget was achieved by substantially increasing indirect taxes. This article focuses on analysing the macro-economic aspect of the new budget.

I. THE 1991/92 FINANCIAL BUDGET

The 1991/92 financial budget is a small surplus budget of HK$ 1.3 billion.[1] With a total government expenditure amounting to $ 119.3 billion, the surplus budget is achieved by increasing various indirect taxes by $ 3 billion and fees and charges by $ 1 billion, allowing a reduction of $ 0.98 billion in direct taxes. The revenue measures, in terms of source and magnitude, are surprisingly similar to those proposed in the 1990/91 budget. The 1990 inflation rate was 9.8 percent, which is much higher than the 8.5 percent projected in the 1990/91 budget. Given the unchanged economic situation and the similar substantial increase in indirect taxes, it is beyond doubt that revenue measures in the 1991/92 budget are also inflationary. The 9.5 percent inflation rate which is forecast for this year (by the Financial Secretary) simply confirms the results of economic forecasts made by academic and financial institutions in early 1991.

It is ironic that the Financial Secretary expresses his apprehensiveness about the damaging effects of a prolonged high inflation rate on the livelihood of ordinary citizens and on the production cost of the economy but nevertheless he proceeded to substantially increase indirect taxes.

Why should the budget be a small surplus budget, rather than a small deficit budget? Is a small deficit budget or a balanced budget requiring only a moderate increase in indirect taxes an alternative? Why must the increased revenues come from indirect taxes rather than from direct taxes? It is a simple fact that given a predetermined level of public expenditure, neither a small surplus nor a small deficit budget would exert a significant difference in its impact on the economy. The choice among different options hinges on a value judgement as regards tax equity and economic justice. My preferred choice for the 1991/92 budget would either be a balanced budget or a deficit budget of $ 1 billion, requiring only a moderate increase in indirect taxes.

Because of the devastating effect of higher indirect taxation on inflation, many social organizations, including labour unions and social welfare organizations, have protested against the inequitable budget by engaging in public rallies and (until now) peaceful and lawful actions. The undesirable impact of social unrest and class conflict inflicted by the 1991/92 financial budget should not be overlooked.

II. LONG-TERM FINANCIAL STRATEGY

Hong Kong society is experiencing drastic changes and will be facing increasing uncertainties until 1997.[2] The demand for additional and improved public services, and the pressure to finance the new airport could result in a prolonged period of budgetary deficits. This trend has already been pointed out in the Mid-Range Forecast of the 1991/92 budget. However, the requirement that the Hong Kong Government maintain a satisfactory level of fiscal reserves to be set aside for the future Special Administrative Region Government has necessitated a prolonged period of budget-

1. All figures are denominated in Hong Kong dollars.
2. According to the Joint Declaration of the Government of the United Kingdom and the Government of the People's Republic of China (PRC), the PRC shall resume the exercise of sovereignty over Hong Kong on 1 July 1997 and shall establish the Hong Kong Special Administrative Region (HKSAR). In this "One Country, Two Systems" political model, the HKSAR shall not practice the socialist system and policies and shall maintain Hong Kong's previous capitalistic system and life style for 50 years.

ary surpluses. The latter factor undoubtedly weighs more heavily in long-term financial planning because it involves political considerations. Achieving these two seemingly conflicting goals is a challenging task for the Financial Secretary.

Taxation is the most important source of revenue in Hong Kong, but the existing tax system and budgetary policy have been subject to heavy criticism on the grounds that they are too inequitable and mechanical. Without a genuine reform, it may not be able to achieve the above-mentioned objective. The Financial Secretary realized the dilemma and in fact did propose a reform. Unfortunately, he failed to spell out a viable long-term financial strategy and his tax reform proposal was narrowly focused and highly inequitable. He has repeatedly argued in his previous financial budgets that the Hong Kong tax system relies too heavily on direct taxation. The tax base must be broadened to ensure financial stability. The best way to achieve this objective is to introduce a broad-based wholesale sales tax (WST) at a low tax rate level. The Finance Secretary has also repeatedly asserted that there is no absolute rule as to the correct level of fiscal reserves. In the 1991/92 budget, he focuses attention on tax reform, and again raises the issue of fiscal reserves and government bonds, all of which are important revenue tools. However, the Financial Secretary only touches marginally on these issues simply by repeating his position; he does not engage in a genuine discussion that deals with the formulation of long-term financial strategy.

Based on the information given in the 1991/92 budget, we are not convinced that the Government has adequate financial resources to fund the large-scale infrastructure project and to maintain a satisfactory level of fiscal reserves. The following subsections discuss issues that must be resolved in order to develop a viable long-term financial strategy for Hong Kong.

A. *Reforming the Hong Kong tax system*

The Financial Secretary suggested in the 1991/92 budget and in his press conference the day after the budget was read that he was still considering the introduction of the WST. He may propose tax legislation if the report from the Commissioner of Inland Revenue on the technical aspects of levying this tax is favourable. The Financial Secretary reasons that broadening the indirect tax base by introducing the WST is crucial to the Hong Kong tax reform. He also claims to have achieved "political success" by convincing the business and professional communities of the need to introduce the WST in Hong Kong. Unfortunately, he did not convince the lower-income class of the merits of the WST because they will suffer more from this highly regressive tax. In fact, the Financial Secretary did not even consult the labour unions on the WST.[3]

The Hong Kong tax system has remained more or less intact during the past 40 years. There were only minor changes in the rates of various taxes in previous budgets. Thus the proposal to introduce the WST represents a fundamental change from the existing system because it is a broad-based indirect tax, a tax the underlying philosophy of which is different from the existing indirect taxes on specific goods and services. Because the WST signifies a fundamental change that will affect the entire tax system, it would be proper to undertake a comprehensive review of the entire tax system in order to increase its tax capacity and reduce its tax inequity. It would be much better than a piece-meal approach to tax reform and may be more acceptable by the general public. Therefore many Legislative Councilors, social organizations and academics repeatedly requested the establishment of a formal Taxation Review Committee to review the taxation philosophy and all matters related to taxation, such as how to broaden the tax base of direct and indirect taxes, the proper balance between direct and indirect taxation, etc. Unfortunately, the request was not entertained by the Financial Secretary.

The sole reason for rejecting the request is that the Financial Secretary was unwilling to allow anyone to share his exclusive and ultimate power in formulating economic and financial policies. The Financial Secretary also maintained that he did not want to see the discussion on tax reform being manoeuvred into a political issue. He also did not want to broaden the base of direct taxation, particularly the standard tax rate provision. The Financial Secretary rejected the request to establish a Taxation Review Committee several times. He has been subject to heavy criticism in the last year because of his biased approach to tax reform. Responding to this criticism, he announced in his concluding remarks at the adjournment debate on the 1990/91 budget that he would invite the Joint Liaison Committee on Taxation (JLCT) to review taxation philosophy and other tax issues. The JLCT[4] is a non-statutory committee that advises the Financial Secretary on technical tax matters and is mainly composed of tax accountants, tax lawyers and representatives from various Chambers of Commerce.

Since the JLCT comments mainly on technical tax issues, it would be inappropriate to review the philosophical and policy issues of taxation exclusively by JLCT. Moreover, JLCT maintains a low profile and its reports are confidential. The general public is unaware of the position and progress of JLCT on tax reform. In fact, the Financial Secretary did not formally announce the terms of reference of JLCT in reviewing the tax system. The general public is neither involved in nor informed about this important review. It is obvious that the Financial Secretary maintains his position that authority in tax reform rests with the Government and cannot be shared.

3. The Financial Secretary formally identified the wholesale sales tax in his 1988/89 financial budget as a possible candidate for broadening the base of indirect taxation in Hong Kong. A consultative paper on WST was published in May 1989. The paper was intended for consultation on the technical aspects of the possible introduction of a wholesale sales tax in the future. But the scope of consultation was restricted to professional (e.g. accountant and law society, etc.) and business (e.g. Chamber of Commerce, Retail Sales Association, etc.) organizations. The OMELCO (Office of Members of the Executive and Legislative Councils) Standing Panel on Finance, Taxation and Monetary Affairs was concerned that there should be thorough consultation with a wide cross-section of the community on this issue, not just confined to a selected business and professional organizations. The Panel also requested the opportunity to discuss the wider social, political and economic implications of such proposals before the WST were introduced. Comments from professional and business organizations were received but the results were not released by the Financial Secretary. There is no hint as to whether a wider scope consultation would be held before entering into tax legislation stage.

4. The JLCT was formed in October 1987 as a reconstituted extension of the former Joint Committee on PRC Double Taxation. The JLCT is an informal committee aiming at promoting liaison between Government and the private sector, and formulating advice to Government on mainly technical matters concerning taxation. The JLCT also contributes to the drafting of tax bills by offering critical and technical advice on a wide range of tax issues. The JLCT comprises Constituent Members (organizations) and Co-opted Members (individuals). There are now six Constituent Members, each nominating two representatives. (They are the American Chamber of Commerce, the Hong Kong General Chambers of Commerce, the Hong Kong Society of Accountants, the International Fiscal Association-Hong Kong Branch, the Law Society of Hong Kong, and The Taxation Institute of Hong Kong.)

Any delay in effecting a genuine review of the tax system by a wider representation from different sectors of the society would further illustrate the unresponsiveness of the tax system to social, economic and financial needs. Without broadening the tax base of both direct and indirect taxes, the system will be unable to generate more revenue to finance infrastructure investments. I do not know how to interpret the announcement of possible WST legislation in late 1991 made by the Financial Secretary in the press conference following the Second Reading of the Appropriation Bill. Is his decision supported by JLCT findings? What is JLCT's position on overall tax reform and on the WST? Why does the Financial Secretary choose to announce the development of the WST issue in the press conference, rather than in the main text of the 1991/92 financial budget? All these questions must be addressed before any tax reform proposal can be entertained.

B. *Fiscal reserves*

In order to accumulate a satisfactory level of fiscal reserves, various guidelines had been adopted to suggest the minimum required level. In the 1970s, the then Financial Secretary Sir Philip Haddon-Cave developed a set of budgetary guidelines, including the guideline on fiscal reserves. The fiscal reserves guideline provides that at the beginning of the financial year the free fiscal reserves[5] should not be less than 15 percent of total budgetary expenditure. This guideline circumscribes the growth of public expenditure to the level of fiscal reserves. Nevertheless, in the 1986/87 financial budget, Sir John Bremridge proposed a new format on Mid-Range Forecast which incorporated some of the budgetary guidelines established by Sir Philip, but he excluded the guideline on fiscal reserves. In his first financial budget presented in 1987, the Financial Secretary Sir Piers Jacobs argued that there was no absolute guideline as to the correct level of fiscal reserves and formally abolished the relationship between the level of fiscal reserves and public expenditure.

Because of the lack of a formal budgetary guideline on fiscal reserves and the pressure to finance the new airport by using fiscal reserves, Mr. Lu Ping, the Director of the Hong Kong and Macau Affairs Office, State Council, People's Republic of China, recently expressed his concern that too little fiscal reserves would be handed over to the future Special Administrative Region Government by the Hong Kong Government. It was also reported that the Chinese Government has requested that a specific amount of fiscal reserves be set aside for the future Special Administration Region Government in 1997. The crux of the problem is identification of the criterion used by the Chinese Government in determining that specific amount of fiscal reserves. Eventually the discussion will return to the guideline issue. Unfortunately, the 1991/92 financial budget discussed only the importance and uses of fiscal reserves, and did not address the guideline issue, i.e. how much of the fiscal reserves could be used to finance investment in the new airport and how much has to be set aside for contingencies, etc.

At the beginning of the 1991/92 financial year, the Hong Kong Government had accumulated over $ 72.7 billion, which is over 60 percent of total budgetary expenditure. Without any outstanding public bonds, the financial position of the Government is very healthy. However, the situation will deteriorate as the Government must finance the construction of the new airport. The Mid-Range Forecast of the 1991/92 financial budget suggests that the fiscal reserves will be reduced to approximately $ 40 billion in 1994/95, representing 23 percent of total public expenditure in 1994/95. Is that level of fiscal reserves satisfactory? Are there any special commitments that the future Special Administrative Region Government must fund with the fiscal reserves? How will the level of fiscal reserves affect the confidence of investors in buying Hong Kong Government bonds to be issued in late 1991? The Financial Secretary cannot avoid addressing these crucial issues.

C. *Government bonds*

The new airport should be financed partly by government bonds. Government bonds were used as one of the important fiscal tools to finance fiscal deficit in the 1970s and 1980s. However, the present proposal for issuance of government bonds serves one more purpose, i.e. to activate and develop the bonds market in Hong Kong, an important step for effective monetary and fiscal policy. Sir Philip established stringent guidelines on the issuance of government bonds in order to limit the government's obligation to service the debt. Those guidelines are as follows:

(1) the proceeds from bond sales must be used in capital expenditure;
(2) the amount of government bonds should not be greater than one half of the non-recurrent account deficit;
(3) the interest expenditure of government bonds should not be greater than the interest income generated by fiscal reserves.

In view of the new function of government bonds, the above guidelines should be revised. The Financial Secretary should also specify the proportion of investment in the new airport to be financed by government bonds and its implication for government spending in servicing the debt.

III. CONCLUDING REMARKS

This is the last financial budget that will be presented by Sir Piers as he officially retires in June. It was his intention to present a "good" budget, as he openly conveyed this message in his press conference before the reading of the Appropriation Bill. Unfortunately, Sir Piers is too conservative and meticulous to undertake new ideas and to review the policy and technical issues of financial management in Hong Kong. A comprehensive review of the tax system is crucial to developing a viable long-term financial strategy. Sir Piers missed the golden opportunity during his tenure to embark on this important task and failed again in the 1991/92 financial budget to recognize this urgent need. The tax burden issue will become even more controversial in the years to come which could cause more social unrest and conflict.

5. Free fiscal reserves is defined as total fiscal reserves minus the reserves set aside as assets to secure the Government's contingent liabilities. Since the nature of the contingent liabilities is such that the Government is most unlikely ever to be called up to meet them, so the Financial Secretary sets a gearing factor of three for the contingent liabilities, i.e. fiscal reserves equivalent to one third of the value of the contingent liabilities were set aside (see Para. 106, 1977/78 Financial Budget, Hong Kong).

IFA NEWS

BRITISH BRANCH

On 25 April Mr. Ian Hunter, Senior Principal Inspector of Taxes, Inland Revenue, International Division spoke at the annual "Supper Meeting" on recent developments in international transfer pricing.

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The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1991 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Loose-Leaf Services

Received between 1 - 30 April 1991

Africa

FIDAFRICA

release 4
Fidafrica, Paris.

FISCALITE AFRICAINE

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Australia

AUSTRALIA INCOME TAX - LAW AND PRACTICE

- Legislation
  releases 18, 19
- Rulings and Guidelines
  releases 85, 86

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SUPERANNUATION AND RETIREMENT BENEFITS IN AUSTRALIA

Brown - Edstein
release 12
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Belgium

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L'INDICATEUR FISCAL

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CED-Samsom, Brussels.

Canada

CANADA'S TAX TREATIES

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International Tax Planning & Offshore Services. Valletta (Malta), 2-6 September (English):
International Tax Planning Course, Foundation for International Studies, St. Paul Street, Valletta, Malta (Attention: Mr. Michael Formosa Gauci). Tel.: (356)-240353; Fax: (356)-230551.

Internationale Steuerberaterseminare Deutschland – Österreich – Schweiz: Basisseminare Deutschland. München, 6-7 September (German):
Bundessteuerberaterkammer, Postfach 1340, 5300 Bonn 1, Federal Republic of Germany. Tel.: 02 28/726 3924. Fax: 02 28/726 3952.

International Conference on Property Taxation and its Interaction with Land Policy. Cambridge, Massachussetts, 22-26 September; Technical Workshop 27-28 September (English):
Lincoln Institute of Land Policy, Attn.: Mrs. Ann Long, Registrar, 26 Trowbridge Street, Cambridge, MA, 02138, U.S.A. Tel.: 617-661-3016; Fax: 617-661-6596.

I.T.P.A. Monte-Carlo Workshop. Monte-Carlo, 23-24 September (English):
Ms. Elisabeth Husband, I.T.P.A., Membership and Conference Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

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U.S. IFA ANNUAL MEETING

This issue contains the text of several of the papers presented at the Annual Meeting of the U.S.A. branch of IFA. The meeting was held in Chicago on 28 February – 1 March 1991.

The advent of 1992 heralds major changes in the way in which cross-border business will be conducted both within and outside the EC. These changes will necessarily affect the decisions of U.S.-based corporations whether to invest in Europe. Experts from both sides of the Atlantic discussed and debated the recently adopted tax measures in the EC and the anticipated response from U.S. business and the U.S. government.

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1990 was an industrious year for the European Community. After years of protracted discussions three measures were adopted – all three aim to eliminate major tax barriers to cross-border activities and facilitate cooperation between enterprises of the different member states. Mr. Goergen overviews the contents of the parent/subsidiary directive, the merger directive and the arbitration convention for transfer pricing disputes. He provides a context for these measures by outlining the decision-making process of the EC.

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This paper explains how the VAT system operates and the changes in its application to cross-border trade after 1992. Mr. Wilkins also discusses the old "turnover" taxes and how VAT – though more complicated – overcomes certain problems by turnover taxes.

EUROPE IN 1992: A U.S. TAX PERSPECTIVE — 328

Donald L. Meier

The fate of U.S. multinationals in Europe after 1992 will depend on a number of factors: having the right structure, the right strategy and needless to say, tax considerations. It is generally agreed that U.S. corporations may find themselves at a distinct disadvantage compared to their European counterparts after 1992 because existing U.S. tax law severely hinders the ability of U.S. companies to compete against EC-based companies. This paper discusses the way in which legislative and regulatory change in the United States could help put U.S. companies in Europe on an equal footing with their foreign competitors.

REDUCING THE IMPACT OF FOREIGN TAXES ON THE GLOBAL TAX BURDEN OF U.S.-BASED MULTINATIONAL COMPANIES — 332

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Changes to U.S. tax law in the 1980s have all but eliminated (or rendered useless) many of the previously used source conversion and expense allocation minimization techniques. As a result, emphasis has shifted towards resolving the problem at its source, i.e. reduction of foreign country tax burdens. This article provides a framework and some specific techniques for foreign tax reduction in today's environment.

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UNITED STATES: ADVANCE PRICING AGREEMENTS UNDER REVENUE PROCEDURE 91-22 — 356

James R. Mogle

The increasingly aggressive approach of the IRS in respect of transactions between U.S. taxpayers and their foreign affiliates is well documented. Section 482 enforcement efforts are even directed toward normal transactions involving affiliates located in developed countries that are U.S. treaty partners. While the IRS has been concentrating on developing improved enforcement tools and techniques to improve its effectiveness in challenging transfer pricing among multinationals, it has also made a serious effort to develop an alternative approach to the resolution of transfer pricing disputes, i.e. the Advance Princing Agreement. Under this procedure a U.S. taxpayer may enter into an agreement with the IRS regarding the prospective U.S. income tax consequences of transfer pricing methodologies. This paper examines the APA – how it works, its benefits and potential pitfalls.

INTERNATIONAL: THE NORTH AMERICAN FREE TRADE AGREEMENT AND CURRENT U.S. TRADE POLICY IN LATIN AMERICA 368 *David A. Gantz and Kevin Lara*

The United States is currently making Mexico and Latin America the major focus of its trade expansion efforts through a proposal for a North American Free Trade Area and its hemisphere-wide Enterprise for the Americas Initiative. There is broad consensus among the United States, Canada and other countries in the hemisphere that increased trade, open borders and broad investment reforms will promote economic growth. Further, the United States will be able to compete more effectively with the EC and Japan as a member of a trade bloc, rather than on its own. This article summarizes U.S. efforts to conclude a NAFTA and other special trade relationships with the nations of the hemisphere.

FOREIGN INVESTMENT IN THE UNITED STATES: PLANNING ALTERNATIVES IN CONDUCTING OR ACQUIRING A U.S. BUSINESS 373 *Stanton A. Kessler and Lawrence J. Zlatkin*

This article will be of interest to all potential investors into the United States as it comprehensively analyzes tax planning alternatives for foreign investment.

CONTINUING TAX REFORM PROGRAMME IN NEW ZEALAND 385 *Andrew M.C. Smith*

The Consultative Committee on the Taxation of Income from Capital has released two discussion papers, one on the core provisions of the Income Tax Act 1976 and the other on tax accounting issues surrounding the determination of income for business taxpayers. This article reviews some of the recommendations made by the Committee in the two papers.

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HARMONIZATION OF ENTERPRISE TAXATION IN THE EUROPEAN COMMUNITY

Robert Goergen

1990 was a significant year for the European Community ("EC") in respect of the harmonization of direct taxes. On 23 July, after years of protracted discussions, the Council of Ministers finally reached agreement on three measures, two of which were adopted as directives, i.e. the parent/subsidiary directive[1] and the merger directive,[2] and a third which was approved as a multilateral convention, i.e. the convention on the elimination of double taxation resulting from the adjustment of transfer prices.[3] Adoption of these measures represents a momentous step on the path to eliminating major tax obstacles to transnational activities and facilitating cooperation between enterprises of different member states.

Robert Goergen: Director for company law and direct taxation, Commission of the European Communities, Brussels

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IV. Conclusion

However, other direct tax obstacles to cross-border cooperation remain and the Commission intends to give these areas top priority since Community tax legislation should be completed by 1 January 1993, i.e. the deadline set by the Single European Act for the completion of the internal market. Two additional proposals (discussed below) have already been tabled, and others may follow.

The need to adopt additional harmonization measures after 1993 in connection with the realization of the internal market has yet to be determined. This is an issue which has sparked considerable controversy – an issue which needs careful examination. The Commission recently established a committee of independent experts to undertake an in-depth study of harmonization, and the Commission will base its decision whether or not to present additional proposals on the results of this investigation.

Before addressing various issues in this regard, I will briefly describe the decision-making process of the EC, particularly in the field of direct taxes.

I. THE DECISION-MAKING PROCESS IN THE COMMUNITY

Three institutions are involved in the decision-making process: the Commission, the Council of Ministers and the European Parliament.

The Commission, which comprises 17 members appointed by the governments of the member states, is the executive institution. The Commission initiates the legislative procedure by formulating proposals. In formulating proposals the Commission consults experts from the 12 tax administrations as well as representative organizations of industry such as UNICE, banks, tax advisers, trade unions, etc. Commission proposals are in the form of draft regulations, directives or "decisions" which are then submitted to the European Parliament for consultation and to the Council of Ministers for deliberation.

The European Parliament, composed of 518 representatives, is primarily a consultative and supervisory body. Although consultation with the Parliament is not mandatory in every case, it is mandatory for draft proposals leading to Council adoption of a directive, regulation or formal decision.[4]

The procedure to be followed differs slightly for indirect and direct taxes. Whereas proposals on indirect taxes only require consultation with the European Parliament, proposals on direct taxes must also be submitted to the Economic and Social Committee ("ESC"). The ESC consists of representatives of various categories of economic and social activities.

The Council of Ministers consists of one representative member of each of the 12 member state governments. The Council is the legislative arm of the EC. In general the Council can only enact Community legislation on the basis of a proposal from the Commission. Since the Single European Act entered into force in July 1987, most decisions can be taken by qualified majority. However, all decisions on tax matters require a unanimous vote.[5]

1. Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 90/435/EEC; *Official Journal of the European Communities* ("OJ") No. L225 (20 August 1990). This directive was first proposed in 1969.
2. Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, 90/434/EEC, OJ L225 (20 August 1990). This directive was first proposed in 1969.
3. Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 90/436/EEC, OJ L225 (20 August 1990). Discussions on this instrument began in 1976, and it was initially introduced as a directive.
4. Regulations are the most authoritative type of EC legislation, i.e. they are binding in their entirety on member states, and unlike directives, no domestic legislation need be passed to implement them. Formal decisions are directed to a particular member state and are only binding on the state to which they are addressed.
5. EEC Treaty, Art. 100(a). Will it be possible to have majority voting in the future? This issue is currently being debated in the framework of two intergovernmental conferences which are preparing new treaty provisions on economic and monetary union and on political union. It is impossible to predict the outcome of these negotiations.

Article 100 of the EEC Treaty is the most important basis for decisions concerning direct taxes.[6] It provides for approximation of the legislation of member states by way of directives.[7]

In addition to Article 100, the Treaty contains another provision which may serve as a basis for tax measures, i.e. Article 220, which provides, inter alia, for the conclusion of a convention between member states with a view to eliminating double taxation. Article 220 is of a subsidiary nature, however, and can only be used if Article 100 does not provide an appropriate legal basis. In fact, Article 220 has been used only once in the tax field, namely for the recent convention on the elimination of double taxation in connection with the adjustment of profits between associated enterprises.

II. ELIMINATION OF TAX OBSTACLES TO CROSS-BORDER ACTIVITIES OF ENTERPRISES

A. *Recent measures*

After 21 years of discussions, on 23 July 1990 the Council adopted two directives: the parent/subsidiary directive and the merger directive. At the same time, representatives of the member states signed a convention on the elimination of double taxation resulting from the adjustment of transfer prices. Enabling legislation under both the parent/subsidiary directive and the merger directive is required by 1 January 1992. No date has been fixed for the convention which will enter into force once it is ratified by all member states.

1. The parent-subsidiary directive

This directive provides for the elimination of double taxation of profits distributed by a subsidiary to its parent company in another member state. In order to benefit from the provisions of the directive, both the parent and the subsidiary must have been created under the laws of one of the member states[8] and must be subject to corporation tax in that state. A company will be considered to be a parent company if it holds a minimum of 25 percent of the capital of the subsidiary. Member states may, however, establish lesser participation requirements, as is already the case in certain states.[9] They may also require that the participation be held continuously for at least two years.

Double taxation under the directive is eliminated as follows: the state where the parent company is resident must either exempt from tax profit distributions by a subsidiary to its parent or allow the parent a tax credit for the withholding tax and the corporation tax paid by the subsidiary on the profits out of which the dividends are paid. The state where the subsidiary is resident must not impose any withholding tax at all on such distributions. However, the directive provides for temporary derogation from the exemption of withholding taxes in the case of three member states: Greece, Portugal and Germany.

Greece may apply a withholding tax as long as it does not tax distributed profits. Portugal is granted an eight year derogation, i.e. withholding tax may be levied at the rate of 15% for five years and at the rate of 10% for a further three years. For both countries, however, the rate of the withholding tax may not exceed the rates agreed upon bilaterally with other member states.

The German derogation is by far the most important one in economic terms. So long as corporation tax is imposed on distributed profits at a rate at least 11 points lower than the rate applicable to retained profits, and at the latest until mid-1996, Germany may impose a withholding tax of five percent in order to compensate for the difference between the two corporate tax rates (36 percent on distributed profits and 50 percent on retained profits) and to place foreign and German parent companies on an equal footing.[10]

2. The merger directive

The merger directive ensures the removal of the fiscal barriers to cross-border mergers, divisions, transfers of assets and exchanges of shares resulting from the taxation of latent capital gains at the time one of these operations takes place. The directive only applies where both companies are resident in EC member states. When such a transaction takes place between companies of the same member state, taxation of capital gains is deferred until the gains are actually realized. The merger directive provides for the same system to apply to cross-border mergers, i.e. a deferral of tax on any gains arising on the transferred assets. To safeguard the taxing rights of the country where the transferring or acquired company is situated, the assets which are being transferred must remain connected with a permanent establishment of the receiving or acquiring company.

The directive defines two situations where member states may derogate from the provisions contained therein. Member states need not apply the merger directive where the transaction concerned is motivated by tax evasion or tax avoidance (e.g. there are no valid commercial justifications for the merger, division, etc.).

The second situation – which is not based on tax considerations – can only be understood against the background of legislation – prevailing in certain member states, that is legislation which provides for employee participation on company boards (co-determination provisions). For example, Germany was concerned that domestic companies might merge with companies from other member states in order to thwart its particularly stringent employee participation laws. The directive therefore allows a member state not to apply the directive if a merger or similar operation results in a loss or an alteration of employee rights. The practical importance of this option should not be over-estimated, however. So long as there is no Community legislation in the field of company law with respect to international mer-

6. This article reads as follows:
"The Council shall, acting unanimously on a proposal from the Commission, issue directives for the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the common market. The European Parliament and the Economic and Social Committee shall be consulted in the case of directives whose implementation would, in one or more Member States, involve the amendment of legislation."

7. According to the Treaty, a directive is binding upon each member state to which it is addressed as to the result to be achieved, but it is up to the authorities of each member state to choose the form and method of implementation. In order to become applicable in a member state, a directive needs therefore to be transposed in national legislation.

8. As a general rule the types of entity which qualify for the benefits of the directive are the public company, the limited company and the partnership limited by shares.

9. For example, the affiliation privilege in France, Germany, Luxembourg and the Netherlands requires a holding of 10%, 10%, 10% and 5%, respectively.

10. It was the disagreement on the German problem which delayed the adoption of the package of three measures. The matter was resolved only after negotiations between Germany and the United States on a revised tax treaty were concluded.

gers, the directive will only apply to the transfer of assets and to the exchange of shares. In the latter case the issue of employee participation does not arise; however, I think it can easily be avoided in the case of a transfer of assets.

3. The convention on the arbitration of transfer pricing disputes

This measure, also designed to reduce fiscal obstacles, is a revolutionary innovation in international tax law. For the first time, tax administrations are legally obligated to eliminate international double taxation, and a time limit is set to resolve disputes regarding transfer pricing adjustments. The convention contains precise rules and procedures to be followed to ensure elimination of double taxation affecting associated enterprises as a consequence of transfer price adjustments.[11]

The EC Convention provides for the general application by all member states of a mutual agreement procedure as envisaged in Article 25 of the OECD model convention. It should be stressed, however, that any agreement reached on the basis of the EC Convention must be implemented regardless of any time limits prescribed by the domestic law of the contracting state.

If the competent authorities fail to reach agreement within two years from the date the case was first presented, the competent authorities must initiate the arbitration procedure. To this end, they must set up an advisory commission, whose task it is to deliver an opinion on the elimination of double taxation within six months from the date the matter was referred to it.

The arbitration commission must comprise, in addition to an independent chairman, two representatives of each of the competent authorities concerned and an even number of independent persons of standing. By mutual agreement, the number of representatives of the competent authorities may be reduced to one.

Although the arbitration commission will submit its opinion on how to eliminate double taxation, the competent authorities are not required to adopt the opinion. The competent authorities may eliminate double taxation by a method different from that recommended by the commission. However, if they fail to reach an agreement within six months, the competent authorities must adopt the opinion of the arbitration commission. Double taxation will thus be eliminated within a maximum period of three years from the date the case was first presented to one of the competent authorities. Under certain circumstances, however, this outcome may not be achieved. More specifically, when one of the enterprises concerned has been subjected to a serious penalty because of its transfer pricing practices, or where judicial proceedings have been instituted for that reason, the competent authority is not obliged to initiate the mutual agreement procedure or the arbitration procedure; in fact the competent authority may suspend such procedures.

B. *New Commission proposals*

On 28 November 1990, the Commission adopted two proposals to supplement the above measures. One proposal – which logically extends the provisions of the parent/subsidiary directive – provides for the elimination of withholding taxes on payments of interest and royalties between parent companies and subsidiaries. The other proposal concerns loss relief for permanent establishments and subsidiaries situated in other member states.

1. Elimination of withholding taxes on interest and royalties

Although the application of withholding taxes on interest and royalties paid between affiliated companies does not in general give rise to double taxation, it entails administrative and financing costs which are clearly incompatible with the functioning of an internal market. Elimination of these withholding taxes should not give rise to serious difficulties given that a majority of bilateral tax treaties already provide for exemption. Zero rates or reduced rates, however, are generally granted only after the fact, i.e. the enterprise must first pay the full rate and then apply for the reduced rate.

Under these circumstances, the Commission is of the opinion that the objective of eliminating withholding taxes can be achieved by 1 January 1993. Temporary derogations are proposed for Greece and Portugal, which are important net importers of capital and technology.

The Council has begun deliberations on this proposal. However, there has been a rather surprising development. Contrary to the position adopted in the preliminary stages of preparation, a majority of national delegations now take the view that abolition of withholding taxes should be extended to all enterprises, whether or not related. The Commission, which had envisaged elimination of withholding taxes in two stages, would welcome such a solution.

2. Loss relief for permanent establishments and subsidiaries

The loss-offsetting provisions in the member states are in many cases clearly discriminatory as far as cross-border activities are concerned. This is true not only with respect to branches, which are not separately taxed entities within national borders, but also for subsidiaries – fiscally separate entities – for which nine out of 12 member states apply special group consolidation or loss relief systems.

The proposed directive permits two methods of loss relief in respect of the losses of permanent establishments, i.e. a tax credit (imputation) method, or an exemption method combined with loss deduction and taxation of subsequent profits up to the amount of the losses previously deducted.

Losses of subsidiaries may only be relieved by the exemption method. However, member states may provide for additional methods of loss relief. To qualify as a subsidiary under the proposed directive, at least 75 percent of the capital must be owned by the parent. Member states are free to reduce the minimum participation requirement on the condition that they require that the parent hold a majority of the voting rights of the subsidiary.

The loss deduction method will always be advantageous for an enterprise, whereas the consolidation method may lead to an additional tax burden for the parent. Given the great diversity of tax rates and base rules within the EC, it will often be difficult, if not impossible, for an enterprise to assess the likely results of a consolidation system.[12]

Although the provisions of the directive are compulsory only in respect of branches and subsidiaries situated within the EC, member states would have the option to extend the benefits to permanent establishments and subsidiaries situated in countries outside the EC.

11. The convention only applies to disputes involving transfer pricing and not to other disputes which are encountered in the context of a double taxation agreement.
12. This is certainly one of the reasons why so little use is made of the French "bénéfice consolidé" regime.

Member states would be free to automatically reincorporate losses that have been deducted from the enterprise's taxable profits in certain circumstances, particularly if the permanent establishment or subsidiary has not made profits by the end of the fifth year following the year of the loss deduction.

Deliberations and a decision on this proposal are not expected to proceed as easily as anticipated on the other proposal. In particular, the provisions on subsidiaries are likely to raise serious reservations.

A useful corollary to this directive is the adoption of common rules on the carryover of losses, as proposed in 1984 by the Commission, at least as far as carryforward is concerned. In the absence of such rules, automatic incorporation of losses after 5 years could lead to double taxation.[13]

C. *Other possible measures*

Besides extending the scope of application of the parent/subsidiary directive with the proposed interest and royalties directive, the Commission is currently studying how double taxation arising from differing transfer pricing adjustments could be prevented. The convention on arbitration, once applied, will bring about a notable improvement, but it only guarantees elimination of double taxation once it has occurred. The ideal solution to this problem would be the adoption and uniform application of common transfer pricing rules. However, this is a long-term objective. In the meantime, less ambitious measures can be envisaged, i.e. the organization of simultaneous or joint tax audits of multinational companies having branches or subsidiaries in different member states and the development of advance rulings.

III. THE NEED FOR FURTHER HARMONIZATION MEASURES

The Commission has long been convinced that full harmonization of corporate tax systems, as well as of the taxable bases of enterprises, was a necessary condition for the establishment and proper functioning of the common market. This view was shared by the six original member states and was reflected in the resolution adopted by the Council in the early 1970s on the gradual realization of economic and monetary union. This view led the Commission in 1975 to present a draft directive on the harmonization of corporate tax systems based on a partial imputation system,[14] and to pave the way for harmonization of the rules for the determination of taxable profits.

This unity of views no longer exists. While some member states continue to support the need for harmonization, other member states consider that the approximation of tax systems will come about as a result of competition of national rules and the pressure of market forces.

The Commission considers that the empirical evidence available does not allow a clear and uncontroversial choice between these two approaches. It therefore withdrew its 1975 proposal on corporate tax systems and abandoned the presentation of a proposal on harmonization of the tax base.[15] At the same time the Commission set up the committee of "wise men" under the chairmanship of Mr. Onno Ruding, the former Dutch Finance Minister, whose task it will be to undertake a general review of harmonization and answer the following main questions:

- Do the differences in national tax legislation create major distortions in investment decisions and competition?
- If so, is it possible to rely on market forces to eliminate these distortions?
- If Community-wide measures are called for to counteract such distortions, how should they be worded?

The Committee's report should be available within one year and provide a sound basis for a final policy decision.

IV. CONCLUSION

The taxation of enterprises will continue to be high on the Community's agenda in the coming years. The most urgent task will be to complete the elimination of tax obstacles to cross-border activities of firms. Decisions on further, more far-reaching measures will depend on the findings of the committee of independent experts.

13. In 1984/85, the Commission proposed unlimited carryforward and carryback for three years.
14. Draft Directive for the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends, COM (75) 392 final.
15. Guidelines on Company Taxation, *Commission Communication to Parliament and Council*, 20 April 1990 SEC (90) 601 final.

IFA NEWS

BRITISH BRANCH

Mr. Leonard Beighton, Director General, Inland Revenue and Mr. Malcolm Gammie, tax partner, Linklaters & Paines were the guest speakers at the May meeting of the British branch. The topic – "Current Developments from the Work of the Tax Law Consultative Committee".

BRITISH AND U.S. BRANCHES

A joint seminar of the U.S. and U.K. branches will be held on 3 – 4 October 1991 at the Le Meridien Hotel in London. Experts from both sides of the Atlantic will discuss transfer pricing (including methodology, APAs, use of specialists), exchange of information and relief under the competent authority procedure, impact of EC tax directives on U.S. groups with European operations, foreign tax credit relief, taxation of foreign exchange gains and losses and issues relating to expatriates.

EUROPEAN COMMUNITIES:

EC TAX HARMONIZATION:

"A EUROPEAN BUSINESS AND INDUSTRY VIEW"

Jan A.A. van der Bijl

I. INTRODUCTION

With the deadline for the creation of a genuine EC internal market rapidly approaching, the issue of tax harmonization in the EC has gained fresh momentum. This particularly applies to the area of indirect taxation where the planned abolition of fiscal frontiers on 1 January 1993 requires an overhaul of the VAT system currently applied to cross-border transactions within the EC. Further, it seems that the abolition of indirect tax frontiers will require a considerable approximation of VAT and excise duty rates as applied in the various EC member states.

The prospect of a full-fledged operative common market within a couple of years has also given new impetus to harmonization efforts in the direct tax area, however difficult this harmonization may have proved to be in the past.

It seems self-evident that in a real internal market business and industry should be able to engage in cross-border trade, and expand on a Community-wide basis with as little hindrance from tax obstacles as they would face if they were operating within one EC member state. We are still far away from achieving such a situation in the EC. It was only very recently that the first encouraging step was made towards removing direct tax impediments, but much work remains in this area.

European business and industry are keenly interested in the issue of EC tax harmonization as almost every development in this area – or, for that matter, lack of development – affects their costs and, consequently, their competitive position.

As more and more decision-making on EC taxation issues takes place in Brussels, it is of prime importance to European companies to make their views known not only to their national tax and financial authorities but also to EC-level institutions, such as the European Commission, the Council of Ministers and the European Parliament. One of the organizations which is particularly active in this respect is the Union of European Industry Federations ("UNICE" after its French acronym), which is recognized as the official spokesman for European business and industry vis-à-vis the EC institutions.

UNICE's statements and position papers on EC tax developments accurately reflect the general views held by European business and industry as a whole and much of this paper is based on these views. This does not alter the fact that certain sectors of business and industry have different opinions depending on their specific activities, specific tax regimes, position in the market or their EC member state of residence.

Currently two EC taxation issues are the focus of interest for European companies:

- the adjustment and further harmonization of the VAT system as a consequence of the abolition of indirect tax frontiers within the EC;
- the harmonization of company taxation, including corporate taxes, withholding taxes and special business taxes.

This paper will briefly touch upon the first issue whereas the second issue will be discussed somewhat more extensively.

II. VAT HARMONIZATION

The planned abolition of indirect tax frontiers within the EC on 1 January 1993 requires an adjustment of the current system of levying VAT on intra-EC cross-border transactions. Under the new system the concepts of "importation" and "exportation" will no longer play a role, since they conflict with the concept of a Community-wide domestic market. However easy this may sound, the design of a new system is desperately complicated by the political precondition that it should not materially affect the current budgetary VAT revenues of the various member states.

The original proposals for a new system as made by the EC Commission were rejected by the member states because they objected to the introduction of a central clearing system aimed at cancelling out the budgetary pluses and minuses between them. As a result of intense discussions between the Council and the Commission over the past months a sort of compromise system has been developed which stays much closer to the current system, eliminates the need for a clearing-house system between the member states and relies heavily on exchange of information and cooperation between the VAT administrations of the various member states.

In addition to the change in the way VAT will be levied on cross-border transactions, there is yet another problem to be solved, i.e. the level and number of VAT rates as applied in the member states. Currently, the differences are significant and countries with relatively high rates fear that opening frontiers without a sufficient degree of approximation of the level and number of VAT rates within the EC will lead to massive cross-border shopping in neighbouring low tax countries by private consumers.

Jan A.A. van der Bijl: Senior Tax Manager, Unilever and secretary to the Tax Committee of UNICE (the Union of European Industry Federations).

To solve this problem the Commission has proposed that the number of rates be restricted to two and that upper and lower limits be set for the level of these rates. Council discussions on this very sensitive issue will commence shortly and it may well turn out to be the hardest nut to crack before indirect tax frontiers can really be abolished.

Obviously, European business and industry attach considerable importance to the elimination of indirect tax barriers within the EC. The delay, red tape and cost-inefficiency inherent in these barriers have long been an irritant and nuisance to companies involved in cross-border transactions within the EC. However, this positive attitude towards the abolition of indirect tax frontiers does not imply support at any cost. For a new system to be acceptable to European business and industry three conditions should be met:

- fiscal border controls and formalities should be totally removed;
- no additional compliance burden should be imposed on companies (in fact it should be reduced);
- no substantial distortion of competition should be created.

Against this background a number of critical comments have been made with regard to the system currently under consideration by the Council. The criticism relates to technical aspects, such as the creation of a new taxable event called "acquisition" which is meant to replace the notion of "importation" but is likely to add complications rather than eliminate them. Further, the European business community strongly opposes the introduction of the requirement for exporters to send quarterly lists to their tax administrations identifying sales to companies based in other member states. Most EC member states do not impose such a requirement at present and in these cases companies would be confronted with additional reporting requirements which might well be extended in the future. Finally, there are serious objections to the way in which the Commission has proposed to structure the exchange of information and cooperation between the member states' tax administrations for the purposes of monitoring the proper operation of the system and preventing fraud.

The European business community regards the proposals as defective because they do not provide sufficient and adequate protection to the taxpayer. They appear to override restrictions on obtaining information from taxpayers as currently laid down in the member states' national tax laws and they further give the EC Commission a coordinating and supervising role which seems to go beyond what can be seen as a justifiable level of involvement for an institution which itself does not levy the taxes concerned.

On the issue of approximation of VAT rates European business and industry have had some difficulty in speaking with one voice. This should not come as a surprise, since companies in high rate countries are likely to suffer from the opening of fiscal frontiers, whereas their competitors in low rate countries will reap the benefits. It is no wonder that the former tend to favour at least a substantial approximation or even unification of rate levels before frontiers are opened up, whereas the latter are more indifferent and claim that market forces will force down high rates in any case.

From the above it should be clear that there is still a long way to go before the European VAT system will be reshaped for the post-1992 era in a way that will be reasonably satisfactory for all parties concerned.

The member states will need to show a great deal of political will to bridge the gaps which still exist between them and it appears uncertain whether the 1 January 1993 deadline for the introduction of the new system will be met.

III. HARMONIZATION OF COMPANY TAXES

From the time the European Community emerged in 1957 until mid-1990 little had been achieved in the field of direct tax harmonization. The EC Commission is certainly not to blame for this lack of progress. Proposal after proposal was submitted to the Council, but all proposals, with the exception of one, were almost immediately shelved. There seemed to be an implicit understanding amongst the member states that harmonization of direct taxes was something of very low priority, if indeed necessary at all. The one proposal which survived in this period of 33 years was a directive on the mutual assistance by tax administrations in the area of direct taxation.

In a way, 1990 seems to be the year in which the deadlock on harmonization of company taxes was broken. The most memorable event in this respect was the adoption by the Council of a package of three proposals, two of which were submitted to the Council as long ago as 1969.

The most important part of the package is known as the parent/subsidiary directive, aimed at abolishing the withholding tax on intercompany dividends paid by subsidiaries to parent companies within the EC. The adoption of the package was delayed for many years primarily because of the unwillingness of the German government to abolish entirely the withholding tax on outbound intercompany dividends.

The package further contained a directive on the fiscal treatment of cross-border mergers within the EC. This directive eliminates fiscal obstacles to cross-border mergers by postponing the realization of capital gains on assets or shares involved in a merger until they are actually sold by the newly-merged company.

The third element of the package is a draft multilateral convention between the member states which introduces an arbitration procedure. This procedure must be invoked by the competent authority of member states if they fail to agree on how to eliminate double taxation within two years after a case has been submitted to them by the taxpayer concerned. A recommendation will then be issued by an arbitration commission which will be binding on these member states concerned if the competent authorities are stilll unable to reach agreement within six months after the recommendation is made.

European business and industry have been lobbying intensively in favour of these proposals for a long time and their adoption has been welcomed as a major breakthrough.

A second interesting development which took place in 1990 was the switch in focus by the EC Commission. In the past the Commission spent considerable time and resources on efforts to harmonize the structure, rates and taxable base of the corporate taxes applied by the member states. However, the idea of a full-fledged, comprehensive harmonization of corporate taxes has always met with fierce reluctance on the part of the member states which seem to regard this as an unacceptable breach of their fiscal sovereignty.

In April 1990 the Commission explicitly disassociated itself from the idea of comprehensively harmonizing corporate taxes and publicly announced that harmonization efforts in the direct tax area would in the future be concentrated on those elements of company taxation which may give rise to international double taxation and which thus create obstacles to cross-border expansion of companies within the EC. This more pragmatic approach is fully in line with the views of European business and industry whose views were expressed in a letter sent by UNICE at the end of 1989 to Mrs. Scrivener, the Commissioner responsible for direct tax harmonization.

This letter listed the priorities which European business and industry feel should be set in harmonizing taxes on companies:

(1) Featured at the top of the list was the package of three draft directives mentioned above, which have been adopted.

(2) As a second priority UNICE identified the so-called Community-wide consolidation of losses. On the basis of such an arrangement parent companies or head offices based in a member state would be allowed to offset against their domestic taxable income losses incurred by subsidiaries or branches based in other member states.

(3) In relation to item 2, the Council was urged to adopt the Commission's proposal regarding the carryover of losses. This proposal provides for an unlimited carryforward of losses as well as a three-year carryback. The proposal is particularly attractive for European business and industry as it is more favourable than the regimes for carryover of losses as currently applied by most member states.

(4) The abolition of withholding taxes on intercompany royalties and interest paid and received within the EC. These measures seem to be a logical follow-up to the abolition of the withholding tax on intercompany dividends.

(5) As its fifth point UNICE mentioned the abolition of non-profit-related direct taxes. Taxes of this kind are applied in some member states (e.g. the "Gewerbesteuer" and "Vermögensteuer" in Germany and the "taxe professionnelle" in France). Their removal would eliminate another source of distortion of competition within the EC.

(6) Finally, the Commission was asked to take initiatives aimed at ensuring the deductibility of pension fund contributions. Some member states do not allow the deduction of such contributions if paid to a pension fund which is not based in the country where the personnel are employed. Particularly in the case of expatriates this sometimes leads to contributions which are not tax deductible anywhere. Conclusive EC legislation could solve this problem.

It was fairly satisfying to the European business community that the Commission, when indicating where its new pragmatic approach would lead to, mentioned several of the areas which UNICE had suggested as being of high priority. Proposals were announced regarding the Community-wide consolidation of losses as well as the abolition of withholding taxes on intercompany royalties and interest payments. These proposals have been submitted to the Council.

European companies welcome these proposals. They are currently being studied and after a first perusal there still seems to be scope for improvement.

The draft directive on the abolition of withholding taxes on royalties and interest payments appears to restrict its application to payments made by a subsidiary to its parent company. In many cases, however, such payments are made to other companies within the group which have a financing function or which hold the group's intangible assets. If the scope of this directive is indeed limited in this respect, it should be changed to cover all payments of royalties and interest within the group.

Further, one could query whether all intercompany payments of royalties and interest should not be exempt from withholding tax, regardless of whether the receiving company is related or unrelated.

The prospects of this draft directive being adopted in the near future seem to be rather good. Ideally, so much speed should be made that it could enter into force at the same time as the directive abolishing the withholding taxes on intercompany dividends, i.e. on 1 January 1992.

Regrettably, the future for the proposal regarding the Community-wide consolidation of losses is likely to be less rosy. Based on the first offhand comments there does not seem to be much support for the proposal amongst the member state governments. Apart from political problems, it cannot be denied that the concept of Community-wide consolidation of losses raises a number of technically complicated issues. By deliberately avoiding some of these issues the Commission attempted to arrive at a practical and workable set-up. It is expected that it will take quite some time before the Council will even start discussions on this proposal. Based on the Commission's proposal, European business and industry will continue to push for an arrangement in this area.

Before making further proposals the Commission intends to await the findings of a recently established committee of independent experts. This committee, which is chaired by former Dutch Finance Minister Mr. Onno Ruding, has as its brief to examine the existing differences in company taxation between the member states, to assess their impact on competition and to come forward with recommendations for measures if action at the Community level is deemed necessary. European business and industry will monitor this committee's work closely and will make known their views on the issues under examination.

Of most interest to both the European and non-European business community is of course the question of what the future will bring. What follows are some personal impressions of potential developments.

It seems to be as certain as things can be in tax matters that complete harmonization of corporate taxes in the EC will be something for the post-2000 era, if at all. Thus the member states will maintain considerable freedom with regard to determining the corporate tax burden. The dramatically increased mobility of companies, capital and individuals in the EC market may well induce member states to use this freedom to adopt a more market-orientated fiscal policy so as to become or remain attractive as a place for investment and business location. An optimist might expect that this tendency would eventually create a friendlier overall tax climate for business and industry in the EC. It is likely, however, that there will be some counter-balancing developments which may turn the tide of corporate tax reductions, if any are indeed made. It might be that – as a consequence of the work of the Ruding Committee – initiatives will be taken within the next few years at the Community level to eliminate some specific features of the members states' company tax systems which clearly distort competition.

On the one hand, this could be an advantage to companies based in certain member states in that unduly heavy additional tax burdens would be removed. On the other, it might lead to the abolition of special beneficial arrangements introduced by member states to attract economic activity. Indicative in this respect is the fact that a preliminary draft proposal for the harmonization of the taxable base of corporate taxes, as circulated by the EC Commission for consultation a few years ago, explicitly prohibited the member states from incorporating into the taxable base elements with the nature of subsidies or incentives. Although this draft has been shelved due to the Commission's new approach, these ideas are still alive and they will certainly resurface.

In the longer term, member states may become so annoyed by the budgetary consequences of their fiscal competition that they will become more receptive to some sort of global corporate tax harmonization, which might at least establish some limits on the extent to which member states can use the tax structure, rate and base to make themselves an attractive location for investment. Ultimately, we may eventually end up with a company taxation in the EC which:

- offers less opportunities to benefit from differences between the systems in the various member states;
- makes it difficult for member states to use it as a vehicle for attracting investments via special tax arrangements;
- has a relatively low overall effective tax burden;
- is more transparent than the current patchwork of different taxes, different rules and special arrangements;
- distorts to a much lesser extent competition between companies based in different member states.

Whether this is to be regarded as positive or negative depends on how one looks at it. Creative and aggressive tax consultants may see the EC as becoming a less target-rich environment. Business and industry, however, may feel comfortable with the possibly lower overall company tax burden and may also be appreciative if tax considerations become a less relevant factor in the business decision process.

EUROPEAN COMMUNITIES:

THE MEANING OF EC TAX HARMONIZATION AND THE INTERNAL MARKET FOR U.S. BUSINESS AND U.S. TAX LEGISLATION

Professor Dr. Lutz Fischer

International Tax Institute of Hamburg University, Germany

I. INTRODUCTION

U.S. companies, which are among the main investors in EC countries, are affected by EC tax harmonization and the internal market in many ways. Three main questions arise in this context:

- What are the competitive effects of tax harmonization and the internal market for non-EC business and industry?
- What can business and industry in the United States (and other non-member states) do in order to benefit from EC tax measures?
- Should the U.S. government respond to the EC tax measures by changing U.S. international tax policy?

All three questions are difficult to answer but the last one is particularly difficult because it is not the task of foreigners to advise the U.S. government as to what measures to take. This paper offers some suggestions as to where changes in U.S. tax policy could be most effective. My comments are restricted to the area of direct taxation, and will consider reduction of tax rates, a trend initiated by the United Kingdom and the United States and continued in Europe (in particular under the auspices of the internal market). After discussing harmonization of the tax base, I will examine the three 1990 directives, i.e. the parent-subsidiary directive, the merger directive and the multilateral convention on the elimination of double taxation in connection with the adjustment of profits, with regard to their economic effect on non-EC business and industry.

II. U.S. DIRECT INVESTMENT IN THE EC

The significance of the EC countries for U.S. direct investment is evident from Table I. Forty percent of U.S. direct investments abroad are located in the EC. Within the manufacturing sector, U.S. direct investment accounts for more than six percent of EC production. U.S. investors employ more than seven percent of the EC labour force. Moreover, U.S. direct investment is highly integrated into the European production system because U.S.-owned manufacturing companies in the EC have a very high "European content" (i.e. nearly 95 percent). Therefore all tax measures taken by the individual EC member states or by the EC itself, particularly measures in connection with realization of the internal market, are of great significance to U.S. business and industry as well as to U.S. tax policy.

Reductions in the tax rates of EC member states

In April 1990 the EC Commission withdrew the 1975 proposal for a directive on the harmonization of the corporation tax systems. The Commission reverted to the so-called "principle of subsidiarity" because under the present state of economic union, member states want to maintain freedom to use corporation tax systems and tax rates as instruments of their own national fiscal policy. Nevertheless, it is obvious that national tax legislation in EC member states will lead to lower tax rates in many European countries until 1992 (see Table 2).

Although the envisaged corporation income tax rates show

Table 1

U.S. direct investments abroad (total balance at the end of the year) in billion US$

	1975	1980	1985	1986	1987	1988	1989
World	124	216	230	260	308	334	373
Japan	2,7	2,9	4,0	4,4	4,8	5,2	5,2
Europe	39,9	44,8	44,7	46,5	47,5	46,6	47,3
EC (12)	32,8	37,4	36,4	38,0	39,0	38,7	40,2
Great Britain	11,2	13,3	14,3	13,6	13,6	14,7	16,3
Germany (Fed. Rep.)	7,0	7,2	7,3	8,1	8,0	6,6	6,2
France	4,6	4,3	3,3	3,4	3,8	3,8	3,9
The Netherlands	2,7	3,8	3,1	4,5	4,7	4,7	4,6
Italy	2,2	2,5	2,6	2,9	2,9	2,8	2,8
Belgium	2,7	2,9	2,2	1,9	2,2	2,2	2,2
Luxembourg		0,3	0,3	0,3	0,3	0,2	0,2
Denmark	0,5	0,6	0,6	0,4	0,4	0,4	0,3
Ireland	0,5	1,1	1,6	1,7	1,7	1,8	1,7
Greece	–	0,2	0,1	0,0	0,0	0,1	0,1
Portugal	–	0,1	0,1	0,1	0,1	0,1	0,2
Spain	1,4	1,2	1,0	1,0	1,2	1,3	1,6

Table 2

Corporation tax rates (%) in 1989 and 1992

	1989	1992
France	43	39
Denmark	50	40
France	39	34
Germany	56/36	50/36[1]
Great Britain	35	35
Greece	46	46
Ireland	43	40
Italy	36	36
Luxembourg	34	33
Netherlands	35	35
Portugal	36,5	36,5
Spain	35	35

1. Due to a temporary surcharge of 7,5% of the tax liability the figures rise to 53,75%/38,7% (only from 1 July 1991 till 30 June 1992).

a downward trend, in many cases the rates will remain higher than the U.S. rate of 34 percent. Therefore a valid – and necessary – question is, what effects will the reductions in European tax rates have on U.S. corporations doing business in Europe? Because of the U.S. foreign tax credit mechanism, which limits the credits to the amount of U.S. tax due on the foreign-source income, a U.S. corporation must pay the greater of U.S. tax or foreign tax. This foreign tax consists not only of the foreign corporation tax on distributions but also local income taxes and the foreign withholding tax.

In order to avoid an excess foreign tax credit situation, U.S. corporations with foreign business interests must achieve, as far as possible, reductions in foreign taxes paid for tax credit purposes. The envisaged European tax rate reductions caused by the completion of the internal market are therefore very attractive to U.S. corporations. The higher after-tax profitability of European investments, which can be attributed to lower tax rates, will give EC countries a better ranking as a location for investment.

III. HARMONIZATION OF THE TAX BASE

As compared to the advantages tax rate reductions may have for U.S. corporations, the intended harmonization of the tax base in the area of direct taxes might be less favourable to U.S. investment in Europe and its after-tax profitability. In 1988 the EC Commission presented a pre-draft for a directive on the harmonization of member states' legislation on the determination of the taxable profits of enterprises. Since member states feared for their fiscal sovereignty this directive was never submitted to the Council. However, this does not mean that the goal of tax harmonization in this field has been completely abandoned.

European national tax systems currently provide for many fiscal investment incentives such as investment grants, accelerated depreciation, etc. These incentives vary considerably from country to country. Under the above-mentioned predraft directive, incentives affecting the tax base would have to be withdrawn which would naturally lead to more predictability in the effective tax burden of European business operations. However, given the policy of U.S. corporations to minimize non-U.S. taxes, abolition of these fiscal incentives could result in a loss of tax-minimization possibilities.

IV. THE 1990 TAX MEASURES

In general the parent-subsidiary directive, the merger directive and the arbitration convention all aim to facilitate the formation of intra-EC, cross-border groups. As a result of the changes, business operations between companies of member states and companies of non-member states will receive less advantageous treatment, particularly in respect of the benefits provided under the parent/subsidiary directive and the merger directive. Will the United States or other non-member countries respond to this obvious discriminatory treatment?

The multilateral convention on arbitration, however, will not only be of importance for EC enterprises. Tax disputes between governments on transfer pricing issues are burdensome and costly in all countries and they have attracted intense political attention, particularly in the United States. Any internationally accepted means – like the convention to resolve transfer pricing problems by the arbitration procedure – will be relevant for tax treaties between other countries.

A. *The parent-subsidiary directive*

The formation of an EC holding company by a U.S. multinational corporation is advisable as a means to offset a U.S. parent company's competitive disadvantage in comparison to an EC-based parent company. Until now using an EC holding company would lead to additional withholding tax on dividends distributed by subsidiaries because the distributed income would be subject to withholding tax in the country of the holding company. To avoid excess foreign tax credit situations, it was more a dvantageous to hold the participation in the subsidiaries directly.

The structure of European operations must be revised in light of the parent-subsidiary directive. An EC holding company can offer tax advantages if the holding company's country has a lower withholding tax rate on dividends paid to the U.S. company than the countries where the operating subsidiaries are located. By utilizing such a structure dividends from the subsidiaries can be paid to the holding company free of withholding tax.

The Subpart F rules must obviously be taken into account in setting up such a structure. Subpart F income of a foreign subsidiary held by an EC holding company would have to be included in the income of the U.S. shareholder regardless of whether the holding company actually made a distribution. Will U.S. tax policy be changed to allow the EC as to be treated "one country" in respect of intra-EC dividends in order to grant the "same country" exception of Subpart F?

There are two further obstacles to creating a European holding company. First, the addition of a further-tier of companies in the structure could lead to "fourth-tier companies" whose income tax is not eligible for U.S. tax credits. Second, it is not certain whether EC member states will invoke the anti-avoidance provisions of the directive.

U.S. direct investment dividends are generally subject to withholding tax so the directive favours intra-EC investments over investments in the EC by a U.S. investor. The same is true in respect of an EC investor who must decide whether to invest in the United States or in the EC. If the investment is made in an EC country, there will be no withholding tax; if the investment is made in the United States, withholding tax will be levied. The competitive effects will be particularly serious if the investor's home country offers a participation exemption. In such a case investment in the United States is clearly disadvantageous. The United States could solve this problem unilaterally by enacting legislation which abolishes the withholding tax, or bilaterally, by amending existing tax treaties to accomplish the same result, i.e. reduce the withholding tax rate to zero. However, lowering the withholding tax rates or abolishing withholding tax altogether is not simply an issue of the competitive position of the United States. Withholding taxes are an essential element of U.S. tax policy for tax equity purposes (e.g. the vigorous "treaty shopping" policy and the 1986 adoption of the branch profits tax, which is a sort of withholding tax).

B. *The merger directive*

The directive on mergers, divisions, transfers of assets and exchanges of shares applies only to companies from EC member states. The purpose of the directive is to stimulate intra-EC, cross-border transactions by deferral of taxation at the shareholder and company level. Again, there is discrimination against businesses operating in EC member states which are owned or controlled by non-EC interests.

If a U.S. company wants to acquire the shares of a company in an EC member state and if the U.S. company is competing with an EC company to acquire the target company by an exchange of shares of the target for shares in the acquiring company, the U.S. company will be in a less competitive position. The shareholders of the target company will not be subject to tax on a current basis if the EC company acquires the target company but they will be if the U.S. company acquires the target company.

Again, this problem could be resolved by establishing a U.S.-owned European holding company, which would be entitled to the benefits of the merger directive by qualifying as an EC resident corporation. The European holding company could benefit from the parent-subsidiary directive. An EC holding company would allow a high degree of flexibility in restructuring business operations within the EC. Nevertheless, in the case of such a restructuring, anti-avoidance provisions in the directive must be considered. Article 11 provides that member states can refuse to apply or withdraw the benefits of the directive if the merger has as its principal objective or one of its principal objectives tax evasion or avoidance, i.e. if it is not carried out for valid commercial purposes.

The U.S. tax legislator may need to address the issue of whether U.S. tax law on restructuring operations should be changed where one of the parties is foreign. As a general rule a property transfer from a U.S. person to a foreign corporation cannot be implemented tax-free except under specific circumstances, the most important of which is the transfer of an active business. Furthermore, when the stock of a foreign corporation is transferred to a second foreign corporation and the foreign corporation whose stock is transferred is a controlled foreign corporation, the transfer will be subject to U.S. tax. Even if the transferred corporation will be acquired by another U.S. company the transaction will be subject to U.S. tax.

Discrimination against U.S. companies operating in the EC compared to EC corporations could be countered by unilateral U.S. measures, as well as by bilateral tax treaty provisions.

Does the deferral of tax payments as a result of the merger directive disadvantage U.S. business so much that counter measures must be taken? If so, a tax convention between the United States and the EC as a whole would be the most favourable alternative. It could secure eventual taxation of the appreciation of assets and stock transferred as well as on the gains at the shareholder level.

It should be noted that the taxation of intra-EC cross-border acquisitions and mergers is not only more favourable than extra-EC cross border transactions, but is also advantageous as compared to purely domestic transactions in many EC countries. It is likely that EC member states will adapt their domestic legislation to the provisions of the merger directive.

C. *The arbitration convention on transfer pricing*

The EC convention which must be ratified by each of the member states before coming into force applies to transfer pricing disputes between EC undertakings. It therefore applies to EC corporations as well as to EC unincorporated businesses. It remains uncertain as to whether European branches of U.S. corporations are covered by the provisions of the convention.

In general the convention gives intra-EC business a competitive edge in comparison with its non-EC counterpart doing business in the EC because double taxation in respect of transfer pricing will be eliminated. This potential disadvantage for U.S. companies does not cover the entire spectrum of EC countries. The new U.S.–German tax treaty, for example, contains a transfer pricing arbitration procedure, which is similar to the convention.

With regard to the disadvantage of European branches of U.S. parent companies in the case of intra-EC business, it would be advisable in specific cases to change the legal form of the branch into a corporation. Obviously there must be valid commercial justifications for such a change.

More important consequences could perhaps arise for U.S. tax treaty policy. Competent authority procedures are extremely difficult and have generated substantial controversy in some cases. Perhaps the United States could include provisions in its treaties similar to those found in the convention. Obviously such a provision would not solve the underlying dilemma regarding the need to develop generally accepted transfer pricing principles. However, it would solve the procedural problems, which is a positive step forward.

V. THE COMPETENCE OF THE EC IN THE FIELD OF COMPANY TAXATION ON BUSINESS OPERATIONS WITH NON-MEMBER STATES

Although the two new directives remove distortions of competition in the case of intra-EC business operations, these distortions remain intact in respect of transactions between EC enterprises and third country enterprises. If member state A applies a participation exemption for dividends received from third countries and member state B applies only a partial participation exemption to such dividends, competition between parent companies in the EC is distorted in spite of the parent-subsidiary directive. Are member states free to include provisions in new tax treaties with third countries which deviate from the parent-subsidiary directive or the merger directive?

Mr. Hubert Hamaekers addressed this issue in a recent article. The European Court of Justice has held that on the basis of Article 210 of the EC Treaty, the Community (which in this case means the Commission) has the legal capacity to establish treaty links with third countries on a range of objectives defined in Part I of the EC Treaty. Moreover, the Court concluded that when, implementing a common policy contained in the EC Treaty, the Community adopts provisions "establishing common rules of whatever form the member states no longer have the individual or collective right to undertake obligations with third countries which affect those common rules". Since the two directives have been adopted to implement a common policy contained in Article 3 of the EC Treaty (i.e. removal of distortion of competition), member states may no longer deviate from the provisions of the directives by concluding treaties with third countries. According to Mr. Hamaekers, the EC should draft appropriate model provisions for tax treaties with third countries which take into account the provisions of the parent-subsidiary and merger directives. Alternatively, existing treaties between EC member states and third countries could be replaced by an EC tax treaty which covers the issues included in the two directives.

Regardless of whether Mr. Hamaeker's opinion will be accepted by member states and the EC authorities the question again arises, whether the United States (or other nonmember countries) is willing to include the provisions contained in the two directives in its own legislation dealing with the taxation of foreign business operations.

VI. CONCLUSION

The EC measures on tax harmonization present a challenge to U.S. enterprises doing business in the EC and to existing U.S. tax policy. Because the harmonization of direct taxation has gained momentum and because the two directives and the convention will certainly be followed by additional EC measures, EC tax policy will need to be carefully monitored in the future.

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VAT IN THE EUROPEAN COMMUNITY: HOW IT WORKS AND MODIFICATIONS PLANNED FOR 1992

John Wilkins, M.A. FCA

John Wilkins is a chartered accountant; member of the (British) VAT Practitioners Group and VAT in Industry Group; adviser on VAT to two major British trade associations for 20 years, and now practicing as a consultant on the upcoming European changes to the tax.

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I. INTRODUCTION

This paper explains how value added tax ("VAT") operates and the changes in its application to cross-border trade after 1992. A simpler form of turnover tax was charged in the past in some EC countries , and the paper describes how VAT, though more complicated, overcomes certain problems created by the previous system.

Rates of VAT vary considerably from one EC country to another, and broadly speaking reductions in rate differences are not necessary for the 1992 changes as they apply to traders. The same is not true, however, as regards private individuals, and the paper concludes with an explanation of this subject.

II. HOW VALUE ADDED TAX WORKS

A. *General*

VAT is a tax on consumer spending, that is, on the goods and services people buy for their personal needs and pleasures, and those of their families and friends, as opposed to the goods and services a firm buys as part of its profit-making activities. VAT is a percentage tax, levied on the price firms charge for the goods and services they supply. No distinction is made according to whether the goods are of a consumer or business kind, and the tax is charged regardless of whether the purchaser is a private person or a business. How then is the tax confined to consumer spending?

The answer is, if the purchaser is a business the tax is repaid to it by the tax authorities. Each trader's periodic tax return therefore shows two totals: the tax the trader owes on his sales in the period, and the tax repayable on his purchases in the period. The trader pays the difference to the tax authorities, and the tax paid by each trader in the chain, when totalled, amounts to tax at the prescribed rate on the price charged to the ultimate consumer (this is explained in more detail below). If a trader's tax on sales is less than the tax on his purchases he is repaid the difference by the tax department.

B. *"Cascade" taxes*

VAT developed from an earlier form of general turnover tax. It, too, was charged on business turnover without distinguishing consumer goods from other goods or business purchasers from other purchasers. Each business passed the tax on in the price it charged, and this process continued until the goods reached a final consumer. The price paid by the final consumer included not only the tax charged by his retailer, but also the tax paid at all earlier stages of manufacture and distribution. Calculation I illustrates the mechanics of this process. The first column entitled "No Tax" shows the position before the tax is imposed, with goods passing through a succession of seven firms, each adding a mark-up to cover labour and profit, and a final selling price by G to a final consumer of 3,000. The second column shows the effect of a cascade tax of two percent.

CALCULATION I

Firm	NO TAX: Purchase price, labour and profit	NO TAX: Selling price	CASCADE TAX AT 2%: Purchase price, labour and profit	Tax*	Selling price
A	nil		nil		
	1,000	1,000	1,000	20	1,020
B	1,000		1,020		
	400		400		
	1,400	1,400	1,420	28	1,448
C	1,400		1,448		
	200		200		
	1,600	1,600	1,648	33	1,681
D	1,600		1,681		
	300		300		
	1,900	1,900	1,981	40	2,021
E	1,900		2,021		
	300		300		
	2,200	2,200	2,321	46	2,367
F	2,200		2,367		
	400		400		
	2,600	2,600	2,767	55	2,822
G	2,600		2,822		
	400		400		
	3,000	3,000	3,222	64	3,286
				286	

* Calculated on the pre-tax selling price.

CALCULATION II

Firm	NO TAX: Purchase price, labour and profit	NO TAX: Selling price	VALUE ADDED TAX AT 10%: Purchase price, less VAT, plus labour and profit	VAT*	Selling price
A	nil		nil		
	1,000	1,000	1,000	100	1,100
B	1,000		1,100		
			− 100	− 100	
	400		+ 400		
	1,400	1,400	1,400	+ 140	1,540
				net 40	
C	1,400		1,540		
			− 140	− 140	
	200		+ 200		
	1,600	1,600	1,600	+ 160	1,760
				net 20	
D	1,600		1,760		
			− 160	− 160	
	300		+ 300		
	1,900	1,900	1,900	+ 190	2,090
				net 30	
E	1,900		2,090		
			− 190	− 190	
	300		+ 300		
	2,200	2,200	2,200	+ 220	2,420
				net 20	
F	2,200		2,420		
			− 220	− 220	
	400		+ 400		
	2,600	2,600	2,600	+ 260	2,860
				net 40	
G	2,600		2,860		
			− 260	− 260	
	400		+ 400		
	3,000	3,000	3,000	+ 300	3,300
				net 40	
			Total VAT	300	

* Calculated on the pre-tax selling price.

1. Disadvantages of a cascade tax

Although a cascade tax is simple to administer it has a number of disadvantages. The total amount of tax, 286 in the example, depends on how often the goods change hands; if A had carried out all the processes and distribution himself and sold to the final consumer for 3,000, the tax would have been only 60. It thus creates a bias in favour of vertical integration, and it gives consumer services an advantage over consumer goods, since goods usually pass through several firms with the bulk of the cost being incurred before the goods reach the retailer. The tax remains a cost on business until the final sale to a consumer; the tax of 20, 28, etc. paid by each business becomes a burden on each business down the chain until it is finally passed on to G's customer.

It is impossible to quantify how much tax the goods have borne. The amount does not only depend on the unknown number of times goods have changed hands in the course of manufacture and distribution; each business will also have incurred tax on its capital equipment and overhead, and will seek to recover this tax by spreading it over its output. The suppliers of the equipment and overhead will themselves have incurred the tax on *their* inputs and added the tax to their own charges.

2. The impact of cascade taxes on exports and imports

One result of a cascade tax is that exports cannot be accurately relieved of the tax, nor imports charged with an accurate compensating tax. If F exports the goods it would be easy to say that no tax should be charged on his sale price of 2,767, but there is no practical way of discovering how much of the 2,767 is due to tax at prior stages. Likewise with imports: assume that G instead of buying from F buys from abroad at 2,600; one cannot calculate accurately what tax he should pay on importation to avoid disadvantaging home suppliers. The rates actually chosen by governments are always open to the suspicion of subsidizing exports and penalizing imports. VAT, among its other advantages, has the enormous merit of making these adjustments automatically and with complete accuracy. It is thus a tax with a special claim in a common market, where one of the essentials is that goods should compete on equal terms regardless of the country which supplied them.

C. *VAT in figures*

Calculation II shows how VAT works. The "No Tax" column is the same as in Calculation I, and the second column shows how VAT would be charged at ten percent. Trader A pays tax of 100 and adds it to his selling price. Trader B is entitled to be repaid the 100, so he deducts it in arriving at his pre-tax selling price, which is therefore 1,400. Tax on that is 140 so his total selling price is 1,540 and the tax he owes is a net amount of 40 (140 less 100). The same pattern is followed in the remaining sales in the chain.

At each stage the total tax paid to date is ten percent of the pre-tax selling price; for example, when E sells to F, the pre-tax selling price is 2,200, and tax on that is 220, made up of 100, 40, 20, 30 and 30. Similarly, the tax paid by the final consumer, G's customer, is 300, which has been paid in instalments by all the traders.

D. *"Exemption"*

VAT is made more complicated by "exemption". Certain kinds of business are difficult to fit into the scheme of the tax, e.g. banking, insurance and certain types of property transactions. These businesses do not have to pay VAT on their receipts, such as bank charges and premiums, and as a rough "quid pro quo" they are not repaid the VAT on what they purchase. In practice most companies in these sectors also have substantial activities that fall within the scope of VAT, so they have to classify their purchases according to whether the VAT can be reclaimed. Similarly most large companies, which at first sight are wholly in the taxable sector, are found to engage in some minor exempt activities and therefore must sift out the purchases relating to these activities.

The effect of exemption on the ultimate consumer can be good or bad. Consider insurance: if private individuals insure their homes, the only VAT included in the premium is the VAT not repaid to the insurance company, which of course is less than the VAT that would have been due on the premium. However, in the case of insurance paid by (e.g.) a manufacturer, first the premium is increased by the tax the insurance company is not repaid, and then that increase in cost is passed on to consumers. Consumers thus bear three lots of tax – the VAT disallowed to the insurance company, tax on that VAT and tax on the premium before it was increased.

E. *Private expenditure by businesses*

As with other taxes, the dividing line between business and private expenditure can cause difficulties. Most EC countries refuse to repay VAT on certain expenses; typically automobiles, entertaining and hotels.

F. *Other features of VAT*

The VAT that is repaid to traders is not confined to goods purchased for resale; it includes VAT on capital equipment and overhead. The capital expenditure and overhead themselves, net of VAT, are reflected in the selling price and enter into the global cost on which final consumers pay VAT.

Calculation II shows that the net tax paid by a trader corresponds to his mark-up; for example, B has a mark-up of 400 and pays a net tax of 40. However, this correspondence is not an essential feature of the tax. If a country has more than one rate of VAT, as most do, the goods and services purchased may be taxed at a different rate from those sold. In such a case the trader is repaid the VAT he actually paid on his purchases and is charged at the rate applying to his sales. The same approach shows through as regards changes in the rate of VAT: once VAT is paid on purchases, the amount recovered is unaffected by later changes in the rate.

There need be no identity between the goods purchased and the goods sold in a quarter. Thus, in a seasonal business a trader may purchase stock in the winter and sell in the summer, in which case he will be repaid VAT on his purchases without waiting until he sells them.

G. *The complexity of VAT*

Even without "exemption" VAT is complicated and often criticized for the absurdity of charging one trader in the chain, only to repay the same tax to the next trader. Why not, for example, just charge the tax at the retail stage?

A variety of answers might be given to this question, but one worth mentioning is that VAT gives the government some protection against the risk that the retailer might evade payment. Suppose a trader absconds after collecting the selling price and VAT from his customers. In all probability he is owed VAT on his purchases, and the government's loss is the net amount. Alternatively, suppose that instead of absconding, the trader omits some sales from his records. This omission may be detected if the trader's sales look unusually low compared with his purchases; and if to guard against detection the trader omits some purchases as well, he forgoes claiming repayment of the tax on them, so that the loss to the government is limited to the tax on the trader's mark-up.

III. VAT IN THE INTERNATIONAL SPHERE

A. *VAT on exports and imports*

Assume that in Calculation II F sells the goods to a foreign customer, in the EC or elsewhere. No VAT is charged on his sale of 2,600, and he is refunded the 220 he paid to E, which is exactly equal to the tax paid to the government by E and the earlier traders. There is no question of export subsidy: the 220 refund to F is equal to the tax paid by the previous traders and his selling price of 2,600 is the same as if there was no tax.

Similarly with imports. If G purchases the goods from abroad instead of from F, he must pay his government "import VAT" of ten percent on the price charged by his foreign supplier, putting him in the same position as if he had purchased the goods at home, and he is later refunded the import VAT to the same extent as on a domestic purchase. This freedom from bias is an essential feature of VAT.

B. *VAT is a tax on inland consumption*

As mentioned above VAT is a tax on consumer spending. It is designed, like most such taxes, to accrue to the country where the consumption occurs, not the country of production.

If the goods in Calculation II are exported by F he is not charged tax on them and the previously paid tax of 220 is refunded to him. Consequently, no tax is received by the exporting country's government even if most of the value was created there.

Similarly, if G purchases his goods abroad, he will incur import VAT at ten percent on the purchase price, whatever that will be, and deduct that tax from the 300 he owes on his selling price. G's government therefore receives tax on the whole of the consumer spending even though most of the value may have been created abroad. The quality of being a tax on domestic consumption is more fundamental to VAT than the fact that it often reaches the government in stages corresponding to each trader's mark-up.

IV. THE 1992 CHANGES

A. *Reason for the changes*

When goods enter a country they incur VAT. A physical check is or may be carried out, and either the tax must be paid at once or credit must be obtained on the strength of a banker's guarantee. These rules, although reasonable as a means of safeguarding the tax, create delays and expense which put cross-border trade at a disadvantage compared with inland trade. The 1992 changes aim to put an end to these disadvantages.

Because member states are independent tax jurisdictions it will not be possible to remove formalities altogether, but the hope is that the Community will come closer to being a single trading area, as the United States (for example) is already. VAT rules for trade with the rest of the world will remain unchanged.

B. *Outline of the new system*

After 1992 there will be no border control to enforce VAT on goods from another member of the EC. As under the current system the exporter will not charge VAT, but the importer will show VAT on the goods as a liability on his VAT return. He will also claim VAT as a deduction in the same way and to the same extent as if he had paid the tax on goods purchased at home. Exempt traders over a certain size will file a return to show the VAT on their imports, and being exempt they will, as now, not be repaid.

In order not to charge tax on exports the seller will need evidence that his customer in another member state is liable to VAT. Precisely what this evidence should consist of is a subject for discussion. The exporter will also need to show that the goods left his country. He must provide evidence of this under the current system but this requirement may be more difficult after the elimination of frontier formalities, particularly if the purchasing trader collects the goods in person from the seller's premises.

These new arrangements only apply to trade with another EC country; for exports to, for example, the United States, the existing rules will continue to apply, and in particular the non-charging of VAT will apply even if the foreign customer is a private person. For imports from outside the EC existing rules will remain in force, requiring VAT to be paid or guaranteed before importation.

C. *Listing of exports to other EC countries*

As mentioned, a trader importing goods from another EC country will need to show the tax on the goods on his return. To ensure the importer complies with this requirement, exporters will have to provide a quarterly return of their exports to other EC countries, showing each customer's VAT number and the total value of the sales in the quarter. These lists will be used to check importers who have come under suspicion or to help carry out spot checks; further, the lists will encourage compliance.

D. *Three-country transactions*

The new arrangements seem fairly straightforward where the goods are transferred from the member state of the seller to the member state of the purchaser, but complications arise where the goods are transferred to a third member state. Tax will be due in the third country but it is unclear how the liability will be enforced against the purchaser or how the third country government will even be aware of such liability.

In a sale between traders in two member states the goods may be transferred to a country outside the EC. No VAT will be due, but the seller's quarterly list will convey the impression that VAT is due. If the goods are originally in a country outside the EC and are delivered to the member state of the purchaser, VAT will be collected on entry under the existing arrangements, but the seller's quarterly list will appear to indicate that the purchaser should have entered the liability on his return.

These and other cases where the transaction does not fit into the simple two-country model need to be sorted out if the new system is to make a smooth transition at the end of 1992.

E. *Statistics*

Currently, each consignment that enters or leaves an EC country is recorded on a form called the "single administrative document" ("SAD"). Originally, this was a tax form but the data contained in it has been expanded to cover statistical information.

The SAD will be abolished for goods moving between EC countries but the need for statistics will remain, and they will be collected by way of a new monthly return. The new procedure will be less burdensome than the existing one in that the data will be more limited in scope and only the 20 percent or so largest companies will be required to file the return. However, companies will have to produce monthly classified totals, whereas at present the data is given "raw" to the authorities and the tax administration classifies and totals.

V. CHANGES AFFECTING PRIVATE INDIVIDUALS

A. *Existing position*

A private individual may encounter the VAT rules on cross-border transactions in two ways: he may order goods by post or telephone from a supplier abroad, or he may bring the goods home with him from abroad. In either case VAT makes border checks necessary.

If an individual orders the goods by post or telephone from a supplier in another member state, the seller charges no VAT, but when the goods enter the customer's country VAT must be paid before they are allowed to enter. If the goods are sent by post the post office pays the VAT in the first instance and then collects it from the purchaser when the goods are delivered.

The situation differs if the purchaser buys the goods while he is abroad. If he buys the goods in a shop, he pays that country's VAT and on bringing the goods home he is not charged VAT again if their value is under approximately US$ 500. If the value of the goods exceeds this amount the purchaser must pay VAT to his own country as well before he can bring them in.

If the goods cost much more than $ 500 the purchaser can use a "personal export scheme". The foreign shop excludes VAT from the price but instead of handing the goods to the customer it despatches them directly to the customer's home; the customer then must make arrangements to pay his own country's VAT.

Finally, goods a traveller buys VAT-free abroad in a duty-free shop can be brought home without paying VAT, but only up to a value of US$ 50. This is a separate allowance from the allowance for goods liable to excise duties, such as alcohol, tobacco and perfume.

B. *After 1992*

In order to abolish border controls the seller will charge his country's VAT, and there will be no liability in the purchaser's country, regardless of the value of the goods.

The new scheme will be beneficial to people living in countries with a high rate of VAT, who will be able to make their expensive purchases from suppliers in a low-rate country and be legally free of their own country's tax. But one man's meat is another man's poison, and businesses and governments in high-rate countries see the scheme as dangerous to their own positions.

It is proposed to limit the variation in VAT rates from one country to another (the existing rates are shown in the attached table). On a prescribed list of necessities the rate is to be between four and nine percent, each country choosing its own rate; and on other items the rate must not be less than 14 percent. In this way there will be a limit on how far one country can undercut the VAT rate of another country. Thus far there has been no agreement on this – the rules have been proposed by the Commission, but governments are far from the necessary unanimous acceptance.

VAT RATES IN MEMBER STATES OF THE EUROPEAN COMMUNITY
February 1991

	Reduced Rates	Standard and Intermediate Rates	Increased Rates
Germany	7	14	–
Belgium	1 and 6	17 and 19	25 and 25 + 8
Denmark	–	22	–
Spain	6	12	33
Greece	3 and 6	16	36
France	2.1, 5.5 and 13	18.6	25
Ireland	0 and 10	23	–
Italy	4 and 9	19	38
Luxembourg	3 and 6	12	–
Netherlands	6	18.5	–
Portugal	0 and 8	17	30
United Kingdom	0	15	–

Ireland, Portugal and the United Kingdom apply a zero rate to some goods and services. The tax on them is nil, and tax incurred by the seller on the goods and services he buys is still repaid to him. This is different from exemption, where such tax is not repaid. The effect of the zero rate is that the goods reach the consumer entirely free of VAT.

Even if rates are agreed upon, on purchases of new cars and "distance selling" the differences in rates could still lead to a substantial diversion of business to low-VAT countries. Cars are expensive and it would make good sense to visit a neighbouring country to save (say) five or six percent. Consequently, there will be a special rule that new cars bear VAT in the country where they are first registered. With "distance selling", i.e. goods sold to a final consumer and delivered by the seller to an address in another member state, low-rate countries could still (it is feared) have an undue advantage, and it is proposed that if a firm's sales of this kind to a particular member state reach approximately US$ 140,000 in a year, on any further sales delivered to it the firm will have to pay VAT to that country at that country's rate. The firm will be required to have a representative there who is responsible for the tax. Firms could opt for this system without waiting until they top the US$ 140,000 figure.

In summary there will be no border controls to enforce VAT on private individuals. In general private purchasers will pay the VAT of the supplier's country, but on new cars and certain distance selling they will pay their own country's VAT.

VI. HOW IMPORTANT ARE DIFFERENCES IN VAT RATES?

High-VAT countries fear that substantially lower rates in other member states will entice their citizens to buy in those countries on a large scale; it is this fear that makes them insist that before dismantling border controls there must be an agreement to limit divergences in rates. Some governments believe this agreement is not necessary; remove border controls, they say, and countries will adjust the rates of their own accord to stem any unacceptable outflow of business. Not surprisingly it is the low-rate countries that find this argument most convincing, but it is true that the Commission's rules would apply even in circumstances (for example, geographical distance) where shopping abroad is unlikely to occur extensively anyway.

For sales between traders rate differences seem irrelevant, since the goods will leave the selling country VAT-free and always incur the VAT of the country they enter. But a dishonest trader could exploit rate differences to defeat one of the defenses built into the VAT system. A trader who conceals sales may think it wise to omit the corresponding purchases to make his records more plausible. By doing so he forgoes claiming the VAT on the purchases; but after 1992 he might be able to buy the goods as a private person in a country with a lower rate than his own. This danger was mentioned in the Commission's paper of 1985 but has not been mentioned since.

EUROPE IN 1992: A U.S. TAX PERSPECTIVE

Donald L. Meier

Don Meier graduated from the University of Illinois with a Master's degree in Accounting and Finance in 1964. He is also a Certified Public Accountant. He joined the Chicago office of Price Waterhouse after graduation. In 1976, he was hired by American Hospital Supply to head up its tax function. In 1980, he joined Sara Lee Corporation as Director of Domestic and International Tax Planning. In the summer of 1988, he became Vice President – Taxes.

Mr. Meier has made numerous speeches before the Tax Executives Institute, the World Trade Institute, and other groups regarding international tax planning and the development of tax savings on a worldwide basis.

I. INTRODUCTION

1992 marks an historic beginning in Europe, a new era. Sometime in the spring, just outside Paris, "Euro Disneyland" will officially open. Now, some say that event represents the ultimate in "Americanization". But somehow, I do not think that is what Winston Churchill had in mind 45 years ago when he called for "A United States of Europe".

Which brings us to the *other* historic event taking place in 1992. The decades-old dream of economic unification will eliminate virtually all barriers to the free movement of people, goods, services and capital between European Community ("EC") countries.

For Sara Lee Corporation and other U.S. multinationals, 1992 raises the question of whether the United States can sell cars and cheesecake as effectively as we export cartoon characters. The answer will depend to a great extent on how well prepared and how well structured we are in relation to this new unified market. Certainly, competition will be fierce, and only the innovative and efficient will survive.

That is why, for some time, many U.S. firms have been streamlining their production, distribution, finance and sales functions to reduce operating costs in Europe. It is also why many have made strategic acquisitions to achieve the "critical mass" necessary for marketing on an EC-wide basis.[1]

But having the right structure and strategy will not be the only factors that determine the fate of multinationals in Europe, i.e. tax considerations will also have an important impact on planning and profitability. U.S. corporations may find themselves at a distinct disadvantage compared to their European counterparts because present U.S. tax law severely hinders our ability to compete against EC-based companies.

To understand why, it is necessary to backtrack a bit in history. Nearly three decades ago, a committee was formed to study the tax systems of various European countries. The idea was to eliminate obstacles that interfered with the smooth functioning of the common market. For the most part, however, the 12 countries which form the EC – France, Germany, Italy, Belgium, the Netherlands, Luxembourg, the United Kingdom, Ireland, Denmark, Greece, Spain and Portugal – did not make much progress "harmonizing" their various income tax systems.

II. EC DIRECTIVES

In July 1990, the EC Council took a major step toward that goal by adopting two directives that become effective 1 January 1992. It is important to understand the significance of the term "directive". A directive is, in effect, an instruction from the EC to the member states requiring them to make such changes as may be necessary to their domestic legislation (including the enactment of new laws) in order to satisfy one of the provisions of the relevant EC treaties. Each directive states an objective, the specific provisions which the member states have to enact and the date by which the relevant provisions must be implemented. Therefore, the resulting legislation will not necessarily be identical in wording or effect in every member state because of differences of interpretation, and because some directives contain options. As history has shown, not every member state will implement all the directives on time; indeed, some have been known to delay implementation for years, even though it appears that the European Court of Justice can be used to "force" a member state to implement a directive.

The first directive on "parent companies and subsidiaries" will largely abolish intra-EC dividend withholding taxes and taxes on dividends received. The second directive on "mergers, divisions, transfers of assets and exchanges of shares" provides tax relief for certain intra-EC corporate transactions. The EC Council also agreed to a convention on the elimination of double taxation arising from transactions between related companies in different member states through arbitration procedures.

Subsequently, the Commission introduced for discussion two additional directives that focus specifically on eliminating double taxation with respect to certain cross-border transactions. One eliminates withholding taxes on royalties and interest paid between EC parent corporations and their direct EC subsidiaries, beginning in 1993. The other, on cross-border loss relief for EC enterprises, privides that member states may permit residents to utilize losses of their permanent establishments or subsidiaries situated in other member states.

Because these last two draft directives have yet to be approved, and will not go into effect for at least 18 months, I will confine my remarks to the first three measures outlined above. In doing so, I will point out the ways in which

1. Sara Lee, for example, has been active in making acquisitions. We now have strong European positions in coffee, tea, snack foods, hosiery and personal care products, such as shoe polish and over-the-counter drugs. In addition, we have concentrated on creating an overall image for our products – one that will be recognized throughout the EC, not just in a single country. Leveraging our strong brands through "Eurobranding" involves creating a similar image in everything from advertising, to marketing manuals, to package design. Developing uniform packaging in particular helps lower manufacturing and packaging costs, while strengthening our brand names at the same time. We are confident such changes will help us attract new customers and improve profit margins throughout Europe.

legislative and regulatory change in the United States could help put U.S. companies in Europe in the same position tax-wise as their foreign competitors. I will also discuss strategies U.S. multinationals can use to minimize the unfavourable impact of these and other tax policies in overseas markets.

A. *Parent/subsidiary directive*

The first EC directive deals with eliminating both withholding taxes on dividends paid and taxes on dividends received. As to withholding tax, the directive states that "[p]rofits which a subsidiary distributes to its parent company shall, at least where the latter holds a minimum of 25 percent of the capital of the subsidiary, be exempt from withholding tax". Since the directive notes that it will be applicable "at least" where the parent has 25 percent ownership, it appears that this ownership requirement is merely optional. Consequently, member states could unilaterally abandon withholding tax on dividends paid to EC member corporations altogether.

The 25 percent test appears to relate to the proportion of par value of issued share capital owned by the dividend recipient. However, it is possible that the test may be applied by reference to voting rights instead. Tax advantages could be obtained, therefore, by carefully structuring the capital ownership of the payor. Member states may, however, impose a time condition requiring, for instance, that a parent company own its stock in the subsidiary for an uninterrupted period of two years before granting exemption from withholding or income tax. There also is provision for the application of domestic anti-abuse rules.

A question may also arise as to whether direct ownership is required. For example, if a Dutch company owns 100 percent of a French company, and the Dutch and French companies respectively own 20 and 80 percent of a Spanish company, it could be argued that the directive would not "count" the Dutch ownership percentage of the Spanish company even though there is 100 percent (indirect) control. However, it is possible that some member states will permit attribution in keeping with the spirit of the directive, if not its actual wording.

There are three notable country exceptions to the application of this directive:

- First, Germany is permitted to continue its dividend withholding tax of five percent until mid-1996, provided that the German rate of corporate tax on distributed profits continues to be at least 11 percentage points lower than the rate applicable to undistributed profits.
- Second, Greece can retain its dividend withholding tax provided it continues to exempt distributed profit from tax at the corporate level. The current Greek practice amounts to giving a tax deduction for dividend payments.
- Third, Portugal is permitted to continue levying a withholding tax of up to 15 percent for the years 1992-1996, and 10 percent for 1997-1999.

As to dividends received, the directive basically states that intra-EC dividend income will either be exempt from tax or, if taxable, offset with a corresponding foreign tax credit allowance.

Because the dividends directive applies only where the subsidiary and the parent are incorporated in EC member states, it will not apply to any dividends from a member state corporation to a U.S. corporation. Therefore, U.S. multinationals will not derive any benefits from this directive if they own the stock of EC subsidiaries directly – which could put them at a competitive disadvantage as compared to EC-based companies. However, U.S. multinational companies can realize the benefit of this directive by changing corporate policy in respect of the repatriation of earnings to the United States, and direct foreign share ownership.

By establishing a European holding company (the Netherlands and Luxembourg are two popular options), and retaining European profits in Europe, U.S. multinationals can, after 1992, avoid local income and withholding taxes on European profits, thus enabling them the same cash flow management opportunities as European companies. Unfortunately, three U.S. tax obstacles presently deny U.S. multinationals the opportunity to take advantage of such savings:

- dividend income between EC countries is immediately taxable in the United States as Subpart F income;
- adding a foreign holding company could create fourth-tier problems resulting in a loss of foreign tax credits; and
- a reorganization of EC companies which is tax-free locally could still be taxable in the United States.

Because of the distinct competitive disadvantage to U.S. multinational companies caused by such provisions, legislative change is necessary. For example, in light of the harmonization of taxes in the EC and the anticipated free flow of capital among EC countries for valid business reasons, U.S. tax policy should treat EC member states as one country, and a group of affiliated corporations operating in the EC should be considered one corporation for purposes of U.S. Subpart F rules.

Additionally, the three-tier rule for claiming deemed-paid credits must be abolished. Alternatively, European holding companies should be excluded from the "tiering" test. It makes no sense to limit a U.S. corporation from claiming taxes paid by a fourth-tier wholly-owned subsidiary. Rather, corporations must be allowed to set up corporate structures that minimize foreign withholding and income taxes. If this involves creating a fourth tier, the U.S. multinational should not be at an economic disadvantage just because of the U.S. tax law's disparate treatment of fourth-tier subsidiaries.

These rule changes should not result in a revenue loss to the U.S. Government. They merely allow U.S. multinationals to efficiently structure their holdings to minimize European taxes. Presently, too much valuable tax time is wasted on restructuring foreign ownership structures to satisfy these arcane U.S. tax rules.

These direct tax changes in the EC highlight the obsolescence of U.S. tax law, which hurts the competitive position of U.S. multinationals. We must remember that Congress initially enacted the Subpart F rules to eliminate abuses that could result when U.S. multinational companies put foreign operations in companies organized in tax havens. The legislation was not meant to hamper operations of U.S. subsidiaries in the countries belonging to the EC – definitely not tax haven jurisdictions. Existing Subpart F rules require U.S. companies to organize separate sales and service subsidiaries in every EC member state where business is conducted to avoid generating currently-taxed Subpart F income. This is obviously costly and inefficient when compared to using a single sales or service company for the entire EC.

The simple solution is to treat the EC as one country and to eliminate the three-tier rule. Enlightened legislation to treat the EC as one country was in fact introduced in the U.S.

House of Representatives just over a year ago. Unfortunately, this bill (H.R. 4136) was never even considered by Congress. I understand, however, that legislation which would achieve similar results through different means will be introduced in Congress this year. I am hopeful that it will be adopted.

B. *Merger directive*

Let me move on to the second directive, relating to the taxation of mergers, divisions, asset transfers and exchanges of shares (the "mergers directive"). The main effect of this directive is the elimination of any capital gains tax that could arise from certain cross-border reorganizations involving member state companies. This directive is roughly comparable to the U.S. rules on tax-free reorganizations. However, it does not apply to the merger of two corporations from the same EC member state. For purposes of the directive, "merger" is defined as one of the following three situations:

(1) One or more companies, on being dissolved, either transfer all their assets and liabilities to another existing company in exchange for securities representing a majority of its capital, and, if applicable, cash of up to ten percent of the value of such securities, or exchange their shares for shares representing a majority of the target company's voting rights. Any assets transferred would retain their carryover bases for purposes of computing depreciation and gains and losses on subsequent sales - and any shares received in an exchange would receive a substituted basis for the transferred shares. This results in a deferral of tax, except as to any cash payments, until ultimate disposition.

(2) Two or more companies, on being dissolved, consolidate into a newly-formed company.

(3) A company on being dissolved, transfers all of its assets and liabilities to a company owning all of its securities.

In addition to "mergers", the directive also provides for divisions (like spinoffs), asset transfers (like U.S. Internal Revenue Code ("IRC") Section 351 transfers) and share exchanges (like U.S. "B" Reorganizations). Divisions and share exchanges, like "mergers", allow cash payments of up to ten percent. Defining mergers, divisions and share exchanges to include transfers for cash may prove helpful in unlocking cash in European groups in a tax-efficient manner. How helpful will depend on how member states implement the directives into their domestic legislation.

Of course, U.S. companies benefit from the increased possibilities of tax-free transactions just as European companies do. If a U.S. company wishes to merge its Spanish and French operations to increase market efficiencies, it is just as concerned about the Spanish or French tax consequences of the transactions as would be a Spanish or French corporation. However, U.S. companies have an additional layer of tax laws to deal with – the U.S. tax consequences of any transaction. For example, while a cross-border merger with some cash may be generally tax-free for European companies under the mergers directive, the receipt of cash, at a minimum, will be considered taxable "boot" by the United States and could result in a different characterization of the transaction.

In the United States, the pendulum has been swinging in the opposite direction from the EC directive. U.S. tax laws in the last few years, for example, have included so-called anti-"mirror" legislation which also narrowed IRC Section 355 in situations not involving mirror transactions, and have severely restricted Section 355 spinoffs and other tax-efficient situations. Spinoffs were a very flexible way to restructure the ownership of foreign entities. Especially when combined with "round trips" of funds – which are clearly ignored for U.S. purposes – it was frequently possible to structure these internal reorganizations without incurring significant foreign or U.S. taxes. The restrictions placed on Section 355 by the 1986, 1988 and 1989 Tax Acts, however, make it impossible to use Section 355 in certain restructurings.

I believe that no U.S. tax policy is served by continuing to restrict the ability of U.S. companies to carry out internal restructuring of their foreign operations – particularly where the restructuring eliminates fourth-tier subsidiaries for U.S. tax planning purposes. As long as U.S. tax law retains a residual right of taxation, and companies sign gain recognition agreements where appropriate, tax receipts will be protected. Congress therefore needs to loosen up requirements for tax-free reorganizations of foreign affiliates. Additionally, Treasury should further relax the Section 367(b) Regulations. Consideration should also be given to adopting special rules for foreign affiliates in EC countries.

In discussing responses to the first EC directive, I noted that U.S. multinational companies should consider establishing a European holding company. The same strategy might well apply here, since such a company could likewise provide a vehicle for U.S. companies to qualify acquisitions of EC companies as tax-free under the merger directive. For example, if both a U.S. and a Dutch company were competing to acquire the stock of a French company after 1 January 1992, the Dutch company could offer its shares to the shareholders of the French target in exchange for their shares. The EC-based shareholders of the French target would not be subject to any current taxes on such a cross-border transaction, but would instead defer tax consequences on their gains until subsequent disposition of their newly-acquired shares in the Dutch company.

In certain countries, the U.S. bidder could not offer a tax-free acquisition, and would therefore be at a competitive disadvantage compared to an EC-based bidder. With a European holding company, however, the U.S. multinational company could take advantage of the merger directive by offering shares of its subsidiary to the target shareholders, assuming there are no other objections to partial outside ownership of the European holding company.

A member state may, of course, refuse to apply the merger directive if one of the principal objectives of the specific transaction is tax evasion or tax avoidance. In this regard, a transaction that is not carried out for valid commercial reasons may give rise to a presumption of tax evasion or avoidance.

C. *Arbitration convention*

Let me briefly touch on the third proposal I mentioned –the Convention which addresses the arbitration of transfer pricing disputes. This Convention – which must be ratified by all 12 member states before taking effect – states that the double taxation of profits arising within a group of companies should be avoided by setting up procedures designed to secure mutual agreement between the tax authorities of the member states involved. Most countries in the EC already have such a procedure via treaty although it should be noted that, surprisingly, not every member state has a double tax treaty with every other member state.

The problem is that there is no current legal obligation for the competent authorities to reach agreement, let alone any time limit. The arbitration convention provides for a two-year period for member states to reach competent authority agreement, starting with the date on which the application for relief is made. If no agreement is reached, an Arbitration Commission must be set up. The Commission has six months to deliver its opinion on how double taxation in the specific situation should be avoided. The tax authorities concerned then have an additional six months in which to reach their own, alternative form of relief; if they still fail to reach agreement, the Arbitration Commission's solution would take effect.

The convention is a multilateral agreement among all member states, rather than a bilateral agreement between two member states in the manner of a double tax treaty. When the Convention becomes effective, it will strengthen competent authority procedures in the existing tax treaties for resolving double taxation issues. Thus, it is anticipated that the Convention will produce more uniform and consistently applied transfer pricing and other rules to avoid double taxation than existing tax treaties.

The Convention also sets forth traditional transfer pricing principles, i.e. the arm's length standard governs related party dealings. We in the United States, of course, are still awaiting the Section 482 White Paper Regulations to see whether and to what extent the IRS will continue to apply the arm's length standard.

As a result, EC companies not only have access to faster, and more certain dispute resolution in respect of their intercompany dealings, they have more certain rules which are consistent from country to country.

III. OTHER PLANNING IDEAS

Finally, let me go a bit beyond the specific provisions of the current EC directives to discuss other tax planning ideas relating to foreign operations of a U.S. multinational corporation under current tax law. The primary objective, of course, is to minimize foreign taxes on foreign income in an intensely competitive international economy.

One method is by reducing local foreign taxes – always a worthwhile objective, especially in light of the relatively low U.S. tax rate today as compared to European countries.

Reducing local foreign taxes can be accomplished by, for example, acquiring foreign trademarks in the United States, assuming foreign tax can be avoided on the transfer. The royalty charged by the United States to the foreign subsidiary is not only deductible in the foreign country but creates 100 percent foreign-source income. Management fees can also be charged if there is proper documentation.

Consideration also should be given to increasing the debt level of the foreign subsidiary. Of course, careful attention should be paid so as not to violate the thin capitalization rules of the respective countries or the United States. Care must also be given to the Section 861 Regulations' "netting" rule, which can interfere with normal debt financing operations. The Section 861 Regulations' interest allocation rules, of course, make it more costly for U.S. companies to borrow than their foreign competitors.

Another means of lowering a company's worldwide tax burden is to generate no-tax, or low-tax foreign-source income, allowing the company to utilize more of its foreign tax credits. One "standard" way to do this is to ensure that there is foreign title passage on all export sales. In most cases, this means that 50 percent of the profit earned on the sale is treated as foreign source. However, the IRS has attacked the 50 percent rule in rulings and is now engaged in attacking it in at least two Tax Court cases.

A final technique is the creation of a finance company in a tax haven, such as the Netherlands Antilles. Excess funds can be contributed by the European holding company to its Netherlands Antilles subsidiary as a contribution, and relent to operating companies in the EC. Treaties should permit the payment of interest from the operating companies to the finance company, and repayment of funds to the European holding company are treated as a return of capital. The tax on the finance company is, of course, low, i.e. two percent in the case of the Netherlands Antilles. Because the loans are to operating companies, the Subpart F income generated and taxed by the United States is active basket, and bears only the low tax rate of the tax haven. However, it nonetheless is Subpart F income that will be taxed in the United States.

Tax haven finance company planning is, however, becoming more and more difficult to implement in practice. Caution should be exercised because EC countries are strongly reacting to this previously common planning technique by either:
- denying interest deductions for foreign equity investments (e.g. the Netherlands); or
- imposing a Subpart F type tax on the tax haven income (e.g. the United Kingdom and France); or
- denying otherwise tax-free treatment on dividends from tax havens (e.g. Belgium, Denmark).

IV. CONCLUSION

In summary, then, there are many strategies U.S. multinationals can and should use to help minimize taxes and maximize opportunities for their international operations.

Some steps, however, cannot be taken on our own. In cases like those pertaining to the EC directives, U.S. tax laws put U.S. firms at a clear disadvantage in the global marketplace. In such cases, Congress *must* change the rules – not in our favour, but simply to put U.S. companies on an equal footing with their foreign counterparts. In the end, that is all we ask of our Government – a fair shot at being competitive. The rest we can take care of ourselves.

REDUCING THE IMPACT OF FOREIGN TAXES ON THE GLOBAL TAX BURDEN OF U.S.-BASED MULTINATIONAL COMPANIES

Thomas R. Bretz and Timothy F. Anson

Thomas R. Bretz and Timothy F. Anson are members of the Price Waterhouse Great Lakes International Tax Services practice unit.

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I. INTRODUCTION

A. *Background*

Most foreign countries tax earnings twice: once at the corporate level when earned, and again at the shareholder level when distributed. This usually means offshore earnings are more heavily taxed than domestic earnings.

The United States taxes that same foreign income, but avoids double taxation by granting a foreign tax credit up to the U.S. tax on foreign-source income. This calculation is made on a basket-by-basket basis to prevent averaging high-taxed active business income and low-taxed passive investment income.

When foreign taxes attributable to foreign income in any basket exceed U.S. tax imposed on that income, excess foreign tax credits ("FTC") arise. In order to cure this problem, the FTC limitation needs to be increased, foreign taxes need to be reduced, or some combination of both.

In prior decades, it was common practice to average-down the effect of high foreign tax burdens by creating low-taxed foreign-source gross income, or minimizing expenses allocated to foreign-source income. These techniques were primarily tax-driven strategies which rarely involved operating personnel.

U.S. legislative changes in the 1980s have all but eliminated, or rendered useless, many of the formerly used source conversion and expense allocation minimization techniques. As a result, the emphasis has shifted toward "curing" the problem at its source – reduction of foreign country tax burdens. This article will provide a framework and some specific techniques for foreign tax reduction in today's environment.

B. *Meaning of foreign tax planning*

If foreign tax planning is to have any impact, it must start with a set of goals. This outline assumes the primary tax goals of a U.S.-based multinational are to minimize the worldwide effective tax rate and maximize the after-tax return on funds invested.

It is also important to recognize that foreign tax planning is no longer a tax- only process. In the past, much of the foreign tax planning involved principally tax and sometimes Treasury personnel. Today, foreign tax planning is a multi-disciplinary process which requires the involvement of operating management as well – both U.S. operating management and local management.

Local management is needed to both buy-in to the plans, and evaluate the practical aspects of implementing operational changes. U.S. management is needed to back the plans, and to take into account the impact on management incentive plans in order to get local management to buy-in to any changes.

Getting management to buy-in to tax planning strategies at an early stage so that they become an integral part of the business decision-making process requires effective communication. In order to communicate effectively, the tax advisor must first understand management's objectives so that the relevant questions are answered. These questions are not always explicitly stated by upper management.

Often there is great temptation for a tax advisor to tell everything he knows that may be remotely relevant, to explore ideas and alternatives, and not to provide bottom-line answers useful for decision-making. While this approach may mitigate risk to the tax advisor, giving *good* advice which is useful for decision-making requires a willingness to take risks based on sound research and analysis.[1]

The key tax planning strategies are to reduce the amount of foreign income taxes paid – both at the corporate level and at the shareholder level. The focus includes the repatriation of earnings which have already suffered a foreign income tax ("after-tax earnings") and earnings which have not yet suffered a foreign income tax ("pre-tax earnings").

In order to effectively plan in today's environment, the first step is to develop a plan of attack.

C. *Plan of attack*

One will need an adequate data base and a good forecasting technique, including "what if" capability. This includes:
- developing a well-designed information system to capture historical, current and planned future results;
- automating the analysis phase to compare historical, current and future tax results with planned changes;
- measuring and effectively presenting a cost/benefit analysis of planning ideas consistent with stated goals.

An organized, thorough approach to reducing foreign tax liabilities must be adopted. This includes:
- a review of the existing legal structure of foreign operations, especially in light of "1992" changes in the EC;
- a review of the capitalization of foreign operations;
- a review of the global allocation of operating profits;
- a review of "in-country" planning ideas.

The balance of this section will set forth a framework for planning under the headings of structural, distribution, intercompany and local country planning. Part II will review some of the available planning opportunities in the context of the capitalization/financing of foreign operations.

Although each area is discussed separately, it should be kept in mind that the areas overlap and are very interrelated.

D. *Structural planning*

Structural planning should focus on the form of organization (branch, subsidiary, partnership, etc.); the ownership structure (direct U.S. ownership vs. offshore foreign holding company); and the location of easily moveable support operations.

The primary goals of the form of organization are twofold. First, to shift operating profits from high-tax jurisdictions to lower-tax jurisdictions; for example, intentional creation of foreign base company ("FBC") sales, services and foreign personal holding company ("FPHC") income in low-tax jurisdictions to average-down the foreign effective rate on income from high-rate foreign operations, and generate general basket income. Second, to minimize withholding taxes on the cross-border movement of funds. This includes:
- offshore holding company and/or "bank" to permit intra-EC movement of funds free of withholding tax;
- financing operations through a tax-favoured financing entity, such as a Belgian coordination centre;
- restructuring techniques such as Internal Revenue Code ("IRC") Section 304 transactions (intra-group share sales treated as dividends), cash mergers and other equity reduction/recapitalization transactions.

E. *Capitalization/distribution planning*

Capitalization/distribution planning includes:

1. Debt/equity capitalization

- the use of dual-character instruments to obtain local interest deductions with deemed-paid foreign tax credits on the "interest";
- establishing an intercompany "bank" (e.g. a Belgian coordination centre) to:
  - average-down the foreign effective rate on income from high-rate foreign operations;
  - create general basket Subpart F FPHC income;
  - permit intra-EC movement of funds free of withholding tax;
- factoring operations to centralize foreign exchange tax risk.

2. Repatriation of foreign earnings pre-foreign tax

This includes:
- debt push-down;
- structuring the ownership of joint ventures through the use of partnerships to gain local "consolidation" results and look-thru treatment for U.S. FTC basket purposes;
- factoring operations to centralize foreign exchange tax risk;
- cross-border intercompany leasing of tangible personal property to:
  - average-down the foreign effective rate on income from high-rate foreign operations;
  - create general basket Subpart F FPHC income;
  - permit intra-EC movement of funds free of withholding tax;
  - obtain double-dip between "legal" and "beneficial" ownership countries.

Distribution planning should focus on effective rate planning. This includes the timing of distributions as compared to the time foreign taxes were paid from:
- high inflation countries to increase the effective foreign tax rate;
- low inflation countries to decrease the effective foreign tax rate.

Consider the following example of a change in the effective rate through currency fluctuation for a high-inflation currency.

	Local currency	*1 : 1 US$*
Pre-tax E&P	1000	1000
Foreign taxes	400	400
E&P	600	600

Distribution of E&P as a dividend when spot rate is 2 : 1.

	Local currency	*2 : 1 US$*
Dividend	600	300
E&P	600	300
Foreign taxes	400	400
Effective rate	40%	57%

Notice the foreign effective rate changed from 40 percent (when earned) to 57 percent (when distributed) simply due to a change in the exchange rate from 1 : 1 to 2 : 1.

1. For additional discussion on this important topic, see Shelby, "How To Talk So Upper Management Will Listen", 43 *The Tax Executive* (January/February 1991), at 37.

F. *Intercompany planning*

Intercompany planning includes an examination of:

1. Intercompany pricing of goods and services

This includes:
- the amount within an acceptable range;
- local currency vs. U.S. dollar invoicing;
- intercompany contract manufacturing or marketing arrangements; and
- reinvoicing centres.

2. Licensing of intangibles

This includes:
- centralizing licensing arrangements to contract manufacturers/marketers to:
  - average-down the foreign effective rate on income from high-rate foreign operations;
  - create general basket Subpart F FPHC income;
  - permit intra-EC movement of funds free of withholding tax;
- cost-sharing arrangements.

G. *Local country planning*

Local country planning includes a review of locally employed methods of accounting to determine whether acceptable alternatives are available for recognizing income or expenses. This has two distinct aspects:
- accounting methods for foreign country income tax purposes (to manage the amount of foreign tax paid);
- accounting methods for U.S. earnings and profits ("E&P") purposes (to manage the amount of the post-1986 undistributed earnings pool).

If local country tax planning took place in the past, it frequently consisted of taking advantage of all permanent differences and mandatory timing differences. A search for non-mandatory timing differences, where permissible, often did not take place because of the additional recordkeeping burden usually associated therewith.

Frequently the controller of a U.S.-owned foreign subsidiary also doubles as the in-house tax department. Due to the existing recordkeeping burdens for local tax purposes, local statutory reporting purposes and U.S. GAAP purposes, it is little wonder that a foreign controller would not "voluntarily" add to the recordkeeping burdens for local tax purposes – especially when the additional timing difference would not affect the "bottom line" due to the need to record deferred income taxes on such timing differences.

In many foreign countries, a non-mandatory timing difference will be acceptable to the tax authorities only if it is also reflected in the statutory books. This causes a subtle "conformity" issue which can cause tension between local law requirements and U.S. tax desires.

H. *EC tax harmonization*

With the advent of 1992, the EC is undergoing significant commercial, regulatory and tax legislative changes. These changes will necessarily affect the decision of many U.S.-based multinational corporations ("MNCs") whether to invest into Europe, and the form to adopt for such an investment.

Tax harmonization among EC member states has so far taken the form of two important directives which are effective 1 January 1992: the dividend directive and the merger directive.

1. Dividend directive

Member states must adopt legislation implementing the elimination of withholding tax on distributions from one EC corporation to another EC corporation that owns at least 25 percent of the capital of the distributing corporation (certain transitional rules apply to Germany, Greece and Portugal). Additionally, the dividends received must be either exempted from tax, or be subject to a credit for corporate taxes paid in the other member state with regard to the distributed profits.

2. Merger directive

Member states must provide for the deferral of corporate level tax where a merger, division or transfer of assets occurs that involves members of the EC and the transferee continues the business activities and assumes the same asset bases of the transferor.

3. Proposed directives

Two additional proposed directives would abolish withholding taxes on interest and royalty payments between EC members and provide cross-border relief for losses incurred by permanent establishments and subsidiaries. It is anticipated that these proposed directives will be adopted by 31 December 1992 with an expected effective date of 1 January 1993.

In order to minimize the tax cost associated with investment in the EC and subsequent repatriation of profits generated by such investments, careful evaluation of these tax directives should form an integral part of a U.S.-based MNC's strategy for establishing European operations.

II. FOREIGN TAX REDUCTION STRATEGIES

A. *Debt push-down*

As a result of the 1986 Tax Reform Act's tightening of interest allocation rules, MNCs in an excess FTC position do not obtain full tax benefit for interest expense. As a result, there is a strong incentive to place indebtedness with affiliates outside the United States.

The key ongoing objectives of a debt push-down are to:
- reduce interest expense subject to allocation;
- achieve a lower U.S. debt-to-asset ratio compared to the foreign debt-to-asset ratio thereby minimizing or eliminating the impact of the controlled foreign corporation ("CFC") netting rule;
- increase foreign-source income (if the loan is intercompany);
- reduce income taxes imposed on foreign operations;
- reduce withholding tax on the cross-border repatriation of earnings (if the loan is intercompany).

The key transactional objectives of a push-down are to obtain dividend-type treatment carrying deemed-paid foreign tax credits; and to minimize dividend withholding tax on the transaction.

Dividend-type treatment will generally result from transactions governed by Internal Revenue Code Section 301, and intra-group transactions governed by Sections 302, 304 or

356. Following is a discussion of several techniques to consider to achieve dividend-type treatment from the push-down of indebtedness.

1. Ordinary dividend

The most straightforward case consists of an ordinary dividend distribution, financed by local borrowing or a loan-back of the funds distributed. Frequently, a dividend results in little or no residual U.S. tax due to the Section 902 indirect credit available with respect to such dividend. However, because most foreign countries impose a dividend withholding tax, there generally is an out-of-pocket tax cost from the use of this technique to push down indebtedness because of inadequate Section 904 FTC limitation to absorb both the Section 902 indirect credit and the Section 901 credit for withholding tax. As a result, other techniques have been used to obtain dividend-type treatment from the push-down of indebtedness, but which avoid a foreign withholding tax.

Before turning to these other techniques, it is important to note that an ordinary dividend distribution may be the most practical (or the only available) solution to accomplish a push-down. If so, the exercise becomes a cost/benefit analysis to determine whether, despite the presence of a withholding tax, the push-down transaction will nevertheless reduce the global tax burden. The following, somewhat oversimplified, example illustrates this cost/benefit analysis.

Assume, for example, P, a U.S. corporation owns all of the shares of F, a foreign corporation. P is profitable and pays U.S. tax at 34 percent. F is also profitable, pays foreign tax at 40 percent, and F's country of jurisdiction imposes a 5 percent withholding tax on dividends but no withholding tax on interest.

F borrows US$ 1,000 from P at a 12.5 percent interest rate and pays a dividend from the loan proceeds to P.[2] P does not pay any residual U.S. tax on the dividend[3] (due to a Section 902 indirect credit of 40 percent) and suffers an out-of-pocket tax cost of US$ 50 – the 5 percent dividend withholding tax. F receives a US$ 50 tax benefit on its US$ 125 of interest expense, but P does not pay any U.S. tax on the US$ 125 interest income because it has excess FTC of US$ 50 from the push-down transaction to shelter the interest income.[4]

At this point, the global tax cost has not been reduced – the foreign withholding tax cost of US$ 50 is offset by the tax savings to F of US$ 50. However, future years' global tax cost will be reduced – by US$ 50 per year as long as excess FTC can shelter the U.S. tax on the interest income of P of US$ 125, and by US$ 7.5 per year thereafter while the loan is outstanding. In addition, there is an annual withholding tax savings of US$ 6.25 on the "repatriation" of interest of US$ 125, which is beneficial as long as P has excess FTCs.

The point of this example is that merely because an out-of-pocket withholding tax cost will be incurred by leveraging to pay a dividend, it is not necessarily unwise to pursue this course of action, if the cost/benefit analysis is favourable.[5] However, if the withholding tax cost can be avoided in the push-down transaction, the results generally are even more favourable. Following is a discussion of other techniques to consider in achieving dividend-type treatment from the push-down of indebtedness, but which may avoid a foreign withholding tax.

2. Equity reduction transactions

An equity reduction transaction is a transaction that consists of either a buy-back by the offshore subsidiary of some of its outstanding shares, or a reduction in its paid-in capital. For U.S. tax purposes, either transaction will ordinarily result in dividend-type treatment (assuming adequate E&P).

A buy-back by the CFC of some of its shares is a Section 302 redemption for U.S. tax purposes, which will result in Section 301 distribution treatment if the U.S. group continues to own more than 50 percent of the CFC's outstanding voting shares.

If the foreign country permits a CFC to buy back some of its outstanding shares, a push-down of indebtedness with dividend-type treatment for U.S. tax purposes can be accomplished by the CFC borrowing from either a third party or the U.S. group to finance the buy-back. The key foreign country issues are whether such buy-back will result in either capital gains tax to the selling shareholder, or dividend withholding tax on the proceeds remitted to the selling shareholder.

It may be possible for the U.S. group to sell some of its shares to a third party (such as a bank), followed by a redemption of such shares by the CFC. If such a sale/redemption is viewed as pre-arranged for U.S. tax purposes, the "sales proceeds" are likely to be viewed as a dividend from the CFC whose shares are sold. If the sale and redemption are viewed as separate steps for U.S. tax purposes, gain on the sale of the shares of the CFC will be dividend income to the extent provided in Section 1248.

Instead of a buy-back of shares, a reduction in paid-in capital may be made in some countries without attracting a dividend withholding tax. Such a reduction in paid-in capital will result in dividend-type treatment for U.S. tax purposes by reason of Section 301.

3. Section 304 redemption

Section 304 is a creature of U.S. tax law that is difficult to comprehend by non-U.S. tax personnel (and U.S. non-tax personnel) because it seems illogical and irrational. It is a "deeming" provision which treats a commercial sale and purchase of shares between related parties as two very different transactions.

First, it treats the seller as having received dividend income (rather than sales proceeds). Second, it treats the seller as having made a capital contribution to the buyer of the shares

2. P's foreign asset apportionment base for interest expense allocation purposes should remain unchanged from the loan/dividend transactions because P's tax book value in the shares of F should be reduced (by the distribution of E&P) by the same amount as P's new foreign asset – the intercompany loan to F.
3. There may effectively be an additional U.S. tax cost where non-interest expense is allocated or apportioned to foreign-source income using a gross-to-gross base for allocation or apportionment. This has been ignored in the example to simplify the illustration.
4. This assumes that none of the interest paid by F is required to be offset by third-party interest expense of P under the CFC netting rules. The excess FTC of U.S.$ 50 from the push-down transaction is derived as follows: the dividend of U.S.$ 1,000 carries with it a Sec. 902 indirect credit of U.S.$ 667, i.e. pre-tax income of U.S.$ 1,667, less 40 percent tax thereon of U.S.$ 667, leaves U.S.$ 1,000 available after-tax earnings for distribution. The U.S. tax on the grossed-up dividend of U.S.$ 1,667 at 34 percent is U.S.$ 567, generating U.S.$ 100 excess Sec. 902 indirect credit. The excess Sec. 902 indirect credit of U.S.$ 100 plus the Sec. 901 credit for withholding tax of U.S.$ 50 yields excess FTC of U.S.$ 150 from the push-down transaction.
5. In measuring the cost/benefit analysis, any excess FTC created by the push-down transaction which is attributable to the Sec. 902 indirect credit is irrelevant because such amount is a "sunk" cost.

of the target (rather than treating the cost of target's shares as a component in measuring the amount of gain).

The amount treated as a dividend is measured first to the extent of the E&P of the buyer, and thereafter, if necessary, to the extent of the E&P of the target, in each case as though paid *directly* to the seller.

Where the seller does not *directly* own 10 percent of the buyer, the seller may not be entitled to a Section 902 indirect credit on the portion of the dividend treated as coming from the buyer's E&P. However, Revenue Ruling ("Rev. Rul.") 91-5 permits an FTC in a cross-chain sale by a first-tier domestic subsidiary of the shares of its wholly-owned CFC to a first-tier wholly-owned sister CFC. How far the IRS will extend the rationale of Rev. Rul. 91-5 remains to be seen.

The amount treated as a capital contribution, if deemed made by a U.S. corporation, is an "outbound" Section 367(a) transfer, requiring a gain-recognition agreement under Notice 87-85, 1987-2 C.B. 395.[6]

This dividend/capital contribution treatment applies to both cross-chain sales (whether brother-sister or uncle-nephew[7] transactions) and down-the-chain sales, but not to up-the-chain sales.[8] The diagrams in Figure 1 illustrate these four transactional patterns.

The most important consequences of Section 304 treatment from cross-chain and down-the-chain sales by a U.S. corporation in considering a push-down are:

(1) dividend characterization (rather than "sale or exchange" characterization) with potential Section 902 indirect credit shelter for a down-the-chain sale or a cross-chain sale;

(2) the capital contribution characterization by a U.S. person is an "outbound" Section 367(a) transaction currently requiring a gain-recognition agreement to avoid a current toll charge;

(3) for foreign country tax purposes, the sale is likely to be treated as a sale (and not as a dividend). Any capital gain arising from such sale characterization is likely to be exempt from foreign tax either by reason of local law or a treaty exemption. Also, sale characterization will avoid a dividend withholding tax being imposed in most cases.[9]

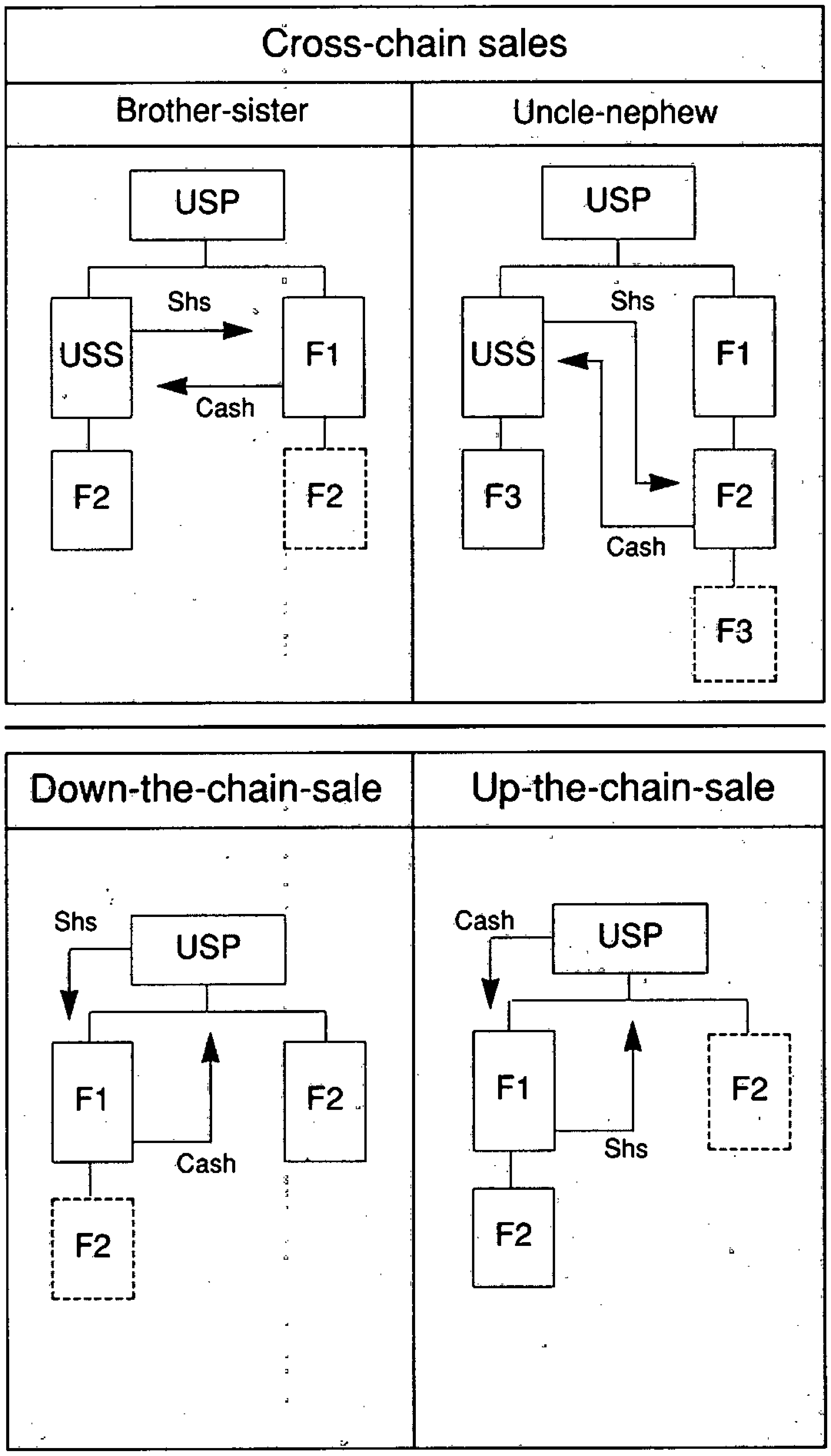
In a soon-to-be-officially released private letter ruling dated 9 May 1991 and reprinted in *Highlights & Documents* of 13 May 1991, the Internal Revenue Service extended the rationale of Rev. Rul. 91-5 to a cross-chain sale by a first-tier foreign subsidiary ("Seller") of the shares of a second-tier CFC ("Target") to a first-tier sister CFC ("Buyer"). Like Rev. Rul. 91-5, the private letter ruling treated the Section 304 dividend flowing from Buyer to Seller as carrying with it underlying foreign taxes eligible for a deemed paid credit under Section 902(b) when such dividend is, in turn, taxed to its U.S. shareholder. In addition to this holding, the private letter ruling went on to provide the following important holdings:

1. To the extent the Buyer's undistributed E&P had been taxed to its U.S. shareholder under Subpart F, thereby giving rise to previously taxed earnings ("PTI"), the Section 304 dividend received by the Seller would be excludable as PTI under Section 959(b), even though the Seller does not own any shares of the Buyer.

2. Any Section 304 dividend to the Seller in excess of PTI is Subpart F FPHC Income in the hands of the Seller, and hence taxable to the shareholder of the Seller, but importantly with an underlying deemed paid credit for any taxes paid by the Buyer on such dividend; and any taxes paid by the Seller on receipt of such earnings.

3. The Seller does not recognize any Section 367-type gain on the transfer of Target's shares to the Buyer; and the

Figure 1



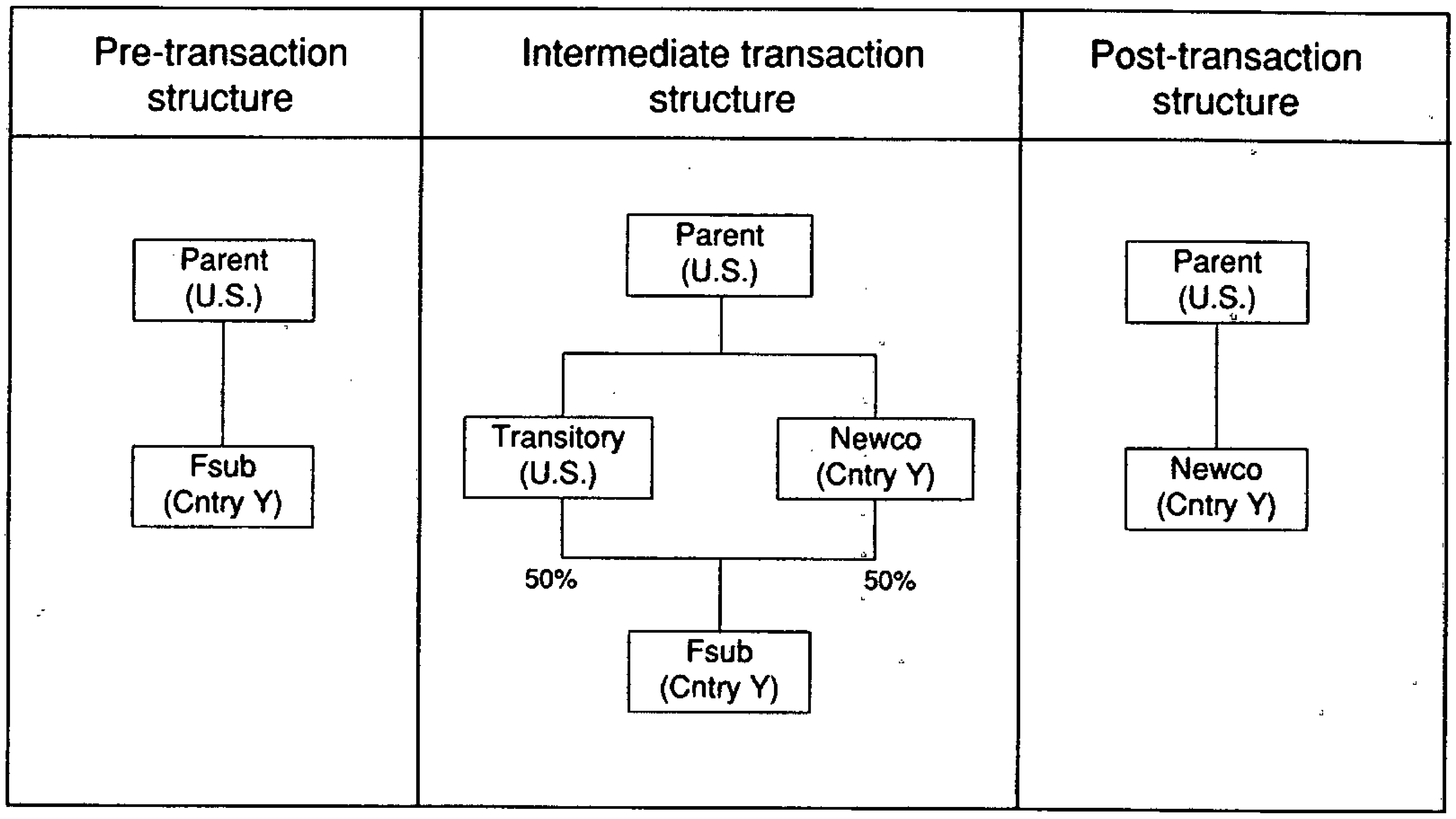
6. 1987-2 C.B. As of the date this article was written, final regulations under Sec. 367(b) and Temp. Reg. §1.367(a)-3T(g) covering Notice 87-85 have not been promulgated. Such regulations are expected to be released in the near future and may include some changes from the rules discussed in Notice 87-85.

7. Rev. Rul. 70-496, 1970-2 C.B. 74.

8. Rev. Rul. 74-605, 1974-2 C.B. 97.

9. Canada is an exception. Under the anti-dividend stripping provisions of Sec. 212.1 of the Canadian Income Tax Act, dividend withholding tax will be imposed on a Sec. 304-type transaction between two Canadian corporations to the extent the sales proceeds exceed paid-up capital of the disposed Canadian corporation and the cash ends up in the hands of a non-resident shareholder. The difference, if any, between the paid-up capital and the shareholder's cost basis will be a capital gain which may be exempt under the U.S.–Canada treaty.

Figure 2



Buyer does not recognize any income from the receipt of Target's shares as a contribution to its capital. In addition, the Buyer takes a carryover basis in the shares of Target, equal to the Seller's basis in such shares immediately before the transaction (i.e. there is no step-up in the shares of Target for the amount recognized as dividend income to the Seller).

4. The portion of the Section 304 dividend excluded as PTI by the Seller causes a basis reduction of the shares of the Buyer in the hands of its shareholder.

In addition to the normal caveats contained at the end of each private letter ruling, this one contains a caveat about whether its rationale would extend to foreign subsidiary Buyers or Sellers below the first-tier, at least with respect to the U.S. shareholders entitlement to an indirect credit arising from the Section 304 dividend.

4. Cash merger

The basic transaction envisions that a same-country leveraged Newco is "merged" with an existing operating subsidiary to push-down indebtedness in jurisdictions where a consolidated-type filing is not permitted. Such "merger" can take several forms, including:

- the merger of a leveraged Newco brother with an existing operating sister;
- an upstream merger/liquidation of an existing operating subsidiary into its leveraged Newco parent;
- the "conversion" of an existing operating subsidiary into a pass-thru entity for local country tax purposes (such as a partnership) owned by its leveraged Newco parent.

The following is an illustration of a transaction used to accomplish a push-down by merger.[10]

Prior to the start of the transaction, a U.S. corporation ("Parent") owned all of the shares of a foreign operating subsidiary ("Fsub") located in Country Y. Parent formed two wholly-owned subsidiaries to carry out the transaction: a U.S. subsidiary ("Transitory") and a Country Y subsidiary ("Newco").

Parent transferred one half of the shares of Fsub to Transitory and the other one half to Newco. Newco then purchased from Transitory all of its Fsub shares for promissory notes of Newco. Transitory then was liquidated into Parent, and Fsub was liquidated into Newco. The diagram in Figure 2 illustrates the structure at the principal stages in the transaction.

In form, the separate steps in the transaction consist of:

- a Section 351 outbound transfer of shares of Fsub to Transitory and Newco;
- a Section 304 cross-chain sale by Transitory to Newco of the shares of Fsub;
- Section 332 liquidations of Transitory into Parent and Fsub into Newco.

The IRS disregarded both the form of the steps and the separate existence of Transitory. Instead, it characterized the transaction as follows:

- a transfer by Fsub of all of its assets to Newco in exchange for Newco shares and notes, and the assumption by Newco of Fsub's liabilities;
- a Section 361(c) distribution by Fsub of the shares and notes of Newco to Parent in complete liquidation. As characterized, the IRS held the transaction qualified as a Section 368(a)(1)(D) reorganization.

The two most important holdings which followed from characterizing the transaction as a "D" reorganization are (1) that the notes received by Parent were treated first as Section 959 previously taxed income, then dividend income under Section 356, which is eligible for a Section 902 indirect credit;[11] and (2) the transaction was subject to the Section 367(b) reporting requirements, but not the gain-recognition agreement under Notice 87-85.

It is understood that the IRS would likely have required Section 304/Section 332 treatment in the event more than 50 percent of the shares of Fsub was purchased for notes or other property (other than Newco shares).

B. *German mirror transactions*

In Germany, it might be possible, given good business reasons, to achieve a push-down of indebtedness – a so-called "mirror transaction".

10. The transaction is based upon Private Letter Ruling ("PLR") No. 89-52048. See also PLR Nos. 89-52041 and 91-17053 for substantially similar transactions.
11. See Rev. Rul. 74-387, 1974-2 C.B. 207.

Figure 3

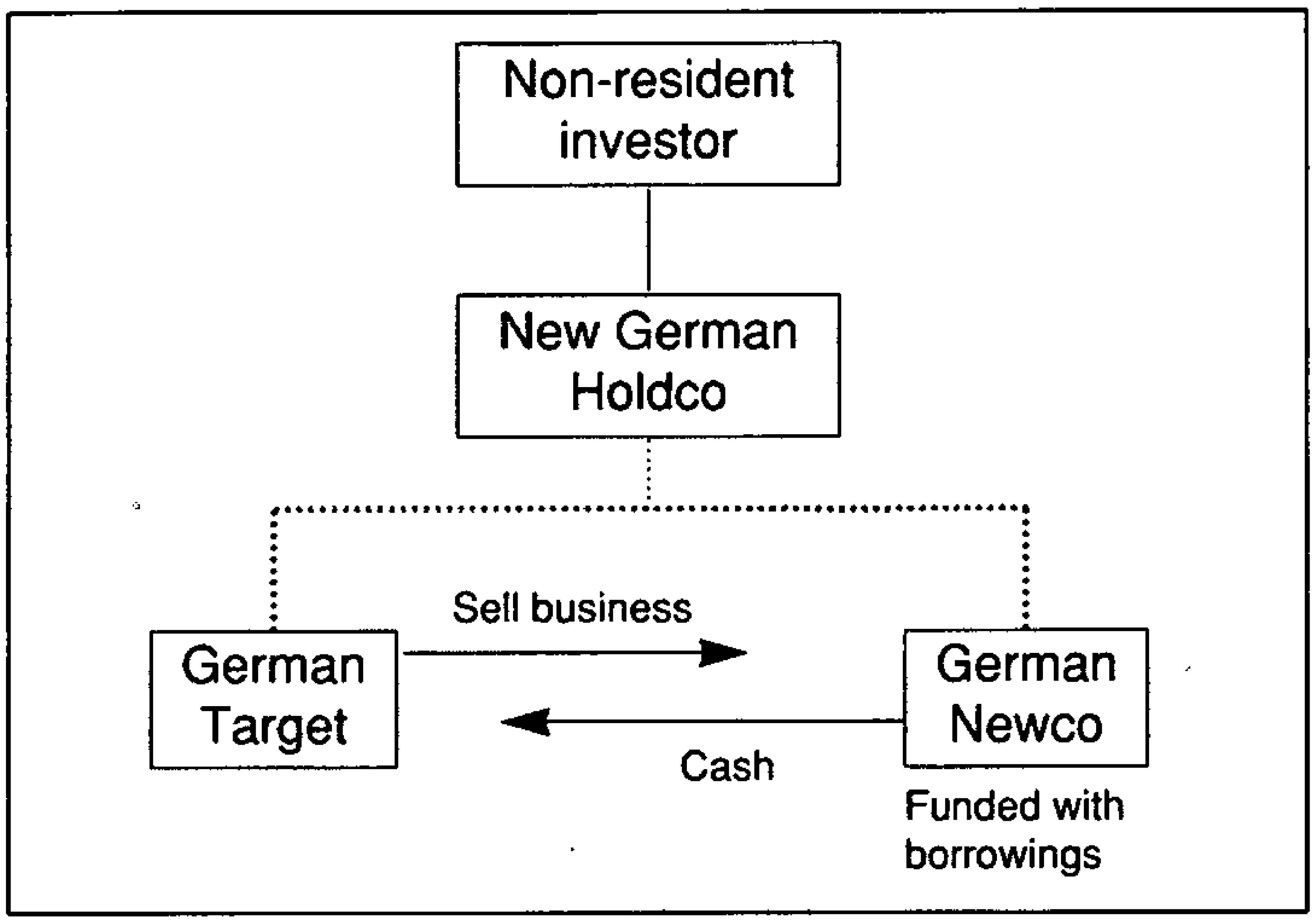
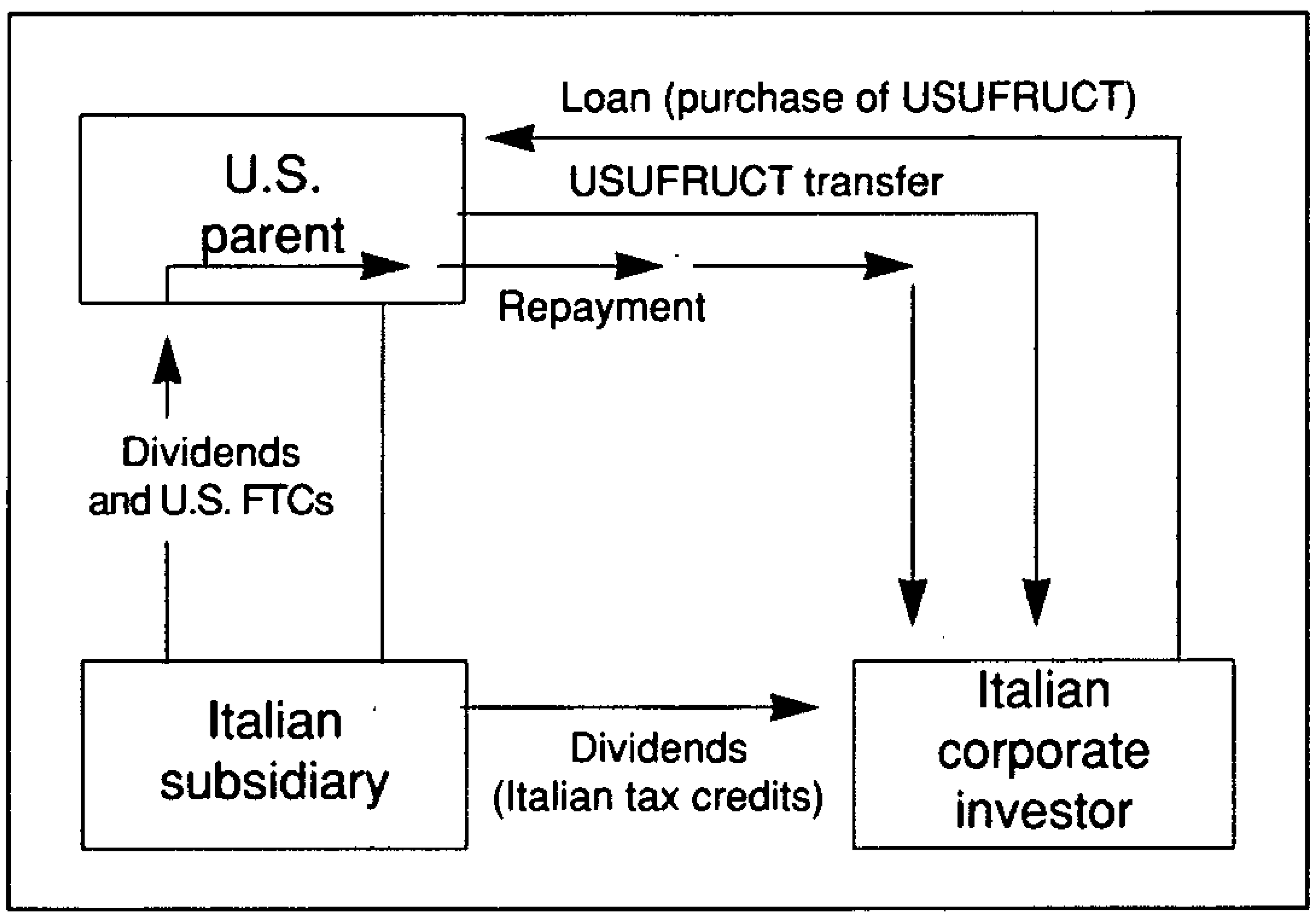


Figure 4



The principal purpose of a mirror transaction is to achieve a step-up in tax basis of the underlying assets in an acquisition of shares in a German company. The technique is motivated largely by the German tax law provision enacted in 1987 which allows for the amortization of goodwill over 15 years. This transaction is only viable where the seller is a German resident taxpayer because of special rules which restrict the write-down of shares as discussed below.

A diagram of the transaction is shown in Figure 3.

The steps of the transaction are as follows:

1. The non-resident investor forms German Holdco and Newco. Holdco acquires the shares of Target.
2. Target then sells its assets to the German Newco at fair market value (the same price as that paid to the seller for the shares). Target will recognize taxable gain on the sale.
3. The profit realized by Target is distributed as a dividend to Holdco. The dividend is tax-exempt for trade tax purposes if Holdco has owned the shares in the Target from the beginning of its business year in which the dividend is received. The dividend is taxable for corporation profits tax purposes, but the corporation profits tax paid by Target on the sale of its assets is treated as a prepayment of tax by the Holdco. (The same applies to the 25 percent dividend withholding tax which has to be deducted from the dividend.)
4. Holdco then writes down the value of its investment in the Target because the latter's value has been "stripped away" by the dividend. This write-down is deductible for corporation profits tax purposes (although not for trade tax purposes) and offsets the dividend income received, effectively permitting Holdco to recover the corporation profits tax paid by Target on the sale of its assets.
5. German Newco will be able to claim amortization deductions with respect to the stepped-up value of assets (including goodwill) acquired.
6. Target will then be liquidated. As it will have assets (cash or receivables from German Newco) equivalent to its capital, no gain would be realized and the repayment of the capital will simply substitute cash for the written down value of the investment on Holdco's books.

The above procedure effectively results in a tax-free step-up in values for corporation profits tax purposes, although there is a "front end" trade income tax cost for Target, because the gain on sale of assets is taxable. Newco will recover this tax over the useful lives of the assets, because depreciation on the stepped-up asset values will be deductible for trade tax purposes.

C. *Italian USUFRUCT transaction*

This technique allows U.S. MNCs with profitable subsidiaries in Italy to raise funds in Italian lire at a cost considerably below domestic and Euro-market financing rates. The technique involves the transfer by a U.S. parent of the right-to-receive dividends from its Italian subsidiary either in perpetuity or for a fixed period of time (the "USUFRUCT"), to a third-party Italian corporate investor (the "Investor") in exchange for a single upfront payment.

The right is typically transferred for a specified period of time, at the end of which it reverts back to the U.S. parent. The stock of the Italian subsidiary continues to be owned by the U.S. parent, and the U.S. parent retains all of the voting rights associated with share ownership, including complete discretion as to the timing and amount of dividend distributions.

The Investor typically has the right to "put" the USUFRUCT to the U.S. parent at any time after the anticipated payment date of the first dividend at a price determined in accordance with a pre-established formula.

The dividends paid to the Investor should be roughly equivalent to the upfront payment so that over the period covered by the agreement, the Investor will recover the entire amount of such payment.

A diagram of the transaction is shown in Figure 4.

The U.S. and Italian tax consequences are summarized below:

United States

(a) The upfront payment by the Investor to the U.S. parent in exchange for the USUFRUCT should be treated as a loan. As a result, the U.S. parent will be treated as if it continued to receive dividends directly from the Italian subsidiary and then used those dividends to repay the loan made by the Investor.

(b) The U.S. parent will be required to include the dividends paid by its Italian subsidiary in taxable income and may be entitled to a deemed-paid FTC under Section 902.

(c) The U.S. parent will be entitled to deduct as interest or bond issuance expense the excess of the aggregate dividend paid to the Investor over the net proceeds which the U.S. parent receives. This would typically be a nominal amount.

(d) Care must be taken to avoid a Section 956 income inclusion to the U.S. parent as a result of an indirect pledge or guarantee of the dividend stream to the Investor using voting stock of the Italian subsidiary.

Italy

(a) Italian law provides that the owner of a share of capital stock may transfer the share coupon to a third party, thereby entitling the holder to receive dividends paid on that share over a specified period of time. The dividends received by the holder of the USUFRUCT of an Italian company qualify for the tax credit applicable to dividends paid to resident corporations. Accordingly, dividends received from the Italian subsidiary will be tax-free to the Investor.

(b) The payment made by the Italian investor to the U.S. parent should not be subject to Italian withholding tax.

(c) For Italian tax purposes, the holder of the USUFRUCT classifies the upfront payment as an intangible asset which is amortizable over the useful life on a straight-line basis.

The primary benefit to the U.S. parent is low-cost financing which avoids Italian withholding tax cost. Little or no interest will be required because of the Italian tax benefits which inure to the Investor. Such benefits include amortization deductions which are allowable over the term of the agreement.

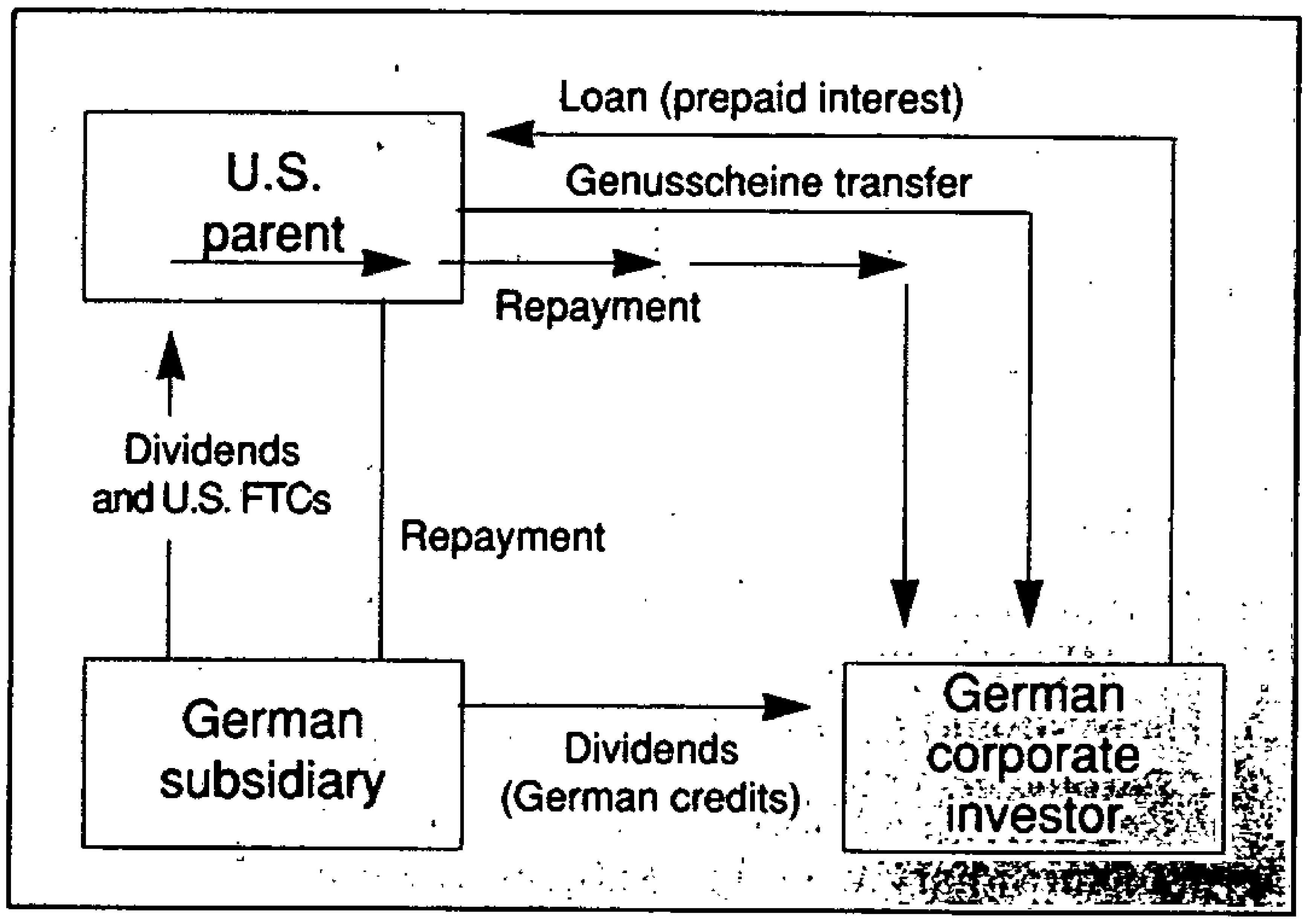
Under U.S. tax principles, it is important to note that there is risk that the Section 902 credit will not be available to the U.S. parent in circumstances where a foreign taxing jurisdiction allows the Investor a refundable credit based in whole or in part upon the foreign taxes that the distributing corporation has paid. The issue turns in part upon the distinctions between an exemption system and a credit system of avoiding a double-level of corporate tax. Under an exemption system, the Investor may obtain a dividends-received deduction to avoid including the dividend in income. This benefit operates only to eliminate tax to the Investor. It does not constitute a refund of taxes paid by the distributing corporation. In contrast, a refundable credit that relates to the tax paid by the distributing corporation, as in the case of Italy, may be treated for U.S. tax purposes as decreasing the taxes paid by the distributing corporation, thereby reducing the Section 902 credit.[12]

D. *Genusscheine*

The German counterpart to the Italian USUFRUCT is the *Genusscheine.* Similar to the Italian USUFRUCT, the objective of this technique is to enable a U.S. parent to obtain low-cost debt financing by leveraging its German subsidiary.

The technique involves creation of a new class of capital owned by the U.S. parent, called "Genusscheine", which is similar to preferred stock. The U.S. parent then executes a matched sale and repurchase of this instrument with a German investor (the "Investor") for a fixed term. The U.S. parent allows the Investor to defer payment for the Genusscheine until the date of the repurchase, receiving interest from the Investor as compensation. Finally, the U.S. parent requires the Investor to prepay interest expense on the deferred purchase price at the outset of the transaction.

Figure 5



The U.S. parent will create a new class of Genusscheine capital in its German subsidiary from existing German subsidiary reserves or retained earnings, or from new capital investment from the U.S. parent. The Genusscheine will carry a fixed cumulative dividend; have a stated maturity substantially exceeding the financing; and have no voting rights. The dividends would be payable out of net earnings prior to addition to reserves and dividends on common stock. If earnings are insufficient, the dividends can be paid out of retained earnings subject to a vote by the holders of the common stock.

During the term of the grant, the Investor would be entitled to receive the dividends on the Genusscheine from the German subsidiary. The Investor will be entitled to "put" the Genusscheine back to the U.S. parent in certain circumstances including a material adverse change in German tax law, change in control of the German subsidiary or U.S. parent, or failure to pay a scheduled dividend. The dividends paid on the Genusscheine to the German investor will be roughly equivalent to the interest paid upfront by the Investor on the deferral of the initial sale price.

A diagram of the transaction is shown in Figure 5.

The U.S. and German tax consequences are summarized below:

United States

(a) The upfront payment by the Investor to the U.S. parent in exchange for the Genusscheine should be treated as a loan. As a result, the U.S. parent will be treated as if it continued to receive dividends directly from the German subsidiary and then used those dividends to repay the loan made by the Investor.

(b) The U.S. parent will be required to include the dividends in taxable income, and may be entitled to a deemed-paid FTC under Section 902.[13]

12. There are three basic theories which could reduce the Sec. 902 credit to the U.S. parent. First, the refunded tax is an advance payment by the distributing corporation of the investor's tax. Thus, the investor and not the distributing corporation is considered to have paid the taxes equal to the credit; second, the investor credit constitutes a refund under Treas. Reg. §1.901-2(e)(2). Such regulation does not explicitly require that the refund be made to the corporation that originally paid the tax. Third, the foreign taxes paid by the distributing corporation are treated as a subsidy pursuant to Prop. Reg. §1.901-2(e)(3).

13. There is a risk that deemed paid foreign tax credits under Sec. 902 would be disallowed as discussed in footnote 12 and accompanying text.

(c) The U.S. parent will be entitled to deduct as interest expense the target yield on the outstanding loan.

(d) Care must be taken to avoid a Section 956 income inclusion to the U.S. parent as a result of an indirect pledge or guarantee of the dividend stream to the Investor using voting stock of the subsidiary.

Germany

(a) The Investor is entitled to a tax credit or payment from the German tax authorities equalling the corporation profits tax payable on the dividends relating to the Genusscheine.

(b) Prepaid interest paid by the Investor should be deductible on a straight-line basis over the term of the grant.

(c) There should be no German income tax payable by the U.S. parent or German subsidiary on the grant of the Genusscheine. In addition, neither the U.S. parent nor the German subsidiary would be subject to withholding tax on the grant of the Genusscheine to the Investor. While Genusscheine dividends paid by the German subsidiary would be subject to 25 percent withholding tax to the Investor, this withholding tax would be fully creditable by the Investor.

(d) Withholding tax should not be levied on the upfront payment of interest under the U.S.–German tax treaty.

(e) Converting previously taxed retained earnings in Germany into Genusscheine would generate a tax refund from the German authorities to the German subsidiary. This refund would equal the difference between the corporate profits tax previously paid (56 percent or 50 percent) and the corporation profits tax payable on distributions (36 percent). As this refund would be treated for German tax purposes as paid to the U.S. parent, the refund would be reduced by the German withholding tax on distributions. Should the U.S. parent prefer to create Genusscheine from existing reserves, there would be no German tax consequences.

The scheme results in low-cost debt financing to the U.S. parent. A relatively low rate of return is required by the Investor because of the favourable German tax benefits derived. In addition, the U.S. parent saves an additional withholding tax expense to the extent that the U.S. parent is in an excess FTC position and thus, would not be able to utilize such taxes as a credit against its U.S. tax liability.

There may be other jurisdictions in which this or a similar technique may have application.

E. *Canadian NRO/Quebec financing company*

An increasingly popular technique to accomplish some push-down objectives is the use of a non-resident owned ("NRO") investment company to invest in a Canadian operating business. The objective of using an NRO is to obtain a reduced shareholder-level withholding tax on a cross-border repatriation of earnings.

An NRO is a Canadian-incorporated company owned entirely by non-residents which derives substantially all of its income from investment-type activities (other than lending money). An NRO is taxed at 25 percent, which is effectively reduced to the 10 percent treaty withholding rate when it pays dividends to its U.S. shareholder.

An NRO will ordinarily be funded entirely with equity capital, which will be used to purchase existing indebtedness owed by a Canadian operating company to its U.S. shareholder or a third-party lender. If this distinction between "purchasing debt" and "lending money" is *bona fide* and not subject to attack under step-transaction or integrated-transaction principles, it should be an eligible income-earning activity of an NRO.

Another technique being considered with respect to a push-down to Canadian operations is the use of a low provincial-rate financing company (e.g. Quebec) to provide loan finance to a high provincial-rate operating company (e.g. Ontario). Because there is a wide range of provincial tax rates (ranging from a low of 6.2 percent in Quebec to a high of 17 percent in Manitoba and Newfoundland – with most provinces in the mid-teens), the Canadian tax savings can be significant. Moreover, if the low provincial-rate financing company is capitalized with equity, dividends paid to the United States will be subject to the 10 percent treaty withholding rate for dividends, rather than the 15 percent withholding rate for interest.

UNITED STATES: FOREIGN SUBSIDIARY EARNINGS REPATRIATION PLANNING IN AN ERA OF EXCESS FOREIGN TAX CREDITS[1]

Howard S. Engle

I. INTRODUCTION

A. *U.S. tax treatment of distributions from foreign subsidiaries*

Under current U.S. laws, the U.S. shareholder of a foreign corporation is generally taxed on cash distributions from such corporation if the foreign corporation is deemed to have positive earnings and profits ("E&P"). After the Tax reform Act of 1986, a foreign corporation's E&P must be calculated in its functional currency and accounted for separately from pre-1987 E&P. The E&P is then translated into dollars at the exchange rate in effect on the date the distribution is included in the taxable income of the U.S. parent. As the E&P is accounted for in the subsidiary's own functional currency, no translation of the foreign subsidiary's balance sheet into dollars is required so that E&P is not adjusted to reflect unrealized balance sheet translation gains and losses.[2]

Accumulated foreign taxes paid by the foreign corporation are accounted for in U.S. dollars and are translated into U.S. dollars using the historical exchange rate in effect as of the date of payment. Any refund of a foreign tax is translated using the rate in effect as of the payment date.[3]

Distributions of positive E&P carry with them underlying foreign taxes which can be claimed as credits against U.S. tax on the dividend. The amount of foreign tax credit associated with a specific dividend is computed on a pooling method and is equal to that portion of accumulated foreign taxes that the dividend paid bears to that subsidiary's accumulated E&P.[4] Or, alternatively,

$$\text{Foreign tax credit in dollars} = \frac{\text{Dividend in functional currency}}{\text{Accumulated E\&P in functional currency}} \times \text{Accumulated foreign taxes in dollars}$$

B. *Excess foreign tax credits*

A U.S. taxpayer has excess foreign tax credits in a taxable year if its available foreign tax credits exceed its foreign tax credit limitation. Although this condition can result from a variety of circumstances, generally this situation occurs if the foreign taxes paid by the taxpayer on its foreign income exceed the U.S. tax on the same income. Such excess foreign tax credits can be carried back two or forward five taxable years to offset U.S. tax on foreign-source income in other taxable years. A taxpayer with creditable foreign taxes less than its foreign tax credit limitation is said to have "excess foreign tax credit limitation" and can absorb excess foreign tax credits from other years to offset U.S. tax on that year's foreign-source taxable income. The excess foreign tax credits can be absorbed only to the extent of that year's excess foreign tax credit limitation.

In a simplified fashion, Figure 1 illustrates the operation of the U.S. foreign tax credit system on a dividend from a subsidiary to a U.S. corporate parent. Assume the subsidiary earns functional currency ("FC") one million of pre-tax profits and pays a local tax of 30 percent when the exchange rate is FC 1 = $ 1.50.

If the subsidiary's after-tax profits are distributed immediately, the U.S. parent receives cash of $ 1,050,000 (FC 700,000 × $ 1.50/FC). If the U.S. parent elects to claim a foreign tax credit to compute the U.S. tax on the dividend, the cash dividend income is then grossed up by the underlying foreign tax credit to arrive at foreign-source taxable income.

Mr. Engle is a tax partner with the Chicago office of Arthur Andersen & Co. and is responsible for the coordination of the firm's international tax services in the Chicago office and the Midwest Region. In that capacity, Mr. Engle devotes considerable time to matters that involve the U.S. tax consequences of U.S. entities conducting operations worldwide. He is also a member of various Arthur Andersen & Co. specialty teams that have particular responsibility for international tax matters.

Mr. Engle received his Bachelor of Science degree in Accountancy from the University of Illinois and his Master of Science degree in Taxation from DePaul University. He is also presently Adjunct Associate Professor of Accountancy in the Graduate Tax Program at DePaul University and a lecturer at the University of Illinois. Mr. Engle is a Certified Public Accountant and a member of the American and Illinois Societies of Certified Public Accountants.

Mr. Engle speaks frequently on matters of international taxation and has addressed the World Trade Institute, the Chicago Tax Club, the International Fiscal Association, the Tax Executives Institute, the Mid-America Committee and other international groups. In addition, he is a regular contributor to professional tax publications, editor of the "International Tax Developments" column of the Journal of Corporate Taxation and a co-author of the BNA portfolio entitled Foreign Corporation Earnings and Profits.

1. Background information and source material for this presentation is adapted from the *Handbook of International Financial Management*, ed. Robert Z. Aliber, Chapter 20, Howard S. Engle and Mark T. Campbell, "Foreign Currency and U.S. Income Taxes" (1989), at 594.
2. Internal Revenue Code ("IRC") Sec. 986. All references are to the IRC.
3. Secs. 986(a)(1)(B)(ii) and 989(c)(4).
4. Sec. 902(a).

FIGURE 1
Illustration of Foreign Tax Credit System

Foreign subsidiary results		*Taxes paid when FC = $ 1.50*
Pretax profits	FC 1,000,000	
Local taxes at 30 percent	FC (300,000)	= $ 450,000
Dividend distributed	FC 700,000	

U.S. tax computations

	Dividend distributed when	
	FC = $ 1.50	FC = $ 1.00
Cash dividend received	$ 1,050,000	$ 700,000
Foreign tax credit gross-up	$ 450,000	$ 450,000
Foreign-source taxable income*	$ 1,500,000	$ 1,150,000
U.S. tax at 34 percent	$ 510,000	$ 391,000
Foreign tax credit	$ (450,000)	$ (391.000)†
Net U.S. tax due	$ 60,000	$ 0
Excess foreign tax credits		$ 59.000

* Assumes no deductions allocated or apportioned to foreign-source taxable income and no withholding taxes on remittance.
† Subject to foreign tax credit limitation.

This total amount of cash and foreign tax credit is the U.S. equivalent of local pre-tax income, that is, $ 1,500,000 = $ 1,050,000 + $ 450,000 = FC 1,000,000 × $ 1.50/FC. Such a dividend is also said to have (for the moment) an effective foreign tax rate of 30 percent = $ 450,000/$ 1,500,000.

The gross U.S. tax is computed on this amount and a credit is allowed for foreign taxes paid, leaving a net U.S. tax due of $ 60,000. As the local tax rate was four percent less than the U.S. rate (34 percent – 30 percent), this $ 60,000 brings the total tax burden on the income up to 34 percent, that is, $ 60,000 = 4% × FC 1,000,000 × $ 1.50/FC.

If the exchange rate falls to FC 1 = $ 1.00 when the dividend is paid, the dividend amount falls in value but the foreign tax credit computed at the historical exchange rate remains unaffected. The effective tax rate on the dividend therefore rises from 30 percent to 39.1 percent = (450,000/ $ 1,150,000). As a result, ignoring other factors for the moment, when the dividend is subject to U.S. tax, excess foreign tax credits will arise.

C. *Fluctuations in effective foreign tax rates*

These changes in effective foreign tax rates can occur because the foreign currency gain or loss on the undistributed E&P is taxed in the United States essentially as another form of dividend income. The foreign taxing jurisdiction in terms of its own currency perceives no such gain or loss and does not tax or tax benefit the foreign exchange gain or loss. Therefore in the Figure 1 example there is no reduction in local taxes for the foreign currency loss.

These rules thus introduce an asymmetry (presumably intended) between the U.S. tax treatment of undistributed earnings, the value of which fluctuates with foreign currency exchange rates, and foreign tax credits, the value of which is fixed at historical exchange rates. For example, in Figure 1, the foreign currency depreciates with respect to the U.S. dollar reducing the value of the dividend while holding the foreign tax credit constant and in the process, increases the effective foreign tax rate. In this case, the higher effective tax rate causes the dividend to generate excess foreign tax credits. If the foreign currency were to appreciate with respect to the U.S. dollar, the exchange gain would be treated as additional untaxed dividend income, the effective foreign tax rate would therefore fall, and the dividend would generate additional excess foreign tax credit limitation.

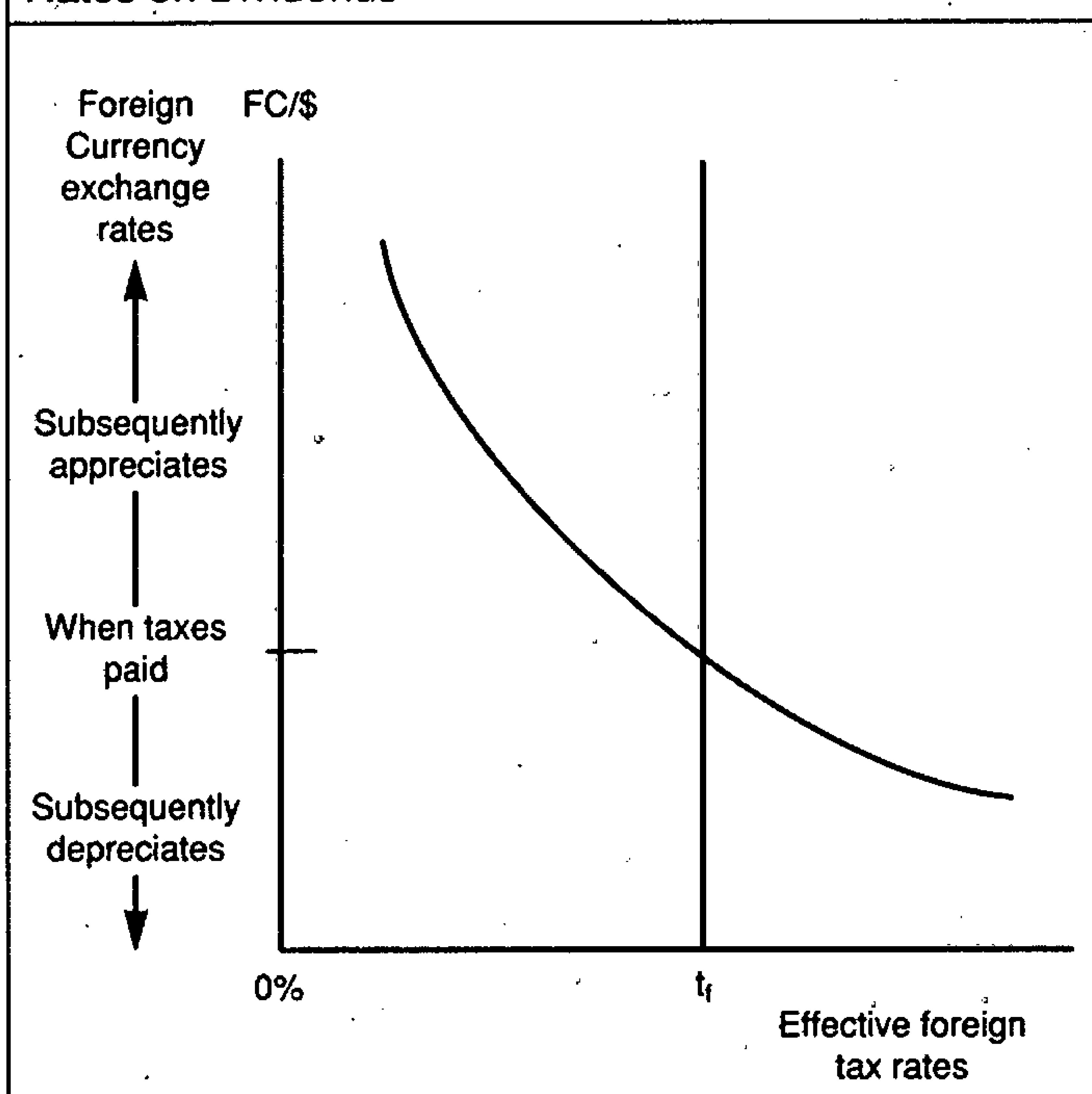
Figure 2 shows how foreign appreciation and depreciation with respect to the U.S. dollar affect the effective foreign tax rate of undistributed E&P. The system values foreign tax credits at their historical fair market value and earnings at their current value. This historical valuation, however, is achieved at the cost of fluctuating dividend effective foreign tax rates.

D. *Pre-1987 earnings of foreign subsidiaries*

The foreign tax credit translation rules in effect before the Tax Reform Act of 1986 were different and continue to apply to undistributed pre-1987 earnings. Under the old rules, an annual E&P and foreign tax credit calculation was made in the subsidiary's functional currency. This resulted in annual layers of accumulated E&P as well as their associated layers of foreign tax credits. Both E&P and foreign tax credits were accounted for in the same functional currency. As dividends were paid out of these E&P layers (on a last-in first-out basis), discrete layer-by-layer calculations were made to determine the foreign tax credits (and effective foreign tax rate) that accompanied each dividend.

The E&P, and the underlying foreign tax credits were then translated into U.S. dollars at the foreign exchange rate in

FIGURE 2
Exchange Rate Changes and Effective Foreign Tax Rates on Dividends



effect on the date of distribution. The historical exchange rate when the taxes were paid therefore had no effect on the undistributed foreign tax credits actually claimed. This system tended to preserve the effective foreign income tax rates in effect when the earnings were earned so that effective foreign tax rates did not fluctuate.

These E&P rules are still in effect if foreign affiliates retain (and subsequently remit) E&P earned prior to 1987. In addition to the old general rules, special rules applicable to such periods also exist for income deemed distributed. Income can be deemed distributed and, therefore, taxable for instance if it arises from passive sources, is invested in U.S. assets or was accumulated in a foreign subsidiary sold by one U.S. person to another. These special E&P rules, under Section 964, allowed the calculation of E&P, and foreign taxes in U.S. dollars. This calculation implicitly allowed the inclusion of unrealized translation losses (and gains) in the annual E&P calculations.[5]

Both of these systems of E&P now coexist with the post-1986 E&P rules. Ordering rules determine which system is used to compute the amount of the deemed paid credit received with a dividend. As a general rule, the most recent E&P are deemed to be distributed first. The deemed paid foreign tax credit is computed using the pooling method, that is, the weighted average is adjusted for foreign exchange effects. Only if a distribution exceeds the total E&P accumulated after 1986 is the layering approach considered. Then that portion of the deemed paid credit is computed using the annual tax rate for each year in reverse order (i.e. first 1986, then 1985, etc.).

II. REMITTANCE DECISION

A. *In general*

Foreign currency fluctuations affect the U.S. tax costs of a multinational firm by constantly changing the effective foreign tax rates on undistributed foreign earnings. In this environment, a U.S. parent of profitable foreign subsidiaries must constantly determine the optimal financing of its foreign subsidiaries. One of these financing decisions is whether the subsidiary should distribute those profits as dividends for reinvestment in the United States or alternatively reinvest local after-tax profits. This dividend or no dividend decision affects the debt-to-equity structures of both foreign subsidiaries and their U.S. parents. Naturally, once profits are distributed back to the United States, the foreign profits are subject to direct U.S. tax. Ideally this dividend decision should produce optimal after-tax financial results for the entity's worldwide operations.

The real world dividend decision is generally made in the uncertain context of both non-tax management or cash flow considerations, as well as a host of U.S. tax considerations, including available but unused foreign tax credits, the allocation of interest expense and a variety of other real life conditions. In this context it may be difficult to appreciate the interaction of foreign currency fluctuation and taxes; therefore, the remaining portion of this discussion compares repatriating or reinvesting foreign earnings in an environment of complete certainty.

B. *Some assumptions*

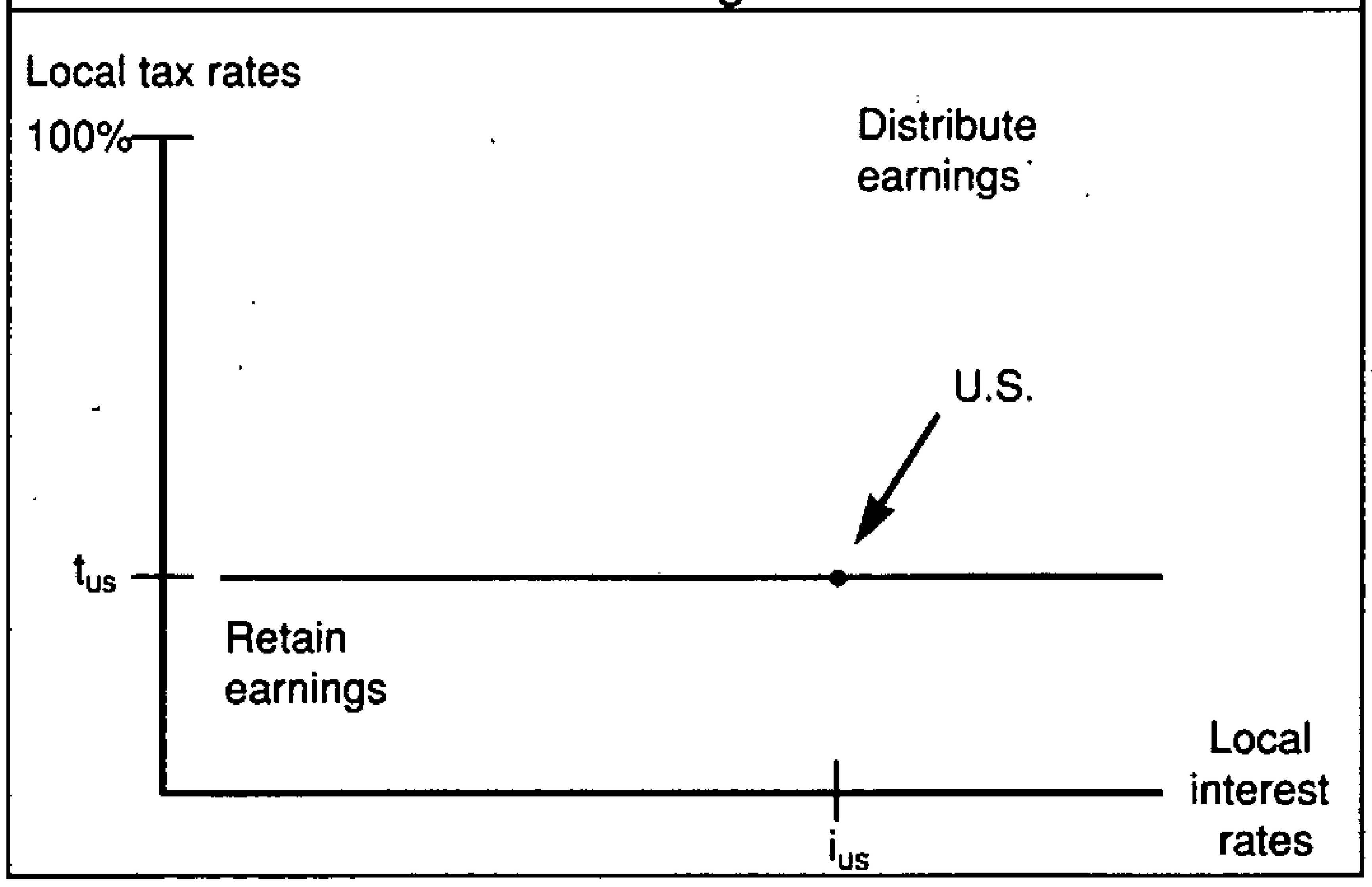
This analysis occurs in a financial environment of both perfect interest rate parity and tax predictability and focuses on how two local country variables, local income tax rates and local interest rates, affect the dividend decision. Interest rate parity assumes that the difference in interest rates between two currencies are perfectly compensated for by anticipated changes in the foreign exchange rate. Initially there are no anticipated tax or interest rate shocks to the system.

Classical income tax systems are assumed so that the local income of a U.S. or foreign subsidiary is subject only to a flat marginal income tax.[6] The after-tax foreign profits are then subject to a flat withholding tax, if any, when distributed back to a U.S. parent. Withholding taxes are not explicitly analyzed here since it can be shown that whatever their rate, they do not affect the fundamental analysis. Every foreign income tax is assumed to be fully creditable in the United States.

The U.S. parent company is assumed to determine its foreign tax credit position first based on its non-discretionary income. That is, the U.S. parent determines if it is in an excess foreign tax credit position or excess limitation position before any of the discretionary dividend income is considered. It is also assumed that it remains indefinitely in that foreign tax credit position regardless of the payment or non-payment of discretionary dividends.

In Figure 3, any country, including the United States, can be shown as a point corresponding to the combination of its local income tax rate expressed as a percentage, and the local interest rate for some comparable debt. The combination for the U.S. company is shown as t_{us} and i_{us}, where t_{us} is the U.S. marginal income tax rate and i_{us} is the interest rate.

FIGURE 3
U.S. Parent with Excess Foreign Tax Credit Limitation

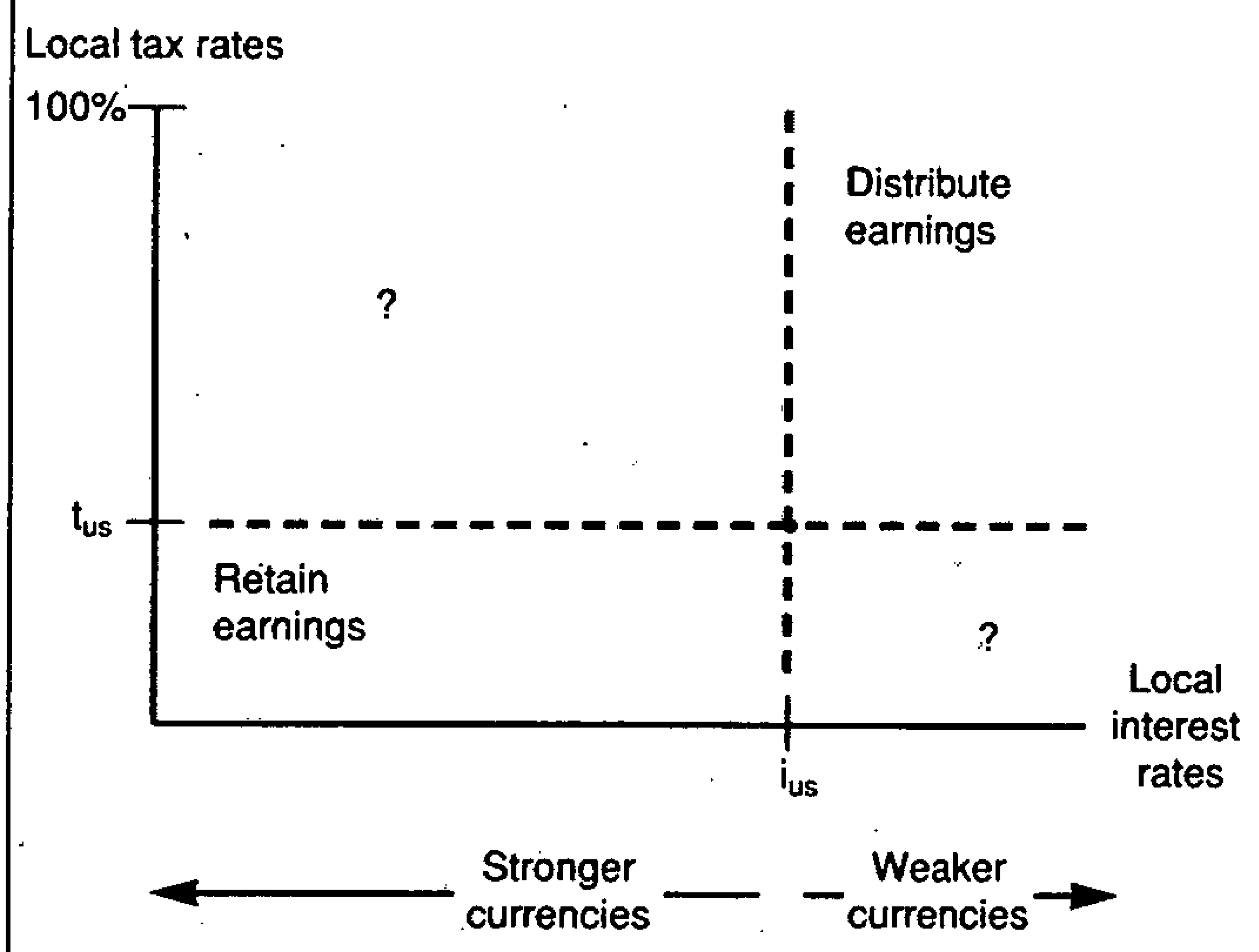


C. *Excess foreign tax credit limitation for the U.S. parent*

If the U.S. parent is in a long-term excess foreign tax credit limitation position, intuitively all foreign subsidiaries with local income tax rates greater than the U.S. rate should distribute their earnings currently for reinvestment in the United States. For instance, if the U.S. tax rate is 34 percent and a foreign country's tax is 50 percent, a dividend of after-tax earnings generates excess foreign tax credits of 16

5. Secs. 902(c)(6) and 964.
6. Countries with imputation systems such as Germany and the United Kingdom do not strictly meet this flat marginal tax rate requirement.

FIGURE 4
U.S. Parent with Excess Foreign Tax Credits



percent which can be claimed against other taxes owed to the United States. The after-tax earnings and excess foreign tax credit themselves generate more earnings which accumulate faster on an after-tax basis in the United States than if they were retained in a high-taxed local country. Conversely, all foreign subsidiaries with local tax rates less than the U.S. tax rate should retain their earnings for local reinvestment.

Foreign subsidiaries with local income tax rates equal to the U.S. income tax rate are indifferent as to whether to reinvest or distribute their earnings because the after-tax profits are the same. For instance, assume that the U.S. tax and interest rates are 34 percent and 8 percent and that the corresponding rates in a foreign country are 34 percent and 10 percent, respectively. If the initial exchange rate is FC 1 = \$ 1 and the interest rate parity holds, the anticipated exchange rate one period later is (1 + 10%)/(1 + 8%) = FC 1.0185 = \$ 1. This means the depreciation of the FC with respect to the dollar is perfectly compensated for by the two percent higher interest rate that can be earned by investing in FC-denominated debt.

If the subsidiary has FC 10,000 of pre-tax earnings, and immediately distributes the after-tax cash permitting the parent to earn U.S. interest thereon, the after-tax results after one period are:

Immediate dividend

Cash flow		
Pretax income	FC	10,000
Foreign tax at 34%		(3,400)
Dividend to the United States	FC	6,600
U.S. parent dividend income	\$	6,600
U.S. interest income at 8%		528
U.S. tax on the interest at 34%		(180)
End of period after-tax cash	\$	6,948

If the funds were retained, reinvested locally and then the total after-tax proceeds dividended back to the U.S. parent one year later, the results would be as in the following table:

Reinvest profits

Cash flow		
Pretax income	FC	10,000
Foreign income tax at 34%		(3,400)
After-tax earnings		6,600
Foreign interest income at 10%		660
Foreign tax on the interest at 34%		(224)
Cash dividend to United States	FC	7,036
U.S. parent dividend income FC 7,036 ÷ \$ 1.0185/FC	\$	6,908
Utilization of excess foreign tax credits computed below		40
End of period after-tax cash	\$	6,948

U.S. tax computation

Dividend income	\$	6,908
Foreign taxes FC 3.400 at 1 FC = \$ 1		3,400
Foreign taxes FC 224 at 1.0185 FC = \$ 1		220
U.S. taxable income	\$	10,528
U.S. tax at 34%	\$	(3,850)
Foreign tax credits		3,400
Foreign tax credit		220
Excess foreign tax credit	\$	40

The U.S. parent is, therefore, indifferent as to whether the earnings are left overseas or distributed back to the United States because, on an after-tax basis, the financial effects of any foreign currency fluctuation are perfectly compensated for. It can also be shown that this effect holds in general.

Because the U.S. parent is indifferent to the strength or weakness of the foreign currency, in Figure 3, all countries below the horizontal line should retain their earnings and not make distributions, while all countries above the line should make the distributions for investment in the United States.

D. *U.S. parent with excess foreign tax credits*

When the U.S. parent is (unfortunately) in an excess foreign tax credit position, the dividend decision depends on not only the local tax rate but also the local interest rate. A U.S. company in a long-term excess foreign tax credit position is essentially taxed as if it pays no marginal U.S. taxes on incremental foreign-source income and receives no U.S. tax benefit for any foreign-source losses. Any additional U.S. tax on incremental foreign-source income is offset by excess foreign tax credits. Any foreign-source loss does not affect net U.S. tax due and yields additional excess foreign tax credits. For such a U.S. parent, therefore, the marginal tax rate on foreign earnings is really only the marginal foreign tax rate including any withholding taxes.

By taxing a dividend at its fair market value when actually received, U.S. tax law treats foreign exchange gains and losses from undistributed subsidiaries' earnings as foreign-source income. However, since these same foreign exchange gains and losses are not recognized by the local tax authorities, they are exempt from local income taxation and can be included in the foreign tax credit computation as zero-taxed foreign-source income or loss.

For instance, consider our previous example of a U.S. parent with an excess foreign tax credit limitation. If the profits were distributed immediately and reinvested in the United States, the after-tax cash flow to the U.S. parent would still be $ 6,948. However, for an excess foreign tax credit parent, the after-tax cash flows are different if the funds are reinvested and distributed one year later. If the U.S. parent is in an excess foreign tax credit position, the after-tax cash flow is not $ 6,948 because only $ 6,908 cash is received. This difference is solely because the U.S. parent cannot obtain a benefit for the $ 40 in excess foreign tax credits.

Figure 4 begins the analysis for a U.S. parent company with continuing excess foreign tax credits subject to a U.S. interest rate of i_{us} and U.S. tax rate of t_{us}. If a foreign subsidiary is generating income subject to a local tax rate lower than the United States and the local interest rate is lower than the United States, the earnings should be retained and reinvested in the foreign subsidiary. The lower tax rate permits faster accumulation of earnings and a lower interest rate (vis-à-vis the dollar) implies the foreign currency is appreciating with respect to the dollar. The dollar value of the accumulating earnings therefore steadily increases. Thus, earnings of foreign subsidiaries subject to local income tax rates less than the United States and interest rates less than the United States should be retained by the foreign subsidiaries and not distributed.

Conversely, earnings of foreign subsidiaries with local tax rates higher than the United States and local interest rates greater than the United States should be immediately distributed. The reason is a higher foreign tax rate slows the accumulation of after-tax profits and a higher interest rate implies the dollar value of the after-tax profits will be falling.

However, it is more difficult to reach a decision for countries with either currencies weaker than the dollar and tax rates lower than the United States, or alternatively currencies stronger than the dollar with higher tax rates. In such cases, the benefits of a lower local income tax rate may or may not be offset by the cost of foreign exchange losses.

Taxpayers should be indifferent to those combinations of tax and interest rates where the after-tax local yield on interest adjusted for the appreciation or depreciation of the local currency with respect to the dollar equals the U.S. after-tax yield on U.S. interest. It is possible, based on the specific values of i_{us} and t_{us}, to calculate the combination of local tax and interest rates for a specific country at which a

FIGURE 5
Distribution/Retention of Local Earnings

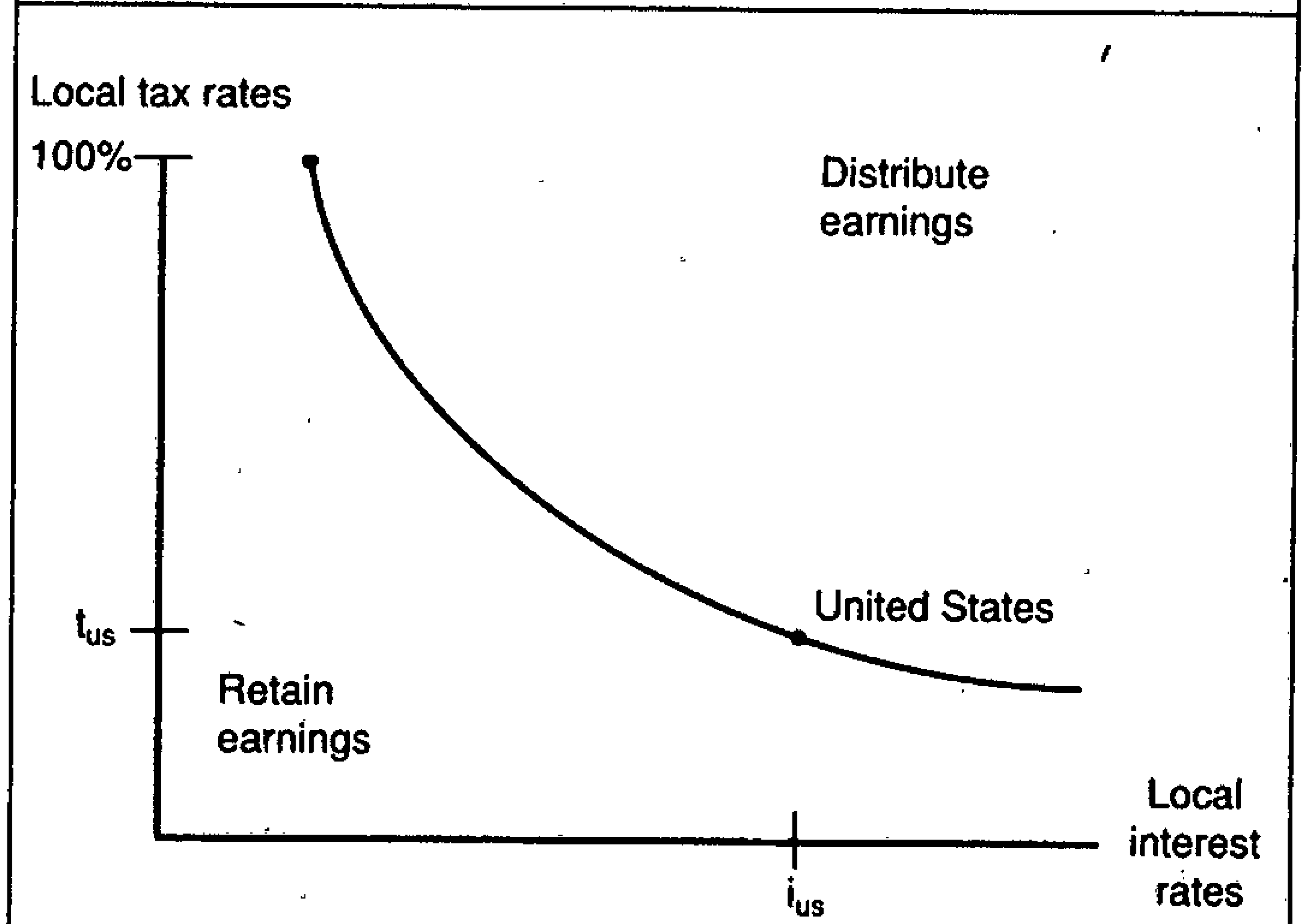
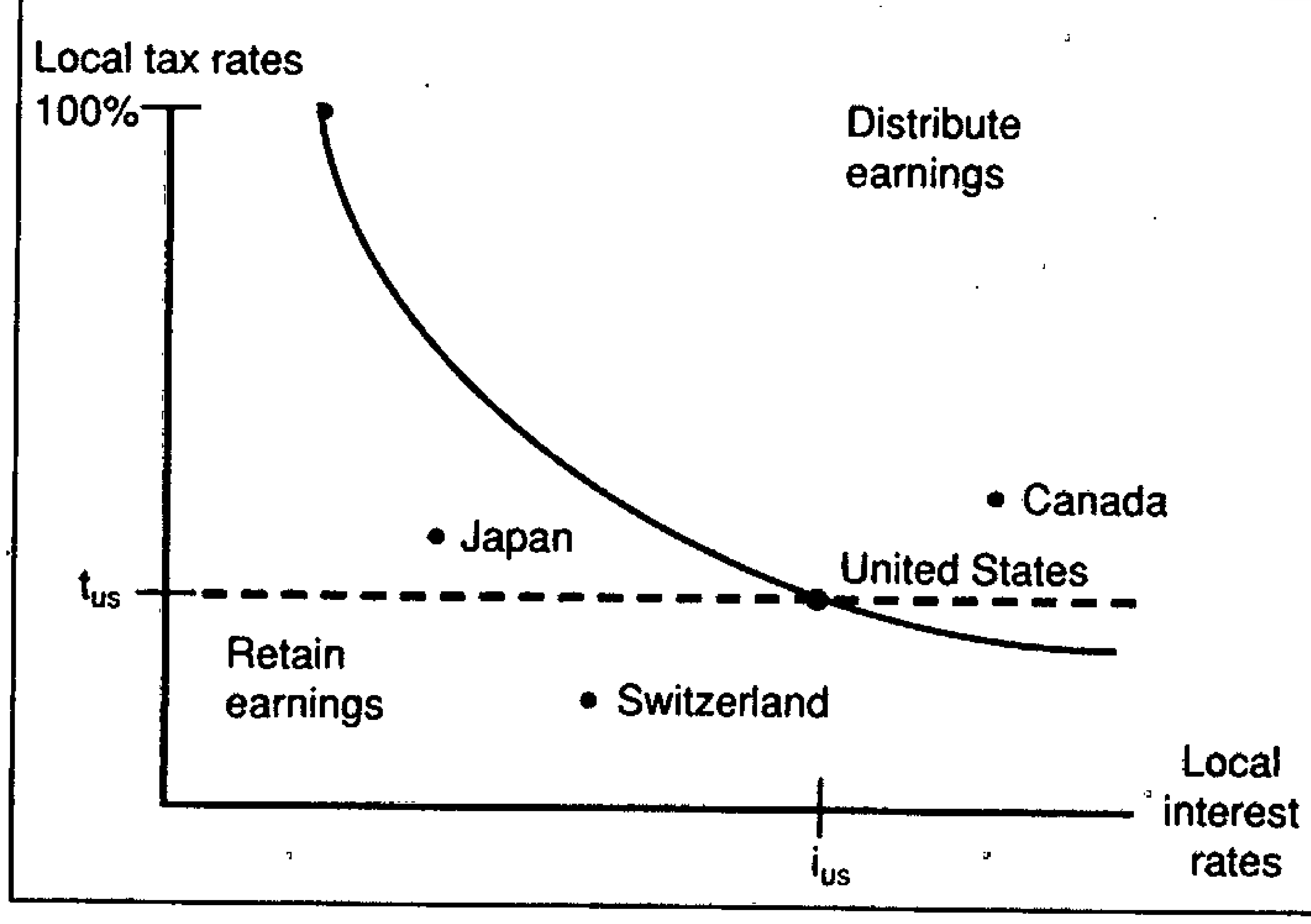


FIGURE 6
Sample Countries



U.S. parent with excess foreign tax credits is indifferent to distributing or reinvesting the foreign subsidiary earnings.

Figure 5 illustrates the locus of such countries where distributing or reinvesting local profit yields the same after-tax return to a U.S. parent. Companies in countries to the upper right of the line should generally distribute their earnings while those to the lower left should generally reinvest. Companies with the same interest and tax rates as the United States can either distribute or retain their earnings.

Figure 6 shows some illustrative countries; this figure is not drawn to scale.

Unfortunately, real decisions are not so simple. This analysis isolates the foreign currency components of the calculation but does not consider a number of other factors, especially the effect of the expense allocation on the foreign tax credit limitation. A highly leveraged U.S. parent company may have a strong bias toward the repatriation of earnings, notwithstanding any tax savings.

E. *Pre-1987 earnings and profits*

The preceding discussion is based on the general rules governing E&P generated after 1986. It is also possible to similarly analyze the factors governing the distribution or retention of pre-198 earnings, which may remain in a number of foreign subsidiaries. In fact, the curve governing pre-1987 E&P whatever the parent's foreign tax credit position is the same curve for post-1986 E&P with the parent in an excess foreign tax credit position. However, pre-1987 E&P can only be distributed after all post-1986 E&P has been distributed, and the local earnings generated from accumulated pre-1987 E&P are all treated as post-1986 E&P.

F. *Shocks to the system*

Figure 7 shows the effect of a reduction in U.S. corporate tax rates such as occurred with the enactment of the Tax Reform Act of 1986 whereby companies in more foreign countries should be distributing their earnings because with a lower tax rate, the United States becomes a more tax-attractive location to do business. U.S. parents in an excess limitation position now repatriate the profits of subsidiaries in countries with tax rates between 34 percent and 46 percent. U.S. parents with excess foreign tax credits also have

FIGURE 7
Decrease in U.S. Tax Rate

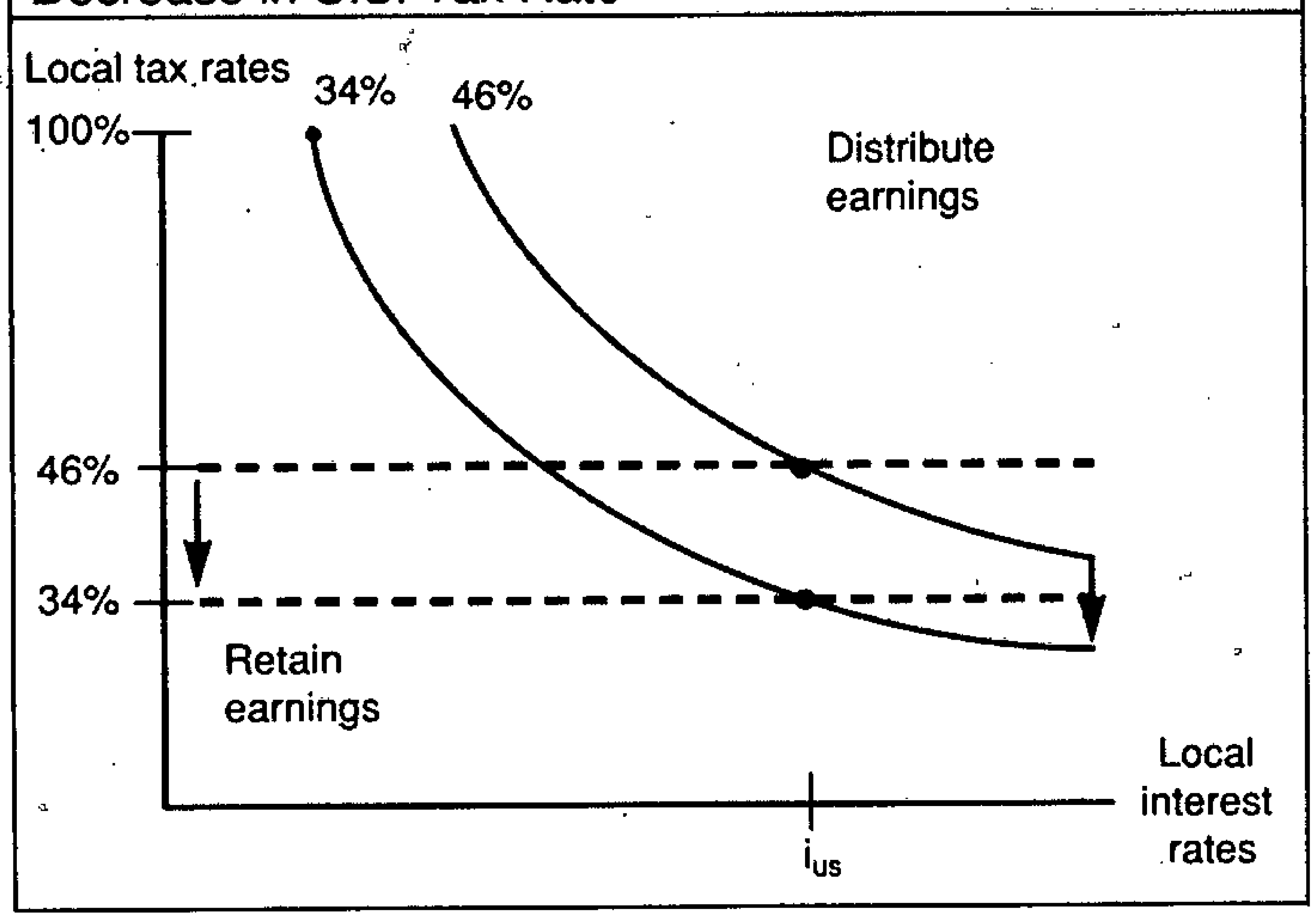
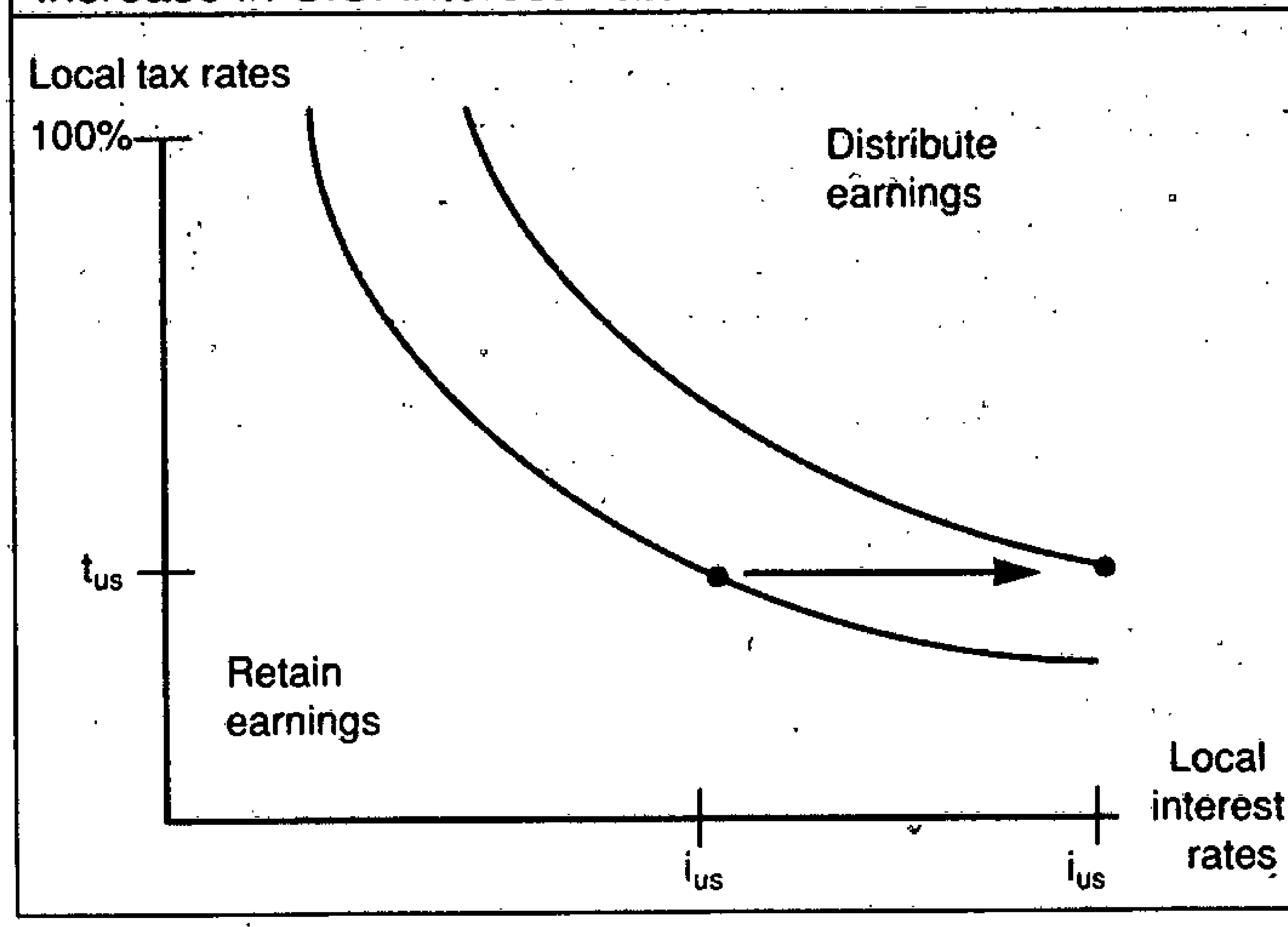


FIGURE 8
Increase in U.S. Interest Rate



their dividend indifference curves shift down, resulting in more countries which should make dividend distributions to the United States.

Similarly, Figure 8 shows the impact of a rise in U.S. interest rates whereby a weaker U.S. dollar may increase the number of countries where reinvestment is preferred. Such a U.S. interest rate change shifts the point for the United States right-ward. This does not affect the decisions of a U.S. parent with excess limitation because only local tax rates determine the decision.

However, a U.S. parent in an excess foreign tax credit position is affected, as the appreciation of undistributed foreign currency earnings is untaxed foreign-source income. It will, therefore, retain earnings in some countries that are converted into sufficiently appreciating currency countries.

III. SOME CONCLUSIONS

Although we have focused on the dividend or no dividend decision, the conclusions are analogous to the optimal marginal debt-to-equity decision for foreign subsidiaries. The financing needs of a local subsidiary can either be satisfied through equity or local debt. For a U.S. parent with excess foreign tax credit limitation Figure 3 can be recast from retained earnings versus dividend earnings into marginal equity or marginal debt. Similarly, Figure 5 can be recast as marginal debt and marginal equity for U.S. parents with excess foreign tax credits.

Our analysis suggests that for tax purposes, U.S. parents with excess foreign tax credit limitation are indifferent as to whether currencies are weaker or stronger with respect to the dollar but are sensitive solely to changes in U.S. and local tax rates. U.S. parents with excess foreign tax credits must balance both interest and tax rates to remain in an optimal capital structure. Occasionally they must distribute or not distribute in apparently counter-intuitive situations.

The complexity of the tax and financial consequences of foreign subsidiary repatriation and capitalization decisions requires not only careful preplanning but also close observation to obtain the optimal financial results. It is important to track a large volume of information, both to substantiate the positions taken on a company's tax return, and to properly fine-tune a company's operations. Sophisticated computer software has become the only realistic solution to this problem.

POST-ACQUISITION RESTRUCTURING OF FOREIGN-OWNED U.S. CORPORATE GROUPS

David R. Tillinghast
Chadbourne & Parke, New York

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I. INTRODUCTION

Many foreign companies that have made acquisitions of U.S. companies which themselves have foreign subsidiaries or branches find that, for operating and/or tax reasons, they would prefer not to hold these foreign operations through the United States. The relevant tax disadvantages may include less favourable U.S. treaties with third countries, duplication of withholding taxes on earnings as they are distributed through the United States to the ultimate parent, the application of the Subpart F and PFIC rules[1] and possible loss of foreign tax credits or other benefits under foreign tax laws (including EC directives).[2]

Since 1986, as a general consequence of the repeal of the General Utilities doctrine and the increasingly aggressive attitude of the United States toward the imposition of tax on foreign-owned U.S. corporations,[3] it has become difficult, if not impossible, for a foreign-owned U.S. company to divest foreign subsidiaries and branches on a wholly tax-free basis. Often the only recourse is to choose the least unattractive of several unattractive alternatives. The ultimate lesson to be learned is that, when a foreign company makes an acquisition in the United States, restructuring problems ought to be anticipated before the acquisition is made. This will be discussed briefly at the end of this paper.[4]

The following discussion will summarize the tax consequences of several different kinds of transactions which might be considered when a foreign acquirer desires to extricate foreign subsidiaries or branches from the U.S. tax grasp. The number of possible variations is almost infinite, and therefore only relatively simple transactional formats will be presented. In the real world, the shape of a transaction will be molded to fit the particular facts; and the design will depend, among other things, on the tax attributes of the U.S. corporation and its subsidiaries, on quantitative relationships (such as the level of applicable withholding taxes or available foreign tax credits) and on the tax posture of the foreign companies involved in their own residence countries. It is impossible to cover all of these considerations in this paper. After discussing the relevant U.S. tax considerations, however, the paper will present a simple case study.[5]

II. BASIC TRANSACTIONS FOR DIVESTING STOCK OF SUBSIDIARIES

A. *Distribution of subsidiary shares as a taxable dividend*

The simplest and most obvious way to divest a U.S. corporation of the shares of its foreign subsidiaries is to have the U.S. corporation distribute them to its parent as a dividend. In the United States, however, this will be a fully taxable transaction.

If the shares distributed have appreciated in value, the distributing corporation will recognize taxable gain equal to their fair market value less its tax basis in the shares.[6] (Loss is not recognized, however.)

1. Secs. 951-964, 1248 and 1291-1297 of the Internal Revenue Code of 1986, as amended (the "Code"). All references herein to a section are to a section of the Code unless otherwise specified.
2. For example, if the foreign acquirer is resident in an EC country, it could receive a dividend from a directly-held subsidiary resident in another EC country without the imposition of any withholding tax. See Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States 90/435/EEC, reprinted in 33 *Official Journal of the European Communities* L225/6 (1990).
3. See, e.g. Sec. 163(j) ("earnings stripping"); Sec. 367(e) and Treas. Reg. §§ 1.367(e)-1T, -2T (recognition of gain on liquidations and spin-offs); Sec. 6038A (information reporting).
4. See text *infra* at Part V.
5. See text *infra* at Part IV.
6. Sec. 311.

If the stock distributed is stock of a controlled foreign corporation ("CFC"),[7] gain will be included under Section 1248 as a dividend to the extent of that corporation's attributable accumulated earnings and profits[8] while an indirect Section 902 foreign tax credit will be allowed.[9]

A tax will also be imposed at the shareholder level. Assuming that the dividend does not constitute "effectively connected" income in the hands of the foreign parent,[10] withholding tax will be imposed on the value of the distributed shares at the statutory or applicable treaty rate, to the extent of the distributing corporation's earnings and profits.[11]

Thus, the straightforward distribution of a dividend in kind may involve substantial tax costs to both the U.S. corporation distributing the dividend and the foreign parent which receives it.

B. *Spin-off of subsidiary shares*

Under U.S. law, a "spin-off" transaction – that is, the distribution to shareholders of the stock of a corporation theretofore controlled by the distributing corporation - under certain circumstances qualifies as a tax-free transaction. To qualify, however, the transaction must meet several statutory tests. No attempt will be made to examine these in detail here.[12] Several relevant points may be noted, however.

First, the transaction must have a "business purpose," and this must be a corporate purpose (i.e. some exigency of the business of the U.S. corporation (or its subsidiary)), as opposed to a shareholder purpose (i.e. the desire of the U.S. corporation's foreign parent).[13] In many cases, this may be difficult to establish.

Second, each of the U.S. corporation and the subsidiary whose stock is distributed must be engaged in the active conduct of a trade or business which has been carried on for at least five years.[14] This may be true in many situations. There is, however, a related five year "waiting period" rule; the transaction will not qualify as tax-free if the foreign parent acquired the U.S. corporation within the five years prior to the distribution.[15]

All of the above hurdles would have to be cleared even if the dividend were being paid to a U.S. corporate parent; but when the distributee is foreign the problems are even more difficult. In such a case, corporate-level recognition of gain (but not loss) will be generally required, even if the other spin-off tests are met.[16] There are three exceptions, of which two are relevant here. The gain recognition rule does not apply if immediately after the distribution each of the distributing corporation and the corporation whose stock is distributed is a U.S. real property holding corporation.[17] Gain will also not be recognized if the corporation whose stock is distributed is a *domestic* corporation and several conditions are met, including the following:

(i) five or fewer individuals or corporations directly own 100 percent of the distributing corporation's stock;
(ii) a holding period of at least two years exists for at least 90 percent of the stock and *all* of the stock held by the distributee;[18]
(iii) if the distributee is a foreign corporation, the value of the stock of the distributing corporation held immediately before the distribution is less than 50 percent of the value of all outstanding stock of the distributee (reduced by the value of cash and marketable securities held by the distributee);
(iv) after the distribution the distributee is resident or incorporated in a country that has an income tax treaty with the United States that provides for exchange of information; and
(v) after the distribution, the stock of the distributing corporation has a value at least equal to the value of the stock distributed.[19]

If the transaction qualifies as a tax-free "spin-off" under the general rules, it will be tax-free at the shareholder level, i.e. no withholding tax will be imposed even if corporate level gain recognition is mandated by these foreign-oriented rules.

C. *Complete liquidation of U.S. corporation*

A possible alternative would be the complete liquidation of the U.S. corporation, which would, of course, result in the distribution to the foreign parent of shares of the subsidiaries of the U.S. corporation (as well as its other assets).[20] In general, the liquidating corporation recognizes no gain if the transaction constitutes the complete liquidation of an 80 percent-or-more-owned subsidiary).[21] The first

7. A CFC is one in which U.S. shareholders (as defined) own more than 50 percent of the stock, measured by value or voting power. Sec. 957(a). Special rules apply to insurance companies. See Secs. 957(b), 953(c).
8. Sec. 1248(f). Notice 87-64, 1987-2 C.B. 375, making Sec. 1248(f) inapplicable in some cases, will not apply in this case because the corporation whose stock is distributed will cease to be a CFC upon the distribution.
9. Under Sec. 902, a U.S. corporation receiving a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock may claim a credit against its U.S. tax for a portion of the corporate-level tax paid by the distributing corporation on the earnings distributed.
10. A foreign corporation is subject to the U.S. corporate tax on net income only with respect to income which is effectively connected with the conduct of a trade or business in the United States. Secs. 864, 882. If the corporation is a resident of a country with which the United States has entered into an income tax treaty, the tax will not normally apply unless, in addition, the corporation maintains a "permanent establishment" in the United States to which the income is attributable. In the interests of brevity, this paper ignores this further treaty qualification in discussing when a foreign corporation's income is subject to U.S. corporate tax.
11. Sec. 881(a). A corporate distribution is a taxable dividend only to the extent of the corporation's earnings and profits. Secs. 301(c) (1), 316. The IRS takes the position that a U.S. corporation must withhold tax on the entire amount of a distribution, even if there are insufficient earnings and profits to cover all of it, and that the recipient must seek a refund of the amount over-withheld. See Treas. Reg. § 1.1441-3(b) (1).
12. For an extended discussion, see B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders,* Ch. 13 5th ed. (Warren, Gorham & Lamont, Inc.: 1987) (hereinafter cited as "Bittker & Eustice").
13. Treas. Reg. § 1.355-2(b)(2).
14. Sec. 355(a)(1)(D) and (b).
15. Sec. 355(c)(2) and (d). If the acquisition was made on or before 9 October 1990, the "waiting period" applies only if there was an acquisition of 80 percent control. If made after that date, however, in certain circumstances the acquisition of as little as 50 percent of the stock of the U.S. corporation will invoke the "waiting period". Sec. 355(d).
16. Sec. 367(e)(1); Temp. Treas. Reg. § 1.367(e)-1T.
17. *Id.* at -1T(c)(1).
18. In determining the holding period of stock, carryover or "tacked" holding periods are not counted unless Sec. 381 applied to the "tacking" transaction. *Id.* at (c)(2)(B). Most importantly for this discussion, this definition does not encompass a Sec. 351 tax-free incorporation.
19. Temp. Treas. Reg. § 1.367(e)-1T(c)(2).
20. A similar effect could be achieved by having the U.S. corporation transfer all of its assets to a foreign subsidiary of the foreign parent in exchange for stock which it distributes to the foreign parent. This could qualify as a tax-free reorganization under Sec. 368(a)(1)(D). However, Sec. 367(a) and the regulations thereunder would require the U.S. corporation to recognize the gain inherent in all of its assets. See Temp. Treas. Reg. § 1.367(a)-1T(b)(1).
21. Sec. 336.

problem here is that a liquidation will occur only if all net assets of the U.S. corporation are distributed,[22] which may be unacceptable as a business matter. This cannot readily be avoided by dropping the liquidating corporation's unwanted assets down into a new U.S. subsidiary before liquidation (or reincorporating them in one afterwards); if this is done, the transaction may not constitute a complete liquidation.[23] In this case, it would be characterized as a dividend distribution, with the tax effects described above.

Here again, even if the transaction qualifies as a liquidation, there is a special "anti-foreign" rule. When the parent-distributee is a foreign corporation, gain must generally be recognized by the liquidating corporation.[24] Losses will be recognized, but only to the extent of offsetting matching gains, i.e. ordinary losses will offset ordinary gains and capital losses will offset capital gains.[25] No loss is recognized, however, on the distribution of property to a related person[26] if the distribution is non-pro rata[27] (this is irrelevant if the subsidiary is wholly-owned) or if the property was acquired in a tax-free incorporation, or as a contribution to capital, within five years before the distribution.[28] This "matching" rule in fact sets up a mismatch when the property distributed is stock of a CFC, because the portion of the gain which is taxed under Section 1248 is included as ordinary income,[29] while any loss on similar shares of stock is a capital loss.

The liquidating corporation is not required to recognize gain if the distributee is not a CFC, if the property distributed is used for ten years after the distribution (or, in the case of inventory, until disposed of) in the conduct of a U.S. trade or business and if certain administrative requirements are met.[30] If, however, the property ceases to be so used, gain will be recognized. Moreover, this exception does not apply to intangibles.[31]

The foreign parent will generally not be taxable on the sale or exchange of stock deemed to occur on the liquidation of the U.S. corporation. Such gain is not fixed or determinable annual or periodic income,[32] and thus would be taxable only if it were "effectively connected" income.

D. *Sale of stock of subsidiaries to foreign subsidiary of the foreign parent*

Often the foreign acquirer of a U.S. corporation owns its existing operating subsidiaries through an intermediate holding company. If so, it may want the shares of the subsidiaries of the U.S. corporation to be owned by that holding company. Accordingly, it is frequently proposed that the U.S. corporation sell the shares to that foreign holding company. In U.S. tax terms, however, this is a disaster.

Because all of the companies involved are under common control, Section 304 applies.[33] As a result, the foreign transferee is deemed to have made a payment to the U.S. transferor in redemption of its own stock. By reason of ownership attribution rules, this hypothetical redemption will not be treated as a sale or exchange but as a dividend,[34] first out of the earnings and profits of the foreign purchaser, to the extent thereof, and then out of the earnings and profits of the corporation whose stock is sold.[35] The remainder of the payment, if any, will be treated as capital gain; since the seller has no actual stock ownership in the buyer, there will be no tax-free return of basis.[36]

It has long been debated whether the dividend deemed to be received from the purchasing corporation will carry with it the Section 902 indirect foreign tax credit which would apply in the case of an actual dividend distribution.[37] For many years the IRS took the position that a Section 304 deemed dividend carried no Section 902 credits because the corporation including the income did not itself own 10 percent of the voting stock of the deemed dividend payor.[38] After lengthy reconsideration, however, the IRS has recently ruled that the Section 902 credit is allowable, at least in some circumstances.[39] In the facts presented in the ruling, a wholly-owned, consolidated (domestic) subsidiary of a U.S. parent sold to a foreign subsidiary, wholly and directly owned by the parent, stock in another foreign subsidiary wholly-owned by the seller. The seller was deemed to own at least 10 percent of the voting stock of the buyer for purposes of Section 902(a). (The seller actually owned, of course, more than 10 percent of the company whose stock it sold).[40] It is not clear whether this ruling would apply to the type of transaction under consideration here. The ruling involved a domestic subsidiary filing a consolidated return with its domestic parent. Under the consolidated return regulations, each member of the consolidated group is deemed to own stock owned by any member of the group.[41] Thus, the subsidiary was considered directly to own the stock of the foreign corporation which was in fact owned by the parent.[42] In the situation discussed here, the U.S. corporation cannot be consolidated with its foreign parent, and this "deemed ownership" rule does not apply. Thus, the indirect foreign tax credit could be denied on the ground that the U.S. corporation does not own stock in the foreign company from which it received the deemed distribution as required by Section 902.[43]

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22. See Bittker & Eustice ¶ 11.02.
23. See Treas. Reg. § 1.331-1(c); Rev. Rul. 76-429, 1976-2 C.B. 97.
24. Sec. 367(e)(2); Temp. Treas. Reg.§ 1.367(e)-2T(b)(l).
25. Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(ii).
26. As defined in Sec. 267.
27. In general, the Sec. 267 rule disallowing loss on sales or exchanges of property to a related person does not apply to the gain recognized by the liquidating subsidiary in a Sec. 336 liquidation. Sec. 336(d)(3). Thus, the rule discussed in the text is less permissive than the general rule.
28. Temp. Treas. Reg. § l.367(e)-2T(b)(l)(ii).
29. Sec. 1248 requires the attributable amount of earnings and profits of the CFC to be included as a dividend.
30. Temp. Treas. Reg. § l.367(e)-2T(b)(2).
31. Id. at (i)(A).
32. Treas. Reg. § 1.1441-2(a)(3).
33. See Rev. Rul. 70-496, 1970-2 C.B. 74.
34. See Secs. 302(b), 304(b)(1).
35. Sec. 304(b)(2).
36. See Rev. Rul. 70-496, *supra* note 33. Many practitioners regard this view as questionable.
37. See, e.g. Dolan, "International Acquisitions, Dispositions and Restructurings in a Post-General Utilities World: Some Ideas for Consideration", 18 *Tax Management International J.* (1989), at 275.
38. See, e.g. Rev. Rul. 84-459, 1984-2 C.B. 207; Private Letter Rulings ("PLRs") 85-10070, 85-15041.
39. Rev. Rul. 91-5, 1991-3 I.R.B. 9.
40. The ruling noted that the foreign corporation whose stock was acquired had both voting and non-voting stock outstanding. This observation relates to the second holding of the ruling, relating to Sec. 351.
41. Treas. Reg. § 1.1502-34.
42. On the other hand, if no one of the corporations in the consolidated return group owns 10 percent or more of the stock of a foreign corporation, separate ownership cannot be aggregated to reach the required 10 percent level. See *First Chicago Corporation v. Comm'r,* 96 T.C. No. 14 (7 March 1991).
43. Rev. Rul. 91-5, *supra* note 39, relied upon the legislative history of amendments to Sec. 304 as the basis for allowing the credit. The ruling stated:

> Consistent with this legislative history, *and in view of the facts presented in this ruling,* DX shall be considered to own at least 10 percent of the voting stock...." 1991-3 C.B. at 10 (emphasis added).

Since the consideration it receives on the sale is deemed to be received as a dividend, the selling corporation is deemed to make the transfer of stock as a contribution to the capital of the buyer. If the seller owns 80 percent or more of the voting stock of the buyer, Section 367(c)(2) applies, and the transfer is treated as a Section 351(a) transaction subject to the regulations promulgated thereunder.[44]

Section 351 applies, however, only when the seller directly has control of the buyer or where it is a consolidated subsidiary of a U.S. parent directly holding control.[45] In other cases, a tax equal to 35 percent of the gain inherent in the transferred shares would be imposed under Section 1491, unless the transferor elected, pursuant to Section 1492, to apply Section 367 principles to the transfer. In that event, the deemed transfer of stock will not qualify for non-recognition, because the transferee will not be a CFC.[46]

E. *Sale of stock of subsidiaries to the foreign parent*

The U.S. corporation might sell the shares of subsidiaries to its foreign parent. This transaction is not treated as a Section 304 transaction.[47] If it were, the effect would be to posit the payment of a dividend by a parent to its own subsidiary; and this is apparently too much even for the IRS.

The result is that the seller will recognize the gain normally associated with the sale or exchange of the stock. Section 1248 amounts will be included as dividends, and applicable Section 902 credits will be allowed.[48] Because the purchaser is a related party, however, no loss will be allowed.[49]

If the foreign parent wants the shares which are being sold to be owned by its foreign holding company subsidiary, it might consider buying the shares and then transferring them to the holding company. Alternatively, it might consider transferring the shares of the U.S. corporation to the foreign holding company and then having the holding company make the purchase. In each of these cases, the question will be whether the IRS, applying "step transaction" concepts, will treat the sales as Section 304 transactions, with the adverse consequences described above. The answer to this question is not clear.[50]

F. *Preferred stock recapitalization of foreign subsidiary, followed by sale of common stock to the foreign parent*

In this transaction, a foreign subsidiary which is to be sold would first issue a class of preferred stock representing the lion's share of its capital to its U.S. parent. The U.S. corporation would then sell the common stock in the type of transaction just described. This would attempt to minimize the gain currently recognized by "freezing" a large part of the value of the subsidiary into the preferred stock, which would be retained by the U.S. corporation. The result would be, of course, that this portion of the subsidiary's capital would remain U.S.-owned; but the hope would be that, as the business grows (or inflation occurs), this would represent a shrinking part of the total equity and that eventually the preferred stock could be retired.

In form, the recapitalization is tax-free. No continuity of interest rule applies in connection with an "E" reorganization, and even a prearranged sale of common following a preferred stock recapitalization does not disqualify the transaction.[51] Although Section 367(b) applies to the recapitalization, no gain will be recognized under the regulations, because the U.S. corporation receives stock in a CFC in which it is a U.S. shareholder.[52] The preferred stock will be Section 306 stock, but this may have little practical consequence.[53] The U.S. corporation will allocate its basis between the preferred and common stock in accordance with their respective fair market values.[54]

The tax consequences of the sale of the common stock would be as described above, except that the amount treated as a dividend under Section 1248 might be different. At the time of the recapitalization, the foreign subsidiary will normally have some accumulated earnings and profits. If so, there is a Section 1248 amount attributable to its stock. When that stock is recapitalized into preferred and common, however, it is not clear what portion of this earnings pool attaches to the preferred stock and what portion remains attributable to the common stock. For periods after the recapitalization, there is an established basis for dividing income or earnings between the two classes of stock,[55] but this does not determine the treatment of pre-capitalization amounts. There is apparently no law on this subject.[56]

A more fundamental question is whether the IRS can apply a step transaction theory to the preferred recapitalization when the subsidiary whose common stock is sold is not a CFC following the sale. The IRS would argue that the substance of the transaction is that the U.S. corporation received preferred stock in a non-controlled corporation and that this requires the recognition of gain with respect to the seller's *entire* stock interest, not just the common stock sold.[57] Here again, there is apparently no governing precedent. Such a theory would, however, require inclusion only of the Section 1248 amount,[58] and the resulting tax might be substantially offset by Section 902 tax credits.

G. *Transfer of stock of foreign subsidiaries to a foreign subsidiary of the foreign parent in exchange for non-voting shares of that subsidiary*

The U.S. corporation could exchange the stock of the subsidiary for non-voting preferred stock of a foreign subsidiary of the foreign parent. As discussed above, a sale or exchange

44. Rev. Rul. 91-5, *supra* note 39. See Sec. 367(a); Treas. Reg. §§ 1.367(a)-1T - -6T; Notice 87-85, 1987-2 C.B. 395.
45. See *Brams v. Comm'r*, 734 F.2d 290 (6th Cir. 1984); Rev. Rul. 78-130, 1978-1 C.B. 114; Rev. Rul. 56-613, 1956-2 C.B. 212; Treas. Reg. § 1.1502-34; Rev. Rul. 89-46, 1989-1 C.B. 272
46. Notice 87-85, *supra* note 44.
47. Rev. Rul. 74-605, 1974-2 C.B. 97.
48. Sec. 1248(a).
49. Sec. 267(a).
50. Sec. 304 was aimed at preventing a "bail-out" of the earnings of a related corporation at capital gains rates. See Bittker & Eustice ¶ 9.12. Accordingly, a sensible rule would be that if the consideration for the purchase came from the foreign parent and could not be traced to the foreign holding company, Sec. 304 should not apply.
51. E.g. Rev. Rul. 77-479, 1977-2 C.B. 119.
52. Treas. Reg. § 7.367(b)-7(c).
53. Disposition of Sec. 306 stock may give rise to ordinary income, rather than capital gains. At the present time, there is no difference in the rate of tax imposed on corporate capital gains.
54. Treas. Reg. § 1.358-2(a) (2).
55. See Treas. Reg. § 1.951-1(e)(2).
56. A reasonable solution would be to divide the accumulated earnings and profits account on the basis of the relative fair market values of the preferred and common stock, thus mirroring the division of tax basis (see text *supra* at note 54) and neither "front-loading" nor "back-loading" the recognition of the Sec. 1248 amount.
57. If a U.S. person exchanges stock in a CFC for stock in a foreign corporation which is not a CFC, gain recognition is generally required. Treas. Reg. § 7.367(b)-7(c)(1).
58. *Id.*

of stock by the U.S. parent to another subsidiary of the foreign parent is generally a Section 304 transaction. In the *Bhada* and *Caamano* cases, however, it was held that an exchange which would otherwise be characterized under Section 304 will not be so treated but will constitute a normal sale or exchange if the consideration received by the transferor consists of stock of the transferee.[59] The rationale is that Section 304 applies only when the described stock transfer is made "in return for property" and that under Section 317(a), the term "property" does not include stock of the acquiring corporation. The *Bhada* and *Caamano* cases involved Section 304(a)(2), but the same language appears in Section 304(a)(1). Section 1248(i), the legislation which overturned the result in these cases, is not applicable in the circumstances presented here.

The exchange will not be tax-free. Section 351 does not apply because the U.S. corporation does not directly control the transferee.[60] The transaction is not a "B" reorganization because that requires the receipt solely of voting stock.[61] The transaction would therefore be treated as an ordinary sale or exchange, with the tax consequences described in "E" above.

H. *U.S. corporation transfers stock of foreign subsidiary to another foreign subsidiary of the foreign parent in exchange for voting preferred stock of that subsidiary*

This exchange would constitute a tax-free "B" reorganization.[62] Section 304 does not apply.[63] Since the stock received is stock of a foreign corporation, however, Section 367 applies. If following the transfer: (i) the transferee corporation is a CFC, and (ii) the transferor is a U.S. shareholder in both the transferee and, applying the indirect ownership rule of Section 1248(c)(2), in the subsidiary whose stock is transferred, no gain inclusion is required.[64] Otherwise, full gain recognition will be required.

An interesting question arises as to what, if anything, happens if the transferee corporation is a CFC at the time of the exchange but ceases to be a CFC at a later date. The preferred stock received by the U.S. corporation: (i) must be voting stock (to make the transaction a "B" reorganization); and (ii) must have at least 10 percent of the total voting power of the stock of the transferee corporation (to qualify the U.S. corporation as a U.S. shareholder and to assure the availability of the indirect foreign tax credit with respect to preferred dividends).[65] But the status of the transferee as a CFC can be established if the stock owned by the U.S. corporation has a value equal to more than 50 percent of the total value of the stock of that corporation, even if the percentage of the voting stock owned by the U.S. corporation is smaller.[66] In the future, this percentage of value may decrease, either because the total value of the stock of the transferee corporation increases, because preferred stock owned by the U.S. corporation is redeemed, or because other assets are added to the transferee corporation.

III. BASIC TRANSACTIONS FOR THE DISPOSITION OF FOREIGN BRANCHES

A. *Taxable sale of assets to foreign subsidiaries*

Often the U.S. corporation which has been acquired (or a domestic subsidiary) has branches located abroad. The foreign acquirer may wish the operations carried on by these branches to be conducted by foreign entities not connected with the United States. One way of accomplishing this objective is simply to have the U.S. corporation (or the domestic subsidiary) sell the branch assets to existing or newly-formed foreign entities owned by the foreign parent. Normally, this will incur a substantial tax cost, however. All gain on the branch assets will be recognized by the U.S. seller. In addition, it is likely that income or gain will be recognized in the country in which the branch is located.

B. *Drop-down of branch assets into a new foreign subsidiary, followed by disposition of the stock*

If the assets of the foreign branch are dropped down into a locally organized subsidiary in exchange for the subsidiary's stock, this could presumably qualify as a tax-free incorporation under Section 351. Section 367(a) will apply, but tangible assets which are to be used in an "active business" are generally permitted to be transferred tax-free.[67] "Tainted" items, such as receivables and inventory, which cannot be transferred tax-free[68] can be left behind. A transfer of intangibles would give rise to taxable gain under Section 367(d), but this may be handled by having the U.S. corporation retain these items and entering into a licensing arrangement.

If the stock of the subsidiary is thereafter sold or exchanged, to the foreign parent or another subsidiary, this raises familiar issues as to whether the "control immediately after" requirement of Section 351 is satisfied.[69]

The subsequent distribution of the stock of the newly-formed subsidiary to the parent would not make Section 351 inapplicable, however.[70] A post-incorporation spin-off of the stock of the foreign subsidiary would raise all of the issues discussed above.[71] The incorporation of the branch would not disqualify the transaction if it is tax-free.[72] If, however, gain is recognized to any extent, this would disqualify the ensuing spin-off.[73] In this regard, there is a disturbing suggestion in a recent private letter ruling. Under Section 987, a foreign branch having a functional currency other than the dollar recognizes foreign currency gain upon a remittance to its home office. The ruling suggests that in a tax-free incorporation of a branch, a remittance may be deemed to occur, with resultant recognition of foreign currency gain.[74]

59. See *Bhada v. Comm'r,* 89 T.C. 959 (1987), aff'd 892 F.2d 39 (6th Cir. 1989); *Caamano v. Comm'r,* 89 T.C. 959, aff 'd 879 F.2d 156 (5th Cir. 1989). The IRS will follow these decisions. News Release 90-07, 2 March 1990.

60. See *Brams v. Comm'r,* 734 F.2d 290 (6th Cir. 1984); Rev. Rul. 78-130, 1978-1 C.B. 114; Rev. Rul. 56-613, 1956-2 C.B. 212.

61. Sec. 368(a)(1)(B). 62. The foreign company would acquire all of the outstanding stock of the foreign subsidiary solely in exchange for its voting stock. See *id.*

63. The legislative history of Sec. 304(b)(3)(A) makes it clear that Sec. 304 is not intended to override the tax-free reorganization provisions, as opposed to Sec. 351. See Bittker & Eustice ¶ 9.12(5). In addition, since the only consideration received in the exchange is stock in the acquiring company, Sec. 304 is inapplicable under the *Bhada* and *Caamano* holdings. See *supra* note 59.

64. Treas. Reg. §§ 7.367(b)-4(b)(1)(i)(A) and (2)(ii); 7.367 (b)-7.

65. Secs. 902(a), 951(b). 66. See Sec. 957(a).

67. Temp. Treas. Reg. § 1.367(a)-2T.

68. See Temp. Treas. Reg. § 1.367(a)-5T.

69. See Bittker & Eustice ¶ 3.09.

70. Sec. 351(c).

71. See text *supra* Part II.B.

72. See Sec. 355(b)(2)(B) and (C).

73. Bittker & Eustice ¶ 13.06.

74. See PLR 88-47055. Although the ruling letter only states that its holding is "subject to" Sec. 987, IRS personnel have stated that the conclusion in the text is what was intended.

C. *Drop-down of branch assets into a new domestic subsidiary followed by disposition of the stock*

In this case, the drop-down could also qualify as a tax-free incorporation and Section 367 is inapplicable. This will solve any recognition problems that might arise upon incorporation of a foreign subsidiary. (It would not, however, solve the problem of possible foreign currency gain referred to above.) The ongoing income of the subsidiary would, of course, remain subject to U.S. tax, but foreign tax credits might offset all or most of this tax. U.S. withholding tax should not apply, however, because distributions by the income of the subsidiary would qualify for the "foreign business income" exception.[75] The disposition of the subsidiary's stock presents the same general problems as discussed above. Since the new subsidiary is a domestic corporation, however, it might qualify under the second exception to corporate-level recognition set forth in the spin-off regulations, discussed above.[76] It cannot so qualify for at least two years, however. The "double spin" of the stock of the new subsidiary to the U.S. parent and by the U.S. parent to the foreign parent can qualify if all of the requirements of Section 355 are met.[77]

IV. CASE STUDY

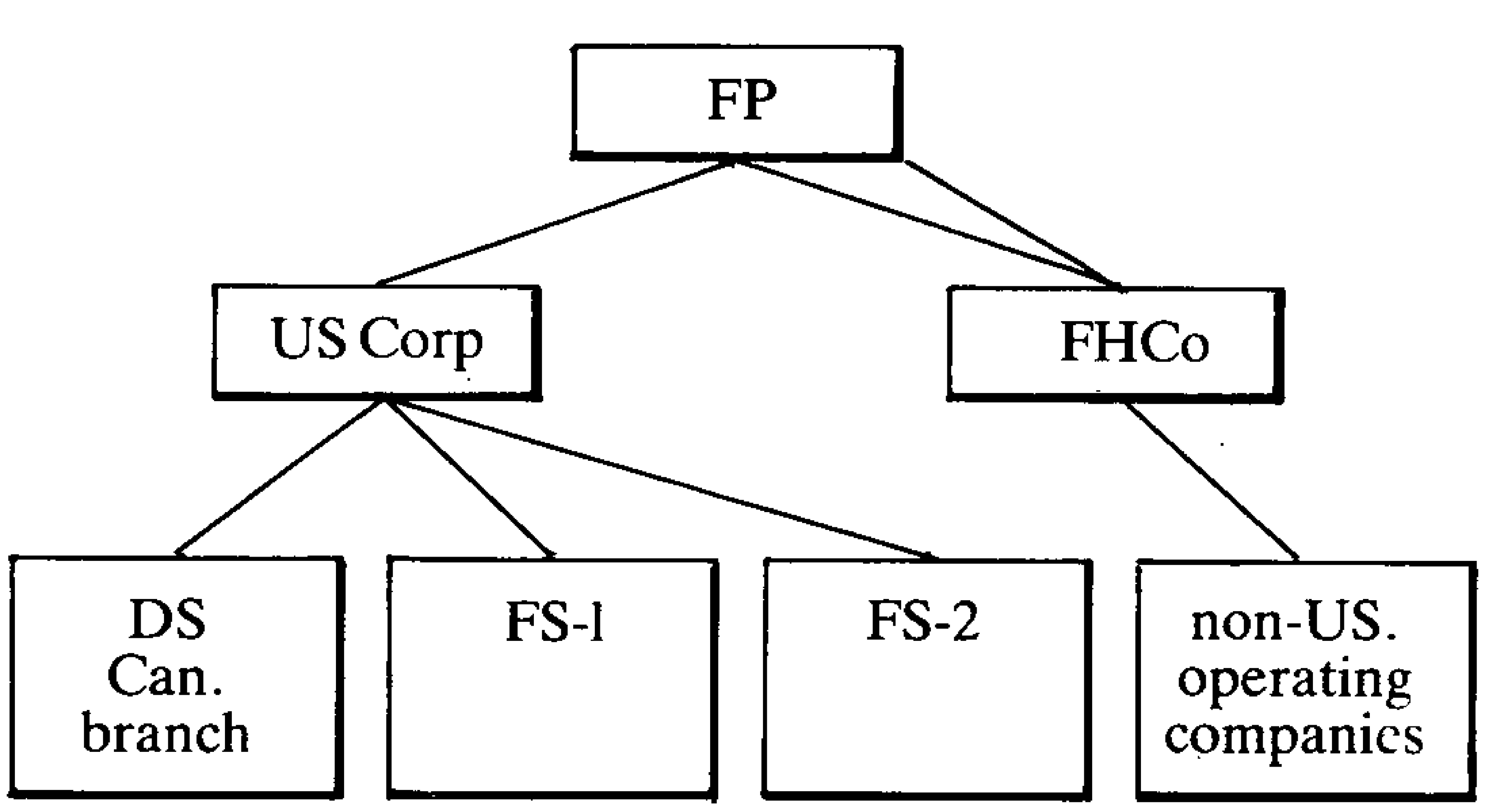
The principles discussed above may be illustrated by examining a simple case study.

A. *Basic facts*

1. Parties

* Foreign Parent ("FP"), a foreign corporation not engaged in trade or business in the United States, is resident in a country with which the United States has a comprehensive income tax treaty.
* Foreign Holding Company ("FHCo") is a foreign holding company, wholly-owned by FP, which owns non-U.S. operating subsidiaries.
* US Corp is a U.S. corporation wholly-owned by FP. It is directly engaged in the conduct of a manufacturing business in the United States and holds the stock of the three operating subsidiaries described below.
* DS is a U.S. corporation, wholly-owned by US Corp, which is actively engaged in the conduct of a manufacturing business in the United States and, through a branch, in Canada.
* FS-1 and FS-2 are wholly-owned foreign subsidiaries of US Corp which are actively engaged in related manufacturing businesses in their respective countries of incorporation.

The corporate structure may be diagrammed as follows:



US Corp has owned its subsidiaries, and they have been engaged in their current businesses, for more than five years. None of the corporations is a U.S. real property holding company, a PFIC or a personal or foreign personal holding company.

2. The prior acquisition

In 1987, FP acquired all of the stock of US Corp for $ 150 million in cash. In connection with the acquisition US Corp incurred $ 50 million in debt. No Section 338 or 338(h)(10) election was made.

3. Current basis and value

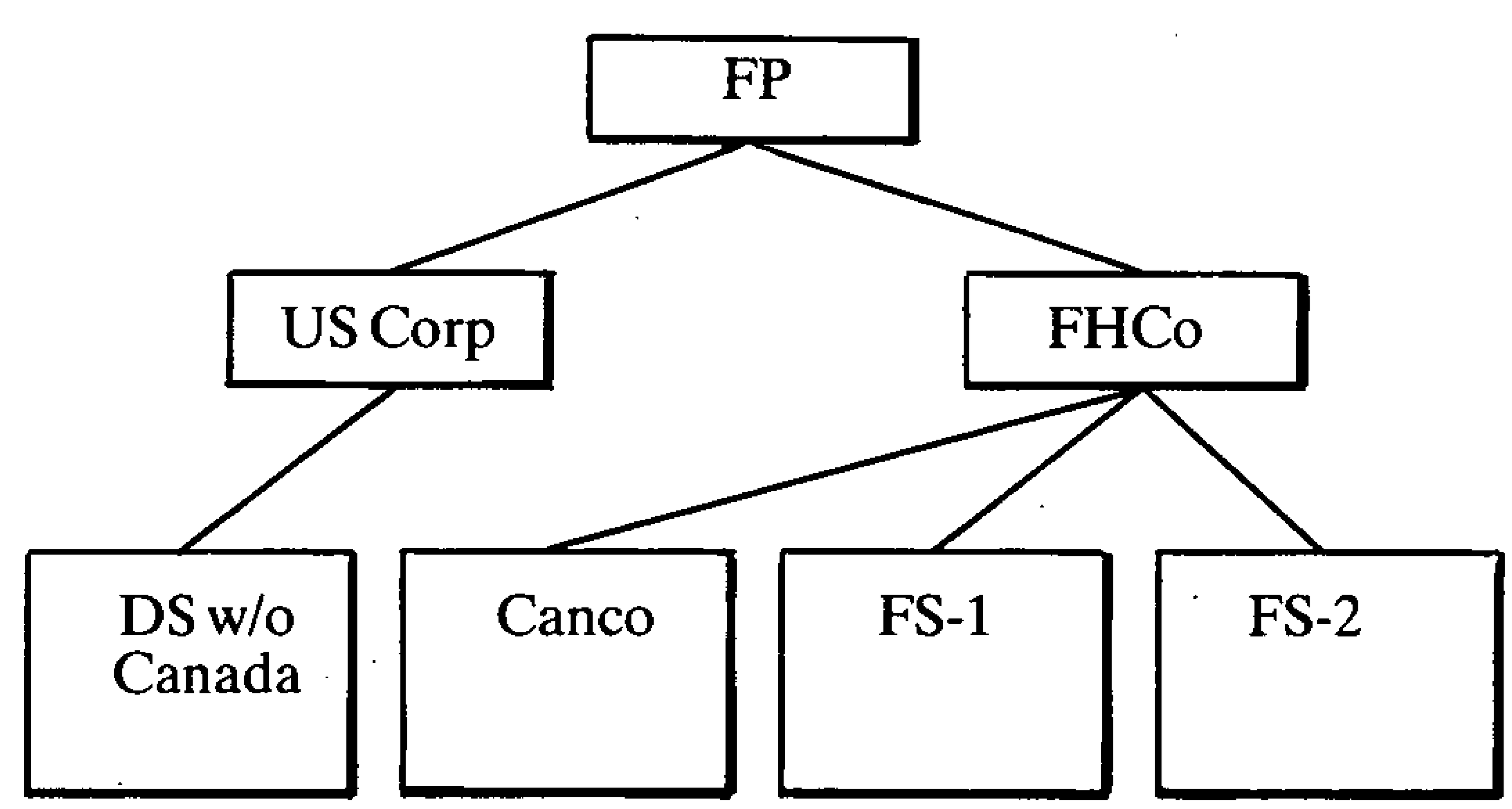
At the present time, FP estimates that:

* The fair market value of US Corp stock is $ 200 million.
* US Corp's basis in its manufacturing assets is $ 35 million and their fair market value is $ 50 million.
* US Corp's basis in the stock of PS is $ 50 million, and the fair market value of the stock is $ 80 million.
  * DS has a basis in the assets of its Canadian branch of $ 10 million, and they have a fair market value of $ 20 million.
* US Corp's basis in the stock of FS-1 is $ 25 million, and the fair market value of the stock is $ 50 million.
  * The Section 1248 amount with respect to FS-1 is $ 15 million, and available Section 902 foreign tax credits equal $ 5 million.
* US Corp's basis in the stock of FS-2 is $ 40 million, and the fair market value of the stock is $ 20 million.

4. Proposed restructuring

To streamline its corporate structure, achieve certain foreign tax advantages and avoid ongoing U.S. tax problems, FP wants the ownership of FS-l, FS-2 and the Canadian branch of DS (or new corporations holding their assets) to be transferred by US Corp to FHCo, which holds the stock of FP subsidiaries operating in several countries.

The desired result may be diagrammed as follows:



B. *Basic transaction I*

The first transaction to be considered is a spin-off of FS-l, FS-2 and an incorporated Canadian branch of DS, followed by a transfer of the stock of these subsidiaries to FHCo.

The tax consequences will be as discussed above. No gain or loss will be recognized by FS-l or FS-2. Under Section

75. See Secs. 861(c), 881(d).
76. See text *supra* at note 19.
77. See, e.g. PLR 87-34062.

311, US Corp will recognize the gain on the stock of FS-1 but not the loss on the stock of FS-2. Since FP acquired the stock of US Corp less than five years ago, the transaction could not qualify as tax-free by reason of Section 355(b)(2)(D) and (d) unless it were deferred until 1993. It is not clear how the "device" requirement of Section 355(a)(1)(B) would be applied here. There may also be a lack of a qualifying "corporate-level" business purpose. In any event, however, US Corp must recognize gain under Section 367(e) and Temp. Treas. Reg. § 1.367(e)-1T.

To the extent of the accumulated earnings and profits of FS-l, gain will be treated as a dividend under Section 1248(f) (Notice 87-64 is inapplicable), and Section 902 foreign tax credits for taxes paid by FS-1 will be allowable. US Corp will recognize a gain of $ 25 million on FS-l. Of this, $ 15 million will be included under Section 1248. This will result in little net tax, because a Section 902 credit of $ 5 million is available. The additional $ 10 million of gain will be fully taxable, however.

If the transaction qualifies as a tax-free spin-off, no withholding tax will be imposed on FP, even if gain is recognized by US Corp. The IRS has ruled that the spin-off would not be disqualified by FP's transfer of the stock it receives to FHCo if that qualifies as a Section 351 transaction.[78]

Treatment of DS transaction[79]

As indicated above, there are two different ways that the Canadian Branch of DS might be incorporated. In the first, assets of the Canadian branch would be dropped down into a new Canadian subsidiary of DS ("Canco"), followed by a "double spin" of the stock of Canco to US Corp and then by US Corp to FP.

At the DS level, this is a Section 351 transaction, subject to the recognition requirements of Section 367(a) and (d). The distribution of Canco stock to US Corp would be tax-free to US Corp if the Section 355 requirements were met; but this will not be true if there is any amount of recognition on the drop-down transaction (apparently, even if only the foreign currency gain recognition referred to above).

On the distribution of Canco stock by US Corp to FP, Section 355(b)(2)(P) will require recognition of gain by US Corp unless the distribution is deferred until five years after the original acquisition of US Corp. In that transaction, moreover, US Corp will be subject to tax on the gain under Section 367(e).

Treatment at the FP level is the same as in the case of the distribution of the stock of FS-1 and FS-2, described above.

It might prove possible for DS to spin-off the stock of Canco to US Corp but, instead of following this with a second spin-off, dispose of the Canco stock in one of the other forms of transaction discussed below.

The alternate form of the transaction proceeds in the same way, except that in this variation Canco is incorporated in the United States. Under these circumstances, Section 351 applies to drop-down, and Section 367 does not apply to require recognition (but query: the foreign currency gain). At the US Corp level, the five-year "waiting period" would still apply. Section 367(e) would also still apply; since Canco is a U.S. corporation, however, the regulatory exception described above could apply. This would, at a minimum, require US Corp to hold the Canco stock for two years.

The ongoing income of Canco will be subject to U.S. corporate tax, but foreign tax credits for Canadian taxes should offset that tax. Assuming that Canco engages in manufacturing activities in Canada, U.S. withholding tax should not apply by reason of the 80 percent foreign business income exemption of Sections 881(d) and 861(c). Canco will, however, be subject to the Canadian branch tax: the 10 percent rate provided for under the U.S.-Canadian treaty[80] may compare unfavourably with the withholding rate which would be available under an applicable Canadian treaty if Canco were incorporated in Canada and owned (directly or indirectly) by FHCo.

C. *Basic transaction II*

In this transaction, US Corp would be completely liquidated. At the corporate level, even if Section 336 would otherwise apply, Section 367(e) will require full recognition by US Corp of gain on all of its assets, including its manufacturing assets, as well as the stock of FS-1, FS-2 and DS. Ordinary and capital gains can be offset by ordinary and capital losses, respectively.

Under the facts presented above, US Corp will recognize a gain of $ 15 million on its manufacturing assets. Some of this (depreciation recapture, for example) will be ordinary income but the rest will be capital gain or gain treated as such under Section 1231. The $ 30 million gain on DS stock will constitute capital gain. As in the case of the spin-off transaction, the $ 15 million of FS-1's accumulated earnings and profits will be included under Section 1248, with an almost fully offsetting Section 902 credit, and the remaining $ 10 million of gain will be recognized as capital gain. Although not allowed in other transactions, the $ 20 million loss on the FS-2 stock will be allowed here as a capital loss; this will offset a portion of the capital gains recognized.

At the shareholder level, no withholding tax would be imposed on FP, because the liquidation is treated as an exchange of stock.

There are (at least) two problems with this transaction. First, even though the loss on FS-2 stock is allowed, this is overshadowed by the gains which must be recognized. Secondly, as a business matter, FP may be unwilling to own directly operating assets located in the United States. If so, it might be necessary to drop US Corp's manufacturing assets down into a new subsidiary before the liquidation. In that case, the IRS might take the position that a complete liquidation has not occurred. Since the drop-down involves $ 50 million out of a total of $ 200 million of assets, this is a close question. To avoid this problem, FP might transfer the stock of US Corp to a newly-formed foreign subsidiary, liquidate US Corp into the new subsidiary and operate the U.S. manufacturing business formerly carried on by US Corp through a branch of that subsidiary. This could qualify for the exception from corporate-level gain recognition referred to above.[81] However, the IRS routinely characterizes

78. PLR 88-23099 and PLR 86-49011 (Sec. 355 spinoff followed by Sec. 351 drop-down); PLR 87-34062 (quadruple Sec. 355 spin-off followed by Sec. 351 drop-down). The IRS recently refused to issue a ruling that a double Sec. 351 drop-down would not disqualify a Sec. 355 spinoff, and is said to be reconsidering whether to permit a single Sec. 351 drop-down. It is difficult to see the IRS's concern.

79. The Canadian tax aspects of this transaction also have to be analyzed. See Steiss, "Acquisition and Disposition of a Canadian Business by Non-Residents", in proceedings of the Canadian Tax Foundation 1990 Corporate Management Tax Conference.

80. Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, 26 September 1980, as amended, Art. X, para. 6, 1986-2 C.B. 258.

81. See text *supra* at note 30.

an exchange of stock-for-stock followed by a liquidation of the corporation whose stock is transferred as a transfer of that corporation's assets.[82] Gain on the transfer of assets would be recognized by US Corp.[83]

Although there appears to be no authority applying this characterization to the "outbound" transfer of assets by a U.S. subsidiary of a foreign parent, the IRS is rumoured to be contemplating a ruling in which "outbound" transfers of domestic stock by U.S. persons in exchange for foreign stock, followed by a liquidation of the domestic corporation into the foreign, would be held to be an asset transfer by the U.S. corporation, followed by liquidation.

D. *Basic transaction III*

The third possible transaction would be the sale of the stock of FS-1 and FS-2 to FHCo. As outlined above, this would be a disaster. US Corp would treat cash or property received as a taxable dividend to the full extent of the earnings and profits of FHCo, FS-1 and FS-2. The fact that a sale of FS-2 stock would produce a loss is irrelevant. Forming a new subsidiary of FHCo to buy the stock, in an effort to minimize the amount of earnings and profits taken into consideration, will not help; in such a situation, the new subsidiary will be disregarded.[84]

The includible dividend could, of course, be offset by Section 902 foreign tax credits. It is unlikely, however, that US Corp will get a Section 902 credit for taxes paid by FHCo. The IRS' favourable ruling would not seem to apply unless US Corp (or a consolidated domestic corporation) had direct ownership of at least 10 percent of FHCo's stock.

The deemed capital contribution of the FS-1 and FS-2 stock by US Corp to FHCo will, in addition, produce taxable gain to US Corp, because it does not qualify for non-recognition under the Section 351(a) regulations.

E. *Basic transaction IV*

This transaction would consist of the sale of the stock of FS-1 and FS-2 (and possibly Canco) to FP. US Corp would use the net proceeds after tax to pay down its $ 50 million of debt. The sale would be treated as a straight sale of stock. The $ 15 million Section 1248 amount with respect to FS-1 is includible as a dividend. The Section 902 credit for foreign taxes paid by FS-1, $ 5 million, will essentially offset the U.S. tax. The additional gain of $ 10 million will be treated as a capital gain. The $ 10 million loss on the stock of FS-2 will not be recognized, however, by reason of the Section 267(e) disallowance of losses on sales or exchanges with related persons.

F. *Basic transaction V*

In a recapitalization transaction, FS-1 would issue $ 24 million of voting preferred stock to US Corp in exchange for 45 percent of its outstanding common shares. US Corp would retain the preferred stock and sell the common to FP for $ 26 million. Net proceeds of the sale could be used to pay down US Corp's debt. In the future, preferred stock dividends or proceeds of redemption could also be used to retire debt.

In this case, FS-1 would cease to be a CFC (assuming that the $ 50 million valuation of its existing common stock is correct). US Corp would recognize a gain of $ 13 million ($ 26 million of proceeds from the sale of common less $ 13 of allocated basis). As discussed above, the $ 15 million Section 1248 amount attributable to the FS-1 stock would have to be apportioned between the new preferred and common in order to compute the portion of US Corp's gain includible under that Section. It would be logical to apportion this account pro rata, in the same way that basis is apportioned. This would produce recognition of $ 7.8 million under Section 1248 and a capital gain of $ 5.2 million.

It is possible that the IRS would seek to recharacterize the recapitalization transaction as being the exchange of stock in a CFC for stock in a non-controlled corporation, because of immediate sale of the common. Such an attack has never been made with respect to domestic recapitalization, but the recognition issues are not the same. This form of attack could be forestalled if US Corp retained more than 50 percent of the vote or value of the FS-1 stock. (Suppose, for example, US Corp retained $ 40 million of preferred.)

G. *Basic transaction VI*

In this transaction, US Corp would transfer all of the stock of FS-1 and FS-2 to FHCo in exchange for voting preferred stock of FHCo worth $ 70 million. Suppose that the preferred stock was entitled to at least 10 percent of the total voting power of FHCo stock and that, after the issuance, the total value of FHCo stock outstanding was $ 130 million.

These transactions qualify as "B" reorganizations. After the transaction, US Corp is a U.S. shareholder (as defined in Section 1248(a)(2)) of FHCo, because it owns at least 10 percent of its voting stock; and FHCo is a CFC, because US Corp owns more than 50 percent of the value of its stock. Under these circumstances, the transaction qualifies for non-recognition under the Section 367(b) regulations.

It does not appear that this result is changed if the status of FHCo as a CFC changes at a later date. Suppose, for example, that one year after the transaction the value of all of the outstanding stock of FHCo has increased to $ 150 million, while the preferred stock held by US Corp is still worth $ 70 million. FHCo is no longer a CFC. This may be a desired result, but it occurred after the exchange. The Section 367 regulations generally refer to the status "immediately after the exchange.[85] One can speculate whether the IRS would feel that the answer should be different if the decrease of the preferred stock as a percentage of the total value of FHCo stock results from FP's contributing to FHCo the stock of another operating company located in another country, or if the value of the FHCo stock does not increase but FHCo redeems, say, $ 20 million of the preferred stock from US Corp.

If FHCo already holds assets so valuable that the preferred stock issued to US Corp would not equal more than 50 percent of the value of all of its stock, FHCo might consider capitalizing a subsidiary, FHCo-1, with, say, $ 30 million. FHCo-1 would then acquire all of the stock of FS-1 and FS-2 from US Corp for voting preferred stock worth $ 70 million. The analysis here would be the same as in the base case, except that FHCo-1 might remain a CFC for a longer period, which may be incompatible with business objectives. FHCo could, however, later contribute more to the capital of

82. See, e.g. Rev. Rul. 87-66, 1987-2 C.B. 168; PLRs 91-05023, 91-01037 and 87-28072. Cf., e.g. *South Bay Corp. v. Comm'r*, 345 F.2d 698 (2d Cir. 1965); Treas. Reg. § 1.382(b)-l(a)(6); Rev. Rul. 67-274, 1967-2 C.B. 141. For a critical appraisal of this position, see Vogelenzang, "The Resequencing Aspect of Rev. Rul. 87-66; Applying Kimbell-Diamond to Reorganizations", 15 *Int'l Tax J.* (1989) at 197, 335.
83. See *supra* note 20.
84. See Temp. Treas. Reg. § 1.304-4T.
85. Treas. Reg. § 7.367(b)-7(c)(1); Notice 87-85, *supra* note 44.

FHCo-1 in order to reduce the value of the preferred stock to less than 50 percent of the total outstanding. As indicated above, the Section 304 regulations (not applicable here) provide a "look through" rule when a new acquiring subsidiary is employed. It is possible that the IRS would seek to apply a similar rule here, even though there is no express regulatory rule to similar effect.

In any of these preferred stock transactions, it is presumably desirable to issue to US Corp the smallest possible amount of FHCo preferred stock, since this will minimize the subsequent dividend flows still subject to U.S. tax. If, however, the value of that preferred stock is demonstrably less than the value of the FS-l stock surrendered by US Corp, the IRS will presumably take the view that the portion of the FS-l stock equivalent to the shortfall should be deemed to have been distributed by US Corp to FP and contributed by FP to the capital of FHCo. In this case, US Corp would recognize gain, and FP would be subject to withholding tax, *pro tanto*.

V. CONCLUSION

As stated at the outset, all of the restructuring transactions discussed above suffer from one tax disadvantage or another. There is simply no wholly satisfactory tax-free solution.

Many of the problems discussed herein would be avoided if, at the time a foreign company acquired the stock of a U.S. corporation, an election were made under Section 338 or 338(h)(10) to treat the transaction as an acquisition of assets. If this were done, all of the assets of the U.S. corporation would take a tax basis equal to their current fair market value, with the result that subsequent dispositions would involve little or no recognition of gain or loss by the U.S. corporation. Moreover, earnings and profits accounts would be wiped clean, and this might minimize the amount of taxable dividends which may be subject to withholding tax or give rise to adverse consequences under Section 304.

Utilizing Section 338 elections does, of course, require gain recognition at the time of the acquisition; and this may alter the economics of the original purchase itself. Nevertheless, there are some cases, at least, in which such an alternative might prove attractive.

Beyond that alternative, the only other obvious planning device would be for the foreign company, before the acquisition, to identify those foreign subsidiaries or branches of the U.S. corporation which it wishes to take out from under the U.S. corporation and to cause these to be separately purchased by the entity which will hold them after the acquisition. Such separate acquisitions may, of course, themselves involve the recognition of gain, and the planning of such transactions is a complete subject in its own right.

UNITED STATES:

ADVANCE PRICING AGREEMENTS UNDER REVENUE PROCEDURE 91-22

James R. Mogle

Mr. Mogle joined General Motors Corporation in 1984 and is the Chief Tax Officer responsible for all tax matters of the corporation. Prior to joining General Motors, Mr. Mogle was a partner in the Chicago law firm of Kirkland & Ellis. He has a B.S. from Northwestern University, an M.B.A. from Stanford University, a J.D. from American University, and an LL.M. (Tax) from George Washington University. He has been admitted to the bar in Virginia, the District of Columbia, Illinois and Michigan. Mr. Mogle is a member of the 1990-1991 Internal Revenue Service Commissioner's Advisory Group. He is a member of the American Bar Association and the American Institute of Certified Public Accountants.

Mr. Mogle has been a participant in many international tax seminars, including most recently the 1991 Annual Meeting of the U.S. Branch of IFA, the 1991 Prentice Hall/Catholic University International Tax Law Institute, the 1990 Georgetown University Conference on Policy & Practice Issues in International Taxation, the 1990 American Tax Institute in Europe Conference on Intercompany Transfer Pricing U.S.A./Europe, the George Washington University/Internal Revenue Service 2nd Annual Institute on Current Issues in International Taxation, the 1989 IFA U.S.-U.K. Technical Seminar, the University of Southern California 40th Annual Institute on Federal Taxation, the University of Chicago 40th Annual Federal Tax Conference and numerous seminars sponsored by the World Trade Institute.

I. INTRODUCTION

A. *Recent developments in intercompany transfer pricing*

The federal income tax consequences of intercompany transfer pricing between a U.S. corporate taxpayer and its foreign parent or its foreign subsidiaries have attracted increasing attention from the Internal Revenue Service ("IRS") and from the U.S. Congress in recent years. As a result, transfer pricing has become the most important audit and litigation issue in the international tax arena.[1]

The perception of egregious under-reporting of income from the U.S.-based operations of multinational corporations has caused the Congress, the U.S. Treasury Department and the IRS to attempt to derive additional tax revenue through increased policing of cross-border, intercompany transfer pricing. To implement this strategic objective, the IRS has been provided with an arsenal of new enforcement tools. These new tools include:

(1) increased reporting and recordkeeping requirements for certain foreign and domestic corporations under Sections 6038A and 6038C, as amended and enacted, respectively, by the Omnibus Budget Reconciliation Act of 1990;[2]
(2) an extension of the 20 percent "accuracy-related" penalty imposed under Section 6662 which may now apply to substantial Section 482 adjustments;
(3) the ability to toll the statute of limitations while a "designated summons" issued under Section 6503(k) is being enforced;
(4) the ability under Section 982 to preclude the taxpayer from using in litigation "foreign-based documentation" that was requested by the IRS but not produced by the taxpayer during an IRS examination; and
(5) an increase in the interest payable by corporations on large under-payments of tax from three percentage points over the federal short-term rate to five percentage points, effective 30 days after the issuance of either a "30-day letter" or a "90-day letter".[3]

Until recently, the principal focus of Section 482 enforcement by the IRS had been directed to potential "tax avoidance" schemes and transactions between U.S. taxpayers and their affiliates located in low-rate "tax haven" jurisdictions. Increasingly, however, aggressive Section 482 enforcement efforts are being directed by the IRS toward normal transactions involving affiliates located in developed countries that are U.S. treaty partners. U.S. taxpayers that are not using transfer pricing for tax avoidance purposes, but rather are seeking only to avoid double taxation are, nevertheless, now facing challenges to their intercompany transfer pricing policies and procedures.

Traditionally, foreign governments have not placed the same focus on transfer pricing by multinational taxpayers as has the IRS. Foreign governments are, however, beginning to react negatively to the IRS' increased aggressiveness on U.S. inbound enforcement, to the "super royalty" provisions of the Tax Reform Act of 1986, and to the U.S. Congress' desire to enact treaty override provisions. As a result, U.S. multinationals may soon begin to experience more aggressive challenges by foreign governments to their transfer pricing policies and procedures.

1. *Hearings on Underpayment of Income Taxes by U.S. Foreign-Owned Subsidiaries Before the Subcommittee on Oversight, House Ways and Means Committee,* 101st Cong., 2d Sess. (1990).
2. All section references are to the Internal Revenue Code of 1986, as amended ("Code"), or to Treasury regulations promulgated thereunder, unless otherwise indicated.
3. Sec. 6621(c).

B. *An alternative approach to resolution of transfer pricing disputes – the advance pricing agreement*

While the IRS has been concentrating on developing improved enforcement tools and techniques designed to improve its effectiveness in challenging transfer pricing among multinationals, it has also made a serious effort to develop an alternative approach to the resolution of transfer pricing disputes. Over the past 18 months or so, the Office of Associate Chief Counsel (International) has been developing a procedure which would allow a U.S. taxpayer to enter into an agreement with the IRS regarding the prospective U.S. income tax consequences of transfer pricing methodologies. In appropriate circumstances, these agreements would be expanded to include the foreign tax consequences of transfer pricing methodologies pursuant to the mutual agreement procedures under various bilateral tax treaties (i.e. competent authority). This new "Advance Pricing Agreement" ("APA") procedure is intended to provide greater certainty with respect to the tax consequences of transfer pricing, and to reduce the time-consuming and costly procedures that now dominate the enforcement of Section 482.

In June 1990 the IRS informally released for comment a Draft Revenue Procedure under which taxpayers could apply for an "Advance Determination Ruling" on a transfer pricing methodology.[4]

The IRS received many comments from practitioners and interested taxpayers regarding the Draft Revenue Procedure. In addition, several taxpayers requested rulings under the Draft Revenue Procedure. The IRS considered those requests as part of a pilot programme to test the feasibility of the advance ruling process. Based on these comments and pilot test programme, the Draft Revenue Procedure was revised, and on 1 March 1991 the IRS issued Revenue Procedure ("Rev. Proc.") 91-22,[5] which sets forth the rules and procedures that will apply to an application for and the subsequent operation of an "Advance Pricing Agreement". Issued simultaneously with Rev. Proc. 91-22 were: (i) Rev. Proc. 91-23, which sets forth revised procedures for obtaining competent authority relief under bilateral income tax treaties of the United States, and superseding Rev. Proc. 82-29; and (ii) Rev. Proc. 91-24, which prescribes additional conditions for obtaining relief otherwise available under Rev. Proc. 65-17.

C. *Potential benefits of an APA*

The primary benefit of an APA is that it will provide certainty with respect to the tax consequences of intercompany transfer pricing. This can be a significant benefit, particularly for large multinational corporations that have a substantial volume of cross-border, intercompany trade flows. Moreover, the concurrent agreement of a foreign taxing jurisdiction in a bilateral APA will reduce or eliminate the risk of retrospective double taxation, without the necessity of lengthy and costly competent authority proceedings.

The APA process is intended to be a negotiating process and not an adversarial proceeding. It provides a taxpayer with the opportunity to address the complex legal and factual issues inherent in any transfer pricing matter with the Office of Associate Chief Counsel (International), the members of which are generally more experienced and more knowledgeable than are revenue agents in the field. Moreover, the APA environment should permit a more principled and less adversarial review of transfer pricing issues than is ordinarily possible in the traditional IRS examination process.

For those corporations subject to the reporting requirements of Section 6038A, an APA may provide a less burdensome alternative to being placed in a position of substantial non-compliance.

D. *Prerequisites to a successful APA process*

In order for the APA process to be successful, both the taxpayer and the IRS will have to meet the following prerequisites.

1. The taxpayer must be implementing an objective transfer pricing methodology that is expected to produce an objectively determined arm's length result. A transfer pricing methodology designed to produce an aggressive, tax-motivated result is not a viable candidate for an APA.

2. Transfer pricing is an inherently fact-driven issue, and the taxpayer has a far superior understanding of the relevant facts. The taxpayer can expect, therefore, to have to carry a substantial burden of proof in the APA process. The taxpayer must be prepared to devote sufficient resources to the development of credible evidence and a rationale to support the arm's length character of the transfer pricing result.

3. If the taxpayer enters into an APA with the IRS, the taxpayer will continue to carry the burden of proof to demonstrate that it has complied with the provisions in the APA. Failure to do so can result in the forfeiture of the benefits sought from the APA process.

4. If the APA process is to be successful, the IRS will have to exercise restraint in its request for analyses and supporting data. The APA process is not a field examination, nor is it preparatory to litigation. If the APA process becomes too burdensome or too uncertain, taxpayers will not attempt to use it.

5. The IRS must be willing to trust the honesty and integrity of the taxpayer requesting an APA. It must resist the temptation to attempt to verify every single fact or assertion made by the taxpayer.

6. Finally, the IRS must be willing to focus on principles and methodology, and not focus solely upon the resulting tax revenue. Arm's length prices provide only an opportunity for profit, not a profit guarantee. If the IRS intends to enter into an APA only when it produces a desired tax result, the APA process will be no better than a field audit, and most taxpayers will elect to take their chances in that venue.

II. ADVANCE PRICING AGREEMENTS

A. *Principles of the APA process*

1. Scope

A taxpayer may obtain from the Office of Associate Chief Counsel (International) an APA regarding the prospective application of a transfer pricing methodology ("TPM") ap-

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4. That draft was published in 2 *Tax Notes International* 565 (June 1990).
5. In Rev. Proc. 91-22, the term "Advance Determination Ruling" has been changed to "Advance Pricing Agreement" to better reflect the true nature of the document to be negotiated between the IRS and the taxpayer.

plicable to some or all of its intercompany transactions with some or all of its foreign affiliates. The APA will apply to such transactions for purposes of Section 482, as well as other relevant Code sections (e.g. Sections 863(b) and 936). The APA process is intended to produce an understanding between the IRS and the taxpayer regarding the appropriate TPM to be applied to specified international transactions, and may or may not actually specify the arm's length results that are expected to be produced by the TPM.

Rev. Proc. 91-22 makes it clear that an APA request need not cover all of the intercompany transfer pricing policies and procedures of a taxpayer. The Draft Revenue Procedure seemed to require a complete description and analysis of all transactions between related parties. This could be very onerous, will usually be irrelevant and could prevent taxpayers from requesting an APA. Clearly, a taxpayer should be required to describe all intercompany transactions that bear directly on the TPM being reviewed. However, there may be different intercompany transactions which require different methodologies, and the IRS and the taxpayer should be permitted to address each methodology separately. To require a complete analysis of all types of transactions in order to obtain an APA on a single type of transaction would make the APA process impractical for many taxpayers.

2. Proposed transfer pricing methodologies

An APA will be premised upon a TPM proposed by the taxpayer. The taxpayer is expected to be able to demonstrate that the TPM is in accordance with the broad principles of Section 482 and the regulations thereunder.

The IRS expects that, whenever possible and practical, the taxpayer will use one of the primary methods prescribed in Treas. Regs. Section 1.482-2 to test the arm's length character of the results obtained from the TPM. These methods include: (a) the comparable uncontrolled price method, (b) the resale price method, and (c) the cost plus method. In support of its proposed TPM, the taxpayer is expected to identify, to the extent possible, comparable independent transactions. Where independent comparables do not exist, the taxpayer is expected to identify types of transactions or businesses that are "similar" to the taxpayer's transactions and/or business and to propose adjustments to create parity with its own business operations.

The APA process does contemplate, however, the use of a "fourth method" where the taxpayer's particular facts and circumstances warrant. In that event, the taxpayer is expected to demonstrate why the primary methods are not applicable or not practical, in addition to showing that the results of the proposed TPM will satisfy the requirements of Section 482.

3. Critical assumptions

The application and operation of a TPM under an APA will be based upon data and analyses provided by the taxpayer, and upon "critical assumptions" agreed to between the taxpayer and the IRS. The taxpayer will be required to file an "annual report" to demonstrate its good faith compliance with the terms and conditions of the APA, and the continued validity of the critical assumptions.

Critical assumptions are objective business and economic criteria that are fundamental to the operation of the taxpayer's proposed TPM. A critical assumption can be a fact, circumstance or result regarding the taxpayer, a third party or an industry which, if it should change or fail to materialize, would significantly affect the substantive terms of the APA.

A critical assumption could change or fail to materialize due to uncontrolled changes in subsequent economic circumstances (e.g. a significant deviation from budgeted sales volume) or due to taxpayer actions initiated for good faith business reasons (e.g. a new business strategy or the cessation of a business segment or material function).

The taxpayer is expected to propose to the IRS the critical assumptions it believes are material to the operation of the TPM. The operative critical assumptions that will be incorporated into the final APA will be negotiated during the APA evaluation process.

The concept of "critical assumptions", is an appropriate one, provided the critical assumptions set forth in an APA are limited to objective arm's length criteria and to business and economic factors. They should not include assumptions regarding the anticipated taxable income to be produced by the proposed TPM. The arm's length standard does not require a guaranteed profit result; it requires only a profit opportunity equivalent to that available to comparable independent parties.

The tone of Section 4.05 of the Draft Revenue Procedure suggested that the IRS would take an extremely narrow and potentially unreasonable view of the critical assumptions set forth in an APA. If the IRS intends no more latitude in the critical assumptions than is indicated by the Draft Revenue Procedure, a taxpayer may well be forced to defend the TPM annually. In that event, the APA will be essentially worthless. The threatening tone of the Draft Revenue Procedure is not repeated in Rev. Proc. 91-22. It is uncertain whether this represents merely a change in tone, or is a genuine and essential change in substance and attitude by the IRS.

4. Compensating adjustments

If the actual operating results for a taxable year covered by an APA fall outside any agreed-upon range of expected results, the taxpayer may make a "compensating adjustment" after the close of the taxable year to bring the pricing result for the TPM within the agreed-upon range. Such a compensating adjustment will have the effect of a retroactive adjustment to the taxable income and earnings and profits of both the taxpayer and its related foreign affiliate, and will be deemed to accrue on the last day of the taxable year to which it applies. The adjusted results will apply for all U.S. income tax purposes, except that they will not be taken into account for estimated tax purposes.

The concept of "compensating adjustments" is a very positive step forward in the practical application of Section 482 to "real-world" transfer pricing dynamics. It recognizes that in the ordinary course of business operations, the dynamics of the market place and the continuing development of business and marketing strategies could produce an unanticipated and unintended transfer pricing result that might not meet the arm's length standard. Through the compensating adjustment mechanism, a taxpayer can promptly correct this result and avoid retrospective adjustment and the related tax and interest assessments that would otherwise be imposed several years later. Provided a bilateral APA is entered into, a taxpayer can also assure itself of a collateral adjustment in the appropriate foreign jurisdiction, thereby avoiding double taxation without the necessity of pursuing competent authority relief.

It is anticipated that subsequent "normal and routine" audit adjustment to transfer pricing results (e.g. correction of a computational error) will be treated as a compensating adjustment without affecting the continued validity or applicability of the APA for those years.

Compensating adjustments must be paid by the taxpayer or foreign affiliate, as appropriate, within 90 days of the filing of the taxpayer's U.S. income tax return for the year giving rise to the adjustment. If so paid, the compensating adjustment will have no other U.S. income tax consequences, including withholding taxes or penalties, and no interest need be paid with respect to such a payable or receivable.

All compensating adjustments and related payments must be documented and disclosed in the annual report.

The Draft Revenue Procedure acknowledged that there is not always a single arm's length price; in fact, the arm's length standard contemplates a range of prices that might be charged by independent comparables.[6]

Appendix VII provides an example of how the range concept applies where the resale price method is used to test the arm's length character of transfer pricing results. It should be clear that if a taxpayer can demonstrate the range of results obtained by independent comparables, any transfer price between the taxpayer and its affiliate that produces a result within that range should, as a matter of law, be an arm's length transfer price.

While it is encouraging to see the IRS recognize the range concept, it is not clear how the IRS will implement the concept. It is understood that in negotiations with taxpayers applying for an APA under the Draft Revenue Procedure, the IRS apparently has anticipated a very narrow range of acceptable results, possibly as narrow as 0.1 percent in results. This will not be realistic in many instances. It is further understood that the IRS has attempted to drive the results of a proposed TPM to the extreme top or bottom of the acceptable range, depending upon whether the transaction at issue is an inbound or outbound transaction. The APA process is unlikely to be broadly successful if the IRS intends to negotiate from a result-oriented, revenue-driven position rather than from an objective and principled position.

It is also understood that the IRS intends to apply a "second range" concept to the compensating adjustment mechanism. That is, a compensating adjustment will not be permitted if the actual results of a proposed TPM fall outside the range of anticipated arm's length results by more than a specific amount, as set forth in the APA. As indicated in Section 4.05(f) of the Draft Revenue Procedure, this "second range" concept is properly considered as part of the critical assumptions upon which the TPM relies. If the actual transfer pricing results exceed the range of anticipated arm's length results by an excessive amount, that is an indication that one or more of the critical assumptions may have changed or may not have materialized.

5. Competent authority considerations

Where an APA applies to transactions with foreign affiliates in countries with which the United States has bilateral income tax treaties, the IRS contemplates that the APA will ordinarily be submitted by the taxpayer to the U.S. competent authority who will then attempt to negotiate a bilateral APA with the appropriate U.S. treaty partner. While a bilateral APA is not mandatory, a taxpayer seeking only a unilateral APA must show "good and sufficient reasons" for such an APA.

The subject of any mutual agreement between the competent authorities will be the taxpayer's proposed TPM. If the competent authorities propose to modify the terms and conditions of the taxpayer's TPM, the taxpayer's consent will be secured before any mutual agreement is reached.

The taxpayer is expected to cooperate with the U. S. competent authority pursuant to the standards set forth in Rev. Proc. 91-23, *supra*. To the extent possible, the IRS will avoid requesting sensitive commercial data in connection with the competent authority proceedings. Moreover, the U.S. competent authority will attempt to secure an agreement with the foreign competent authority to give all data provided under the APA request the same degree of confidentiality provided for in the United States under Section 6103.

If the competent authorities reach agreement on a TPM, the IRS will execute an APA with the taxpayer on substantially the same terms and conditions as contained in the mutual agreement between the competent authorities. If no agreement is reached, the IRS and the taxpayer may, nevertheless, execute a unilateral APA which will then be applicable for U.S. income tax purposes only.

As part of any mutually agreed-upon bilateral APA, the U.S. competent authority will attempt to negotiate the inclusion of provisions that will ensure substantially identical treatment by the foreign taxing jurisdiction of the taxpayer and its foreign affiliate with respect to compensating adjustments. Moreover, the U.S. and foreign competent authorities will attempt to agree on a consistent statute of limitations for any taxable year covered by a bilateral APA.

If a bilateral APA is negotiated, the IRS expects to advise the foreign competent authority of any subsequent modifications, cancellation, revocation or renewal of the APA, as well as an evaluation of the taxpayer's annual reports and examination of the taxpayer's compliance with the terms and conditions of the APA.

If the taxpayer has entered into a unilateral APA, the regular competent authority procedures set forth in Rev. Proc. 91-23, *supra*, will apply if double taxation subsequently develops as a result of the taxpayer's compliance with the terms and conditions of an APA. Importantly, the U.S. competent authority may deviate from the terms and conditions of the APA in an attempt to negotiate a settlement with the foreign competent authority.

6. Disclosure

The Office of Associate Chief Counsel (International) is aware of taxpayers' concerns regarding the public disclosure of sensitive commercial and proprietary data that might be submitted to the IRS and potentially to foreign competent authorities. It is understood that it is the IRS' position that information received or generated by the IRS in connection with a taxpayer's application for an APA is "tax return information" subject to the confidentiality requirements of Section 6103. The taxpayer will be asked to authorize the disclosure of such information to an "independent expert" (if any) who is participating in the APA process, and to a foreign competent authority (if applicable).

It can be anticipated that the confidentiality of an APA and supporting data and analyses may be challenged.[7] It is understood that the IRS believes that confidentiality is an essential element of the APA process and, accordingly, will forcefully resist any such challenge.

6. See Sec. 4.04 of the Draft Revenue Procedure. The range concept has been retained in Rev. Proc. 91-22.
7. See e.g. 2 *Tax Notes International* 1127 (November 1990).

It should be noted, however, that there is no authority to support the IRS position that an APA and its supporting documentation is "tax return information" under Section 6103, or that it would satisfy any of the exemptions from disclosure under Section 6110(c).[8] Thus, a taxpayer requesting an APA should be prepared for public disclosure of at least a redacted version of the APA and its supporting documentation.

7. Legal force and effect

An APA may take any form mutually acceptable to the taxpayer and the IRS. Although an APA is not a private letter ruling or a closing agreement under Section 7121, an APA is intended to be a legally binding agreement between the taxpayer and the IRS covering the prospective treatment for U.S. income tax purposes of transfer pricing covered by the APA. Provided that the taxpayer complies with the terms and conditions of the APA, the results obtained under the TPM will be deemed to satisfy the arm's length standard and will not be challenged by the IRS.

The protection provided by an APA will apply only to the TPM specifically covered by the APA, and not to any other intercompany transfer price or transaction of the taxpayer.

Except as provided by mutual written agreement between the taxpayer and the IRS, neither the APA itself nor any *non-factual* representations or submissions made in connection with the APA request may be introduced by the taxpayer or by the IRS as an admission by the other party in any judicial or administrative proceeding involving any taxable year or any transaction not covered by the APA. In this regard, the taxpayer may provide a list of representations and submissions it considers non-factual for review by the IRS. This same restriction will apply if an APA is not executed or if an APA is executed but later revoked.

Notwithstanding the technical limitations to be placed on the use of non-factual information, it can be anticipated that, as a practical matter, Revenue agents will attempt to retroactively apply concepts from the APA to support transfer pricing adjustments if those adjustments are favourable to the government. This practical fact, together with the substantial involvement of the District Director in the APA evaluation process, may put a taxpayer at significant risk for years prior to the effective date of an APA.

As part of an APA process, a taxpayer may develop non-factual information and/or a rationale that it wishes to apply to a year prior to the effective date of an APA. The taxpayer will not be precluded from doing so by Rev. Proc. 91-22 whether or not an APA is ultimately entered into with the IRS.

During the competent authority negotiations that would precede the execution of a bilateral APA, it is the intention of the IRS to negotiate similar restrictions on the use of non-factual information by foreign governments. There can be no assurances, however, that such limitations will be accepted by foreign governments, or, if accepted, that such limitations will be effectively enforced.

It is understood that the IRS will take the position that there are no limitations on its right or ability to use factual information submitted in connection with the APA request in any manner it deems appropriate. Accordingly, the IRS may use factual information obtained in the APA process to challenge a taxpayer's TPM or results in taxable years or for transactions not expressly covered by the APA.

B. *Content of an APA request*

1. Prefiling conference

In recognition of the fact that not all APA requests will require the same degree of factual disclosure and economic or legal analysis, taxpayers will be encouraged to use a "prefiling conference" procedure. A taxpayer requesting an APA will be permitted to have one or more prefiling conferences with the IRS to: (i) explore informally the chances for a successful APA process, (ii) clarify the data, documentation and analyses that will be required, (iii) consider the possibility of an agreement among competent authorities, and (iv) determine the IRS schedule and methods of coordinating the evaluation of the APA request with the appropriate District Director and other IRS officials.

The prefiling conference is potentially the most important new aspect of the APA process contained in Rev. Proc. 91-22. Whether the costs and burdens of the APA process can be justified will depend to a very significant degree on the outcome of the prefiling conference(s). For example, at the prefiling conference(s) a taxpayer will have the opportunity to limit the scope of the documentation that will be necessary to satisfy the IRS. It is essential, therefore, that a taxpayer be well prepared before initiating the APA process through a prefiling conference.

2. General requirements

The taxpayer is expected to provide a detailed explanation and analysis of the proposed TPM. Subject to the agreement reached at a prefiling conference, the taxpayer will ordinarily be expected to provide the following general information:

- an illustration of the operation of the proposed TPM by application to the most recent three years' financial and tax data of the parties, or by some other appropriate pro forma simulation;
- a description of the general history of the business operations, organizational structure, ownership and capitalization, and major transaction flows for each affiliated entity that will be covered by the requested APA;
- representative financial and tax data for each relevant party for the preceding three years, including identification of functional currencies, taxable years, significant accounting methods and differences between U.S. and foreign tax accounting rules;
- existing intercompany pricing, distribution or licensing agreements;
- marketing and financial studies, company-wide accounting procedures, business segment reports, budgets and projections, business plans and worldwide product line or business segment profitability reports;
- discussion of statutory provisions, tax treaties, court decisions, regulations, revenue rulings and revenue procedures that "significantly and directly" relate to the proposed TPM; and
- an explanation of the taxpayer's and the IRS' positions (and positions of any relevant foreign taxing jurisdiction) on previous and current issues at the examination, appeals, judicial or competent authority levels which relate "directly" to the proposed TPM.

8. See e.g. *Willamette Industries. Inc. v. United States,* 689 F.2d 865 (9th Cir. 1982) and *Tax Analysts & Advocates v. Blumenthal,* 566 F.2d 130 (D.C. Cir. 1977), *cert. denied,* 434 U.S. 1086 (1978).

3. Specific factual guidelines for a proposed TPM – not a cost sharing arrangement

In order to demonstrate that the proposed TPM meets the arm's length standard, the taxpayer may be required to submit the following additional information for the preceding three-year period, or some other period that may be necessary to reflect the volatility of a particular industry:

- pertinent measurements of profitability and return on investment (such as gross profit margins, net profit margins, return on assets, etc.) which can serve as the basis of comparison to comparables or similar businesses;
- a functional analysis of each party involved with the TPM, setting forth the economic activities performed, assets employed, costs incurred and risks assumed;
- an economic analysis of the general industry pricing practices and pertinent measurements of profitability and return on investment within the markets and geographic areas covered by the APA request;
- a list of the taxpayer's competitors and a discussion of businesses that might be comparable or similar to that of the taxpayer; and
- a detailed analysis of possible independent comparables, criteria used to select possible comparables and pertinent measurements of profitability and return on investment for each possible independent comparable.

In many cases, the analysis of comparables will be the most important aspect of a request for an APA. This will be particularly true where the taxpayer is using the resale price method or the cost plus method to demonstrate the arm's length character of its transfer pricing. In developing an analysis of comparables, the reported profitability of comparables will usually have to be adjusted to achieve true comparability. Such adjustments may include segmentation of businesses, accounting reclassifications and adjustments to reflect differences in functions performed, risks assumed and the scale of operations.

Appendices I through VII demonstrate an approach to the application of the resale price method, including the identification of comparables and the determination of the adjustments necessary to achieve reasonable comparability. The approach demonstrated in these Appendices has been successfully applied in a "real-world" environment.

4. Specific factual guidelines for a proposed TPM cost sharing arrangement

If the requested APA will cover a cost sharing arrangement, the following information may have to be submitted to demonstrate the arm's length character of the proposed cost sharing arrangement:

- a history of the business operations and geographical locations of each participant in the arrangement;
- copies of any prior cost sharing arrangements between the participants and all amendments and modifications thereto;
- a written agreement for the cost sharing arrangement to be covered by the requested APA, the date the arrangement commenced, the date it was reduced to writing, the date each participant entered the arrangement and each participant's original contribution to the arrangement (including tangible and intangible contributions);
- a description of the activities to be covered by the cost sharing arrangement, including whether the arrangement provides for research and development in general product areas and/or specific products, and whether the arrangement provides for contract research;
- a description of what costs are to be shared and how the division of costs is to be determined;
- the accounting procedures to be used to determine costs to be shared and contributions to be made by each participant;
- how cost sharing payments are to be made;
- the ownership rights of each participant in the developed products and intangibles;
- the expected benefits of each participant, how those benefits are to be determined, and whether there will be provisions for periodic review of the expected benefits and corresponding adjustments of cost shares;
- whether royalties are to be paid to participants that contributed intangibles to the arrangement;
- whether new participants may join the arrangement and, if so, under what terms;
- whether any payments are to be received from third parties and, if so, how such payments are to be treated for U.S. income tax purposes;
- each participant's gross and net profitability with regard to the product area covered by the arrangement for the five preceding years and projected profitability for the succeeding two years; and
- identification of all internal manuals, studies, budgets, business plans, reports, etc., that may relate to the implementation or operation of the cost sharing arrangement.

The potential amount of documentation that could be required by the IRS in order for a taxpayer to successfully complete the APA process is substantial, almost overwhelming. Rev. Proc. 91-22 does not mandate any particular documentation, but provides an expansive list of potential document requirements. It is anticipated that the taxpayer and the IRS will attempt to negotiate a reasonable documentation agreement during the prefiling conference(s). It is submitted that the likelihood of success for the APA process will depend to a significant degree on how reasonable the IRS is in its document requirements. If the proposed regulations recently issued under Section 6038A are indicative of the IRS' expectations in this regard, it is doubtful that very many taxpayers will be interested in the APA process.[9]

5. Miscellaneous requirements

The following requirements must also be met as part of the submission of an APA request:

- original documents should not be submitted as all documents submitted will be retained by the IRS;
- all documents submitted in a foreign language must be accompanied by a certified English translation;
- applicable terms and conditions should be proposed by the taxpayer, including the initial term of the APA, renewal conditions, critical assumptions, compensating adjustment procedures, competent authority considerations, use of independent experts and such other terms and conditions that the taxpayer deems appropriate;

9. Prop. Regs. Sec. 1.6038A-1 through Sec. 1.6038A-3, IL 868-89, 55 Fed. Reg. 50,706 10 December 1990).

- relevant collateral U.S. income tax issues raised by the proposed TPM (if any) should be discussed in the APA application. This seems to be a more narrow requirement than was contained in the Draft Revenue Procedure. Section 5.09 of the Draft Revenue Procedure required an extraordinarily broad discussion of collateral issues and suggested that the IRS is more interested in tax revenue to be produced by a proposed TPM than it is in whether the proposed TPM will produce an arm's length result. If the APA process is to be successful, the IRS should ordinarily be willing to enter into an APA based on the substance of the pricing methodology without a full understanding of the bottom-line tax result;
- a power of attorney (Form 2848) must be included for any person authorized to represent the taxpayer in connection with the APA request;
- a perjury statement signed by an officer of the corporation with personal knowledge of the facts must accompany the APA request and all supplemental submissions; and
- the APA request must be filed in triplicate, together with a $ 5,000 user fee, with the Associate Chief Counsel (International) CC:INTL:FO, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20224, or be hand delivered pursuant to Rev. Proc. 88-4.

C. *Processing an APA request*

1. Evaluation of an APA

Once an APA request has been formally filed with the Office of Associate Chief Counsel (International), that office will evaluate the request "in coordination with the appropriate District Director". This evaluation will not constitute an examination of the taxpayer's books and records under Section 7605(b).

Section 6.05 of the Draft Revenue Procedure provided that the "primary responsibility" for the evaluation of a taxpayer's proposed TPM was to be assigned to the District Director. It is submitted that this was a fatal flaw in the Draft Revenue Procedure. If Revenue agents, who generally lack the expertise to deal with complex transfer pricing issues and who are often biased toward tax revenue production, are permitted to play the dominant role in the APA process, it is unlikely that taxpayers will find the process worth the effort.

Encouragingly, Rev. Proc. 91-22 expressly states that the Office of Associate Chief Counsel (International) will be responsible for evaluating an APA request "in coordination with the District Director". Hopefully, this is a change in substance, and not merely a cosmetic change in the language of the revenue procedure.

During the evaluation process, additional information may be requested from the taxpayer. It is expected that such requested information will be provided within a specified period of time. If the requested information is not provided within the specified time, negotiations on the request for an APA may be terminated unilaterally by the IRS.

The taxpayer may withdraw the APA request at any time prior to the later of the competent authorities reaching an agreement, or the IRS and the taxpayer executing an APA. If an APA request is withdrawn, "neither party will have any obligations to the other, and any obligations to the other and any previous understandings between the parties will be of no further force and effect unless otherwise required by law".

It can be anticipated that the APA negotiation process will involve several conferences with the IRS. As a practical matter, the number of such conferences will be unlimited so long as they are necessary and appropriate to the full understanding by the IRS of the proposed TPM. In any event, the taxpayer will have, as a matter of right, a minimum of one conference with the IRS during the evaluation process, and one additional conference should the IRS propose to reject an APA request.

2. Independent expert opinion

The taxpayer may be required to provide at its own expense an independent expert, mutually acceptable to the taxpayer and the IRS (and, if necessary, the appropriate competent authorities), to review and opine on the proposed TPM. It is not expected that an independent expert will be required in every case.

The independent expert will be expected to render an opinion that the proposed TPM is "supportable, fairly presents the economic interests of the parties to the APA, [and] supports and produces an arm's length approach". In addition, the independent expert will be expected to provide a basis for such conclusions.

Both the taxpayer and the IRS will have access to the expert's report and documentation. The expert's opinion will not be binding on either the taxpayer or the IRS.

An "independent" expert will generally not have participated to any material extent in the development of the taxpayer's APA request.

The Rev. Proc. 91-22 requirement that an "independent" expert not have participated in the development of the TPM may prove to be unworkable in many situations. A taxpayer that is attempting to develop a sophisticated and demonstrable arm's length pricing methodology will probably require outside expert assistance. The expert retained to do this will be the most qualified person to explain and support the methodology to the IRS. Moreover, the taxpayer may not be willing to bear the expense of paying one expert to develop the methodology and paying another expert to review the methodology and opine on whether the first expert is correct.

In Section 5.02(d), the Draft Revenue Procedure provided that the taxpayer will have to propose two experts for each country. This is excessive and is no longer a strict requirement in Rev. Proc. 91-22. The underlying business and economic issues generally do not require country-specific experts. Moreover, many consulting firms have multiple offices around the world, and would typically use a multinational team to do the work.

It would appear that the IRS views the role of the expert in the APA process as that of an independent arbiter. This is unnecessary and inappropriate. The IRS must have more trust in the integrity of the taxpayer. Non-compliant taxpayers are not likely to avail themselves of the APA process. Moreover, what is "arm's length" is often a subjective issue; the IRS and the taxpayer should be able to reach an agreement in most instances, provided both are acting in good faith and are not unreasonable. If the APA process is nothing more than an arbitration process between adversaries, the taxpayer may as well go to court and get an independent "arbitration" under known rules of procedure.

D. *Administration of an APA*

1. Annual reports

A taxpayer that enters into an APA will be required to file an annual report that is intended to demonstrate that there has been good faith compliance with the terms and conditions of the APA. The specific content of an annual report will be defined and mutually agreed upon during the APA negotiation process. In addition to demonstrating compliance with the APA, the taxpayer may use the annual report to request a renewal, modification or cancellation of the APA.

The annual report must be filed with the Office of Associate Chief Counsel (International) no later than 90 days after the taxpayer's U.S. income tax return for the year has been filed.

The annual report will be reviewed by the Office of Associate Chief Counsel (International), the appropriate District Director, and in the case of a bilateral APA, the appropriate competent authorities. Ordinarily, the IRS will not contact the taxpayer regarding the annual report unless it is necessary to clarify or complete the information contained in the report. Neither the review of the annual report, nor a request to submit additional information in connection with the annual report will constitute an examination or the commencement of an examination for purposes of Section 7605(b).

The annual report concept does not seem necessary to a successful APA process. It is not apparent why the APA process should be any different than the normal private ruling process where a taxpayer is expected to demonstrate upon regular examination that it has complied with the terms and conditions of a ruling. Presumably, the annual report requirement reflects the IRS inherent distrust of multinational taxpayers. If so, a successful APA process will be difficult to achieve.

The annual report will be reviewed by the District Director outside the normal examination process. This seems unnecessary and is an unreasonable burden on the taxpayer. The involvement of the District Director in the APA evaluation process and in the review of annual reports, taken together, may constitute a process more burdensome than the one currently in existence. Moreover, the substantial involvement of the District Director in the overall APA process detracts from one of the more significant potential benefits of the APA process – the opportunity to have transfer pricing reviewed by experienced National Office personnel outside the adversarial environment of an examination by Revenue agents.

Rev. Proc. 91-22 attempts to assure taxpayers that the District Director's review of annual reports will not be a re-evaluation of the TPM. Experience with Revenue agents suggests, however, that unless the Office of Associate Chief Counsel (International) exercises unusually strong influence over the role of Revenue agents participating in the APA process, taxpayers will, in fact, be forced to defend the acceptability of the TPM to the satisfaction of the Revenue agents.

2. Examination

The existence of an APA will not preclude the District Director from conducting an examination of transfer pricing under the APA. However, such an examination will not be a re-evaluation of the acceptability of the TPM covered by the APA, and will be limited to a determination that the taxpayer has properly implemented the TPM and has complied in good faith with all of the terms and conditions of the APA, and that all material representations made in the APA and annual reports remain valid.

If the District Director determines that the taxpayer has not satisfied all of the requirements of the APA, the matter will be submitted to the Office of Associate Chief Counsel (International) for resolution. If the taxpayer's position is sustained, the District Director will apply the APA; if the District Director's position is sustained, the APA may be revised, revoked or canceled, or the IRS may pursue any other alternatives available to it under the terms and conditions set forth in the APA.

The District Director will be entitled to propose "normal and routine" adjustments to the determination and computation of the taxpayer's transfer prices under the TPM without first securing the consent of the Chief Counsel, and without jeopardizing the continued validity or applicability of the APA itself. If the taxpayer agrees with such adjustments, they may be given effect under the provision in the APA for compensating adjustments. If the taxpayer does not agree with the proposed adjustments, the taxpayer may contest them through the normal administrative and judicial procedures.

3. Record retention

The taxpayer must maintain sufficient books and records to enable the IRS to conduct an examination of the taxpayer's compliance with the APA. A record retention agreement may be negotiated during the APA process. Upon examination, the taxpayer will be expected to provide such books and records within 60 days of a request. The fact that a foreign jurisdiction may impose a penalty upon the taxpayer, its affiliate or any other party for disclosing the books and records will not constitute reasonable cause for non-compliance with the IRS' request for documentation.

4. Revocation and cancellation for cause

An APA may be revoked retroactively if the IRS determines that there has been (i) "fraud or malfeasance" (as defined in Section 7121) or "disregard" (as defined in Section 6662(b)(1) and (c)) on the part of the taxpayer in connection with material facts set forth in the APA request, subsequent submissions or the annual report, or (ii) lack of good faith compliance by the taxpayer with the terms and conditions of the APA. Revocation by the IRS is not mandatory, and the taxpayer may be required to comply with the APA for the remainder of its term. If the APA is revoked, the IRS may determine appropriate deficiencies and additions thereto in accordance with applicable provisions of the Code. In addition, the taxpayer may be: (i) denied the benefit of the relief provisions of Rev. Proc. 65-17, (ii) treated as an "egregious case" under Rev. Rul. 80-231, or (iii) denied the unilateral relief provisions of Section 9.06 of Rev. Proc. 82-29.

If the IRS determines that there were material misstatements of fact or a lack of good faith compliance with the APA that do not rise to the level of "fraud or malfeasance" or "disregard", then the APA may be canceled rather than revoked. Cancellation will be effective as of the beginning of the taxable year to which the misstatements or non-compliance relate.

The Draft Revenue Procedure provided unreasonably strict terms and conditions that could trigger the revocation of an APA.[10] While the language in Rev. Proc. 91-22 is more

10. See Sec. 4.05(d) and (e).

reasonable, it is not clear whether a substantive change was intended. It is submitted that unless the IRS exercises restraint in applying the revocation provisions of the APA process, the concept of an APA will fail. The IRS must recognize that business factors and market forces are dynamic. Businessmen who make decisions in response to these factors seldom consider the tax effect of their actions. Corporate tax departments are not always promptly notified of actions taken. The APA process will not be usable if it requires excessive monitoring of business activity by the tax department and/or excessive risk of revocation of the APA.

5. Revision of an APA

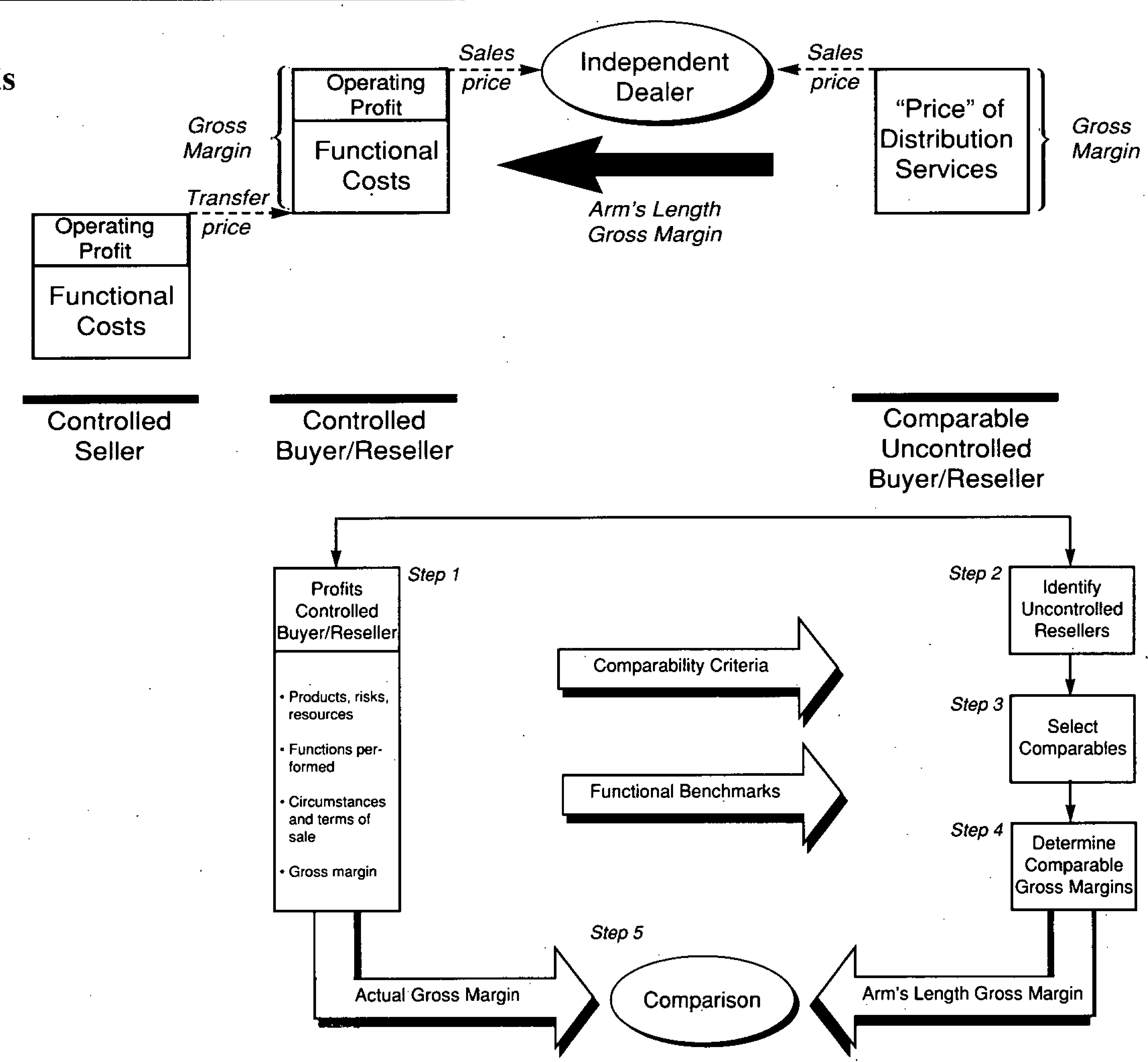
If there is a change in one or more of the critical assumptions specified in the APA, the taxpayer is required to notify the Office of Associate Chief Counsel (International) no later than the date for filing the annual report for the year. (Note that a change in law or a change in an application treaty may require a revision in the TPM or the terms and conditions of the APA.) In that event, the taxpayer and the IRS will negotiate in good faith with the objective of executing a new and revised APA. If no agreement can be reached, the APA will be canceled as of the beginning of the year encompassing the event causing the change in a critical assumption.

6. Renewal of an APA

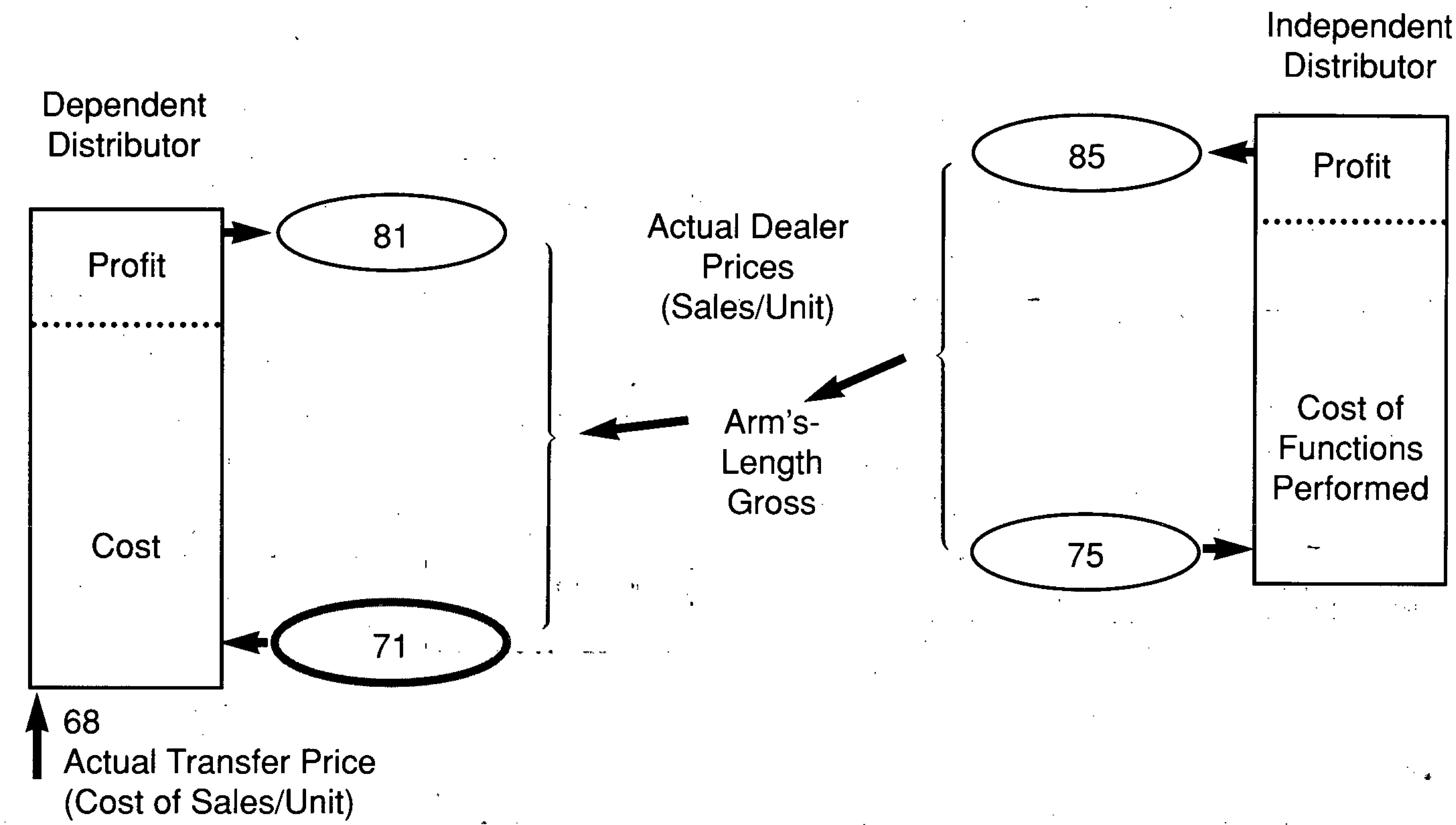
The initial term of an APA will be determined during the APA negotiation process. It is understood that the IRS believes that a three-year term would ordinarily be appropriate, although the actual duration of an APA will depend upon the particular industry, product or transaction involved. The taxpayer and the IRS will mutually agree upon an appropriate renewal period. A request for renewal can be initiated by the taxpayer no earlier than nine months prior to the expiration of the current APA. An application for renewal will generally follow the procedures for an initial APA. Where the IRS and the taxpayer are satisfied that the TPM in the initial APA has conformed to expectations, the renewal process will focus on updating critical assumptions. Where substantial changes in facts, critical assumptions or in the TPM itself are required, full documentation in support of the proposed changes will be required.

A three-year term as envisioned by the IRS is a very short period given the effort and cost that is anticipated to be required to successfully complete the APA process. Taxpayers will likely wish to negotiate a longer period, and may even make a longer term a prerequisite to continuing the APA process beyond the prefiling conference stage. The renewal process will also influence what is an acceptable term from the taxpayer's viewpoint. If there is a reasonable expectation that the renewal process will be more or less perfunctory, a shorter initial term might be acceptable. If, on the other hand, it is anticipated that the renewal process will essentially repeat the initial application process, the entire APA concept will likely be unworkable unless the term of an agreement is significantly longer than three years.

Appendix I –
Resale Price Analysis
Overall Logic...

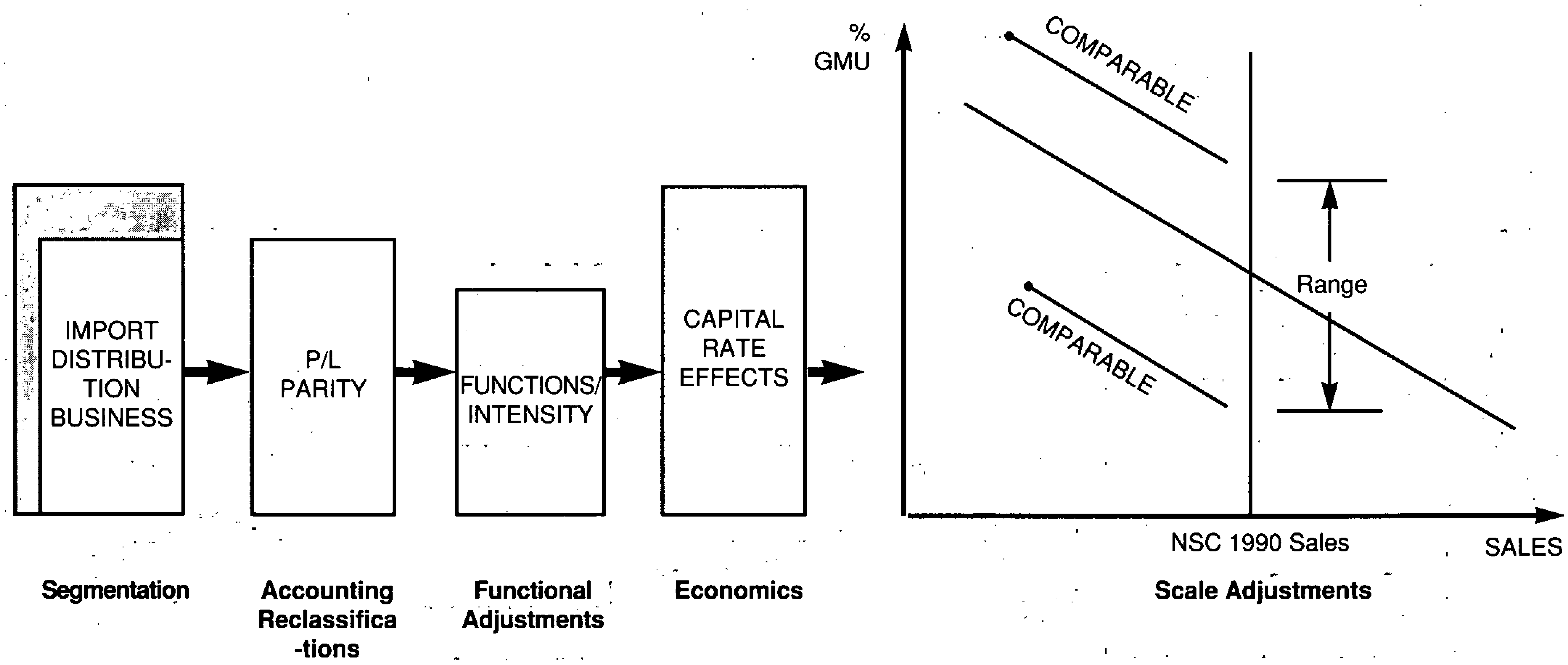


Appendix II – Key Concept: Arm's-Length Gross "Markup"



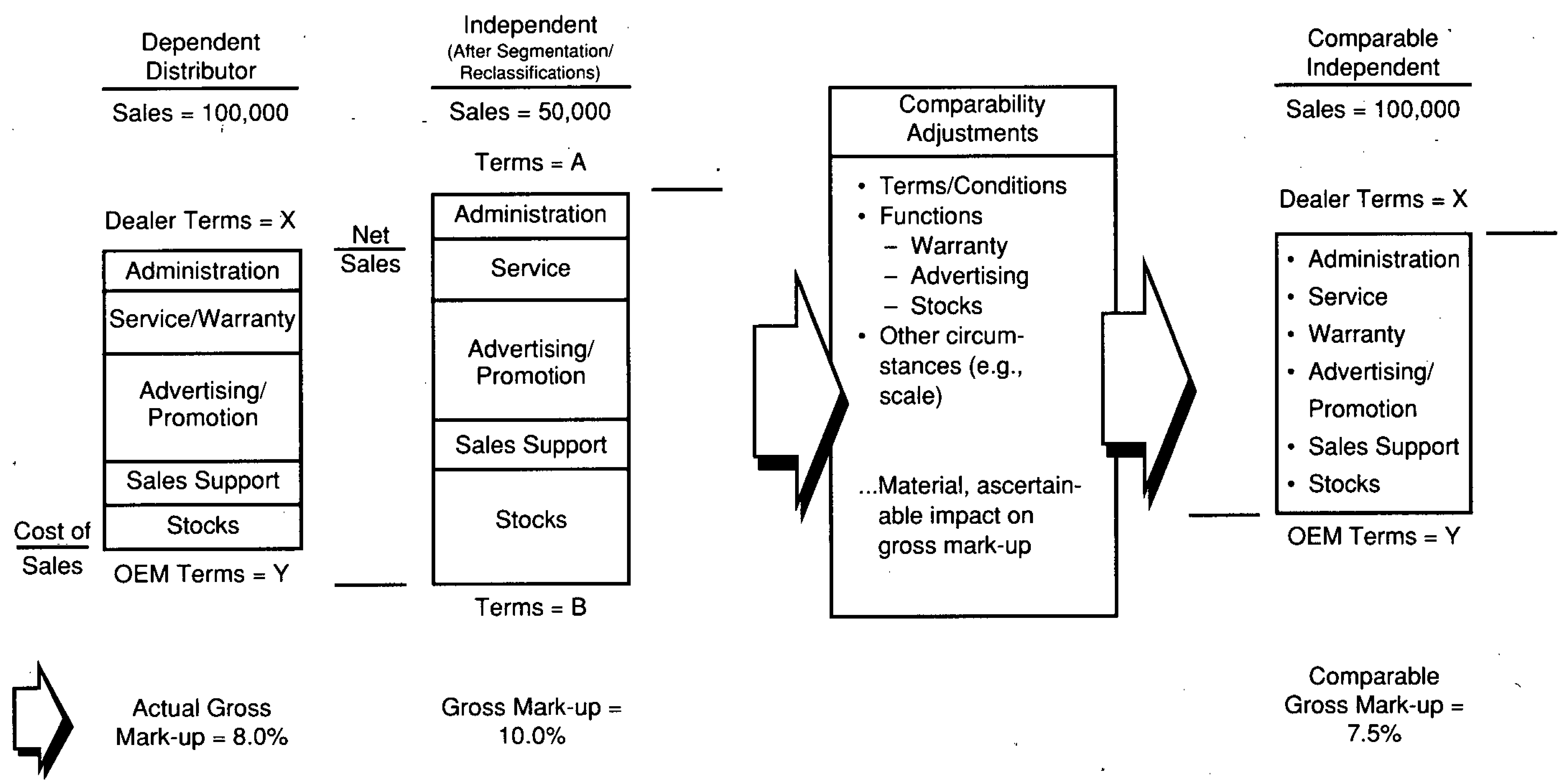
...Not Comparing (Targeting) Dealer Prices or Operating/Taxable Profits

Appendix III – Overall Adjustment Logic



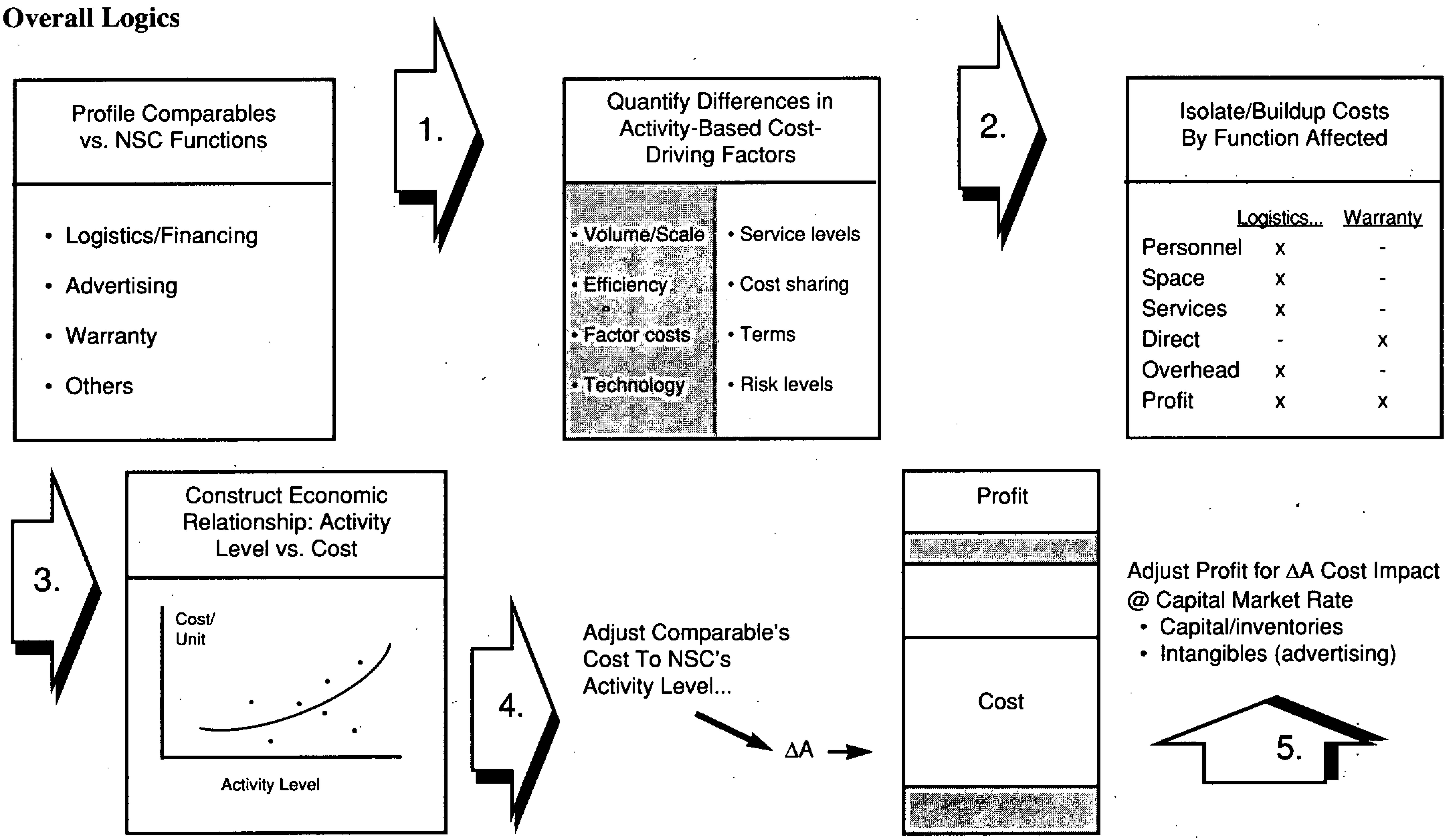
Appendix IV –
Key Concept – Comparability

• Comparable functions/circumstances...not "equal" costs/profits



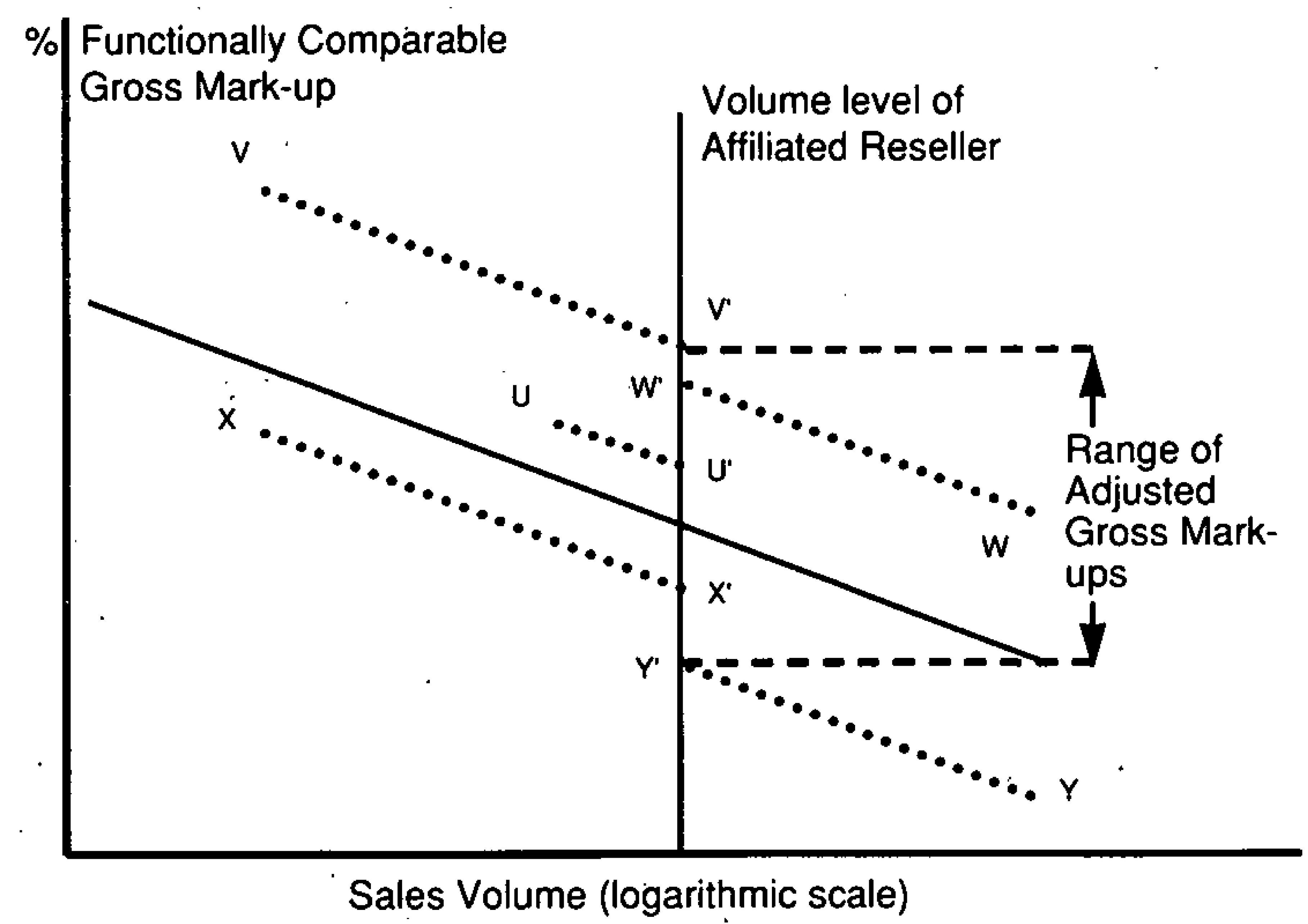
Appendix V –
Functional Analysis, Adjustments

Overall Logics



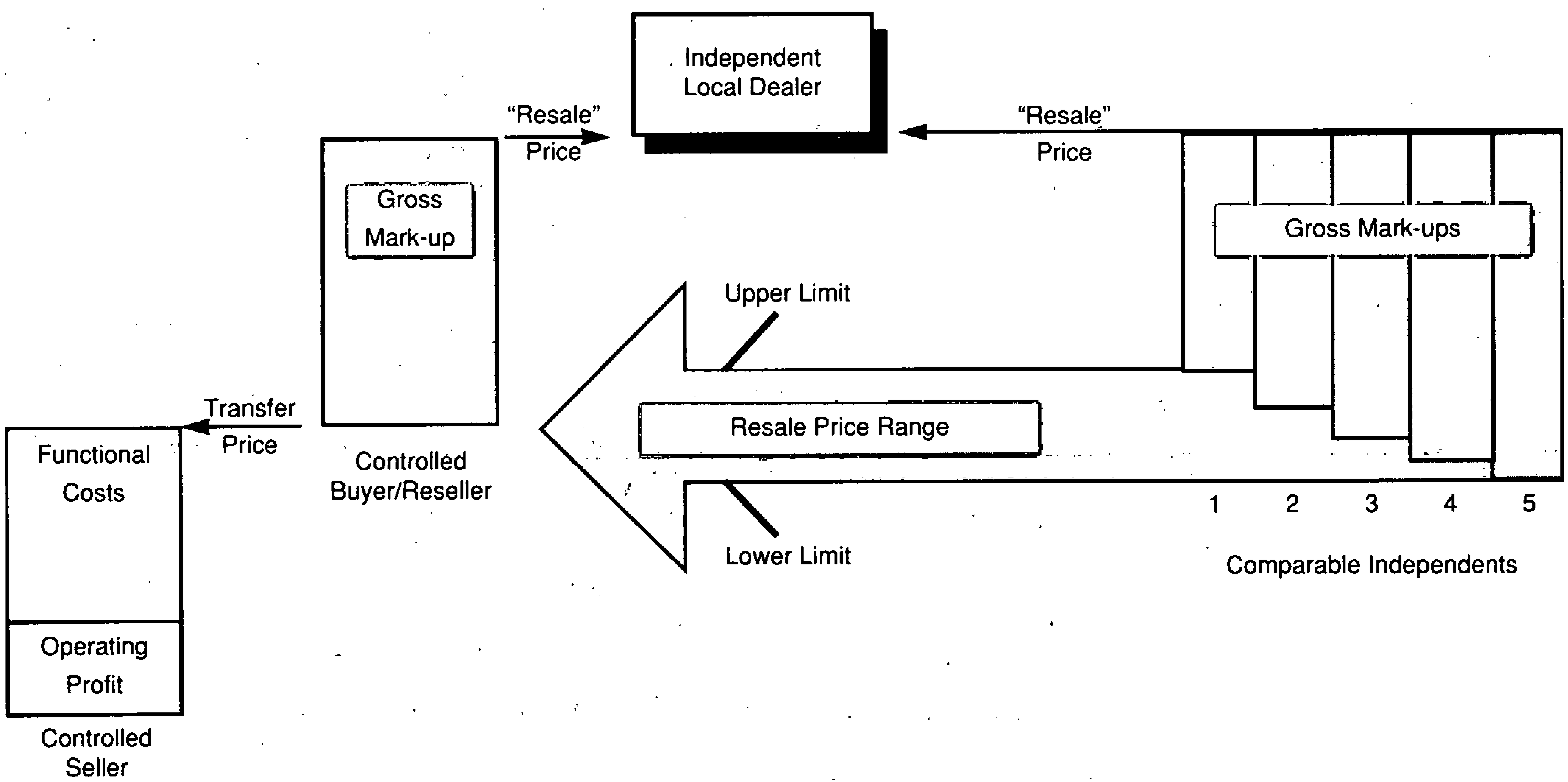
Appendix VI – Functional Analysis

Scale Adjustment



Appendix VII – Comparison of Actual Gross Mark-up with Gross Mark-ups of Comparable Independents

- **The Gross Mark-ups of comparable independents set a resale price range, which defines the lower and upper limit of an arm's length transfer price**



INTERNATIONAL:

THE NORTH AMERICAN FREE TRADE AGREEMENT AND CURRENT U.S. TRADE POLICY IN LATIN AMERICA

David A. Gantz and Kevin Lara

Reid & Priest, Washington, D.C.

I. INTRODUCTION

The United States is currently making Mexico and Latin America the major focus of its trade expansion efforts, through a proposal for a North American Free Trade Area ("NAFTA") and its hemisphere-wide Enterprise for the Americas Initiative ("EAI"). U.S. interest in Mexico and the hemisphere is not new. Periodically, the United States has undertaken major initiatives in the region, such as the "Alliance for Progress" in the 1960s. What makes the current developments of greater consequence is the growing agreement, not only in the United States and Canada, but also among the other countries of the hemisphere, that increased trade, open borders and broad investment reforms are the most likely route to economic growth and a higher standard of living. It is also significant that the Bush Administration and an apparent majority of the Congress are convinced that the United States will be able to compete more effectively with the European Economic Community and Japan as a member of a North American or hemisphere free trade bloc, rather than on its own.

Several countries, such as Mexico and Chile, have begun to implement market-opening principles through broad tariff reductions and border-opening measures. Others, such as the Argentina/Brazil/Paraguay/Uruguay group, have begun this process through a regional approach. The agreement on the policies and goals should prove helpful in achieving eventual integration of the Americas into a single prosperous market. In the short term, Mexico appears fully committed to continuing the process which began with Mexican accession to the General Agreement on Tariff and Trade ("GATT"), until it results in a free trade agreement with the United States and Canada.

These developments, particularly the U.S./Mexico/Canada NAFTA, should create significant opportunities for companies interested in manufacturing and selling goods and services in the hemisphere, as well as new investments. U.S. foreign investments in Mexico, and Mexican exports to the United States, have increased dramatically in the past several years and this process can be expected to continue as progress toward a NAFTA continues. A NAFTA should ultimately have a significant impact on the North American market just as the "Single Market – EC 1992" process is having on firms that operate in or export to the European Community, and will require similar strategic planning for firms that wish to remain competitive. Delays in the Uruguay Round of GATT negotiations, increasing the U.S. focus on regional arrangements, may even accelerate progress on a NAFTA and, to some extent, on the EAI.

This article summarizes the current status of the NAFTA, the EAI and the Andean Trade Preference Initiative.

II. A NORTH AMERICAN FREE TRADE AGREEMENT

The proximity of Mexico to the United States creates a natural attraction for trade and today both countries are moving rapidly to transform this attraction into real economic benefits for their citizens. While the economic development of the two countries has not advanced at the same pace, there has, nevertheless, been a growing recognition that the unique strengths of the two countries do in fact complement each other. This fact may lead to greater economic prosperity in both countries, if pursued thoughtfully.

Nine months ago, the United States and Mexico proposed a bilateral Free Trade Agreement ("FTA") to expand their trade and improve trade relations. Almost immediately, the movement towards a "North American Free Trade Zone" was joined by Canada, which responded by expressing a strong interest in participating in the U.S.-Mexico FTA negotiations. On 5 February 1991 the United States, Mexico and Canada announced their intention to pursue a trilateral North American FTA (i.e. "NAFTA").[1] The three countries are now set to begin negotiations in June 1991, assuming that U.S. "fast-track" negotiating authority is extended by Congress. Many in the business communities in North America are preparing for what they believe will be one of the greatest opportunities for growth and expansion in years.

A NAFTA should foster sustained economic growth through expanded trade and investment in a three-country market comprising over 360 million people and US$ 6 trillion in output. With a market larger than the European Community, both in terms of population and total output, a NAFTA could be the most important trade agreement worldwide since the formation of the European Economic Community three decades ago.

A NAFTA would eliminate all or virtually all tariffs among the three nations, probably in stages over ten years or more. A NAFTA is also likely to address non-tariff barriers, rules of origin, foreign investment, protection of intellectual property rights, dispute settlement mechanisms, rules for trade in services and the like. Contemporaneous agreements are almost certain to address such non-trade issues as worker rights and environmental protection. In a recent hearing before the U.S. Senate Finance Committee, United

1. The White House, Office of the Press Secretary, Joint Communiqué issued by the President of the United States, George Bush; the President of the United Mexican States, Carlos Salinas de Gortari; and the Prime Minister of Canada, Brian Mulroney (5 February 1991).

States Trade Representative Carla A. Hills indicated that with the exception of large-scale labour movement, which has been excluded from the bargaining table, the United States has an open mind on issues surrounding the NAFTA. Mexican officials have indicated that negotiations will not include access to Mexican oil reserves, which are constitutionally protected as a Mexican natural resource, but trade in energy may well be covered by the agreement.

A. *Timetable*

While there is considerable opposition to the NAFTA concept in the United States, Mexico and Canada, particularly from organized labour unions such as the AFL-CIO in the United States, the three governments have expressed their full support for the negotiations, and are likely to pursue an agreement to a successful conclusion. If all goes well, an agreement could be in force by early 1993.

The process of negotiating an FTA is arduous and time consuming, particularly from the U.S. perspective. In the United States, the process begins with Presidential notification to Congress of the Administration's intent to begin negotiating the FTA under what is known as the "fast-track" process.[2] This notification must be received at least 60 legislative days before the President's notification to Congress of his intent to actually enter into the agreement (President Bush notified Congress of his intent to enter such negotiations with Mexico on 25 September 1990, and included Canada in a broader request made on 5 February 1991). The House of Representatives and Senate may jointly rescind the proposal's "fast-track" status by voting to disapprove negotiations within the 60 legislative-day period. (As a practical matter, the 60 day period may last up to six months due to holidays, weekends and vacations.) With regard to Mexico, the 60 legislative-day review period expired on 27 February 1991 without any blocking effort.

Under the "fast-track" procedures, President Bush must notify Congress of his intent to actually conclude an agreement at least 90 calendar days before signing the document. After signing, the President submits implementing legislation to Congress, which must either adopt without amendment or reject the legislation. The Administration consults with Congress on a continuous basis during the negotiations, and the resulting implementing legislation is effectively a joint effort between the Administration and the responsible congressional committees.

Assuming favourable conditions, if the United States, Mexico and Canada begin negotiations by the spring or summer of 1991, it is possible that the negotiations could be completed by the end of 1991. However, a number of other factors may affect this timetable. On the U.S. side, the Bush Administration faces the expiration of the "fast-track" authority on 1 June 1991. On 1 March 1991, the President requested an extension of the "fast-track" authority. Opposing interest groups are challenging the President's request in an effort to block the negotiations; at this writing, disapproval resolutions have been introduced in both the House of Representatives and Senate. Some members of Congress have expressed an unwillingness to provide an extension without certain concessions from the Bush Administration and recently requested that the Administration produce an "Action Plan" for the negotiations by 1 May 1991, including details of how it will handle controversial issues like environmental protection and worker rights. Opposition to the extension of "fast-track" for use in completion of the "Uruguay Round" of GATT negotiations may also complicate the process since the extension would apply equally to the NAFTA and to the Uruguay Round. However, despite such opposition, it is likely that the extension request will ultimately be granted before 1 June. Without "fast-track" procedures, the practical impediments to negotiating an agreement – which could be amended by Congress after negotiation and signature by the President – would be all but insurmountable.

Some experts have suggested that a continued recession in the United States with high unemployment will make it more difficult for the President to obtain approval of a NAFTA. The upcoming Presidential elections in the United States, in 1992, and Mexico, in 1994, may also influence the timing of the NAFTA. Both governments are likely to be anxious to complete a NAFTA before the U.S. Presidential election campaign heats up in early 1992. The need to negotiate with Canada may also lengthen the negotiating period.

B. *Potential NAFTA benefits and anticipated commercial effects*

The greatest impact of a NAFTA is likely to be on U.S.-Mexican trade. The United States and Canada established a bilateral regime through an FTA two years ago, which addresses many of the issues currently under discussion for a NAFTA. Also, while total U.S.-Mexican trade amounted to approximately $ 59 billion last year, Mexican-Canadian trade was approximately $ 2 billion. Much time and effort has already been expended by the U.S. government and the private sector to determine the effects of an FTA between the United States and Mexico. For example, the U.S. International Trade Commission has prepared a series of three reports analyzing the course of future trade relations between the United States and Mexico. The first two reports, released in April and October 1990, analyze the trade and investment liberalization measures undertaken by Mexico since 1985 and present experts' views on prospects for future U.S.-Mexican trade relations.[3] The third report concerns the likely impact on the United States of an FTA with Mexico and analyzes the impact of such an agreement on specific U.S. industry sectors.[4] Generally, it is anticipated that a NAFTA would benefit both the U.S. and Mexican economies. Given the size of the U.S. economy and the fact that only seven percent of U.S. trade is with Mexico, while 70 percent of Mexico's trade is with the United States,[5] the impact on Mexico is logically expected to be much greater.

A NAFTA is expected to produce substantial opportunities of mutual benefit to the United States, Mexico, Canada and to third country firms operating in any of the three signatory countries. According to a recent U.S. International Trade Commission study addressing the future of U.S.-Mexican

2. Trade Act of 1974, Pub. L. 93-618, §§102, 151, 88 Stat. 1982, 2001 (1975), codified at 19 U.S.C. §§2112, 2191 (1988); Trade Agreements Act of 1979, Pub. L. 96-39, §1101, 93 Stat. 307 (1979); Trade and Tariff Act of 1984, Pub. L. 98-573, §401(a)(6), 98 Stat. 3013-15 (1984); Omnibus Trade and Competitiveness Act of 1988, Pub. L. 100-418, §§1102, 1103, 102 Stat. 1135 (1988).

3. "Review of Trade and Investment Liberalizations Measures by Mexico and Prospects for Future United States-Mexican Relations – Phase I, Recent Trade and Investment Reform Undertaken by Mexico and Implications", April 1990, USITC Publication 2275; "Phase II, Review of Trade and Investment Liberalization Measures by Mexico and Prospects for Future United States-Mexican Relations", October 1990, USITC Pub. 2326.

4. "The Likely Impact on the United States of a Free Trade Agreement with Mexico", February 1991, USITC Pub. 2353.

5. *Id.* at 1-3.

trade relations, Mexico and the United States could benefit as follows:

1. A NAFTA could enhance the two countries' competitive advantage in a world of emerging trade blocs. Generally, it could allow manufacturers in each country to globalize their operations more thoroughly, thus making the manufacture of their products more cost-effective and hence more competitive. Many observers view the U.S. and Mexican economies as complementary due to the U.S.'s need for a low-cost labour work force such as that offered by Mexico.

2. A NAFTA could improve U.S. access to a growing Mexican market of 85 million consumers through the elimination of existing tariff and non-tariff barriers, while Mexico could gain greater access to U.S. technology and a "secure" market.

3. A NAFTA could benefit specific U.S. and Mexican industrial and agricultural sectors. These include computers and software, certain steel products, automobiles, pharmaceuticals, alcoholic beverages, telecommunications, processed foods, furniture, household appliances, paper, transportation services and metal-working equipment. Tariff and non-tariff barriers, such as licences, quotas, and technical barriers, which have severely curtailed exports of many products, could be eliminated.

4. A NAFTA could help develop the U.S.-Mexico border area by attracting new industries.

5. A NAFTA could increase employment in the United States in certain sectors. For instance, increased demand for U.S. equipment and components used by manufacturers in Mexico could result in new U.S. jobs. A NAFTA could also increase employment in Mexico, particularly in the lower-wage manufacturing sector.

6. A NAFTA could make Mexican economic liberalization permanent, providing greater certainty and predictability to U.S. investors, while increasing Mexico's foreign exchange to meet its foreign debt burden.

7. A NAFTA could benefit U.S. consumers with greater access to lower-priced Mexican products while lowering inflation in Mexico as a result of price competition from imports.

While in general, the effects of a NAFTA should be positive on the relationships between the countries, there are a number of cited disadvantages to entering such an agreement. For the United States, the greatest concern is a potential shift of jobs to Mexico and increased competition from certain Mexican agricultural products. To some extent, under the NAFTA, U.S. jobs would be shifted to Mexico instead of other lower-wage nations such as those in Southeast Asia. For Mexico, there is concern from local manufacturers regarding their ability to compete with the exports of larger, more efficient U.S. producers, and with large U.S. financial institutions. The benefits will not fall evenly on the economic sectors of each country; some industries or industry sectors, as well as individual firms, will be harmed. Moreover, it is likely that a NAFTA could cause substantial trade and investment diversion to Mexico from the developing countries in the Caribbean, Latin America and Asia, and thus adversely affect U.S. economic and political relations with those countries.

The impact on third-country firms may also be substantial. In particular, the following issues could be important to those firms exporting or manufacturing in North America:

1. Tariffs within the region are likely to be eliminated within ten years (or slightly longer) on all products, giving manufacturers in any of the three nations (whether locally or foreign-owned) an advantage over third country exports if explicit rules of origin are met.

2. Like the U.S.-Canada FTA, the NAFTA is likely to contain strict and detailed rules of origin provisions to prevent assembly industries from taking advantage of duty-free access to the other markets without substantial local or regional value added. Among other things, this may require changes in sourcing for and operations of third-country-owned border industry plants, if their products are to be eligible for duty-free entry into the United States. Firms that meet the requirements in import-sensitive industries, such as textiles and steel, may find access to the U.S. market from Mexico easier than from third countries.

3. Mexican foreign investment regulations will be liberalized further. While some of these changes may only apply strictly to U.S. and Canadian investors, the rules for third-country investors are also likely to be relaxed. This may increase opportunities for joint ventures both in manufacturing and service industries.

4. Service industries – particularly transportation, banking, securities and insurance – are likely to be covered by the NAFTA. While the benefits of the NAFTA in this area will only apply to the three members, if there is a GATT agreement on services third countries may enjoy some of the benefits through operation of "most favoured nation" principles.

5. Intellectual property issues are very likely to be covered in the NAFTA. The prospect of the NAFTA and pressures from the United States have encouraged Mexico to propose legislation improving patent and copyright protection. This legislation is expected to be enacted into law this spring; it aims to protect all foreign-owned technology entering Mexico.

6. U.S. environmental groups and many in Congress are seeking inclusion of environmental protection rules within the NAFTA framework. Regardless of whether environmental rules are incorporated in a NAFTA or a separate understanding, there will be intense pressure on Mexico to strengthen its rules and enforcement policies on air and water pollution, and toxic waste through new legislation. These stricter rules are likely to affect all firms operating in Mexico, probably increasing somewhat the cost of doing business there.

7. The U.S. labour movement opposes the NAFTA, principally because its leaders fear a shift of jobs to Mexico (which in fact is likely, at least in the short run). Among the arguments made by labour is that Mexican labour costs are lower in part because Mexico discourages labour organization and has weak laws protecting worker rights and ensuring safe working conditions. Even if labour issues are excluded from the NAFTA, which is likely, there will be pressure on Mexico to enact laws improving working conditions. These laws, if enforced, will of course impact all firms doing business in Mexico, and will inevitably raise labour costs.

8. If the NAFTA is successful, it will assist the economic development of Mexico. While this is a long-term process, the NAFTA should lead ultimately to a substantial increase in Mexican consumer buying power, which will make the Mexican internal market, with over 85 million persons, more attractive. Much of the current foreign investment in Mexican manufacturing is focused on exports to the United States. In the future, there will be greater focus on the Mexican internal market, which should lead to larger and more efficient production facilities.

9. If it appears to U.S. business that the NAFTA is likely to be successful, some firms that would be moving production from the United States to other countries will move it instead to Mexico. Duty-free entry is the prime but not the only consideration. Mexico is geographically close, facilitating the use of U.S.-made components and common U.S.-Mexican upper management. Shipping distances and travel costs are lower and may be further affected by favourable changes in transportation costs and shipping regulations as a result of an agreement. While labour is not as efficient as in other countries, the costs are competitive. Over five to ten years, this phenomenon could result in a significant shift in manufacturing resources away from other countries, particularly as the weak northern Mexico infrastructure is improved.

10. Unlike the "Single Market-EC 1992" movement, the NAFTA is not expected to increase protectionism with regard to third-country trade. The United States expects the NAFTA to strengthen U.S.-North American competitiveness with the European Community, Japan and Asia. Yet, the United States, Mexico and, to a lesser extent, Canada, remain committed to more open trade. U.S. external tariffs average only four percent; Mexico's average rate has declined from near 50 percent five years ago to approximately ten percent today. Further decreases are likely as a result of the Uruguay Round.

However, there may be some product areas in which quotas now apply to U.S. imports (e.g. textiles, steel and various agricultural products) in which restrictions on Mexican- and Canadian-origin products will be removed. Additionally, there is some reason for concern that the traditional global U.S. trade focus will shift to regionalism, with the U.S. Government devoting less of its resources to other areas. On balance, it may be difficult for third-country firms to take full advantage of the NAFTA without an increased physical presence in North America.

As a result of the significant impacts from a NAFTA, both positive and negative, businesses on both sides of the border and third-country firms trading with or operating in any of the NAFTA countries will have an interest in evaluating their position vis-à-vis the agreement. This should include analyzing the possibilities of new markets, new investments, diversification, more efficient competitors and other export/import strategies to protect and expand basic market positions.

Finally, as the U.S. Trade Representative prepares to begin negotiations on a NAFTA, the U.S. Department of Treasury will try to conclude a treaty relating to the avoidance of double taxation with Mexico and which will cover a wide range of tax matters during a third round of negotiations commencing in April 1991.[6] Clearly, the results of the latter negotiations will have a significant impact on business planning for U.S. investment in Mexico and vice versa. (The United States and Canada have benefitted from a modern double taxation treaty since 1984.)[7] Closer economic ties between the United States and Mexico will almost inevitably lead in time to closer cooperation between tax authorities, particularly in respect of exchange of information and transfer pricing issues.

III. THE ENTERPRISE FOR THE AMERICAS INITIATIVE

In addition to the NAFTA, last year the Bush Administration introduced the "Enterprises for the Americas Initiative". The EAI seeks a new economic partnership with the countries of Latin America and the Caribbean, utilizing three elements: trade, investment and debt reduction. In the trade area, the EAI seeks to accomplish two objectives, i.e. close cooperation with Latin American countries in the Uruguay Round negotiations of trade liberalization, now being revised under the GATT, and the execution of "Framework Agreements" in the trade and investment areas.[8]

The United States has also indicated its willingness to enter into FTAs with Latin American and Caribbean countries while working toward a hemisphere-wide free trade system. However, given other priorities on the U.S. trade policy agenda, and a continuing preference for dealing with country groupings rather than individual nations, the Bush Administration is unlikely to pursue any new FTAs with Latin American countries, other than with Mexico, in the immediate future. (Chile is probably the next promising candidate.) Instead, the Administration appears to be focusing on additional Framework Agreements and efforts to encourage regional common groupings, such as the newly formed Southern Cone Common Market comprised of Argentina, Brazil, Paraguay and Uruguay.[9]

In the investment area, the EAI seeks to create an investment-sector loan programme and a multilateral investment fund, through the Inter-American Development Bank ("IDB"). The investment-sector loan programme would provide both technical advice and financial support for privatization efforts and liberalization of investment regimes. In a parallel effort, the multilateral investment fund would be used to advance comprehensive investment reforms in Latin America and the Caribbean. The fund would provide grants of up to $ 300 million annually in response to broad investment reforms, and will probably place special emphasis on smaller countries in the region such as those in Central America and the Caribbean. The Bush Administration has asked Congress to authorize a U.S. contribution of $ 500 million, to be made available in five annual instalments of $ 100 million each, beginning in fiscal year 1992. However, it remains unclear whether such a request will be granted in view of the current budget deficit. The remaining two-thirds of the fund's capital is expected to come from contributions by other countries.

The fund would also support efforts to privatize government-owned industries and to finance worker training, education and health programmes to develop human resources. Through these programmes, the Bush Administration hopes to increase capital flows to those Latin American and Caribbean countries that are willing to liberalize their trade and investment regimes.

6. A tax information exchange treaty between the United States and Mexico went into effect in early spring 1990, and the two countries are seeking to complete negotiations on a broader tax treaty as a sign of good faith prior to negotiating a NAFTA.
7. The United States and Canada signed an Income Tax Convention on 26 September 1980 and exchanged instruments of ratification implementing the treaty on 16 August 1984. (The treaty was amended by Protocols on 14 June 1983 and 28 March 1984.)
8. Framework Agreements generally are aimed to open trade and investment regimes and encourage close cooperation and systematic consultation between the signatory countries. They usually include a statement of principles, a consultative mechanism, data exchange and an "Immediate Action Agenda".
9. The United States has entered into Framework Agreements with Mexico, Bolivia, Columbia, Ecuador, Chile, Honduras and Costa Rica, and is actively negotiating agreements with Venezuela, Peru, Jamaica, El Salvador, Nicaragua and the Southern Cone Common Market (Argentina, Brazil, Paraguay, Uruguay) as a single party.

The EAI also creates a debt-reduction programme to spark further investment and growth. The reduction of official bilateral debt proposed under the EAI complements the international efforts under the Brady Plan to address a country's commercial bank debt problems. To qualify, the applicant country must implement liberal investment reforms, be in good standing with the IMF and World Bank and have manageable debt agreements with its commercial banks. Once these benchmark requirements are met, the Bush Administration will provide debt relief depending on the individual circumstances of each country.

Rather than continuously adjusting its debt service payments to its ability to pay, the particular country's stock of concessional debt will be substantially reduced through negotiations with the United States. Accordingly, the country's concessional debt will be eliminated within a designated shorter period. New dollar payments on this reduced debt will then be applied to retire principle.

Last year, Congress enacted legislation authorizing the reduction of PL-480 (food assistance) debt for countries pursuing strong economic and investment reform programmes. Congress also authorized the establishment of a mechanism for channeling local currency interest payments to support environmental projects. However, to fully implement the debt reduction elements of the EAI, the Bush Administration needs legislation authorizing the reduction of foreign economic assistance obligations to AID in the same manner as provided for PL-480 assistance, as a far larger share of the Latin American countries' debt is owed to the Agency for International Development. The Bush Administration is also seeking authority to sell, reduce or cancel a portion of assets held by the Commodity Credit Corporation as a result of its credit guarantee programmes and a portion of Eximbank loans to facilitate debt/equity, debt-for-nature and debt-for-development swaps in eligible countries.

As a result of the reduction, restructuring and sale of concessional and non-concessional loans, the programme is designed to give Latin American and Caribbean countries an opportunity to invest in their own countries, while in some instances, providing for environmental protection. Specific legislation required from the U.S. Congress is currently pending.

IV. ANDEAN TRADE PREFERENCES

The Bush Administration has also put forth an "Andean Trade Preferences Initiative" providing duty-free treatment to particular exports from Andean nations. This is designed in large part to facilitate non-drug related development in those countries. The Andean Trade Preference Initiative would provide Colombia, Bolivia, Peru and Ecuador with tariff benefits similar to those provided to Central America and the Caribbean under the Caribbean Rescue Initiative. Most products of these countries would enjoy duty-free access to the United States market although sugar, textiles, canned tuna, footwear, watches, petroleum and petroleum products, would be excepted.[10] The Administration's implementing legislation was not enacted by Congress last year but was reintroduced during January 1991 and is currently pending.

V. CONCLUSION

Clearly, if the United States is able to successfully implement its Latin American trade policy, substantial structural and economic changes will occur throughout a multitude of industries, and only those companies with the foresight to plan and begin adapting today will benefit tomorrow. The NAFTA represents the first major step towards the eventual economic integration of the hemisphere and is viewed as a likely road map for future FTAS, particularly by countries at different stages of economic development. The EAI has been well received by Latin American countries and should be closely observed as the final implementing components are put into motion by the enactment of specific legislation in the U.S. Congress this year. Finally, the Andean Trade Preferences Initiative, while limited in impact from the U.S. perspective, may provide the Andean Countries the much needed stimulus to diversify their economies. Overall, the United States has made Latin American trade a priority in its trade agenda, and the successful implementation of these policies will not only produce substantial opportunities for the private sector but will probably directly affect the U.S.'s ability to compete worldwide in the future.

10. H.R. 661, 102nd Cong., 1st Sess. (1991).

FOREIGN INVESTMENT IN THE UNITED STATES:

PLANNING ALTERNATIVES IN CONDUCTING OR ACQUIRING A U.S. BUSINESS

Stanton A. Kessler and Lawrence J. Zlatkin
Mayer Brown & Platt, Chicago

I. U.S. TAXATION OF FOREIGN PERSONS - OVERVIEW

A. *Two methods of taxation applicable to foreign persons*

The United States applies two methods of taxing the income of a foreign person based on whether or not the level of income-producing activity of the foreign person constitutes a U.S. trade or business. A foreign person engaged in the conduct of a U.S. trade or business is subject to tax on its net income "effectively connected" with the conduct of the trade or business at graduated rates in a manner similar to that of a U.S. person with business income.[1] Currently, the maximum marginal rate of tax imposed on the net trade or business income of a foreign person is 34 percent in the case of a foreign corporation and 31 percent in the case of a non-resident alien individual.[2] A foreign corporation also may be subject to a branch profits tax in connection with the income arising from a U.S. trade or business.[3] A foreign person not engaged in the conduct of a U.S. trade or business is subject to tax on the gross amount of non-business U.S. source income at flat tax rates, typically collected through withholding taxes.[4] The flat rate of tax, unless modified by a treaty with the foreign country of residence of the foreign person, is 30 percent.

1. Foreign person

"Foreign person" refers to a foreign corporation, non-resident alien individual, foreign partnership and foreign estate or trust.[5] The characterization of a foreign organization as a corporation, partnership or an estate or trust will be based on U.S. law by reviewing the legal relationships established by the members of the organization among themselves, with the public at large and in relation to the organization's assets.[6] Because the U.S. tax consequences applicable to operating through a corporation, partnership, trust or estate will vary, the correct determination of the status of a hybrid foreign form of operation is critical.

An alien individual will be taxed as a non-resident alien, and, therefore, as a foreign person only if he is not treated as a resident alien. An alien individual will be taxable as a U.S. resident alien on his worldwide income and in a manner identical to a U.S. citizen based upon his status as a permanent resident of the United States for immigration purposes or based upon his satisfaction of a "substantial presence" test.[7] "Substantial presence" generally consists of physical presence in the United States, as measured and weighted over a three-year period, of 183 days or more.[8]

A foreign partnership and a foreign estate or trust may not be subject to direct U.S. taxation, and careful attention must therefore be taken in determining the method of taxation applicable to their respective partners and beneficiaries, whichever the case may be.

1. Internal Revenue Code, Secs. 871(b), 882. All Section references are to the Code unless otherwise stated.
2. Secs. 1, 11.
3. Sec. 884.
4. Secs. 871(a), 881, 1441, 1442.
5. Sec. 7701(a)(30).
6. Rev. Rul. 88-8, 1988-1 C.B. 403.
7. Sec. 7701(b).
8. Sec. 7701(b)(3).

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2. U.S. trade or business income

The determination of whether a foreign person is engaged in the conduct of a U.S. trade or business is a question of fact. With the exception of certain limited activities described below, there is no bright-line test to determine whether a foreign person has crossed the threshold of being engaged in the conduct of a U.S. trade or business. Generally, the higher the level of contact with the United States, the more likely the foreign person will be treated as being engaged in the conduct of a U.S. trade or business. A trade or business implies a certain "scale for income producing purposes" where there is "regular and continuous activity of the kind which is commonly concerned with the employment of labour".[9]

(a) *Factors to consider*

The following factors, while hardly exhaustive, may be taken into account in determining whether a foreign person is engaged in the conduct of a U.S. trade or business:

(1) use of a U.S. office or other fixed place of business;
(2) use of U.S. employees;
(3) use of a resident agent or other local representative and such person's power to contractually and legally bind the foreign person;
(4) number, frequency and range of U.S.-based activities;
(5) investment through a partnership or trust;
(6) types of investments;
(7) character of the activities.

(b) *"Effectively connected income"*

Only income that is "effectively connected" with the conduct of the foreign person's U.S. trade or business will be treated as U.S. trade or business income and will be subject to tax at graduated rates.[10] U.S. source income that is "fixed or determinable annual or periodical" ("FDAP") income (mainly, passive income such as interest, dividends, rents, royalties, etc.) will be regarded as effectively connected U.S. trade or business income only if one of two tests is satisfied; that is, the "asset use" test or the "business activities" test.[11] U.S. source income that is not FDAP income generally will be regarded as effectively connected U.S. trade or business income.[12] In certain limited cases, foreign source income also may be regarded as effectively connected U.S. trade or business income, but only if the foreign person has an office or other fixed place of business to which such income is attributable.[13]

(c) *Treaty modifications*

The United States currently has in force 39 treaties with foreign countries. A resident of one of these countries typically can rely on its country's treaty with the United States to prevent the taxation of its business income as U.S. trade or business income, except to the extent the business income is attributable to a U.S. "permanent establishment". Each of these treaties provides a specific definition of a U.S. permanent establishment, but a permanent establishment generally will be found if the foreign person maintains a "fixed place of business" in the United States from which the income is derived.[14] The treaty requirement that a foreign person have a U.S. permanent establishment (i.e. a fixed place of business) before it is subject to U.S. taxation on its business profits generally is considered harder to satisfy than the non-treaty rule of applying U.S. taxation on trade or business income. Except where the income is of a passive type such as interest, dividends, rents, royalties, etc. (where the absence of a permanent establishment means that the foreign person will be subject to a flat tax on the gross amount of such income of up to 30 percent, usually reduced by the treaty), the absence of a U.S. permanent establishment means that the foreign person will be exempt from U.S. tax on its business profits.[15]

(d) *Taxation of trade or business income on a net basis*

A foreign person engaged in the conduct of a U.S. trade or business will be subject to tax on its "effectively connected" income, net of deductions.[16] Only deductions which are attributable to the foreign person's "effectively connected" income will be taken into account. A foreign person is obligated to file an income tax return in connection with its U.S. trade or business activities.[17] Deductions otherwise attributable to a foreign person's "effectively connected" income may be disallowed if the foreign person fails to file a tax return on a timely basis with respect to its trade or business activities.[18] The deductions will be allocated and apportioned to "effectively connected" income in accordance with the rules of Treasury Regulations.[19] Any deduction of the interest expense of a foreign corporation will be subject to special limitation rules.[20] The Internal Revenue Service ("IRS") takes the position that the interest expense of a foreign corporation will be so limited, notwithstanding the argument that a tax treaty overrides this result and provides for a deduction of all expenses, including all interest expense, properly attributable to a U.S. permanent establishment.[21]

(e) *Election to treat real property income as effectively connected income*

In certain instances, it may be beneficial for a foreign person to be subject to U.S. tax on its real property income on a net basis rather than a gross basis, even when the foreign person's activities do not give rise to trade or business income. The foreign person can elect to be treated as a person engaged in a U.S. trade or business with respect to its real property income.[22] This election applies only to income from real property held for the production of income and located in the United States, including rents or royalties from mines, wells or other natural deposits. It is revocable with the consent of the IRS, but, upon revocation, the foreign person will be barred from making a subsequent election for a five-year period.[23]

(f) *Branch profits tax*

A foreign corporation engaged in the conduct of a U.S. trade or business also may be subject to a branch profits tax on its "effectively connected earnings and profits", as

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9. *Pinchot v. Commissioner,* 113 F.2d 718 (2d Circ. 1940). See also, Isenbergh, *International Taxation,* (1990) Ch. 9, at 275-312.
10. Secs. 871(b), 882.
11. Sec. 864(c)(2); Treas. Reg. § 1.864-4.
12. Sec. 864(c)(3).
13. Sec. 864(c)(4); Treas. Reg. §§ 1.864-5, 1.864-6, 1.864-7.
14. See e.g., U.S.-Canada tax treaty, Art. V.
15. *Id.,* at Art. VII.
16. Treas. Reg. §§ 1.873-1, 1.874-1, 1.882-4.
17. Treas. Reg. §§ 1.6012-1(b), 1.6012-2(g).
18. Treas. Reg. §§ 1.874-1, 1.882-4.
19. See Treas. Regs. § 1.861-8 et seq., including (among other provisions) Treas. Reg. § 1.861-8(g)(example 21) (expenses of foreign corporation) and Treas. Reg. § 1.861-9T(d)(2) (interest expense of non-resident aliens).
20. The special limitation rules are contained in Treas. Reg. § 1.882-5.
21. Rev. Rul. 85-7, 1985-1 C.B. 188 (U.S.-Japan tax treaty); Rev. Rul. 89-115, 1989-2 C.B. 130 (U.S.-U.K. tax treaty).
22. Secs. 871(d), 881(d).
23. *Id.*

though it repatriated its earnings and profits ("E&P") from the United States in the form of a dividend from a subsidiary entity.[24] The branch profits tax is imposed at a maximum rate of 30 percent on the "dividend equivalent amount" (as though the branch issued a "dividend" of its E&P for the year) and is intended to place branches of a foreign corporation on a level playing field with the operation of a U.S. trade or business through a domestic subsidiary.

(1) *Deferral of branch profits tax*
Since the branch profits tax is based on the assumption that "effectively connected earnings and profits" are repatriated each taxable year by the foreign corporation, the reinvestment of such E&P in the United States through an increase in the foreign corporation's "U.S. Net Equity" will defer the branch profits tax until such time as the foreign corporation's "U.S. Net Equity" decreases.[25] Income subject to the branch profits tax can never exceed the foreign corporation's "accumulated effectively connected earnings and profits" as of the close of its preceding taxable year.[26]

(2) *Termination and incorporation of the U.S. business*
Special rules apply when a foreign corporation terminates, incorporates or reorganizes its U.S. trade or business.[27] The foreign corporation will be exempt from the branch profits tax in the year it "completely terminates" its U.S. trade or business on the assumption that the foreign corporation would not receive dividend income in liquidating a domestic subsidiary were its U.S. trade or business incorporated.[28] Should the foreign corporation decide to incorporate its U.S. branch in a domestic subsidiary, the act of incorporation will not trigger a branch profits tax, but the foreign corporation must agree to carry over all of its "non-previously taxed accumulated effectively connected earnings and profits" to the domestic subsidiary as accumulated E&P.[29] The foreign corporation must also agree to treat certain future gains from the sale of the stock of the domestic subsidiary as amounts subject to the branch tax.[30] Additional rules (generally related to the deferral of the branch tax) apply to the reorganization or other potentially tax free restructuring of a foreign corporation's U.S. branch.[31]

(3) *Exemption of certain income*
Certain "effectively connected" income of the foreign corporation will be exempt from the branch profits tax, such as, for example, gain from the disposition of shares of a U.S. real property holding corporation (but not gain from the disposition of other U.S. real property interests).[32]

(4) *Rate of tax*
Since the branch profits tax is imposed on the "dividend equivalent amount", it is imposed at a rate lower than 30 percent in the case of a foreign corporation treated as a "qualified, resident" in a tax treaty jurisdiction with a reduced rate of tax on dividend income. The rate of tax will equal the rate of tax allowable on dividend income pursuant to the tax treaty.[33]

(5) *Second-tier withholding tax and tax treaties*
The application of a branch profits tax will prevent the imposition of a "second-tier withholding tax" on any dividends paid by the foreign corporation of its "effectively connected earnings and profits" to another foreign person.[34] The payment of a dividend by a foreign corporation to another foreign person can, in certain cases, be subject to U.S. tax, including withholding taxes, to the extent of the payor foreign corporation's U.S. "effectively connected" income.[35] U.S. tax will apply to a dividend paid by a foreign corporation to another foreign person only in the case of a foreign corporation, 25 percent or more of whose income consists of U.S. "effectively connected" income over the preceding three-year period.[36] A number of tax treaties prevent the imposition of the second-tier withholding tax, whether or not the branch tax is applicable.[37] Certain tax treaties prevent the imposition of the branch profits tax, but the foreign corporation eligible for this exemption must be a "qualified resident" of the treaty country, as defined by the Code.[38] Certain tax treaties also prevent the application of both the branch profits tax and the second-tier withholding tax, subject to the "qualified resident" limitation of the foreign person claiming the benefit of the tax treaty.[39]

(6) *Branch level interest tax*
Interest paid to a foreign person by a U.S. trade or business of a foreign corporation will be treated as U.S. source interest as though it were paid by a domestic corporation.[40] In certain cases, this treatment will be prevented by a tax treaty.[41] Additionally, a foreign corporation may be liable for a branch level interest tax on certain "excess interest" deemed paid by its U.S. trade or business.[42] This arises when the foreign corporation incurs less interest expense in its U.S. trade or business than its allowable deduction for interest expense under Treas. Reg. § 1.882-5.

(g) *Partnership or trust investments*

An investment in the United States through a partnership or trust, whether domestic or foreign, requires a determination of whether the partnership or trust is engaged in a U.S. trade or business. The activities of the partnership or trust, including the activities of a general partner (in the case of a limited partnership) or trustee, will be attributed to the foreign partner or foreign beneficiary, even if the foreign person has no direct connection to the United States.[43] In the case of a treaty resident, the foreign person may be regarded as having a U.S. permanent establishment if the partnership or trust itself maintains a U.S. permanent establishment.[44]

(h) *Special rules for securities and commodities trading*

There are special liberal rules applicable to the trading of securities and commodities which, in a large number of cases, prevent the taxation of the income from such trading as U.S. trade or business income. Dealers in securities and commodities may trade in the United States through resident independent agents without giving rise to U.S. trade or business income.[45] Non-dealers may trade for their own

24. Sec. 884(a).
25. Sec. 884(b).
26. Sec. 884(b)(2)(B).
27. Temp. Treas. Reg. § 1.884-2T.
28. Temp. Treas. Reg. § 1.884-2T(a).
29. Temp. Treas. Reg. § 1.884-2T(d).
30. Temp. Treas. Reg. § 1.884-2T(d)(5).
31. Temp. Treas. Reg. § 1.884-2T(c).
32. Sec. 884(d)(2).
33. Sec. 884(e)(2)(A); Temp. Treas. Reg. § 1.884-1T(h).
34. Sec. 884(e)(3).
35. Sec. 861(a)(2)(B).
36. *Id.*
37. See e.g. U.S.-Netherlands tax treaty, Art. XII.
38. See e.g. U.S.-Japan tax treaty, Art. 7.
39. See e.g. U.S.-U.K. tax treaty, Arts. 10, 24. Secs. 884(e)(1), (e)(3), and (f)(3); Temp. Treas. Reg. 1.884-1T(h), 1.884-3T, 1.884-5T.
40. Sec. 884(f)(1)(A).
41. See e.g. U.S.-U.K. tax treaty, Art. 11.
42. Sec. 884(f)(1)(B). 43. Sec. 875.
44. *R.Unger,* 58 T.C.M. 1157 (1990); Rev. Rul. 85-60, 1985-1 C.B. 187.
45. Sec. 864(b)(2)(A)(i), (B)(i).

account through a resident dependent or independent agent, including a U.S. office with U.S.-based employees, without giving rise to U.S. trade or business income.[46] This rule applies only to securities and commodities and may not apply to new or complex financial instruments since such instruments may not satisfy the definition of securities or commodities in existing Treasury Regulations.[47]

(i) Special rule for certain deferred payments and certain property transactions

The receipt of income after the foreign person ceases to be engaged in its U.S. trade or business nonetheless may be treated as U.S. trade or business income. In the case of a sale or exchange of property or the performance of services by a foreign person where the income to be received by the foreign person is deferred to a subsequent taxable year, the determination of whether such deferred income is treated as U.S. trade or business income will be made as if such income were taken into account by the foreign person in the preceding taxable year when the sale or exchange or the performance of services occurred.[48] Additionally, if a foreign person used property in connection with its U.S. trade or business, ceases such business and disposes of the property within ten years after ceasing its business, the determination of whether the income arising from the disposition is U.S. trade or business income shall be made as though the disposition occurred immediately prior to the cessation by the foreign person of its U.S. trade or business.[49]

3. U.S. non-business income

U.S. source income that is not treated as U.S. trade or business income will be subject to tax at flat rates of up to 30 percent.[50] The gross rather than the net amount of the income will be taxable so that deductions attributable to the income will be irrelevant. The income subject to tax under this flat rate tax regime predominantly includes U.S. source FDAP income. Accordingly, with limited exceptions, there are two conditions which must be met before the income is taxable.

(a) *Two conditions relevant to taxation of non-business income*

(1) *U.S. source income*
First, the income must be derived from U.S. sources.[51] Foreign-source income, even if paid from the United States and by a U.S. person, will not be subject to U.S. tax, provided the foreign recipient is not required to treat the income as U.S. trade or business income.[52] An example of foreign source income not subject to U.S. tax would be notional principal contract income (e.g. interest rate swap income) paid by a U.S. contracting party from the United States.

(2) *FDAP income*
Second, with limited exceptions for the sale of certain mineral interests, the sale of certain intangibles and the sale of original issue discount obligations, the income must be FDAP income.[53] This includes almost all forms of non-business income, especially of a passive type (e.g. interest, dividends, rents, royalties, etc.), but it does not include most forms of capital gain income (although capital gain income received by a non-resident alien individual present in the United States 183 days or more during the taxable year will still be subject to U.S. tax).[54] Capital gain income arising from the disposition of a U.S. real property interest, however, will be treated as U.S. source "effectively connected" income and will be subject to tax at graduated rates even though the foreign person would not otherwise be engaged in a U.S. trade or business. This exception to the non-taxability of capital gain income of foreign persons was enacted through the passage of Foreign Investment in Real Property Tax Act ("FIRPTA") in 1980.[55]

(b) *Treaty modifications*
In the case of a foreign person resident in a treaty country, the rate of tax on non-business income may be reduced to a rate below 30 percent. For example, numerous tax treaties provide for an exemption from U.S. income tax in the case of interest income.[56] This includes interest paid to residents of the United Kingdom, France, Germany and the Netherlands (but not Canada, where the rate is reduced instead to 15 percent). In other instances, the rate of U.S. tax is reduced to a rate below 30 percent but above zero percent, such as the reduced rate of tax typically imposed on dividend income (generally, within the range of 5 percent – 15 percent, with the lower rate often available to major shareholders of the entity paying the dividend).[57] The one condition is that the income may not be attributable to a permanent establishment of the foreign person within the United States, the effect of which would be that the income would be treated as business income and subject to tax at graduated rates.

(c) *Portfolio interest and other exemptions*
In certain limited cases, non-business income may be exempt from U.S. tax even if the income is U.S. source income even if there is no treaty exemption. Exemptions apply to interest paid on bank deposits and certain dividend income paid by domestic corporations at least 80 percent of whose income is active foreign business income.[58] The most widely used exemption is the "portfolio interest" exemption for interest paid on debt obligations of certain U.S. persons.[59] This exemption is conditioned on the completion by the foreign person of certain documentary requirements (generally, the provision of a "certificate of foreign status" on IRS Form W-8).[60] It is not available for most forms of related party debt (e.g. loans by a foreign shareholder with an equity interest of ten percent or more in the U.S. debtor corporation) and to a foreign bank in connection with an extension of credit in the ordinary course of its trade or business.[61]

4. Capital gain income

(a) *Exemption from tax*
Capital gain income (other than FIRPTA income from the disposition of a U.S. real property interest) from the sale or exchange of U.S. property by a foreign person generally will be exempt from U.S. tax. In many instances, the income

46. Sec. 864(b)(2)(A)(ii), (B)(ii).
47. See generally, Treas. Reg. § 1.864-2(c) (securities) and Treas. Reg. § 1.864-2(d) (commodities).
48. Sec. 864(c)(6).
49. Sec. 864(c)(7).
50. Secs. 871(a), 881.
51. *Id.*
52. Sec. 864(c)(4).
53. Secs. 871(a), 881.
54. Treas. Reg. 1.871-7(d); 1.881-2(a)(1).
55. Sec. 897.
56. See e.g. U.S.-U.K. tax treaty, Art. II.
57. See e.g. U.S.-Canada tax treaty, Art. X.
58. Secs. 871(i), 861(c).
59. Secs. 871(h), 881(c).
60. Secs. 871(h)(2)(B), (h)(4), 881(c)(2)(B). Treas. Reg. § 35a.9999-5.
61. Secs. 871(h)(3), 881(c)(3).

will be exempt as foreign-source capital gain income based on U.S. sourcing rules for the sale of property.[62] In the case where the income is still treated as U.S. source income (e.g. sale through a U.S. office or other fixed place of business), the income may still be exempt from U.S. tax (e.g. when the income arises from the sale of property that is a security or commodity which satisfies the trade or business exception of Section 864(b)(2)).[63] The exemption will not apply to a non-resident alien individual present in the United States for a period aggregating 183 days or more during the taxable year.[64] Additionally, the exemption from U.S. tax generally will not apply when the income is effectively connected with the conduct of a U.S. trade or business or, or in the case of a foreign person resident in a treaty country, when the income is attributable to a U.S. permanent establishment of the foreign person.

(b) *Exemption may be limited*

In the previous two years, however, Congress has considered the imposition of a tax on the capital gain income of a foreign person to the extent the gain is attributable to the sale of stock in a domestic corporation in which the foreign person holds an equity interest of ten percent or more. The income would be treated, as in the case of FIRPTA income (see below), as income effectively connected with the conduct of a U.S. trade or business. Originally, Congress intended to apply the tax, notwithstanding the provision of a tax treaty to the contrary. In the Omnibus Budget Reconciliation Act of 1990 ("the 1990 Act"), Congress modified its "treaty override" provision to allow for a treaty exception to the tax under certain conditions. Not all gains would be exempt from U.S. tax, however, even if a tax treaty provided otherwise. To date, Congress has only considered expanding the taxation of capital gain income of foreign persons, but has not yet passed such a provision into law. It is uncertain whether Congress will reconsider such a provision in its current session, but, given current U.S. fiscal problems, that appears likely.

5. FIRPTA income

Income arising from the disposition of a "U.S. real property interest" (e.g. income from the sale of land or a building in the United States or income from the sale of a U.S. corporation, 50 percent or more of whose assets consist of U.S. real property), which otherwise would be exempt from U.S. tax as non-business capital gain income, will be treated instead as income "effectively connected" with a U.S. trade or business and subject to tax at graduated rates.[65] This rule is imposed pursuant to the FIRPTA 1980 and is applied regardless of a treaty provision to the contrary. The tax is collected in part through withholding of ten percent of the gross proceeds from the disposition, but the withholding tax is only an approximation of the final tax, thereby requiring the filing of a tax return as in the case of all U.S. trade or business income.[66]

B. *Withholding taxes*

U.S. taxes may be collected from a foreign person through the application of withholding taxes.

1. U.S. trade or business income

In most cases, a foreign person will not be subject to U.S. withholding taxes when the income it receives is U.S. trade or business income.[67] The foreign person, however, may be asked to submit IRS Form 4224 (confirmation by the foreign person that the income is trade or business income) on an annual basis to prevent withholding.[68] The Tax Court has interpreted the filing requirement of Form 4224 very strictly, thereby increasing the risk to the payor of not withholding if the Form is not regularly submitted.[69] Withholding taxes will still be imposed on trade or business income, however, in the following two cases.

(a) *FIRPTA income*
As noted above, FIRPTA income which is considered U.S. trade or business income will be subject to a withholding tax, with certain exceptions. The tax will equal ten percent of the amount realized from the disposition of the U.S. real property interest.[70]

(b) *Partnership income*
In the case of a foreign person holding an interest in a partnership with U.S. trade or business income, the partnership generally will impose withholding taxes on the foreign partner. The taxes will be collected from the foreign partner either on its allocable distributive share of "effectively connected" taxable income from the partnership (under a system of taxation as though the partnership made estimated tax payments on behalf of its foreign partners) or on actual distributions made to the foreign partner (only in the case of a publicly traded partnership).[71] In the case of "effectively connected" taxable income of the partnership attributable to FIRPTA, the FIRPTA withholding tax of ten percent generally will be waived in favour of the partnership withholding provision.[72]

(c) *Personal service income*
Income from the performance of personal services (e.g. salaries, wages and compensation income) will be subject to withholding at a rate of 30 percent even if the income is treated as trade or business income.[73] Generally, one personal exemption can be used to offset the 30 percent withholding tax applicable to the personal service income of a non-resident alien.[74] Certain exceptions apply to the rule of imposing a 30 percent withholding tax on personal service income, including the case where the income is exempt by treaty, the case where the income is subject to employer withholding and the case of alien commuters from Canada or Mexico.[75]

2. U.S. non-business income

In the case of non-business income that is from U.S. sources and which is FDAP income, the payor of the income will withhold up to 30 percent of the amount paid to the foreign person as a withholding tax.[76] Generally, the 30 percent withholding tax matches the 30 percent flat tax imposed on the foreign person with respect to non-business income. The withholding tax is considered a final tax and no further

62. Sec. 865.
63. Treas. Reg. 1.871-7(d); 1.881-2(a)(1).
64. Sec. 871(a)(2).
65. Sec. 897.
66. Sec. 1445.
67. Sec. 1441(c)(1).
68. Treas. Reg. § 1.1441-20-4(a).
69. *Casa de La Jolla Park, Inc. v. Commissioner,* 94 T.C. 384 (1990).
70. Sec. 1445.
71. Sec. 1446; Rev. Proc. 89-31, 1989-1 C.B. 895.
72. Rev. Proc. 89-31, 1989-1 CB.895, § 7.02(2).
73. Treas. Reg. § 1.1441-4(b).
74. Treas. Reg. § 1.1441-3(e)(2).
75. Treas. Reg. § 1.1441-4(b)(1).
76. Secs. 1441(a), 1442(a).

income tax reporting is required from the foreign person.[77] If the withholding tax is incorrectly imposed or if there is overwithholding, the foreign person may file an income tax return to claim a refund. The foreign person also may claim any overwithholding as a reimbursement from the payor of the income, provided the claim is made by 15 March of the succeeding calendar year to the year in which the payment was made.[78] Nonetheless, the payor or withholding agent may not be obligated to refund the amount of overwithholding, in which case the foreign person may file an income tax return to claim the amount of overwithholding from the IRS.[79]

(a) *Withholding tax exemptions*
In the case of certain types of non-business income, no withholding taxes will apply either as a result of U.S. domestic law or as a result of a tax treaty. These exemptions are discussed in greater detail above. These exemptions typically are claimed by a foreign person through the submission of standardized tax forms to the withholding agent (e.g. Form 1001 for treaty exemptions or reduced rate of tax; Form W-8 for portfolio interest).[80] There is no requirement to submit tax forms to claim reduced withholding on dividend income.[81]

(b) *Capital gain income*
Under current law, capital gain income of a foreign person that is not U.S. trade or business income generally is exempt from U.S. tax. No withholding taxes will be imposed on any payment of this income. Capital gain income that is FIRPTA income from the disposition of a U.S. real property interest is treated as trade or business income and is subject to a separate withholding tax regime (where the amount realized from the sale generally is subject to a ten percent withholding tax).[82] As noted above, Congress has considered treating certain non-FIRPTA capital gain income from stock sales as though it were U.S. trade or business income. Congress has also considered applying a ten percent "FIRPTA- type" withholding tax in such cases.

II. CHOICE OF ENTITY FOR FOREIGN PERSON INVESTING IN UNITED STATES

A. *Primary forms of conducting business in the United States*

There are three primary forms of conducting business in the United States: a domestic subsidiary, a branch or a joint venture.

1. Domestic subsidiary

The principal and generally preferred method of a foreign person conducting business in the United States is through the creation and use of a domestic subsidiary. As shall be noted in greater detail below, this form of investment has become especially attractive in light of the rather low rate of taxation now imposed by the United States. Unlike many other industrialized countries, the maximum marginal rate of tax on business income in the United States is rather low, currently 34 percent. When the foreign person is from a high tax jurisdiction, as will be likely, there is little or no tax advantage in repatriating profits back to the foreign person's home jurisdiction. Instead, the domestic corporation can be used as a low tax shelter for the earnings of the foreign investor's U.S. business. Another distinct advantage of this form is that it often simplifies recordkeeping and financial reporting. The domestic corporation will follow U.S. Generally Accepted Accounting Principle ("GAAP") reporting and generally will have fewer problems in coordinating its own books and records with its foreign investor's books and records than if the foreign investor conducted its U.S. business through a branch.

2. Branch

A foreign person may prefer to operate its U.S. business by utilizing a branch. Certain tax treaties with the United States contain non-discrimination provisions to prevent adverse tax treatment of the branch versus a U.S. person conducting the same activities. For example, non-discrimination provisions are the basis upon which the branch tax may be avoided by the foreign person.[83] The branch of a foreign corporation will be treated like a subsidiary in certain cases with respect to unrelated foreign investors, as in the case of interest paid by the branch to foreign persons and the second-tier withholding tax. The interest will be treated as domestic source interest and the dividend may be subject to U.S. tax based on the level of "effectively connected" income of the branch.

3. Joint venture

In the case of two or more investors, the choice of entity generally will be a jointly owned domestic corporation or a partnership. For a variety of reasons, described below, the most tax efficient structure for a joint venture generally will be the use of a general partnership held by the joint venture parties through wholly-owned domestic corporations.

B. *Branch vs. domestic subsidiary*

Although a domestic subsidiary generally is preferred by foreign corporate investors in conducting U.S. business operations, the advantages and disadvantages of operating through a branch should be carefully examined based on the specific needs and circumstances of the foreign investor.

1. Advantages of a branch

(a) *Use of start-up losses*
The foreign investor may prefer to use a branch because it anticipates start-up losses which it can offset against its foreign income for purposes of its own foreign taxes. Presumably, the start-up losses incurred by a domestic corporation cannot be utilized by the foreign corporation in calculating its foreign income tax liability. Indeed, this should be the primary basis for a foreign investor to use a branch: the disadvantages of using a branch, as shall be noted below (other than by a non-resident alien individual), generally outweigh the benefits, unless offsetting start-up losses against foreign income is of major importance. Even if this right of offset against foreign income is lost, the foreign investor should note that the net operating loss carryforward and carryback rules of U.S. law will allow a domestic subsidiary, subject to certain limitations, to utilize its losses against its own income from profitable years. In the event

77. Treas. Reg. §§ 1.6012-1(b)(2)(i), 1.6012-2(g)(2)(i).
78. Treas. Reg. § 1.1461-4(a).
79. Sec. 1464.
80. Treas. Reg. §§ 1.1441-6; 35a.9999-5.
81. Treas. Reg. § 1.1441-6(c).
82. Sec. 1445.
83. Treas. Reg. § 1.884-1T(h). The tax treaty with Canada is more limited in this respect, but it does prevent disparate treatment of a permanent establishment of a Canadian resident from a U.S. person conducting the same activities. U.S.-Canada tax treaty, Art. XXV.

that start-up losses are anticipated and a branch is the preferred method of investment, it may be wise to invest in a branch through a newly organized foreign corporation, provided the newly organized foreign corporation can join in some form of consolidated return with the other profitable group of foreign corporations. In this case, the liabilities of the U.S. branch may be segregated from the remaining foreign group, thereby reducing the legal exposure of the other members of the group.

(b) *Branch tax benefits*
In certain instances, generally limited to the case where a tax treaty prevents the application of both the branch tax and the second-tier withholding tax, a branch can be used by a foreign corporate investor without the application of a branch profits tax and the second-tier withholding tax. This allows the foreign corporate investor to repatriate funds from the U.S. branch free of withholding taxes that would otherwise be applicable to the repatriation of profits from a domestic subsidiary as dividend income. This benefit though should be balanced against the taxes to which the repatriated income will be subject in the foreign corporation's home jurisdiction. If foreign taxes on the repatriated income are significantly higher than 34 percent, the maximum marginal rate of U.S. corporate tax, little will be gained by continually repatriating income from the United States. The foreign investor also should note that the United States is actively engaged in the re-negotiation and "modernization" of its existing tax treaties to conform to changes made by the Tax Reform Act of 1986, including the introduction of the branch tax. Accordingly, the benefit of avoiding the branch tax may be short lived.

Prior to the introduction of the branch tax and the lowering of U.S. corporate tax rates, a branch was more attractive as a form of investment because the foreign corporate investor often could repatriate funds from the United States free of withholding taxes. Often, a tax treaty prevented the application of the second-tier withholding tax on dividends paid by the foreign corporation. Alternatively, under prior law, it was much easier for a foreign corporation to avoid the second-tier withholding tax. Under pre-1987 law, the second-tier withholding tax applied only if 50 percent or more of the foreign corporation's income consisted of U.S. "effectively connected" trade or business income. This threshold was reduced to 25 percent in the Tax Reform Act of 1986.[84]

(c) *Lower tax rates for non-resident alien individual*
A non-resident alien individual may prefer to operate a U.S. business directly because the maximum marginal rate of tax on the individual will be 31 percent rather than the higher maximum marginal rate of tax on corporations of 34 percent. The individual, by definition, will also be exempt from U.S. branch taxes. However, the benefit of lower rates has to be offset by two major drawbacks in engaging in direct branch operations. First, the foreign person may be a resident of a high tax jurisdiction, in which case, the benefit of lower U.S. taxes will be eliminated. While the foreign person will pay a lower rate of tax on his U.S. trade or business income, he may still be required to pay the higher foreign rate of tax on all of his income, including the U.S. trade or business income. In effect, he will not be able to shelter his U.S. trade or business income at lower U.S. tax rates. Second, the foreign person will be subject to liability in his personal capacity on the obligations of his U.S. trade or business as a direct owner. Most persons would prefer to operate in corporate form to mitigate personal liability in conducting business operations. While a U.S. person would consider the alternative of operating through a "Subchapter S" corporation to benefit from lower individual tax rates, foreign persons are not eligible to organize and become shareholders of a "Subchapter S" corporation.[85]

(d) *Interest stripping for non-resident alien individual*
A non-resident alien individual also can take advantage of the sourcing rule for interest to strip a considerable level of income from his U.S. business operations, provided the operations are conducted in branch form. The interest paid on debt obligations of a non-resident alien individual is treated as foreign-source income and will be exempt from U.S. tax (including withholding taxes) when received by a foreign person (other than the limited case of a foreign person which treats the income as effectively connected with its U.S. trade or business pursuant to Section 864(c)(4)(B)(ii)).[86] The interest on the debt will be deductible (subject to certain limitations) to the extent the debt is secured by and attributable to the U.S. business assets of the foreign person.[87] Moreover, the interest expense will not be subject to the "interest stripping" rules of Section 163(j) enacted in the Omnibus Budget Reconciliation Act of 1989 ("the 1989 Act"). The principal limitation will be that the interest expense will not be deductible to the extent it is attributable to debt which exceeds more than 80 percent of the gross assets of the U.S.trade or business.[88] In effect, the interest expense will substantially reduce the trade or business income of the alien individual and will be free of U.S. tax to the foreign person which receives it, including a foreign bank or finance company. An alien individual residing in a high-tax jurisdiction who intends to self-finance his U.S. trade or business may find this conclusion interesting but not altogether helpful if he organizes a foreign entity to issue debt to his U.S. trade or business and the foreign entity is subject to the higher level of foreign tax. However, the alien could organize a special purpose finance corporation in a tax haven to receive the tax-free interest income, in which case the interest income paid from the U.S. trade or business may be exempt from all taxes.

2. Disadvantages of a branch

(a) *Taxation by two jurisdictions*
A branch generally will be subject to two taxing jurisdictions and the branch may, therefore, be required to keep multiple sets of financial books and records. Additionally, the laws of two taxing jurisdictions may not always readily conform to one another, thereby producing odd or inconsistent results. For example, taxing jurisdictions often apply their own unique rules in determining net income and in setting forth limitations on the availability of foreign tax credits. However, in some instances, inconsistencies may be helpful, as in the case of certain financial products which may be treated differently.

(b) *U.S. tax rates may provide no benefit*
U.S. tax rates are now among the lowest in the world, 31 percent (the maximum marginal rate) in the case of business income of non-resident alien individuals and 34 percent (the maximum marginal rate) in the case of foreign corporations. These low tax rates will be of little value if the foreign investor is still subject to a higher overall foreign tax rate on its branch level income. The use of a domestic subsidiary

84. Sec. 861(a)(2)(B).
85. Sec. 1361(b)(1)(C).
86. Secs. 861(a)(1); 862(a)(1).
87. Temp. Treas. Reg. § 1.861-9T(d)(2)(i).
88. Temp. Treas. Reg. § 1.861-9T(d)(2)(ii)(A).

will allow the foreign investor to defer foreign taxation to the date on which profits from the domestic corporation are repatriated as dividend income. Until dividends are paid, the domestic corporation can shelter the U.S. business profits of the foreign investor from higher foreign taxes.

(c) *Subjecting foreign investor to U.S. jurisdiction*
A foreign investor operating a U.S. branch will be subject to U.S. legal jurisdiction as a foreign person doing business in the United States. The use of a domestic subsidiary can shield the foreign investor from legal jurisdiction since the business is conducted by a separate entity with limited liability. However, in the case of taxing jurisdiction and enforcement, the IRS now has broad authority to require foreign investors to maintain records and disclose certain transactions between related parties whether the foreign investor operates through a domestic subsidiary or a branch.[89] This authority has increased considerably in the last number of years because of perceived abuse and tax avoidance by foreign entities conducting business in the United States.

(d) *Branch tax more burdensome*
In certain instances, the branch tax on a foreign corporate investor may be more burdensome in its application than withholding taxes on dividends from a domestic subsidiary. The branch tax will be applied on "effectively connected" E&P unless certain deferral mechanisms are satisfied (or the U.S. business is terminated or incorporated), while the withholding tax on dividends will be applied only when dividends are actually paid. The simplicity of applying the withholding tax only on actual dividends improves the control the foreign investor has in repatriating the profits of its U.S. business. Additionally, the foreign corporate investor may be a resident of a treaty country for purposes of dividend withholding, but not a "qualified resident" for branch tax purposes. The branch tax rate, in this case, would be imposed at a rate of 30 percent, while dividends paid by the domestic corporation to its foreign corporate owner would be subject to reduced treaty withholding tax rates (generally, between 5 percent and 15 percent).

(e) *Loss of consolidated return benefits*
A foreign person investing in the United States may prefer to engage in a number of business activities through separate entities. These entities can join in the filing of a consolidated return, assuming the foreign investor organizes a U.S. parent company to hold the U.S. group of companies (it can also be an operating company) and requisite control exists through the parent company of each member of the "affiliated group".[90] While a foreign corporation can also engage in U.S. business activities through multiple U.S. branches, this form would be considerably more cumbersome and would expose each branch to the risks of the businesses of the other branches.

C. Special estate tax considerations of non-resident alien individuals

1. High estate taxes on U.S. property

Foreign persons that are non-resident alien individuals ("non-resident non-citizens" for estate tax purposes) will be subject to U.S. estate taxes on their property located within the United States.[91] Estate taxes may be substantial since they can be applied up to a maximum marginal rate of 55 percent (in certain cases, 60 percent), although the first $ 60,000 of a foreign person's estate generally is not subject to U.S. estate tax.[92] The estate tax may be modified in the case of non-resident alien decedents in certain countries through the estate tax treaty network of the United States.

2. Foreign corporation for U.S. investments

One alternative to direct investment by a non-resident alien individual would be to utilize a foreign corporation as the investor. Assuming the foreign corporation is respected for estate tax purposes, the non-resident alien individual would not be considered the owner of the U.S. property at death (since the individual holds shares of a foreign corporation), thereby circumventing the estate tax. There is little authority on whether the foreign corporation would be respected for estate tax purposes, but preliminary guidance is favourable.[93] The courts have even ruled that the formation of a corporation and its continued use for the sole purpose of reducing estate taxes is a legitimate corporate business purpose and that the corporation should be respected for tax purposes.[94] However, there are certain adverse consequences which can arise from using a foreign corporation as the investor. First, the use of a foreign corporation may have adverse tax consequences in the foreign individual's country of residence.[95] Second, the branch tax or the second-tier withholding tax could apply to the foreign corporation (unless it is exempt as a "qualified resident" of a tax treaty jurisdiction which prohibits the branch tax and/or the second-tier withholding tax) both on its current income and on the gain attributable to the sale or other disposition of the U.S. real property. Third, if the U.S. investment consists of U.S. real property which the foreign person intends to sell in the near term, the foreign corporation will be subject to a higher level of taxation than the non-resident alien individual on any gain attributable to the sale. The foreign corporation will be subject to U.S. tax at the maximum marginal rate of 34 percent, rather than 31 percent in the case of a non-resident alien individual, and the foreign corporation may be subject to a branch tax of up to 30 percent on the residual profits remaining after the corporate level tax is imposed.

D. *Organizing a U.S. business in domestic corporate form*

1. Tax-free incorporation

The contribution of cash and other property to a newly organized domestic corporation solely in exchange for stock will be tax-free, provided the transferor "controls" the transferee corporation immediately after the transfer (generally, "control" is satisfied through 80 percent ownership in the transferee corporation).[96] The transaction will not be

89. Sec. 6038A and C.
90. Secs. 1502, 1504(a).
91. Secs. 2101, 2104. Canadians may be particularly hard hit by the estate tax, since there is no current coordination of Canadian taxes and duties imposed on deceased persons (which is limited to the income tax that would be imposed on any unrealized gains attributable to capital assets held by the deceased person as though the assets were sold for their fair market value) and the U.S. estate tax, thereby creating the possibility that the estate would be subject to double taxation by both the United States and Canada.
92. Secs. 2101(c), 2102, 2001.
93. *Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Corporation of America v. Commissioner,* 81 T.C. 520 (1983).
94. *Sparks Farm, Inc. v. Commissioner,* 56 T.C.M. 464 (1988).
95. Under certain circumstances, however, Canada will respect special purpose corporations which are organized for the sole purpose of holding U.S. real property. See Barnicke, "U.S. Vacation Property", 37 *Can. Tax J.* (May-June 1989), at 763.
96. Secs. 351(a), 368(c).

tax-free to the extent "securities" (as opposed to stock) are exchanged by the transferee for property. This is a new restriction on the tax-free nature of this type of transfer added by Congress in the 1989 Tax Act. Foreign investors actually may be helped by this provision to the extent they intend to contribute appreciated property (especially, appreciated intangible property) to a newly organized domestic corporation. To the extent "securities" are exchanged for the appreciated property, the transfer will be treated as a taxable transaction for U.S. tax purposes, and the domestic corporation will have a stepped-up basis in the appreciated property, a rather desirable result. While the transaction is considered taxable, in many cases (e.g. if the property is foreign in origin and is not sold through a U.S. office), no U.S. tax will arise from the "taxable" transfer, either because the income will be treated as foreign source income or because the income will be exempt from U.S. tax as capital gain income.[97]

2. Capitalization of the domestic corporation – the question of interest stripping

For some foreign investors, it may be beneficial to strip out as much income as possible from the United States on a tax-free basis. The principal tool in accomplishing this objective is to use related party debt rather than equity in capitalizing the newly organized or acquired domestic subsidiary, thereby "stripping out" interest from the domestic corporation through the related party indebtedness. The process of using debt to strip earnings from a U.S. business is labelled "interest stripping" or "earnings stripping". In other cases, however, it may be preferable to incur little or no U.S. debt. This strategy will be attractive if only because it is conservative and therefore unlikely to result in any challenge from the IRS. More importantly, however, this strategy of minimizing debt is attractive because, with corporate tax rates set at a maximum marginal level of 34 percent, the United States is somewhat of a tax haven jurisdiction, especially compared with some of the higher taxed European countries and Japan. Accordingly, the idea of "sheltering" income in U.S. corporate form is not altogether unsound.

3. Two assumptions of interest stripping

Interest stripping, if it is to work at all, is based on two assumptions. First, it assumes that the foreign investor can rely on an income tax treaty with the United States that reduces the rate of withholding tax on interest to zero percent or that the foreign investor can fully (or in large part) offset the withholding tax through the use of foreign tax credits. Second, it assumes that the foreign investor can shelter the interest income from higher foreign taxes, either in its home jurisdiction or in a third country that has a favourable tax treaty with the United States.

The first assumption can be easily satisfied since there are a number of income tax treaties that reduce the level of withholding on interest to zero percent (e.g. treaties with Netherlands, Germany, France, United Kingdom).[98] The second assumption is harder to satisfy since many of the countries that have treaties with the United States impose a rather significant level of tax which, if higher than the U.S. tax, would be to the disadvantage of the foreign investor. Some treaty countries, however, impose low tax rates on entities that are used as holding or finance companies. The second assumption also will be satisfied if the debt is acquired by an entity in a treaty country which offsets its interest income with a similar, if not identical, debt obligation to another related party, presumably in a tax haven or zero taxed environment. The problem in using offsetting debt (often called "back-to-back debt") is that the withholding tax exemption may be challenged by the IRS based upon the claim that the holder of the debt of the U.S. corporation was not the true holder and that the treaty exemption from tax, therefore, did not apply.[99]

4. Limitations on interest stripping

Even when interest stripping is still viable for the foreign investor, it is subject to certain limitations which could diminish its importance for tax purposes.

(a) *Thin capitalization*
While there is no definitive test of debt versus equity in U.S. tax law, at a certain point debt will not be respected as debt and will be treated instead as equity, even if the parties document the debt as such and intend the debt to be true debt. This can occur because of certain of the debt's features or because the obligor is thinly capitalized.[100] Thin capitalization is a major feature of the debt versus equity analysis and is based on the view that, at a certain point, a corporation has incurred so much indebtedness that a new lender intends to subordinate its return to the vicissitudes and fortunes of the business as an equity holder and not as a debt holder.[101] There is no specific point at which debt will be treated instead as equity, although in its proposed debt versus equity regulations to Section 385 (now withdrawn), the IRS provided a safe harbour rule which limited debt to equity in the case of related party indebtedness to a ratio of 3 to 1.[102]

(b) *Original issue discount obligations*
In the case where a domestic corporation incurs indebtedness with a related foreign corporation and the indebtedness contains original issue discount, the domestic corporation will be denied a deduction for the original issue discount accruing on the obligation until cash is actually paid to the foreign person. This is designed to defer the deduction to the point in time at which the foreign person will be subject to U.S. tax on the original issue discount income, generally the date a cash payment is made.[103]

(c) *Regulatory authority*
The IRS has the authority to issue regulations limiting a deduction of interest (or any expense) payable to a foreign person when the amount payable is not includible in the income of the foreign person.[104] To date, the IRS has not issued regulations to this effect.

(d) *Interest stripping rule*
Section 163(j) was introduced by Congress in the 1989 Tax Act with the intention of limiting interest stripping in the case of interest paid to related persons exempt from tax on interest income, including (if not targeting) foreign persons exempt from U.S. withholding taxes on interest income.

(1) *Preliminary tests*
Section 163(j) does not automatically apply; it is limited to

97. Sec. 865(a).
98. Noticeably absent from this list of tax treaties are the tax treaties with Canada and Japan.
99. See e.g. Rev. Rul. 84-152, 1984-2 C.B. 381, 84-153, 1984-2 C.B. 383; *Aiken Industries v. Commissioner,* 56 T.C. 925 (1971).
100. Sec. 385.
101. See e.g. *Kraft Food Co. v. Commissioner,* 232 F.2d 118 (2d Cir. 1956); *Tyler v. Tomlinson,* 414 F.2d 844 (5th Cir. 1969).
102. Prop. Treas. Reg. §§ 1.385-6(f).
103. Secs. 163(e)(3), 871(a)(1)(C), 881(a)(3).
104. Sec. 267(a)(3).

the case where a domestic corporation has a ratio of debt to equity exceeding 1.5 to 1 and where the domestic corporation's "net interest expense" (generally, interest expense less taxable interest income) exceeds 50 percent of its "adjusted taxable income" (generally, this is taxable income with certain modifications).[105] "Adjusted taxable income" also includes certain additions of "excess limitation" from the preceding three taxable years, representing the excess of 50 percent of "adjusted taxable income" over net interest expense from the preceding three years (in effect, "unused" or "excess" limitation from prior years). Because of the additions to "adjusted taxable income", the second test, for the most part, is a measure over a four-year period. These tests contain a number of definitions for which there is little or no guidance from the IRS (other than preliminary statements of how regulations will be drafted). A number of important interpretative issues also arise, including the question of how to apply the debt to equity ratio in the case of a newly acquired domestic corporation where the basis of the corporation's assets is not stepped-up to reflect the purchase price paid for the corporation's stock. Because of this overall uncertainty, there are a number of open questions on how the rule will be applied.

(2) *Application of rule*
In the case where both of these two tests are satisfied, any interest paid to a related person which is exempt from U.S. tax will be disqualified as a deduction to the payor.[106] In the case of payments to a foreign person where the tax treaty reduces the rate of withholding tax below 30 percent but not to zero percent, the amount of disqualified interest is not the entire amount of interest paid, but the product of the amount of interest paid and a fraction equal to the ratio of the amount the tax is reduced as compared to the flat 30 percent tax.[107] For example, if the rate of tax is reduced to ten percent, two-thirds of the interest paid will be disqualified as a deduction to the payor, since it is assumed that two-thirds of the interest paid is exempt from U.S. tax.

(3) *Expansive nature of rule*
The interest stripping rule will apply to interest paid to persons exempt from U.S. tax even if the interest is subject to high foreign taxes. It may, therefore, apply to situations where interest is not paid to a foreign person for purposes of tax avoidance (i.e. it is not restricted to the case where interest is paid to a foreign person located in a tax haven).

E. *Acquiring an existing U.S. business – stock vs. asset acquisitions*

1. Stock acquisitions generally

When a foreign investor intends to purchase an existing U.S. business, the acquisition may be accomplished in one of two ways. First, the foreign investor can acquire the stock of an existing company (the "target corporation"). Second, the foreign investor can buy the assets of the target corporation directly. Each of these two methods has advantages and disadvantages which should be analyzed by the foreign investor. Often, however, the foreign investor will have no choice in structuring its acquisition (e.g. stock must be acquired because the seller will not complete the acquisition otherwise).

105. Sec. 163(j)(2)(A).
106. Sec. 163(j)(1).
107. Sec. 163(j)(5)(B).
108. Secs. 382-384.

2. Advantages to a stock acquisition

There are certain advantages which arise in a stock acquisition.

(a) *Tax benefit to seller*
Assuming the sellers are individuals, the sale of stock rather than assets means that the sellers will avoid corporate level tax on the appreciation of the underlying corporate assets. Since the repeal of the *General Utilities* doctrine, under which the assets of a liquidating business could be sold or distributed with the application of only a shareholder level of tax, the only method for a seller to avoid the corporate level tax on the gain attributable to the target corporation's assets is to sell stock of the target directly rather than the target's assets. Clearly, this tax benefit to the seller should be a point in negotiating the purchase price, especially since the buyer will not be able to step up the basis of the underlying assets of the business (thereby, limiting its ability to depreciate the assets over time).

(b) *State transfer taxes and other state benefits*
Many states will impose transfer taxes on the sale of assets, especially real property assets. The transfer of stock, however, will rarely be subject to transfer taxes. Often, the corporation will also be the owner of a state charter to conduct business (e.g. regulated industry) or another state benefit which cannot be transferred with assets unless the state first issues its consent. By acquiring stock, the foreign investor may avoid the delay of first obtaining consent to the transfer of these state benefits.

(c) *Preservation of net operating losses*
By acquiring stock, the foreign investor may preserve the net operating loss benefits and certain other tax credits of the target corporation. This consideration will be especially relevant when the foreign investor intends to acquire a minority or non-controlling equity stake in the target corporation. Because of the limitation provisions applicable to the utilization of net operating losses and other tax benefits when the corporation undergoes a change in ownership, this benefit will be significantly reduced when the foreign investor obtains a majority or controlling stake in the target corporation.[108]

(d) *Depreciation may be higher*
In limited cases where the purchase price for the stock is lower than the aggregate adjusted basis of the corporation's depreciable assets, the foreign investor will consider a stock acquisition to be more tax efficient. This can occur when the value of the corporation and its underlying assets have declined precipitously (e.g. because of unforseen liabilities or in a recessionary business environment), but where the depreciable corporate assets still have high adjusted basis for tax purposes. The high adjusted basis of these assets should be preserved for their tax benefits and can be preserved if the foreign investor acquires stock rather than assets.

3. Disadvantages to a stock acquisition

In many, if not most cases, it will be preferable for the foreign investor to acquire assets rather than stock. Certain disadvantages should be considered in completing a stock acquisition.

(a) *No step-up in basis of assets*
In the majority of acquisitions, the purchase price will exceed the aggregate adjusted basis of the underlying depreciable corporate assets. In this case, a purchase of stock rather than assets will reduce the ability of a foreign buyer to

depreciate its newly acquired assets for the full purchase price. Instead, the adjusted basis of each depreciable asset will be preserved. However, as noted below, both the buyer and the seller can elect to treat the stock sale as an asset sale under certain circumstances.

(b) *Assumption of liabilities*
Another major disadvantage to a stock acquisition is that the purchaser will be acquiring the existing corporate entity with all of its legal attributes, in addition to the corporation's going business. Because the corporation will remain intact, the purchaser will assume all of the corporation's existing, contingent and unstated liabilities (e.g. tax and other general legal claims). Nonetheless, there are means to mitigate this type of exposure. The buyer can negotiate warranties and indemnification provisions from the seller as a device to protect itself against future unforseen liabilities. When the seller is a substantial company or otherwise creditworthy, a warranty or indemnity can significantly reduce the risk of loss to a buyer. Another alternative would be to hold back part of the purchase price until a future date when the buyer has more knowledge of the liabilities to which the target corporation is subject. The "holdback" amount can be applied by the buyer against future liabilities if and when they arise.

4. Section 338 elections and their effect on basis

As noted earlier, one drawback concerning a stock acquisition is that the basis of the underlying assets of the target corporation will remain the same and cannot be "stepped up" to reflect the purchase price paid by the buyer for the target corporation's stock. However, in certain cases, Section 338 of the Code can be used by a foreign corporate buyer to "step up" the basis of the target corporation's assets.

(a) *Section 338(a) election*
Under certain circumstances, the buyer can elect to step up the basis of the target corporation's assets to reflect the price paid for the target's stock, provided the target corporation agrees to treat the "step-up" as though it sold all of its assets at the close of the acquisition date for cash at fair market value and further agrees to be treated as a new corporation with a new history of tax attributes beginning on the day after the acquisition date.[109] The principal drawback with this election is that the target corporation, and, indirectly, the buyer, will recognize taxable income from the net gain attributable to the appreciation of the target corporation's assets (and incur additional tax liabilities), even though the buyer presumably has paid for the full net fair market value of these assets. The seller will not recognize gain or loss attributable to the deemed sale of target corporation's assets and will not report the deemed sale in its own tax return, even if the target corporation was a member of the seller's affiliated group for consolidated return purposes. Any tax liability attributable to the sale will be the separate tax liability of the target corporation, and, indirectly, the buyer.[110] Prior to the repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986, and the collateral repeal of the *Kimbell-Diamond* rule, this deemed liquidation-reincorporation and "step-up" of basis could be accomplished tax-free. Now the deemed sale of the target corporation's assets will be taxable to the target corporation. For this reason, the election is rarely used. The additional tax liability generally will be higher than the tax benefit of deferred depreciation arising from the "step-up" in the basis of the target corporation's assets.

(b) *Section 338(h)(10) election*
Under this election, both the buyer and the seller agree to treat the stock sale as a deemed sale of the target corporation's assets.[111] The seller will recognize gain or loss attributable to the sale of the target corporation's assets (through the target corporation) rather than gain or loss attributable to the sale of the stock of the target corporation.[112] In many cases, though, the seller will be indifferent to the election from a tax perspective since the gain attributable to the sale of assets will be the same (or possibly less) than the sale of the target corporation's stock. The buyer will be treated as though it purchased the target corporation's assets rather than the target corporation's stock. All of the target corporation's historic tax attributes will be inherited by the seller.[113] This election can be made only if the target corporation is a member of an affiliated group of corporations that files a consolidated return (although regulations are to be issued allowing the election whether or not the group files a consolidated return).[114] Accordingly, the target corporation cannot be a foreign corporation engaged in the conduct of a U.S. trade or business. Any other benefits of a stock sale (e.g. state law benefits) will be preserved, since under state law, the sale consisted of the stock of the target corporation, not its assets.

5. Tax-free acquisitions

(a) *Tax efficient means of acquiring a U.S. target corporation*
A foreign corporate buyer may prefer to complete a tax-free acquisition of a target U.S. corporation by tendering its own stock (or, in limited cases, securities) as consideration to the seller. The advantage to the seller is that the seller can defer gain, and taxes, from the "sale" (but not from the receipt of boot) by taking an equity interest in the buyer. The buyer may be in a position to negotiate a more economical sale because of the tax savings realized by the seller, although at the cost of providing the seller with an equity or other stake in the buyer.

(b) *Section 367 complexity*
Although both the foreign buyer and the seller may agree on the terms of a tax-free acquisition, Section 367, especially Section 367(a), may prevent treatment of the acquisition on a tax-free basis. Section 367(a) provides an exception to the treatment of certain acquisitive reorganizations on a tax-free basis in the case where a U.S. person transfers property (e.g. stock or assets of the target corporation) to a foreign corporation.

(1) *Favourable treatment of stock-for-stock acquisitions*
Nonetheless, certain stock-for-stock acquisitions may still be tax-free.[115] This includes "B" reorganizations where the U.S. "sellers" of the target corporation agree to exchange a controlling ownership interest in the target corporation (i.e. at least 80 percent of the target's stock) for stock of the foreign corporate buyer.[116] Any U.S. seller that receives less than a five percent interest in the foreign corporate purchaser will be entitled to treat the acquisition on a tax-free basis.[117] In certain other cases, the transaction will be consi-

109. Sec. 338(a).
110. Temp. Treas. Reg. § 1.338-1T(f)(3).
111. Sec. 338(h)(10).
112. Sec. 338(h)(10)(A)(ii); Temp. Treas. Reg. § 1.338(h)(10)-1T(e).
113. Temp. Treas. Reg. § 1.338(h)(10)-1T(e).
114. Sec. 338(h)(10)(B).
115. Temp. Treas. Reg. § 1.367(a)-3T; Notice 87-85, 1987-2 C.B. 395.
116. Sec. 368(a)(1)(B).
117. Notice 87-85, 1987-2 C.B. 395.

dered tax-free, but the U.S. sellers will be required to enter into a "gain-recognition" agreement with the IRS providing for the recognition of gain by the U.S. sellers if the foreign corporate purchaser sells its interest in the target corporation within a specified period of time (five to ten years).[118] In no event will a single U.S. seller enjoy tax-free treatment if the seller receives more than a 50 percent interest in the foreign corporate purchaser.[119]

(2) *Target corporations that are controlled foreign corporations*

When the target corporation is a foreign corporation that is a controlled foreign corporation ("CFC") for tax purposes, the U.S. sellers that are "U.S. shareholders" of the CFC will not be entitled to enter into a tax-free stock-for-stock acquisition unless they receive in exchange stock of another CFC of which they are "U.S. shareholders".[120]

F. *Planning a joint venture*

Generally, there are two forms used in planning joint ventures. First, the parties can agree to organize a corporation as the joint venture entity where their respective interests will be reflected in their share ownership. Second, the parties can agree to organize a partnership as the joint venture entity where their respective interests will be reflected in their distributive share interests in the partnership's income, losses and other attributes. For the reasons stated below, the partnership should be the preferred method of organizing a joint venture.

1. Advantages of a partnership

In most cases, joint venture parties should organize a general partnership as the joint venture entity and invest in the partnership through wholly owned U.S. corporations.

(a) *Start-up losses*

This will allow a U.S. joint venturer to utilize the start-up losses of the partnership against its other income, assuming the U.S. joint venturer files a consolidated return. Otherwise, if the joint venture entity were a corporation, these losses would be restricted to the U.S. joint venture corporation and could not offset other income of the U.S. joint venturers (unless one of the U.S. joint venturers took an 80 percent or more interest in the joint venture corporation). Similarly, the foreign joint venturer can utilize the start-up losses of the partnership against the income of its other U.S. controlled subsidiaries that join in the filing of a consolidated return with its wholly owned U.S. corporate partner.

(b) *Repatriated profits*

The partnership structure also facilitates the repatriation of profits of the joint venture entity. Each joint venture party can repatriate profits from the partnership without additional tax consequences. Dividends paid by a joint venture corporation, however, would be subject to tax both in the case of a foreign joint venturer (withholding taxes would arise) and a U.S. joint-venturer (generally, only 70-80 percent of the dividend would be eligible for the dividends received deduction).

(c) *Limited liability*

One concern arising from the use of a partnership is that the liabilities of the partnership would not be limited to the partnership itself and, therefore, would expose the joint venturers to additional risk. This risk would be absent if the joint venture vehicle consisted of a corporation. However, the liabilities of the partnership can be limited just as in the case of a corporate joint venture vehicle. The organization of new U.S. corporations solely for purposes of investing in the joint venture partnership should still preserve the benefit of limited liability since the partnership's liabilities would not extend beyond the partnership's corporate partners. In this regard, the foreign investor should pay close attention to the doctrine of "piercing the corporate veil". The corporation should be given substance and independence apart from the foreign investor (e.g. corporate board meetings should be held, the outside world should be on notice that the holder of the joint venture interest is the corporation, not the foreign investor, etc.).

2. Pitfalls in partnership planning

Generally, the partnership vehicle should not be used unless the foreign joint venturer intends to acquire its interest in the partnership through a wholly-owned domestic corporation. There is a certain disadvantage in the direct use by a foreign person of a partnership as the joint venture entity, principally because of the additional level of complexity that arises from a partnership which has foreign partners. The foreign partner of a partnership will be treated as being engaged in the conduct of a U.S. trade or business based upon the activities of the partnership, including the activities of a general partner in the case of a limited partnership.[121] In the case of a partnership engaged in the conduct of a U.S. trade or business, certain partnership withholding tax rules will be applied, generally requiring the partnership to make estimated tax payments of the tax liabilities attributable to the distributive share of "effectively connected" taxable income of its foreign partners.[122] A foreign corporate partner cannot circumvent the application of the interest expense limitations of Treas. Reg. § 1.882-5 through the use of a partnership in calculating its effectively connected income.[123] A foreign corporate partner also cannot circumvent the branch profits tax rules through the use of domestic partnership, including the use of a domestic partnership to artificially increase its level of U.S. assets.[124]

118. Temp. Treas. Reg. § 1.367(a)-3T(g).
119. *Id.*
120. Notice 87-85, 1987-2 C.B. 395; I.R.C. § 367(b); Temp. Treas. Reg. § 7.367(b)-7.
121. Sec. 875.
122. Sec. 1445. Rev. Proc. 89-31, 1989-1 C.B. 895.
123. Temp. Treas. Reg. § 1.861-9T(e)(7).
124. Temp. Treas. Reg. § 1.884-1T(d)(9).

CONTINUING TAX REFORM PROGRAMME IN NEW ZEALAND

Andrew M.C. Smith

Andrew M.C. Smith is a Senior Lecturer in Accountancy, Faculty of Commerce & Administration, Victoria University of Wellington, Wellington, New Zealand.

Despite having undertaken an ambitious tax reform from the mid-1980s, the New Zealand Government is still planning further income tax reforms. This continuing reform programme stems more from the objective of improving the workability of the existing tax system rather than from enacting further fundamental changes.

I. BACKGROUND TO FURTHER REFORMS

Since 1984 the New Zealand Government has completed an ambitious tax reform programme. This has included the introduction of:

- a tax on employers providing fringe benefits to their employees;
- a value added tax (the "goods and services tax");
- a comprehensive accrual regime for interest income and expenditure;
- a system of dividend imputation for companies;
- an international tax regime to prevent tax avoidance by New Zealand residents using offshore vehicles such as controlled companies, trusts and investment funds; and
- a withholding tax regime for interest and dividend payments to resident taxpayers.

In 1989 the Government released a discussion paper, the *Consultative Document on the Taxation of Income from Capital,* which set out comprehensive proposals for a capital gains tax with substantive indexation provisions. Later that year the Government established a committee (the Consultative Committee on the Taxation of Income From Capital, hereinafter referred to as "the Committee") to evaluate submissions on the capital gains tax proposals. This Committee recommended that the Government first simplify and rationalize certain parts of the existing income tax statutes before introducing a capital gains tax.

The Government's proposals for a capital gains tax were not well received by the public or by the business community. In response to mounting political pressure and an election scheduled for late 1990, on 20 March 1990 the Minister of Finance delivered an economic statement announcing that "capital gains tax and indexation are off the agenda". The Minister stated that the Committee would turn its attention towards further improving the income tax system as recommended in the discussion paper on capital gains and that this would complement the work undertaken on tax simplification by another committee.[1] An agenda of topics to be considered was released inviting submissions from the public.

Since March 1990, the Committee has released two discussion papers stemming from their review. These papers consider the core provisions of the Income Tax Act 1976 (hereinafter referred to as "the Act")[2] and tax accounting issues surrounding the determination of income for mainly business taxpayers.

This article reviews some of the recommendations made by the Committee in its two reports. The fundamental structure of the Act in respect of the assessability of income to tax and the deductibility of expenses incurred in the production of that income are examined, and this provides a platform for the subject matter of the second paper on specific tax accounting issues.

A. *Financial accounting practices and standards*

The Committee has recognized the influence of expert accounting witnesses in income tax litigation, particularly in cases concerning the determination of income. Many of the Committee's recommendations are made with explicit reference to financial accounting practices and standards. This reflects the importance the courts have placed on financial accounting concepts in the determination of income and also that a financial accounting-based income determination measure more often than not reflects an accurate and appropriate way to determine income.[3] It is the basis on which the managers of a business report income to the owners and thus what these parties perceive as income from their own perspective.

B. *Resolution of ambiguities*

The Committee has recognized that the Act contains numerous ambiguities which may favour neither revenue nor taxpayer. Indeed certain provisions of the Act have long been the subject of explicit criticism by the Courts without a legislative response from Parliament.[4]

The Committee acknowledged the desirability of greater certainty for taxpayers as to the tax regime applying to their affairs, and that there are shortcomings for both taxpayers and the Commissioner where clarification of the Act must be obtained through protracted litigation. This continues the approach adopted by several other tax reforms introduced since 1984.

1. This committee, the "Tax Simplification Committee", was to investigate ways to make the tax system simpler and reduce taxpayer compliance costs without a major loss of revenue. The recommendations of this Committee are beyond the scope of this article.
2. Unless otherwise stated, all references in this article are to the Act.
3. This emphasis can be seen in the interest expenditure/income accrual rules (Sec. 64B-M) which often make reference to financial accounting and commercial practices; e.g. Sec. 64C(2), (3) and (4).
4. For example, the depreciation provisions in Sec. 108.

C. *Codification of administrative practices*

The Act provides taxpayers with little guidance on a number of matters pertaining to income determination. To some degree this reflects the Act's emphasis of taxing income on a net basis, leaving the method of income calculation to established commercial or accountancy practices/concepts. Over a long period of time the Commissioner of Inland Revenue has adopted a number of administrative practices and rulings to assist in this regard, despite an absence of statutory authority to do so in most cases.[5] The Act does not give any status to the Commissioner's administrative guidelines nor does it allow the Commissioner to provide binding determinations in response to general taxpayer requests for clarification of the Act.

While many of the Commissioner's practices are consistent with the provisions of the Income Tax Act they may not always be so. Reviews of some established administrative practices by the Commissioner have sometimes led to sudden changes when legal opinion suggests that existing practices are not supported by tax statutes. Sudden reversals of long standing administrative practices have caused considerable concern to affected taxpayers and often give rise to litigation for ultimate clarification from the courts.[6]

In its review the Committee has placed considerable emphasis on greater codification of tax accounting and income determination issues but in a way that leaves scope for flexibility. This includes codification of existing administrative practices and court rulings where appropriate. Recommendations include provisions allowing the Commissioner to make binding determinations upon taxpayer request or upon the Commissioner's own volition. In making a determination the Commissioner is required to consider relevant financial accounting and commercial practices.

II. CORE PROVISIONS OF INCOME TAX ACT 1976

The Committee saw the role of the Act as being to translate Parliament's tax policy objectives "into operational rules that taxpayers must employ to compute their tax liabilities".[7] The central provisions of the Act that perform this role are:

(i) those that impose a liability on assessable income derived;
(ii) those that exempt certain income from taxation; and
(iii) those that govern the scope and timing of expenditure that is deductible in computing net income.[8]

In the opinion of the Committee, the core provisions of the Act do not have a "coherent relationship with each other or the rest of the Act".[9] The Committee identified several problem areas as follows:

- the Act uses terminology that intermingles gross and net concepts of income;
- the absence of symmetry between the treatment of income and losses;
- weaknesses in key provisions governing the deduction of expenditure for repairs and maintenance, bad debts and the provision of depreciation allowances; and
- the absence of statutory detail in the Act.

A. *Conceptual basis for income determination*

The New Zealand income tax legislation was originally based upon a British colonial model which was schedular in approach and imposed tax based on a concept of net income. Since their introduction in 1891, the income tax laws have been modified in piecemeal fashion gradually adopting a global basis of income determination. Unfortunately the global method has not been adopted comprehensively, which accounts for some of the current deficiencies.

The Committee identified the main approaches to income determination as the adoption of a "global or schedular" basis and a "gross or net" basis. Calculation of income on a gross basis results in an independent calculation of gross revenues and expenses with the two set off to obtain net income. Calculation of income on a net basis starts with a net income figure determined in accordance with commercial or accounting criteria which is then subject to statutory modification for certain items.

A global approach to income determination includes all income from all sources either on a gross or net basis. The schedular approach determines assessable income on a source-by-source basis.

Currently, the Act utilizes a combination of all of these approaches. For example, Section 65(2)(a) deems assessable income as "all profits and gains derived from any business"; this appears to impose income tax on a basis of net income, i.e. gross revenues less expenses incurred in producing that income. However, taxpayers must then rely on other provisions in the Act to obtain deductions for any "expenditure or loss" incurred in the production of those "profits or gains". Therefore it appears the words "profits or gains" in Section 65(2)(a) refer to business income in a gross sense. By way of contrast, other parts of Section 65 list sources of income which appear to be specifically in the gross sense; for example "all monetary remuneration" (i.e. salary and wages) under Section 65(2)(b) or "dividends" under Section 65(2)(j).

The gross and net bases of income determination should both produce the same final income figure. However, currently they produce different results mainly due to the timing and scope of the deductibility of expenses and losses. The gross approach does not implicitly adopt a matching concept (which has required the introduction of specific provisions to control the timing of certain expense items, in particular interest) as the net approach does. This leads to the second deficiency.

B. *Symmetry of treatment for gains and losses*

When the Act extends the tax base to include certain capital gains, it does not follow that corresponding capital losses are deductible because of a prohibition on deducting capital losses. This may cause problems for the deductibility of certain types of expenditure. For example, Section 67 codifies the basis upon which profits from land sales are to be taxed, again using the phrase "all profits or gains". Unfortunately the section is silent as to the tax treatment of land transactions where a loss is incurred in situations where, if a profit was made, it would be assessable income under Section 67. More typically, if a taxpayer seeks to deduct a net loss on a land transaction in such cases, a

5. The only exceptions are provided for under the interest accrual rules and the international tax regime as they affect "foreign investment funds".
6. See J. Prebble, *Advance Rulings on Tax Liability* (Wellington: Institute of Policy Studies, Victoria University of Wellington, 1986), at Chapter 2.
7. *Discussion Paper On The Core Provisions Of The Income Tax Act 1976*, at ii.
8. *Id.*
9. *Id.*

deduction may be prohibited under Section 106(1)(a) which denies a deduction for capital items.

C. *Weaknesses in major deduction sections*

The Act contains three major deduction sections:
1. Section 104 is a general deduction section.
2. Section 106 prohibits the deduction of specific items and indirectly authorizes the deduction of expenses such as interest and bad debts.
3. Section 108 specifies a test for deductions of repairs and maintenance expenses and authorizes the Commissioner to give allowances in respect of the depreciation of assets used in the production of income.

The working of these sections is not always clear nor are the interrelationships between their provisions. For example, Section 106(1)(a) denies a deduction for capital expenditure, while Section 108 permits the Commissioner to grant depreciation allowances. The relationship between these two sections is not specified in either Section 106 or 108. The deprecation provisions are obscure and the ability of taxpayers to claim depreciation allowances is based on the Commissioner's discretion, the statutory provisions of which are minimal.[10]

D. *Absence of statutory detail*

In respect of many tax accounting matters the Act provides no guidance, e.g. accounting for long-term construction projects and the valuation of manufacturers' inventories and work in progress. In practice, the matter is often left to be resolved by reference to financial accounting practices, by a Commissioner's administrative ruling or by the courts if a taxpayer initiates litigation.[11] Reforms enacted in 1986 applying to interest expenditure/income accruals are a good example of this shift towards codification in the Act.

The Committee perceived several disadvantages to the lack of statutory detail. There was decreased parliamentary control over tax law "contrary to the fiscal and constitutional significance of taxation".[12] Uncertainty was not resolved unless taxpayers initiated litigation in the courts. Additionally, foreign judicial precedents are increasingly less relevant as New Zealand taxing statutes become more individual to this country. Reliance on accounting criteria does not necessarily create certainty as with many accounting matters there is debate over the appropriateness of methods. Many financial accounting standards are subjective, providing for options to accountants to choose between based on their professional judgement.

III. PROPOSALS TO REFORM THE CORE PROVISION OF THE ACT

The Committee considered that the resolution of these issues was fundamental to making further reforms to the Act and it recommended that the Government amend the Act to meet the perceived deficiencies in the core provisions. In the Committee's opinion, the principal weakness is the mixing of gross and net concepts in the determination of income.

To remedy this the Committee believes that the Act should impose income tax on a net income basis, with statutory modifications directed at refining the concepts of gross revenues and gross expenditures in calculating net income. The existing ambiguities in Section 65 would be resolved by those sources of income being deemed "gross revenue". Income tax would be expressly imposed on *net income* which would be determined as the difference between "gross revenue" and "deductible items".

The Committee further stated:

> We do not favour adopting an exhaustive definition of income and therefore recognize that the Act must, to some extent, build on an undefined concept. This underscores the continuing significance of commercial accounting principles and practices, particularly in circumstances where the Act effectively adopts a term from the world of commerce or business without definition, or in circumstances where the calculation of net income clearly requires the use of a commercial or an accountancy principle to carry out the calculation of the net income subject to the statutory charge. Although the charging provisions should emphasize a net concept, the statutory modifications should be directed at gross revenues and gross expenditures as the two elements implicit in the calculation of net income.[13]

The Committee did not consider it appropriate to place all taxing provisions in the Act on a single net or gross basis. It recommended that those specific regimes already provided for in the Act be retained, such as the foreign investment fund regime.

A general matching provision should be introduced (called Section 85C) to provide a better basis for matching income and expenditure. This provision would approximate the basis promulgated in the Statement of Standard Accounting Practice #11 issued by the New Zealand Society of Accountants in 1979. To a large degree the provisions would limit the deferral of expenditure recognition to that provided for under ordinary accountancy treatment. If expenditure does not produce identifiable or measurable benefits in future income years that expenditure would be immediately deductible provided the main deductibility test in Section 104 was met. In most cases this will bring the determination of taxable income more in line with accountancy and commercial practice. Additionally, the Commissioner would retain power to make binding determinations as to how certain types of expenditure are to be accounted for, as is presently provided for in Section 104A.

In respect of the key deduction provisions, the Committee recommended that the provisions be redrafted to clarify their relationships. Repair and maintenance should be subject to the normal tests of deductibility in Section 104 while Section 108 should be redrafted as a positive entitlement to depreciation allowances. Other recommendations relating to depreciation are covered later in this article.

IV. DISCUSSION PAPER ON TAX ACCOUNTING ISSUES

The discussion paper on tax accounting issues builds on the matters covered in the discussion paper on core provisions, and proceeds on the basis that the recommendations are enacted. The tax accounting paper addresses more specific income determination issues.

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10. See discussion on depreciation in text *infra*.
11. E.g. *CIR v. Farmers' Trading Company Limited* (1982) 5 NZTC 61,201. This case concerned the determination of income from instalment sales by a department store. The case has been before the High Court and the Court of Appeal five times since 1980. *H.W. Coyle v. CIR* (1980) 4 NZTC 62,558 concerned the determination of income from long-term construction contracts.
12. See *supra* note 7, at 25.
13. *Id.*, at 26.

Initially the Committee considered the relevance of asset valuation and measurement in the determination of income. Tax accounting has tended towards a transactional basis of income measurement with a focus on revenues and expenditures. Accounting for financial reporting has tended to put greater emphasis on determining income from changes in asset and liability values over a time period (with allowances for capital contributions and profit withdrawals) as well as third party transactions. The Committee recognized that a strictly transactional approach to income determination was limited as it fails to accommodate unrealized variations in asset values, changes in asset uses and assets not acquired through external transactions (e.g. self-constructed assets). For these reasons the Committee recommended that for tax purposes the "net-accretion" method of income determination be used for all revenue assets (such as trading stock, non-trading stock revenue assets, prepaid expenditures and long-term construction projects).

If income measurement is to reflect changes in asset values then the basis of asset valuation is critical. The New Zealand tax system operates solely on a basis of historical cost. Over long periods of time the historical cost system tends to overstate revenues and understate costs even if annual inflation rates are low. If an entity is taxed on this basis it may result in capital erosion. The tax legislation has specified historical cost mainly because of its objectivity and simplicity.

When a capital gains tax was originally proposed in 1989, provisions for systematic indexation were also recommended. In the tax accounting paper the Committee concluded that indexation is an issue distinct from that of capital gains taxation and that there is "considerable merit in advancing indexation as a reform initiative although we note that there has been great difficulty in achieving general acceptance of an appropriate accounting method in practice".[14] Unfortunately the Committee advances no further arguments on indexation and it appears that the issue is unlikely to receive any further consideration by Government. Indexation of gains for the effects of inflation have normally been resisted on grounds of potential loss of revenue and administrative complexity. Additionally, it has been argued that the absence of indexation is balanced by a tax deferral obtained by taxpayers through deferring the realization of revenue assets.

Let us now consider each of the major Committee recommendations in respect of tax accounting for the determination of business income.

A. *Apportionment of expenditure*

In the determination of income for tax purposes it often is necessary to apportion some form of expenditure on the grounds of some particular objective or purpose. For example, expenditure incurred may relate to more than one income year or not entirely to the production of assessable income. Benefits of a private/domestic nature may be enjoyed, or non-taxable/exempt income may be produced as a result of that expenditure.

The Act currently provides for apportionment of expenditure under the general deduction test in Section 104. However, apart from Section 104 the Act is generally silent on the issue of apportionment. In the Committee's opinion, clearer and more precise apportionment rules are desirable. In this regard the Committee considered it necessary to distinguish between interest costs and other types of expenditure.

1. Apportionment of interest expenditure

The provisions for the deductibility of interest have concerned policymakers for some time. Under New Zealand law interest expenditure is subject to a separate test of deductibility. A recent Court of Appeal judgement in *CIR v. Brierley*[15] held that the interest deduction test was independent of the general deduction provision in Section 104 and thus the apportionment provisions of Section 104 are not applicable to interest expenditure.

Difficulties over interest apportionment arise when interest incurred produces both income and other non-income benefits for a taxpayer. For example, where borrowing is used to finance a rental property, rental income as well as non-assessable capital gains upon the sale of the property are produced.[16] In such cases it is difficult to quantify the benefits obtained (rental income and capital gain) upon which to base an accurate apportionment.

The Committee concluded that the problem of interest deductibility was overstated as normally an interest deduction to one taxpayer will result in the return of interest income to the lender. In an overall sense there was little revenue loss to the state. It is difficult to see how this argument can be confined to interest expenditure since it could also be applied to all types of expenditure. The Committee also noted the considerable difficulty in formulating an interest deduction test that would easily apportion interest expenditure between the production of taxable income and other uses without extreme complexity and compliance costs to taxpayers.

For these reasons the Committee recommended that the interest deduction test provide for all interest expenditure to be deductible, except where it is private or domestic in nature or where it relates to the production of exempt income. In these cases an apportionment, such as that proposed for non-interest expenditure (discussed below), would be required. While this proposal would greatly simplify the interest deductibility provisions, it could also create a number of problems; for example, when a taxpayer's home is temporarily let out during an absence overseas or pending sale. In such cases a common measure test would be difficult to apply and if the dominant purpose test was used it could result in denial of an interest deduction. Some clarification or refinement of either the interest deduction and/or the apportionment tests is necessary to prevent such anomalies.

The existing provision (Section 106(1)(h)(ii)) which allows a company a deduction for interest on funds borrowed to finance the acquisition of shares in another company forming part of a company group (in terms of Section 191) would be repealed. This deduction would be continued under the revised test of deductibility by providing that intercompany dividends (which are normally exempt under Section 63) be treated as assessable income for the purposes of the interest deduction test.

The Committee did note the possibility that the proposed test would allow non-residents a tax deduction in New Zealand for funds employed outside the scope of the New Zea-

14. *Tax Accounting Issues*, at 13.
15. (1990) 12 NZTC 7,184.
16. From 1982 to 1990, certain sales of property sold within ten years of acquisition were liable to be taxed on any capital gain derived, based on the amount of interest claimed for income tax purposes in respect of the purchase of that property. The vendor was taxed on the lesser of the capital gain or the amount of interest claimed (Sec. 129).

land tax system. To overcome this problem the Committee proposed that non-residents only be allowed to deduct interest when the funds borrowed produced income with a New Zealand source.

2. Apportionment of non-interest expenditure

The Committee believed some apportionment rule was necessary where non-interest expenditure produces concurrent benefits other than production of assessable income and that more explicit apportionment rules should be introduced into the Act for this purpose. Apportionment should be on a basis that is

> fair and reasonable, conforms with commercially acceptable practice and is based on relevant available objective factors measuring on a comparable basis the extent to which the expenditure or loss meets the criteria for deduction provided in this Act and the extent to which the expenditure or loss does not meet such criteria.[17]

Where possible apportionment would be on a "common measure" basis "which fairly and reasonably results in an objective allocation of the joint expenditure between assessable and non-assessable benefits".[18] In cases where it was impractical to do so, expenditure would be apportioned by a dominant purpose test, whereby the whole deduction would be determined by the dominant purpose of incurring the expenditure. For particular types of expenditure that are likely to cause problems in practice it was recommended that specific rules be introduced (as has been the case with motor vehicle expenses) to apportion expenditure between private and business use.

Again the dominant purpose test would be likely to be used when private/domestic benefits arise. It could result in a denial of deductions if the private/domestic purposes are held to be the dominant ones, resulting in a potentially harsh outcome for the taxpayers concerned. In a number of situations the proposed apportionment tests could be difficult to apply fairly and may give rise to considerable litigation, particularly in respect of the relevance of minor/incidental purposes or benefits flowing from expenditure incurred.

B. *Non-market transactions and asset classifications*

In most instances the current income tax laws do not take into account changes in market values of assets[19] unless the asset is realized and the resulting gain/loss is of a revenue nature for tax purposes. As a consequence, the classification of an asset upon acquisition is crucial for income tax purposes. The existing laws are unclear in some respects, giving rise to uncertainties as to how some assets are to be treated and providing incentives for retrospective reclassification of assets after acquisition where this is advantageous.

The Committee specifically recommended that the Act provide for asset classification rules, defining revenue assets as ones giving rise to assessable gains or deductible losses on disposal. If an asset is both trading stock and a depreciable asset, the former category would take priority. All other assets would be regarded as held on capital account. Assets would be classified at the time of acquisition. Movement out of the tax system would be deemed a taxable event. The existing provisions prohibiting certain categories of taxpayer from holding certain types of assets on a portfolio basis (investment/capital) would be removed along with the associated person provisions.[20]

In respect of land and excepted financial arrangements,[21] it was recommended that taxpayers identify such assets acquired on revenue account in the year acquired; otherwise the assets would be deemed to be held on capital account. These types of assets have typically been the source of the greatest problems for the revenue authorities. Taxpayers would not be able to claim that the asset is held on a contrary classification unless the Commissioner exercises his discretion to so decide. The classification of an asset would not override other provisions of the Act applying to property sales. Taxpayers whose assets were held on capital account would still be subject to the provisions covering gains on the sale of real and personal property (Section 65(2)(e) and potentially Section 67).[22] Unfortunately these proposals could prove more difficult to administer consistently in practice than is apparent in the discussion paper.

While these rules may appear unfair to taxpayers, the Committee argues they would be better than the current non-portfolio rules and associated person provisions. Protection would be accorded to the revenue against deduction of losses made on the sale of capital assets and the non-assessability of gains made on the sale of revenue assets. The classification adopted by a taxpayer under the rules would also be of relevance to the Commissioner and the courts in making a determination as to whether or not a gain on the sale of capital assets was assessable.

The Committee recognized that the emphasis on asset classification rules would require a deemed disposal in some circumstances in order to protect the revenue base. It proposed that when an asset enters or leaves the tax base, is reclassified or is subject to a non-market disposal (gift, bequest, etc.) that a deemed disposal and acquisition for tax purposes occur at market values. Thus taxpayers obtaining or losing New Zealand tax residency would be regarded as having entered or left the tax system as would non-residents who shift assets in or out of New Zealand, and assets shifted from private to business use or vice versa. In the case of assets reclassified from trading stock to non-depreciable revenue assets or from depreciable capital or depreciable revenue assets, it was recommended that a rollover relief be made available so that the gain on disposal only be realized for tax purposes when the asset is finally sold to another party.

Company losses

Currently New Zealand companies are taxed independently even if they are part of a group of companies. Sales of assets between companies forming part of a group can give rise to taxable gains in the same way as if they were derived from sales to arm's length parties. A member company of a group may also be taxed on capital gains if another company in the group would derive assessable income from the transaction.[23] The Committee recommended that intra-group

17. See *supra* note 14, at 147.
18. *Id.*, at 25.
19. The current exceptions are certain provisions relating to trading stock (Sec. 85), certain types of financial arrangements (futures and options contracts, and debt instruments for dealers) and depreciation.
20. These rules apply mainly to taxpayers in certain businesses connected with land sales/development. These associated person provisions in respect of land transactions under Sec. 67 are considered very wide and potentially harsh.
21. "Excepted financial arrangements" are assets such as equity and preference shares and certain specific types of debt instruments (hire-purchase agreements), leases, certain options to acquire property, etc.
22. These provisions are discussed in the text *infra*.
23. Sec. 191(4A).

transactions be ignored for income tax, gift duty and stamp duty purposes if those companies form part of a "specified group".[24] The grouping provision (Section 191(4A)) for assessability among a group of companies was also recommended for repeal.

A number of changes were recommended for the loss offset requirements among groups of companies. Currently, loss offsets among groups where there is not 100 percent common ownership are made by way of a "subvention payment". This involves the profit company actually paying the "loss" to the loss company – the payment received by the loss company is assessable (cancelling out the loss) and the payment is deductible to the company paying it (reducing its income). Such payments can have major implications for minority shareholders. The Committee recommended that in such cases the companies have the option of transferring losses by way of an election without the need to make subvention payments.

C. *Trading stock*

The existing trading stock provisions are one of the few instances in the Act that currently allow income to be determined by using market values.[25] Section 85 grants taxpayers the option to use cost, selling price or replacement prices to determine closing year trading stock values. Taxpayers can change their valuation basis at any time. The trading stock valuation is critical in the determination of taxable income and therefore requires careful consideration.

Doubts have arisen about the scope and application of the trading stock provisions. As the provisions allow taxpayers to recognize unrealized losses they have become attractive to taxpayers wishing to obtain deductions on assets which have decreased in value but which have not been sold. Further problems arise with respect to the scope of what may constitute trading stock and how it is to be valued for taxpayers such as manufacturers. To some extent manufacturers have freedom as to how to value their completed and partly completed stock which can give rise to tax avoidance opportunities.

The Committee recommended that the definition of trading stock be limited to businesses and to items that are acquired for the ultimate purpose of resale, such as goods but not services. It felt the definition should be inclusive and allow a common law definition of trading stock to be accommodated but should exclude categories of assets that are subject to special taxing regimes in the Act (e.g. financial arrangements).[26] Assets such as land, shares, consumable and spare parts would be able to be classified as trading stock.

The Committee recommended that taxpayers continue to have the option to value stocks either on cost or entry market or exit market value, except for land and excepted financial arrangements (such as shares) which would be valued on a cost basis only. In practice this restriction applying to land and shares could be overcome by arranging sales and buy-backs near the balance date and arguably provides little useful purpose. Land and shares would also be able to be transferred between companies in a specified group without giving rise to a taxable transaction.

A substantial number of recommendations were made regarding the valuation of manufacturers' stock. If enacted this would represent a substantial codification of accepted management accounting methods. It was recommended that certain minimum costs should be taken into account in the calculation of such stock, including indirect material costs, utilities costs, indirect factory labour, repairs/maintenance/leasing charges/depreciation of factory plant. Budgeted costs would be acceptable for valuation of stock provided variances between actual and budgeted costs are averaged between costs of goods manufactured and closing stock. Absorption level costing of indirect costs must be based on actual production, not on budgeted level of production. Processes involving joint products or by-products should be costed on either the sales value of the various products or the physical measure of the various products, whichever is most appropriate. Further, the method adopted by the taxpayer for valuation of manufacturing stock must be consistent across lines of stock and income years. However, a taxpayer would be able to use different valuation methods across different lines of stock provided they are used consistently.

In some aspects the proposals for manufacturers' stock are unduly complex and likely to give rise to high compliance costs for small taxpayers. In some situations they may give rise to higher values than would be obtained by using financial accounting standards, which is unwarranted.

In certain cases it was recommended that taxpayers have the option to value their trading stock based on discounted selling prices. This would be subject to conditions, including that the value of all trading stock on hand was less than NZ$ 200,000, the selling prices used were normal retail, not discounted, prices, and the discount factor would be based upon normal margins. This option would replace the cost option for a taxpayer. In certain cases the Commissioner would have discretion to allow the method for taxpayers with stock above the NZ$ 200,000 level.

The Committee further recommended that trading stock should not be valued using standard values unless specifically authorized by statute. This reflects concerns about earlier livestock valuation provisions which conferred substantial tax concessions on farmers using artificially low standard values.

Cost-flow assumptions were to be continued based on a FIFO or weighted average. LIFO has never been acceptable in New Zealand for income tax purposes.

The Committee recommended special rules for the valuation of excepted financial arrangements (e.g. shares), i.e. they would be required to be valued on a FIFO, weighted average basis without specific identification. Specific rules would apply to the valuation of shares where bonus issues or share splits had occurred.

D. *Land and property sales*

The Act has two sections for taxing land and property transactions. Separate taxing regimes are applied to non-real property and land transactions. These provisions are the closest provisions New Zealand has to a capital gain tax. Significantly, these provisions apply to non-residents as well as residents.

Non-land property sales are taxed under Section 65(2)(e) and are assessable if the taxpayer's business is dealing in those articles or if the property is acquired for the *purpose* of resale, or if the profits are derived from any profit-making

24. A "specified group" exists if there is 100 percent common ownership.
25. The interest accrual rules (Sec. 64B-M) also allow market values to be used for dealers in debt instruments and for futures and options contracts.
26. E.g. debt instruments, futures and options. These "financial arrangements" are accounted for under the interest accrual rules Sec. 64B-M.

scheme or undertaking. The latter would not necessarily have to involve the sale of property but would be some undertaking less than the carrying on of a business which would be assessable under Section 65(2)(a).[27]

In earlier years the courts tended to adopt a narrow interpretation of this section. For example, in a 1958 court decision[28] it was held that in applying the second limb of this section the taxpayer's purpose of acquisition could be distinguished from the taxpayer's intention. In another case[29] it was held that the second limb of the subsection did not apply to disposals of property arising from compulsory acquisition by the Crown or a local body.

Prior to 1973 land sales were also governed by the above provisions. Because of difficulties in applying the section and the narrow interpretation adopted by the courts, the law applying to land sales was substantially codified (Section 67). Sales of land are taxed under seven provisions:

(1) land acquired for the purpose(s)/intention(s) of resale;
(2) land sold by land dealers for their dealing business or any non-dealing land sold by them, or parties associated to them, within ten years of acquisition;
(3) land sold by land developers for their developing business or any non-development land sold by them, or parties associated to them, within ten years of acquisition;
(4) land sold by builders for their building business or any non-building land sold by them or parties associated to them, within ten years of completion of building improvements made to that land;
(5) land subject to rezoning which was sold within ten years of acquisition and at least 20 percent plus of the profits made were subject to rezoning;
(6) schemes/undertakings involving land made within ten years of acquisition of the land;
(7) major subdivisions commenced at least ten years after acquisition of the land.

Specific and limited exemptions are provided for taxpayers' homes and business premises. Small-scale subdivisions involving a taxpayer's own home property and economic farm subdivisions are also exempt. The associated person provisions applying to (2), (3) and (4) above are very broad and often resulted in unintended consequences to taxpayers who purchased shares in land-owning companies.

The courts have held that in calculating gains under the above provisions no allowance can be made for inflation.[30] Given New Zealand's poor inflation record, until very recently this meant that the real tax impact was increased and many taxpayers faced erosion of their capital by the taxation of gains derived from land sales.

The Committee carefully considered the taxing provisions for both land and non-land sales, including a recent Court of Appeal decision in *CIR v. National Distributors*[31], which concerned the taxation of profits derived from the sale of shares under the second limb of Section 65(2)(e). The Committee's view was that this case represented a shift in judicial attitudes towards the taxing of property sales away from some of the more narrow judicial interpretations of earlier courts and thus represented a satisfactory balance between taxpayers and the revenue.

The Committee recommended that Section 65(2)(e) be retained with several major modifications. Land sales should not be subject to a separate taxing regime and should be brought back with Section 65(2)(e). The section should apply whether the property was acquired voluntarily or involuntarily (e.g. by way of gift) and if the property was disposed of by way of compulsory acquisition by the Crown or any other party.

More importantly, the section should be reworded so that the sale of any property would be liable to tax if the property was acquired "for *a* purpose or with *an* intention of the disposition of the specified property at a profit".[32] Therefore if a taxpayer could point to multiple purposes or intentions for the acquisition of the property, if one purpose or intention was to make a profit it would be sufficient for the sale to be liable to tax. This represents a substantial extension of the current Section 65(2)(e) as this only applies where a *dominant purpose* of resale exists. The absence of any reference to the role of subsidiary or incidental purposes or effects could result in substantial disputes over application of the provision.

A change to the third limb of the section is proposed to extend the meaning of the phrase "profit-making scheme or undertaking" to include arrangements where property is acquired by a company and is disposed of by the taxpayer by way of sale of the shares in the company which owns the property.[33]

The Committee believes that the proposals concerning property sales "achieve[s] an appropriate balance within the charging sections while having regard to current judicial trends".[34] This is not a view which has been widely agreed upon. As they stand, the proposals represent a considerable extension of the law because they provide for the taxation of capital gains.

The recent Court of Appeal decision in *National Distributors* (discussed above) appears to represent a deliberate judicial decision to extend capital gains taxation. In taking such a step the Court of Appeal will be well aware of the effect of their decision to extend a capital gains tax without Parliament having to debate the difficult issue and enact legislation. For many citizens the effect of the Court of Appeal's decision will not yet be appreciated. Given the fact that in 1989 the Government dropped proposals for a capital gains tax with indexation, it is the author's view that it is undesirable that a capital gains tax now be further extended through indirect means. New Zealand tax legislation has a long history of such an approach[35] to the taxing of capital gains which represents a pragmatic legislative response to popular public sentiments against such taxes.

The proposals will increase taxpayer uncertainty and give rise to unnecessary litigation. Further, no allowance will be made for inflation. The current taxing provisions for land sales in Section 67 have led to harsh results due to non-indexation. It is disappointing that indexation is not advocated given the earlier recommendations for indexation along with the proposed capital gains tax in 1989. These recommendations appear to be at odds with the Committee's stated objections in the core provisions discussion paper to the lack of statutory detail on the grounds that "parliamen-

27. Potentially certain land transactions falling outside Sec. 67 could be assessable under the third limb of Sec. 65(2)(e).
28. *Plimmer v. CIR* (1958) NZLR 147.
29. *Public Trustee v. CIR* (1961) NZLR 1034.
30. *Lowe v. CIR* (1981) 5 NZTC 61,006.
31. (1989) 11 NZTC 6,346.
32. See *supra* note 14, at 166.
33. Such schemes are used to avoid the realization of gains on the sale of real estate or shares where the sale of those underlying assets would normally give rise to taxable income.
34. See *supra* note 14, at 80.
35. For example, the interest clawback provisions in Sec. 129 which applied to land sold within ten years of acquisition.

tary control over the detail of tax law is lessened, contrary to the fiscal and constitutional significance of taxation".[36]

The proposal that land sales be treated on the same basis as other property sales does not necessarily represent the major concession to taxpayers which it initially appears to be. While the associated person provisions will no longer apply to taxpayers involved with land sales, the revised Section 65(2)(e) will give rise to greater doubts as to the taxing regime for land transactions. For example, there are no longer specific exemptions for the sale of a taxpayer's residence or business premises, and given the proposed rewording of Section 65(2)(e), it will be much easier to tax sales of a residence or business premises than it would have been under the current Section 65(2)(e) even in the absence of the specific exemptions in Section 67.

The only positive aspect is that the proposals on trading stock and the core provisions of the Act will clarify whether taxpayers can deduct losses from the sale of property that otherwise would have been taxed under Sections 65(2)(e) or 67 if a profit had been derived.

E. *Long-term construction projects*

Under existing provisions in the Act, the appropriate accounting method for construction projects for income tax purposes is not clear and existing practice is inconsistent among taxpayers. This is mainly because of the absence of specific provisions in the Act and uncertain judicial guidance in *H.W. Coyle v CIR.*[37] The *Coyle* case did not strongly endorse any particular tax accounting method and gave authority for methods by which taxpayers could in some circumstances delay the recognition of construction revenue until the project concerned was fully completed.

The Committee therefore recommended that a specific provision be inserted in the Act to deal with tax accounting for long-term construction projects where the project is for periods longer than 12 months. Both the finished contract method and percentage of completion method would be available depending on the terms of the construction project. If a project was constructed for a predetermined customer then the percentage of completion method should be used but not until the project is at least 20 percent completed. If a construction project is not presold then revenues and expenditures would only be recognized when the project is sold.

In cases where the sale of a project is undertaken by sale of shares in a company, the profit on the sale of those shares will be assessable using the same tax accounting methods as for construction projects.

F. *Depreciation*

Section 108 is an obscure provision which remains substantially unchanged since 1894 and which has been the target of a number of judicial criticisms over the years.

The section denies a deduction for the repair of premises, plant and machinery or equipment used in the production of income beyond the sum usually expended in any year for such repairs. Later the section, by way of proviso, permits the Commissioner to give an allowance for depreciation of assets caused by fair wear and tear or by obsolescence which cannot be made good by repair. The actual rates of depreciation are left to the Commissioner to determine. There are other provisions in the Act which allow a deduction for depreciation for specific types of assets, e.g. Section 74 for plant and machinery used in forestry. The Commissioner has the power to limit depreciation deductions where depreciated assets have been acquired under Section 111 (designed to prevent taxpayers from selling and repurchasing assets from related parties in order to claim more depreciation) and under Section 117 (revised assessments where depreciable assets are sold in excess of their depreciated cost).

Apart from the obscure provisions permitting allowances for depreciation, the relationship of Section 108 to other deduction sections such as Section 104 is not clear. The class of property which can be depreciated is narrow; for example, intangible assets cannot be amortized under Section 108.[38] The right to deduct depreciation is not automatic, nor is it based upon explicit criteria. No guidance is given to the Commissioner as to the basis for determining appropriate depreciation rates nor are there any formalized procedures to allow taxpayers higher depreciation rates in special circumstances, although in practice such rates may be given. The method of calculating the cost of an asset for depreciation purposes is not specified nor is the method of depreciation. The depreciation recovery provisions are also subject to the Commissioner's discretion.

Given the obvious deficiencies in the depreciation regime in the Act, it is not surprising that the Committee has recommended substantial changes to depreciation provisions. These changes codify and clarify much of what has become established practice, and in some instances make changes to what is currently provided for. It is not expected that these changes will significantly affect many taxpayers unless there are substantial changes to depreciation rates as a result of the proposals or as a result of a current review the Commissioner is undertaking in respect of depreciation rates.

First, the Committee recommended that the definition of "depreciable property" be extended to include all tangible and intangible assets which satisfy specific deductibility criteria with exclusions for trading stock, financial arrangements and land and for assets permitted deductions elsewhere in the Act. The existing provisions for intangible property would be repealed and consolidated into one provision. Depreciation deductions would be available to taxpayers by way of a statutory entitlement rather than the Commissioner's discretion. Repairs and maintenance expenditure would be deductible under the ordinary deductibility provisions of the Act.

A deduction for depreciation would be allowed in each year in which a depreciable asset is used or is available for use in gaining or producing gross income, or is held and available for use in a business for the purpose of gaining or producing gross revenue of the taxpayer. It was proposed that the Commissioner continue to set the rates of depreciation but that rate-setting criteria be codified along with procedures for taxpayers to obtain determinations for higher depreciation rates where appropriate. It is also proposed that the diminishing value or straight-line methods of depreciation be available at the taxpayer's option.

Existing standard value, replacement only and annual revaluation methods are proposed to be replaced by a pool assets method to be used for assets costing less than

36. See *supra* note 14, at 25.
37. (1980) 4 NZTC 61,558.
38. Certain types of intangible assets can be amortized under other provisions. For example, premiums paid upon the grant of a lease by a tenant can be amortized under Sec. 137. The costs of acquiring patent rights can be amortized under Sec. 142.

NZ$ 2,000 per unit or when book values of other assets fall below NZ$ 2,000. Pool assets would be depreciated under a diminishing value method only at the lowest rate applicable to any of the assets in the pool. Any gains upon the sale of pool assets above their book values would be treated as gross revenue.

The Committee recommended that the treatment for the adjustment of gains/losses on the sale of depreciable assets be uniform, and in particular, losses on the disposal of buildings be deductible as for other types of assets. This will mean that the current prohibition for deduction of losses from the sale of buildings will be removed. Removal of assets by non-residents will also be deemed a disposal of the asset for tax purposes.

The pool assets proposals have several deficiencies and are not consistent with the proposals for depreciation of other assets. Depreciation rates for some pool assets will end up being lower than if the method was not adopted. The provisions for recognizing gains/losses on the sale/disposal of pool assets are not consistent with those for other assets in that all gains on a sale will be taxable (not just the recovered depreciation) and deductions for losses on sale will essentially be deferred over a number of years instead of being recognized immediately.

V. SUMMARY AND CONCLUSION

The Committee work represents a substantial move towards improving the current Act, and will provide major benefits to both taxpayers and the Commissioner. Submissions have been sought from the public on the proposed changes and a paper outlining the Committee's Final Recommendations is expected in August/September. At this point the Government will indicate how it will proceed with the proposals.

Most of the proposals will enhance the operation of the Act, improve clarity, reduce uncertainty/compliance costs and possibly litigation. However, several of the proposals are flawed as they stand. The proposals for interest deductibility and expense apportionment require further consideration. The taxing regime for property sales needs to be completely rethought to provide taxpayers more certainty and protection against potentially harsh and inappropriate effects. It is hoped that the Committee carefully considers all submissions received and effects improvements where required.

C)nference Diary

SEPTEMBER 1991

International Tax Planning & Offshore Services. Valletta (Malta), 2-6 September (English):
International Tax Planning Course, Foundation for International Studies, St. Paul Street, Valletta, Malta (Attention: Mr. Michael Formosa Gauci). Tel.: (356)-240353; Fax: (356)-230551.

Internationale Steuerberaterseminare Deutschland – Österreich – Schweiz: Basisseminare Deutschland. München, 6-7 September (German):
Bundessteuerberaterkammer, Postfach 1340, 5300 Bonn 1, Federal Republic of Germany. Tel.: 02 28/726 3924. Fax: 02 28/726 3952.

International Conference on Property Taxation and its Interaction with Land Policy. Cambridge, Massachussetts, 22-26 September; Technical Workshop 27-28 September (English):
Lincoln Institute of Land Policy, Attn.: Mrs. Ann Long, Registrar, 26 Trowbridge Street, Cambridge, MA, 02138, U.S.A. Tel.: 617-661-3016; Fax: 617-661-6596.

I.T.P.A. Monte-Carlo Workshop. Monte-Carlo, 23-24 September (English):
Ms. Elisabeth Husband, I.T.P.A., Membership and Conference Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

OCTOBER 1991

Leasing. Brussels, 1-4 October (English):
Customer Service Department, Management Centre Europe, Postbus 95, 3417 ZH Montfoort, The Netherlands. Tel.: 32/2/516.19.11, ext. 934; Fax: 32/2/513.71.08.

45th Congress of the International Fiscal Association; Subjects: The Determination of the Tax Base for Real Property; Protection of Confidential Information in Tax Matters. Barcelona, 6-11 October (English, French, German, Spanish):
Wagons Lits Viajes, Central de Congresos, Madrid; Virgen de los Peligros, 2, 1° – 28013 Madrid, Spain. Tel.: (1) 532 99 09/531 27 20; Fax: (1) 532 50 80.

International Taxation Management Techniques: Transfer Pricing, Mergers and Acquisitions, Financing Techniques, EC Tax Harmonization. Brussels, 24-25 October (English):
Customer Service Department, Management Centre Europe, Postbus 95, 3417 ZH Montfoort, The Netherlands. Tel.: 32/2/516.19.11, ext. 934; Fax: 32/2/513.71.08.

Internationale Steuerberaterseminare Deutschland – Österreich – Schweiz: Aufbauseminare. Frankfurt, 25-26 October (German):
Bundessteuerberaterkammer, Postfach 1340, 5300 Bonn 1, Federal Republic of Germany. Tel.: 02 28/726 3924. Fax: 02 28/726 3952.

NOVEMBER 1991

New Legislation in Australia on Offshore Companies and Trusts; Asset Protection trusts; Immigration; Developments in New Zealand. Sydney, 18-19 November (English):
Ms. Elisabeth Husband, Conference Director I.P.T.A., Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1991 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

South Africa

INCOME TAX ACT 1990-1991.
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Cape Town, The Taxpayer, 1991, pp. 286.
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ASIA & THE PACIFIC

Australia

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Volume 20, 1989-90.
North Ryde, Butterworths Pty Limited, 1990, pp. 1894.
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THE FOREIGN-RELATED TAX LAWS and Regulations of the People's Republic of China. Authorized English texts of Laws, Regulations, Rulings and Tax Treaties.
Amsterdam, International Bureau of Fiscal Documentation, 1991.
Compiled and translated by the State Tax Bureau and the Law Department of the Ministry of Finance of the People's Republic of China. Reviewed and approved for official use by the Legislative Bureau of the State Council of the People's Republic of China. Published in cooperation with the China Financial and Economic Publishing House. Loose-leaf publication containing the official English texts of foreign-related tax laws, regulations, rulings and tax treaties of the People's Republic of China. The material will be updated by Supplements. An introduction to the Chinese tax system is appended.
(B. 57.592)

TAXES AND INVESTMENT IN THE People's Republic of China.
Amsterdam, International Bureau of Fiscal Documentation, 1991.
Loose leaf publication providing information on the investment laws of China and other related matters important for doing business or investment in China by foreign companies. An outline of the tax system in China describing both the foreign-related taxes levied on foreigners and enterprises with foreign investment in China as well as the domestic-Chinese taxes levied on Chinese enterprises and individuals. Special tax incentives granted in Special Economic Zones, Coastal Cities and other preferred areas are dealt with.
(B. 57.593)

DOING BUSINESS IN PEOPLE'S Republic of China.
Price Waterhouse 1988, pp. 248.
Information guide on the investment climate, doing business, audit and accounting as well as taxation in China. A cumulative supplement of 1 August 1990 updates the material of this guide.
(B. 110.694)

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Amsterdam, Price Waterhouse, 1988, pp. 120.
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An in-depth analysis of the Swedish VAT system. A principal theme of the study is to compare the basic rules for VAT with the rules for income taxation in order to clarify the basic structures of income taxation in order to clarify the basic structures of the VAT, discuss the meaning of the rules and suggest changes. The VAT rules are further examined from the point of view of consistency and neutrality.
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EXECUTIVE DIRECTOR RETIRES

D.A. VAN WAARDENBURG

After 35 years of invaluable service to the IBFD, Drs. Dirk A. van Waardenburg, Executive Director, retired on 31 August 1991. Mr. Van Waardenburg has exerted a dynamic influence on the scientific research of the IBFD and distinguished himself in international tax circles.

Mr. Van Waardenburg's career at the IBFD was launched in 1956 when he was offered a position as senior researcher. He was appointed under-director of research in 1967 and Executive Director in 1980. As Executive Director he was responsible for maintaining the quality of the scientific publications and research reports.

During his career at the IBFD Mr. Van Waardenburg assumed myriad roles. He has been the oracle to whom IBFD researchers and outsiders alike have turned for technical advice and definitive answers. He supervised and carried out countless research projects, including projects on tax harmonization matters in the EC and on tax reform and tax treaty policy in many countries.

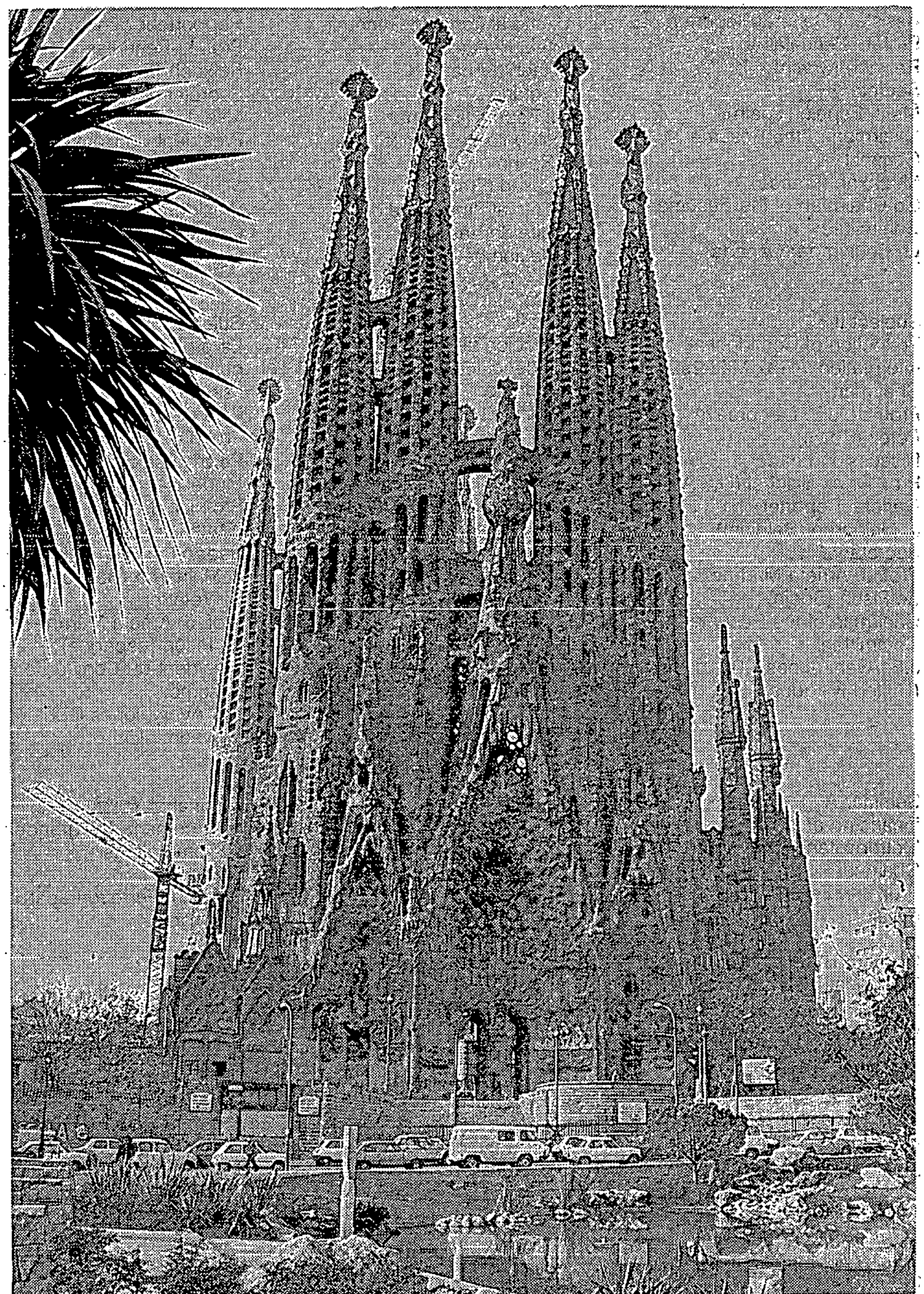
Mr. Van Waardenburg was a prolific author and his numerous articles contributed significantly to the development of international and comparative fiscal law. From 1962 he was international tax editor for the Dutch monthly periodical, *Maandblad voor Belastingbeschouwingen.*

Mr. Van Waardenburg's influence on the direction of the IBFD's monthly periodicals, *European Taxation* and the *Bulletin for International Fiscal Documentation,* was incalculable. From 1961-1985 he was the responsible director of *ET* and a member of that periodical's editorial board until his retirement. From 1971-1989 Mr. Van Waardenburg acted as director for the IBFD's oldest international periodical, the *Bulletin.* He also served on the *Bulletin*'s editorial board.

Mr. Van Waardenburg remains active in international tax circles. He is a member of the International Fiscal Association (IFA), the Netherlands Society for International Fiscal Law, the Society for Fiscal Science, and the latter society's Commission on Foreign Companies.

On the occasion of his retirement Queen Beatrix of the Netherlands appointed Mr. Van Waardenburg "Officier in de Orde van Oranje Nassau", a distinguished position in the Netherlands.

IFA Congress Barcelona 1991



The "Sagrada Familia" in Barcelona, a work of the Catalan architect Antonio Gaudi, has remained uncompleted since his death in 1926. – Foto ANP

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TAX POLICY IN SPAIN

Antonio Zabalza Martí
Secretary of State for Finance

I. INTRODUCTION

The Spanish tax system is undergoing a comprehensive reform. The reform begins with individual taxation, will continue with corporate taxation and eventually, under the harmonization scheme of the European Economic Community (EEC), with indirect taxation. Although this article mainly concentrates on the basic features of the individual tax reform, the general economic framework under which the Spanish tax system operates will also be addressed.

II. MACROECONOMIC FRAMEWORK

The obvious reference for the structure of Spanish economic policy is the EEC, both in terms of setting objectives and the design of instruments.

Geographically, historically and culturally, Spain is closely linked to Europe but it is less developed than other EEC countries. Its income per capita is only 75 percent of the EEC average. Consequently, the basic economic policy aim of the present government (and supported by the various political parties and economic and social organizations) is to maintain rates of growth higher than those of the EEC in order to reduce disparities in income, employment, public and social services and general welfare. To achieve this goal, the Spanish economy must become more competitive, particularly as the internal market becomes a reality and as the process of economic and monetary union is finalized.

Mr. Zabalza Martí is Doctor in Economics from the University of Barcelona and Ph.D. from the University of London.

During 1976-77 he was Post-Doctoral Fellow at the University of Chicago and, from 1977-1984 visiting lecturer at the Department of Economics of the London School of Economics.

On several occasions he has been advisor at the World Bank and the IMF.

Mr. Zabalza Martí is currently professor in Theory of Economics at the University of Valencia, under special leave of absence.

From 1984-1987 he was Director of the Cabinet of the State Secretary of Finance; from 1987-1988, General Director of Planning at the Ministry of Economics and Finance; from 1988-1991, General Secretary of Planning and Budget; and as of 15 March 1991, he is Secretary of State for Finance.

The gradual integration of the EEC considerably restricts the policies that each member state can design to achieve domestic goals. In particular, the completion of the internal market by the end of 1992, and the abolition of obstacles to the free circulation of goods and services and the free movement of capital and labour, means that it will be impossible to use measures against other EEC countries to protect national production. In addition, the European Monetary System and the path to monetary union will mean increasing difficulties in using exchange rate policies as a means to alter competitiveness. In this new environment, improving competitiveness demands more than ever higher productivity, and consequently the maintenance of high investment rates in both the private and the public sector.

To a large extent, this has been Spanish economic policy since its entry into the EEC. In 1985 there was a financial surplus in the private sector, i.e. a huge excess of private saving over investment, which was sufficient to finance the high public deficit that existed at that time (6.9 percent of GDP), and to lend resources to the rest of the world with a value equivalent to 1.4 percent of GDP. In contrast, the end of 1990 was characterized by a public deficit (which had fallen to 3.7 percent) and a private sector, which due to the huge increase in investment (from 15.5 percent of GDP in 1985 to 21 percent in 1990), could no longer contribute to finance this lower deficit. Consequently, in 1990 the total volume of foreign resources required by the economy was equivalent to 3.7 percent of GDP.

The basic conclusion to be drawn from these figures is clear: given the massive investment effort undertaken by the Spanish economy, the level of savings generated domestically is inadequate. Until now, this excess of investment over domestic savings has been covered without difficulty because Spain has been able to attract sufficient resources from abroad. However, in the future, and because of the commitment to eliminate controls on capital movements before 1993, there is a risk that it may not be possible to maintain the interest rate differentials necessary to attract capital from abroad. We must therefore increase our own savings rate, while continuing to attract foreign resources.

Raising domestic savings is of course a difficult task, particularly if it must be done by tax instruments. Both actual policy experience and research demonstrate that the ability to manipulate private savings by using fiscal measures is fairly uncertain. The recent U.S. experience is a good case in point. In the 1981 and 1986 reforms, the rates of personal income tax were substantially reduced with the purpose, among others, of stimulating family savings and encouraging the supply of labour. Neither of these goals seems to have been clearly achieved.[1] Moreover, the possibilities of compensating for lower personal tax receipts by increasing company taxation are limited, as companies tend to reduce their savings when faced with an increase in corporation tax in order to maintain their dividend distribution policy. It seems that the best and most secure means to ensure an increase in domestic savings is to reduce the public deficit. Thus it is crucial that the tax reform is not costly in terms of revenue. Savings can also be helped if revenue is shifted from the individual income tax towards a tax on consumption and, to a lesser extent, on corporate benefits.

III. THE SPANISH PUBLIC FINANCE SECTOR

The existing structure of the Spanish tax system is relatively recent. In 1977, following the lines of taxation models in the EEC, an individual income tax, conceived of as a very general tax, and a corporation tax were introduced as the core of the direct taxation system. The keystone of the indirect taxation system is a value added tax which was introduced in 1986 when Spain became a member of the EEC. The fiscal framework is completed with a group of less significant taxes: a net wealth tax, a capital transfer tax and specific taxes on certain forms of consumption.[2]

The gradual introduction of this new framework over the last 15 years has taken place in conjunction with a substantial transformation of the Spanish public sector. The main changes can be summarized as follows:

- Tax revenue, which in 1977 represented 21.5 percent of GDP, was 32.8 percent in 1988. Despite this rather hefty increase, Spain (together with Greece and Portugal) is one of the European countries with the lowest tax burden, i.e. eight points below the EEC average, which in 1988 was 40.8 percent of GDP.
- Public expenditure, which represented 27.5 percent of GDP in 1977, reached 4.1 percent of GDP in 1988. The size of the Spanish public sector has also expanded considerably, moving closer to the European average, which in 1988 was 49.9 percent of GDP.
- The growth of the public sector in this period was accompanied by a marked decentralization of public expenditure in favour of regional and local government and to the detriment of central government. Central government lost about ten percent of its share of total public expenditure over the last ten years.
- The public deficit grew substantially until 1985, when it was 6.9 percent of GDP. After that year it fell steadily until 1988, reaching 2.0 percent of GDP. Subsequently, it stabilized around that level.

The freedom of action of taxation policy is therefore severely restricted by the need to continue reducing the public deficit. This is necessary to increase the overall savings rate and to fulfill the convergence requirements imposed by the process towards the European monetary union. The increase in the tax burden implies that further reductions in the public deficit should be achieved by containing public expenditure rather than by increasing tax revenues.

IV. THE CURRENT TAX REFORM

The current reform focuses on the taxation of individuals and was brought about by several factors:

- The decision of the Constitutional Court of 20 February 1989, which allowed family members to be taxed separately. Similar to what took place in Germany and Italy, the Constitutional Court concluded that economies of scale produced in a family unit were not a sufficient reason to set the family as the basic unit upon which to tax economic capacity. Consequently, the Court ruled that joint family taxation could not be more burdensome than separate taxation of each family member.
- Fiscal competition in the EEC. Given the freedom of movement of capital under the new framework, the incentive for a member state to set an effective tax on a non-resident's unearned income lower than that of EEC countries in order to capture the greatest volume of savings from abroad, is indeed very strong. In this respect, the Spanish tax system cannot remain on the sidelines of the changes taking place in Europe. It is imperative to create the appropriate tax environment in order to retain national savings and attract foreign capital.
- Past experience with the operation of the individual tax system. Application of the system revealed the practical difficulties of certain taxes without due regard to the scarce resources of the tax administration.
- The extent of tax fraud.

After an intense debate with representatives of social organizations, resulting in more than 300 replies to a questionnaire about the reform, a White Paper was produced with an initial proposal of fiscal reform which was the base of the system that eventually appeared as the Personal Income Tax and the Wealth Tax Bills.

The date initially planned for both Bills to come into force was 1 January 1991. However, the Government had to delay implementation until 1 January 1992 because of the extended Parliamentary debate on these laws. However, the two bills have attracted the highest level of political consensus ever attained by a tax law since the beginning of the present democratic period in 1976.

The primary goals of the reform are as follows:

- To keep total tax revenue as a share of GDP at present levels in order to guarantee the necessary increase in public savings. This objective can be compatible with a reduction in per capita tax revenue as a result of the expected enlargement of the tax base.
- To shift the balance of the fiscal burden from personal income to consumption and corporate taxation.
- To eliminate tax distortions by reducing top marginal rates of tax on income and by broadening the tax base by reducing tax expenditure.
- To improve horizontal equity.

As far as the individual income tax is concerned, the main modification concerns the change in the taxable unit. However, for reasons of simplicity, and given the socio-economic and legal realities in Spain, joint taxation has been retained. For many Spanish families, joint filing will continue to be more beneficial.

The modifications to the taxation of income from capital result from a desire to achieve more neutrality and efficiency by reducing distortions caused by the differential tax treatment of different types of income, to encourage the level of savings of Spanish families and particularly to avoid the outflow of domestic and foreign savings to foreign financial markets.

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1. J. Pechman, "Why we should stick with the income tax", *The Brookings Review* (Spring 1990).
2. These taxes correspond to the State tax system. In addition, there is a regional and a local tax system, and a fairly well developed social security system.

The new income tax introduces several regimes to achieve these objectives: the popular savings plan whose yields are exempt from taxation; more favourable treatment of pension plans; a tax-free allowance for income earned from financial investments; and simplification of the taxation of capital gains and losses. Capital gains will be taxed in a manner similar to the other EEC countries, as there will be no need to declare capital gains obtained from small transfers, and long-term capital gains will not be taxed at all. Additionally, there will be an increasing exclusion rate depending on the length of time the asset was owned.

The taxation of businesses and professionals has also undergone significant changes in order to achieve better coordination with the corporation tax and to improve compliance by substituting the present method of calculation of profits (which is neither technically nor economically correct) by another method based on objective indices.

Concerning the tax schedule, the Government is aware that the current maximum marginal rates may induce significant distortions in economic decisions and may even be a disincentive to pay tax. As a result, the progressivity of the tax will be significantly reduced from the existing maximum marginal rate of 56 percent to 53 percent in 1992, and to 50 percent in 1993. The level of income at which this rate starts is also increased by more than the inflation rate. Finally, for families opting for joint filing, the excess burden that the progressivity of the schedule would imply is corrected by means of a second schedule.

Freedom in the international movement of capital within the EEC is also taken into account in the new income tax, with a view to encouraging foreigners to transfer their savings to Spain and to prevent the use of certain financial centres to avoid taxes. To achieve this goal, interest income and capital gains derived from assets in Spain by residents of other EEC countries will not be subject to tax unless they are obtained through certain listed tax havens.

The new wealth tax concludes the emergency and temporary nature of the previous tax. Its redistributive nature is somewhat reinforced and a more realistic valuation of wealth is introduced, while maintaining its traditional control function.

Spain currently has a corporation tax comparable to that of other western countries, with the advantage of having one of the lowest nominal rates in the OECD. Although the corporation tax has recently been adapted to the new mercantile legislation and to the reform of the individual income tax itself, other measures will still need to be introduced to conform to EEC fiscal harmonization. This will affect significant aspects of company taxation, such as mergers and the relationship between holding companies and subsidiaries.

The future modifications of indirect taxation will be influenced by the actual experience with the existing system and by EEC directives that are being adopted in this area. Specifically, the Spanish VAT structure faithfully respects the theoretical EEC model, with one of the lowest general tax rates in the EEC. For this reason, adaptation to the EEC directives will not affect the main aspects of the indirect tax system, except for the rates. The reference rates proposed by the EEC in the context of the single market are higher than those currently applied in Spain. Finally, EEC proposals on excise duties may affect the tax structure (wine may have to be taxed) and the rates applied (the rates are generally lower than those applied by other EEC countries).

V. CONCLUSION

These are the main legal changes which have been or are about to be introduced in the Spanish tax system. Nonetheless, experience has proven that to improve the tax system it is not sufficient to merely adopt legislative amendments. A well-functioning administration is also necessary. To this end, the AEAT (Agencia Estatal para la Administración Tributaria) will be established; it will have a more autonomous and flexible status than the present tax administration, and therefore should be more effective in the fulfilment of its objectives. One of the main objectives of the AEAT will be to meet the need for public sector resources in a way which is just and balanced, and which takes into account the new realities of the European internal market.

SPANISH POLICY ON INTERNATIONAL FISCAL RELATIONS

Miguel Cruz Amorós

Director General for Taxes

This article examines the evolution of Spanish policy on international fiscal relations since 1978 (the year of the major tax reform that established the main features of the current Spanish income tax system), particularly in respect of the taxation of non-residents and how the tax system affects double taxation agreements.

Mr. Miguel Cruz Amorós holds a Master's Degree in Law from the Universidad Complutense, Madrid, and a Master's Degree in European Community Law from the Centre of Constitutional Studies.

In 1973 he became a member of the Corps of Fiscal Inspectors of the State, assigned to the Finance Delegation of Barcelona.

Between 1981 and 1986 he was Deputy Director General at the Studies Department of the General Directorate of Taxes of the Ministry of Finance.

Since 1987 he has been Director General for Taxes of the Ministry of Finance.

A lecturer and regular contributor of articles on fiscal matters, Mr. Cruz Amorós is a member of the Counsel of the Spanish Association on Financial Law and President of the Foundation for the Promotion of Financial Studies.

I. THE TAX REFORM OF 1978: TAXATION OF NON-RESIDENTS

Non-residents are liable to income tax in respect of their income derived from Spanish sources.

Fiscal residence is defined in Law 44 of 8 September 1978 on the Income Tax on Individuals, and is based on physical presence in Spain for more than 183 days in a calendar year. Normal absences from Spain are not taken into account in computing the 183-day period if the circumstances indicate that the taxpayer intends to return to Spain and that the absence will not exceed three years. Law 61 of 27 December 1978 on corporate taxation defines the fiscal residence of legal entities by reference to either the place of incorporation, the place where the head office is located, or the place of effective management.

Under both laws, non-resident individuals and corporations are subject to tax on Spanish-source income by virtue of their economic attachment to Spain (e.g. place of performance of activities, use of capital, location of assets, residence of the payer, etc.).

Under the 1978 system, three categories of income were relevant for non-residents: business income derived through a permanent establishment, income (other than capital gains) derived without a permanent establishment, and capital gains. Different rules for the computation of taxable income were applied to each category.

The definition of permanent establishment is similar to the definition found in the OECD model treaty. A non-resident taxpayer is deemed to have a permanent establishment in Spain if it has an installation or workplace in Spain, or a building site lasting more than 12 months, or an agent or representative authorized to conclude contracts in his name. Income derived through a permanent establishment was taxed on a net basis and computed as the difference between gross receipts and necessary expenses incurred in relation to those receipts.

In general, capital gain is the difference between the value at the time of acquisition and the sales price of the asset. Capital gains derived by non-residents were computed in accordance with the same rules that applied to resident taxpayers. Thus the taxable base could be reduced depending on the length of time the seller owned the property.

Non-resident individuals and companies without a permanent establishment in Spain that derive income from the Spanish territory were subject to tax on a base obtained as a given percentage of gross income depending on the sector of activity.

Initially, non-resident taxpayers were taxed on an overall base computed by reference to the fiscal year. Individuals were subject to the Spanish progressive income tax on all income and capital gains derived in Spain or paid by a legal entity resident in Spain. Non-resident companies were subject to tax at the general rate of the corporate tax (35 percent).

The main thrust of the 1978 reform, which established a comprehensive system of taxation by abolishing the schedular tax system and replacing it with a progressive system of taxation for individuals and a flat rate system for companies, was to take account of the most pressing political concerns of the time, including taxation in conformity with the general economic capacity of the individual. Spain's international business relationships were rather limited in scope in 1978, so international aspects of the reform were a low priority. The detailed non-residents' regime has been the subject of extensive criticism, particularly because of the loopholes in the legislation.

The first significant changes to the non-resident regime were introduced in 1983. Royal Decree-Law 24 of 29 December 1982 introduced a specific system for the taxation of Spanish-source income derived by non-resident individual and company taxpayers without a permanent establishment in Spain. Under the revised regime each item of income is taxed separately, i.e. liability to tax arises upon the total or partial accrual of income liable to tax, without reference to a fiscal year. The new rules also provide for a flat and final tax on such income, regardless of the legal status of the recipient. The general tax rate applying to income derived by a non-resident without a permanent establishment was 16 percent, but this rate has progressively increased in subsequent Budget Laws, and currently stands at 25 percent. Reduced rates apply to particular items of income.

Taxation at different rates, depending on the legal status of the recipient, continues to apply to income derived by a non-resident through a permanent establishment and to capital gains. The 1988 Budget Law completed the process begun in 1983; Spanish-source permanent establishment income and capital gains derived by both individuals and companies are subject to income tax at the rate of 35 percent.

Regulations issued in 1983 contain administrative rules for the taxation of income derived by non-residents without a permanent establishment. The procedure, which still applies, requires the approval of the government agencies responsible for exchange control, and requires that the tax return be cleared by the tax administration before any funds are remitted abroad. The return must be filed and signed by the non-resident's appointed representative or, if there is no representative, by the payer of the income. The representative and the payer are jointly liable for payment of the tax due. This procedure has significantly helped to improve taxpayer compliance, although it has also contributed to delays in the administration of the non-resident regime.

II. RECENT CHANGES

Spain's entry into the global market place, advanced by its membership in the EEC and the liberalization of capital flows, compelled a reform of the taxation system applicable to non-residents in order to attract more foreign capital and to provide the requisite measures to prevent and counter tax avoidance schemes.

Among the measures adopted is the exemption (as of 1 January 1991) of interest and gains from the alienation of movable property, derived by residents of other EEC countries. The exemption does not cover capital gains arising from the disposal of shares in corporations whose assets consist mainly of real property situated in Spain, or capital gains derived from the alienation of a substantial participation (i.e. a participation of 25 percent). Nor does the exemption apply to income derived in certain countries or territories which are listed as tax havens by the government.

The limitation of the exemption to a specific geographic area (i.e. EEC countries) implies liability to tax as a general rule, which is waived only when the foreign tax administration certifies the residence of the recipient. This is intended to ensure that granting the exemption does not inhibit the tax administration's ability to control international capital flows, whose opacity is increasingly perceived as a cause of instability in the financial markets.

III. 1992 TAX REFORM

The 10 February 1989 ruling of the Spanish Constitutional Court against the assessment of income tax on the basis of the aggregated income derived by all members of the family unit necessitated an in-depth reform of the individual income tax system. In this context the tax regime for non-residents was also examined.

The Law on the Individual Income Tax, passed by Parliament on 6 June 1991, will enter into force on 1 January 1992. It maintains the general structure of the non-resident regime as described above, introducing necessary modifications to meet the changes in the international context.

The most important changes of the new law are summarized below.

A. *Definition of fiscal residence*

The criterion of physical presence is supplemented by a new criterion, the centre of vital interests (i.e. economic or professional interests) of the taxpayer. In addition, an individual will be deemed to be a resident if other members of his household have their habitual abode in Spain, unless proven otherwise.

The purpose of the new definition of fiscal residence is to counter tax avoidance schemes where taxpayers establish a fictitious residence in low-tax countries. Residence based on the sole criterion of physical presence proved inadequate and its application will be increasingly difficult given the progressive abolition of frontiers in the EEC.

B. *Scope of limited liability*

With respect to individuals, the law provides an exemption for interest and movable capital gains derived by residents in EEC countries (see above).

C. *Taxation of permanent establishments*

The Law introduces a surtax of 25 percent on the after-tax corporate profits of a permanent establishment. This surtax substitutes for the tax on dividends payable by foreign companies that was never brought into effect. Initially, the corporate tax law provided that any profits distributed by non-resident companies operating in Spain through a branch office would be taxed as dividends. This provision never came into effect. Most double taxation conventions concluded by Spain preclude this kind of taxation; hence it can only apply to permanent establishments of companies resident in countries without a treaty, or under treaties with countries which impose this type of surtax (e.g. the branch profits tax in the United States). The aim of the surtax is to provide a level playing field for the foreign operations of Spanish enterprises in relation to foreign enterprises doing business in Spain.

1. Taxation of real property

Real property held by non-resident legal entities will be subject to a special tax levied at the rate of five percent on the cadastral value of the property. This tax will not apply, however, when the non-resident company carries on a continuous business in Spain, other than the exploitation of real property. Further, the tax will be waived if the legal entity discloses the identity of its shareholders, members or participants.

The special tax is intended to counter tax avoidance in respect of real property through interposed entities set up in low-tax jurisdictions, a practice which has steadily increased over the past few years.

2. Gains from the alienation of real property

When non-residents dispose of real property, the purchaser will be required to withhold tax at the rate of ten percent of the sale price, on account of the tax due by the seller on the related capital gain.

3. Thin capitalization

The Law introduces rules to prevent thin capitalization. The rules are based on the application of ratios which will be specified in regulations.

4. Double taxation of dividends

Spanish companies holding a substantial participation (25 percent or more) in foreign subsidiaries will benefit from the new regime. Such companies receiving dividends from foreign subsidiaries will be allowed a credit in respect of the corporation tax paid by the subsidiary to its country of residence in an amount relating to the dividend received (i.e. credit for the underlying taxes).

After the new law enters into force the tax administration will issue regulations for the administration of the non-resident regime with a view to improving its effectiveness in an economy open to international economic exchanges.

IV. DOUBLE TAXATION AGREEMENTS

One of the fundamental priorities of Spanish fiscal policy is the negotiation of double taxation agreements in order to expand the treaty network to countries maintaining economic relations with Spain, and to renegotiate, as necessary, existing treaties so that they conform to the new economic and fiscal guidelines. Spain has currently entered into 26 treaties.[1] One draft convention is being discussed by Parliament (Philippines),[2] two treaties have been signed and are ready to be sent to Parliament for ratification in the near future (China and Ecuador); and five treaties have been initialled (Australia, Ireland, India, Indonesia and Yugoslavia). Spain is presently negotiating with Mexico, Chile, Turkey and Thailand, and renegotiating the existing conventions with the Netherlands, Finland and France.

The Spanish position in the negotiation of double taxation treaties has traditionally been that of a net capital-importing country. Most Spanish conventions with OECD countries allow source taxation of dividends paid to a parent company at the rate of ten percent, in accordance with Spain's reservation to the 1977 OECD model convention, which provides for a maximum rate of five percent in respect of such dividends. The rate applying to other dividends is 15 percent,[3] the same as that provided in the OECD model.

The withholding tax rate applicable to interest is, in most cases, ten percent, the ceiling set forth in the OECD model, although some treaties grant an exemption at source in respect of certain types of interest (interests on public credit, commercial credit or long-term bank loans).

In accordance with Spain's reservation to the OECD model, which attributes the taxation of royalties solely to the country of residence, Spanish treaties have maintained source taxation of royalties at rates ranging from five to ten percent. A provision attributing the sole right to tax cultural royalties to the country of residence is found in certain treaties.

The method used to eliminate double taxation by the country of residence of the investor is the ordinary credit method which favours fiscal neutrality in respect of a decision to invest abroad.

V. CONCLUSION

The recent changes in the taxation of non-residents (although generally limited to residents of EC countries) will ultimately lead to a revision of the traditional Spanish position in the negotiation of double taxation treaties. Contributing to this change in policy will be pressure from third countries, seeking to maintain their own competitive position in bilateral relations with Spain.

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1. Austria, Belgium, Brazil, Bulgaria, Canada, Czechoslovakia, Denmark, Finland, France, Germany (Fed. Rep.), Hungary, Italy, Japan, Luxembourg, Morocco, Norway, the Netherlands, Poland, Portugal, Romania, Sweden, Switzerland, Tunisia, the USSR, the United Kingdom and the United States.
2. A draft treaty has been signed with Greece, pending review of certain technical aspects.
3. As a sole exception, the Convention with the USSR provides for taxation at source of dividends at the rate of 18 percent in all cases. See Spain–USSR treaty of 1 March 1985, Art. 8(1).

SPAIN:

COMPREHENSIVE TAX REFORM

A NEW APPROACH TO THE INDIVIDUAL INCOME TAX, THE NET WEALTH TAX AND LOCAL TAXES

M.-A. García Caballero

Principal Research Associate – Head of the Americas and Africa Division of the IBFD

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I. INTRODUCTION

In a decision of 20 February 1989 the Spanish Constitutional Court declared several provisions of the Individual Income Tax Act ("LIRPF") unconstitutional. These provisions prescribed the mandatory aggregation of all income in a household and required each household to file a joint tax return. In its decision the Court instructed Parliament to make the necessary tax amendments. Parliament first patched up the LIRPF and Net Wealth Tax for the tax years 1988 – 1991.[1] On 30 May 1991 Parliament passed the final Individual Income Tax ("IRPF") and Net Wealth Tax ("IP") Reform Bills. The goal was to obtain as broad a social consensus as possible after the bills were published in the Congressional Record of 4 August 1990. Both Bills were the subject of further debate and amended accordingly; they were finally enacted on 6 June 1991 as Law 18/1991 ("LIRPF") and Law 19/1991 ("LIP"). Under the new IRPF, taxpayers are required to file individual returns in order to be taxed separately; however, resident taxpayers who are members of the same household have the option to file a joint tax return for the household. In all cases, the IP return must be filed separately by the owners of the underlying assets.

1. The patchwork was basically made by means of Law 20/1989 of 28 July (for the tax years 1988 and 1989), whose provisions were retained with a few cosmetic changes for tax years 1990 and 1991 by urgent tax measures Laws 5/1990 of 29 June and 17/1991 of 27 May.

In addition, the amended IRPF reduces the tax burden for all taxpayers. The reduction is approximately 20 percent for households with only one income earner, between 6 and 7 percent for households with two income earners and between 5 and 6 percent for unmarried taxpayers.[2] The amended IP reduces the tax burden only for taxpayers whose net wealth is below 110,000,000 Ptas.

Through some further provisions the LIRPF has produced a series of important amendments in respect of the corporate income tax. These amendments (which are outside the scope of this article) include:

- endorsement of the unilateral price adjustment in intercompany transactions as consistently upheld by the tax administration;[3]
- introduction of an anti-avoidance rule in respect of thin capitalization;[4]
- introduction of an underlying foreign tax credit for substantial participations;[5] and
- amendment of the fiscal transparency regime in respect of the tax treatment of the company's non-resident members[6] and the tax treatment of transparent chain companies.[7]

The new IRPF and IP will enter into force on 1 January 1992. The IRPF will apply in respect of actual or imputed income and capital gains/losses arising as of 1 January 1992, as well as income accruing thereafter by virtue of the allocation rules of the former income tax legislation.

The discussion below is intended to provide readers with a practical approach to the new legal framework of the IRPF, the IP and the new local tax system.[8] Accordingly, this survey first describes the reformed individual income tax system, dealing separately with resident taxpayers and non-residents. It then focuses on the reformed net wealth tax system and various local taxes.

II. TAXABLE PERSONS

An individual who is a resident of Spain is liable to IRPF in respect of his worldwide income, regardless of the residence of the payer.

An individual is deemed to be a resident of Spain for tax purposes if:

(a) his stay in Spain exceeds 183 days in any calendar year;[9] or
(b) his centre of vital interests (i.e. his economic interests or business or professional activities) are in Spain; or
(c) his (non-legally separated) spouse and minor dependent children qualify as residents of Spain under "a" or "b" above (unless the taxpayer can prove that he is resident in another country).

For tax purposes a household consists of a husband and wife and their minor (under 18 years of age) children (unless living apart with parental consent). In the case of unmarried parents or legally separated spouses, the dependent minor children form part of the household of the custodial parent.

For details on non-resident taxpayers, see V.

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2. From a lecture given by Mr. M. Cruz Amorós, Director General of Taxes, at the Menéndez Pelayo International University in Santander on 4 July 1991.

3. The controversial issue concerning "unilateral" versus corresponding or symmetrical adjustment of non-arm's length transfer pricing in intragroup transactions in Spain has been resolved in favour of the tax administration by the reformulated Art. 16(3) of the Corporate Income Tax Law, thus endorsing the unilateral method of adjustment which has been upheld by the Spanish tax administration.
The tax administration has consistently interpreted the rule of Art. 16(3) (which provides that transactions between related enterprises in Spain be valued for corporate tax purposes at arm's length prices) as allowing only the unilateral or asymmetrical adjustment of intra-group real transfer prices in Spain to arm's length prices, i.e. only where such adjustment results in a greater taxable base (i.e. more profits or less deductible expenses than those shown on the profit and loss statement) and therefore a greater tax collection.
Under the amended Art. 16(3), a corporate taxpayer may apply a corresponding adjustment on his self-assessment return, regardless of whether the result is an increase in profit or reduction in expenses (i.e. a greater taxable base through "positive" adjustments) or reduction of profits or increase in expenses (i.e. a lesser taxable base through "negative" adjustments). However, where the voluntary period to file the tax return has expired and the tax administration proceeds to adjust the valuation of transactions between related enterprises, such adjustment will be unilateral (i.e. the adjustment may not result in either a reduction of taxable income or an increase in expenses) for either party.
The unilateral method of adjustment is an imperative rule of valuation which applies to any transactions between the following:
(i) a resident company (or permanent establishment) and a directly or indirectly related non-resident company (or permanent establishment), unless a tax treaty provides for corresponding adjustments;
(ii) a company that owns, directly or indirectly, a substantial participation (25% or more) or exercises control over another company;
(iii) companies which are members of a corporate group (majority voting rights or exercise of control).
Under the Spanish tax treaty network (currently 25 tax treaties), only the treaties with Canada, Czechoslovakia, Poland, Romania, Sweden and the United States include a mutual agreement provision to eliminate double taxation by means of corresponding adjustments.

4. In general, a Spanish company may receive foreign-source loans without limitation. However, pursuant to (new) Art. 16, para. 9 of the Corporate Tax Law, if the lender is a related enterprise which is non-resident in Spain and the amount of the loan exceeds the borrowing company's equity capital multiplied by a certain coefficient (to be established in a forthcoming regulation), then the interest paid on the excess will be treated as dividends for tax purposes. This means that the interest on the excess is not deductible for Spanish corporate income tax purposes and the payment to the non-resident lender will be subject to the Spanish withholding tax applicable to dividends, as modified in the tax treaty.
For example, if the equity capital (paid-in capital plus reserves) is 100,000,000 Ptas., the appropriate coefficient is 2 and the loan from a non-resident related party is 250,000,000 Ptas., then the interest on 50,000,000 Ptas. is not deductible but is subject to dividend withholding tax.

5. Under the amended Art. 24(5) of the Corporate Income Tax Law, where a Spanish parent company holds a 25% or more interest in a foreign subsidiary, the parent may credit not only the foreign withholding tax paid on the dividends in order to avoid international juridical double taxation (i.e. dividend credit), but also the amount of foreign corporate tax attributable to the subsidiary's profits out of which the dividends were paid (i.e. credit for underlying tax). The foreign tax effectively paid in respect of the distributed profits of the non-resident subsidiary must be included in the tax base of the resident parent company and the credit for the aggregate of the foreign corporate income tax and the withholding tax on the distributed profits is subject to the customary limit, i.e. the Spanish tax attributable to the profits if they had been derived from domestic sources.

6. A resident transparent company with non-resident members constitutes a mixed or partially transparent company. Its taxable base is divided into two parts according to the proportion of capital held by resident and non-resident members. The first part is imputed to the resident members under the normal fiscal transparency regime; the second part is taxed under the general corporate tax rules. Dividends and other profit distributions to the non-resident members are taxed as such according to the general rules for non-residents and the applicable treaty provisions.

7. Any interposed transparent company which is a shareholder or member of another transparent company is penalized by being subject to the general corporate tax regime but at the highest marginal IRPF rate (i.e. in 1992, 53% instead of 35%).

8. The reformed legal framework of the local tax system is set forth in Local Finance Act (Law 39/1988 of 28 December, as amended).

9. Note that computation of the taxpayer's period of stay in Spain does not take into account his temporary absences from Spain, unless the taxpayer can prove to the tax administration that he maintains his habitual abode in another country for 183 days or more in that year.

III. RESIDENT TAXPAYERS

A. *Taxable base*

1. Taxable event

The receipt of income constitutes the taxable event. Income encompasses income from five basic categories according to the source or origin:
(a) income from employment;
(b) income from capital (i.e. from movable and immovable property);
(c) business or professional income;
(d) capital gains; and
(e) positive imputed income under the fiscal transparency regime.

For computation purposes, the taxpayer's income is classified and broken down into ordinary income and irregular income (see below).

As a general rule, income is taxable in the year of accrual and related expenses are deductible in the year incurred, regardless of when receipt and payment occur. Income spreading is not allowed except for gains derived from instalment sales or deferred payments (but not life or temporary annuity arrangements), in which cases the taxpayer may apportion the gains to the tax years in which the payments are received. The taxpayer may elect, however, to allocate the entire amount of income to the tax year of the transfer.

2. Exempt income

The following items are exempt from IRPF:
(a) qualifying prizes;[10]
(b) indemnities for permanent disability recognized by the social security or a similar agency and unemployment benefits recognized by the unemployment board;
(c) extraordinary public indemnities to victims of terrorism;
(d) invalidity and permanent disability pensions for public servants;
(e) mandatory indemnities received as severance pay or for termination of employment up to the maximum legal amount (45 days pay for each year of service to a maximum of 42 months salary);[11]
(f) indemnities for injuries in the statutory amount or under a court order, and the first 25,000,000 Ptas. indemnity received under an insurance policy;
(g) public scholarships to earn a university degree (but not a doctorate);
(h) court-ordered children support;
(i) public allowances received for home care of disabled persons or persons over 65 years of age;
(j) Spanish-source income from sea and/or air transport enterprises (as expressly granted under international reciprocity by the Minister of Economy and Finance);
(k) interest from qualifying investments in savings plans (maximum 10,000,000 Ptas.) created by a maximum annual instalment of 1,000,000 Ptas. (including the capitalized interest) and retained for at least five years after the investment; and
(l) capital gains qualifying for exemption (see below).

3. Taxable income

For IRPF computation purposes, the taxpayer's income from the different categories is broken down into two basic components, ordinary income and irregular income.

Ordinary income comprises any income which is not classified as irregular, and in respect of irregular income, the amount resulting by dividing the total irregular income by the number of years over which the income accrued, or five years if the actual period of accrual is unknown.

The net amount of ordinary income is the balance resulting from the computation of the positive less negative amounts of ordinary income under the different categories, plus any positive amounts of imputed income from companies under the fiscal transparency regime, plus the positive balance of ordinary capital gains less losses for the year, plus the averaging of irregular income from employment, capital and business or professional activities, less the average negative amount of irregular income from business or professional activities. The resulting amount constitutes the ordinary taxable base portion.

Irregular income[12] is (i) income from any category or source, i.e. income from employment, capital or business or professional income (negative net ordinary business or professional income, however, is excluded) which is derived by the taxpayer either over an irregular period of time, or if regularly derived, if its accrual period exceeds one year; and (ii) capital gains or losses from the disposal of assets (other than those attached to the taxpayer's business or professional activities) owned for more than one year before the transfer; and preemptive rights to a share subscription owned for more than one year.

In order to mitigate the effects of the progressive tax rates, when determining the net amount of irregular income under (i), the amount of irregular income is split into two portions:
- the annual average portion, which is the amount resulting from dividing the net total of each type of irregular income by the number of years over which the irregular income accrued or five years if the actual accrual period is unknown. The result is treated as ordinary income for calculating income tax liability at progressive rates; and
- the remaining portion of irregular income, which is included in the taxpayer's irregular taxable base component to be subject to IRPF at the appropriate average rate (see below).

The calculation of annual net income under the different categories is discussed below.

B. *Types of taxable income*

1. Income from employment

Income from employment comprises any emoluments or benefits in cash or in kind which arise directly or indirectly

10. Qualifying prizes comprise those from the National Lotteries and Betting Organization, those organized by the Regional Communities, from the ONCE (National Organization for the Blind), from Spanish Red Cross raffles and for significant literary, artistic or scientific work as defined by the Ministry of Economy and Finance.
11. Note, however, that the entire amount becomes fully liable to tax if the taxpayer is newly hired within the next three calendar years either by the former employer or by any associated enterprise under a parent-subsidiary relationship.
12. Examples of irregular income are the following:
- the lump sum received by an employee from his private pension plan or the voluntarily agreed lump sum received upon termination of employment;
- proceeds received by a soccer player to sign up for a club for a certain number of years;
- proceeds allocated to the participants upon dissolution or liquidation of a private pension plan or to the insured upon redemption or surrender of a life or capital insurance contract;
- the positive balance of sales proceeds received in the current year by a lumber merchant from felling trees grown over a period of years.

from the rendering of dependent services by the taxpayer and which do not constitute business or professional income; for example, public servants, employees, pensioners in general, directors, managers, administrators and ministers of any religion.

If spouses file separate returns, irrespective of their marriage regime, employment income (excluding pensions) and related deductions are attributed exclusively to the direct earner.

(a) *Types of employment income*

(1) *Salary*

The concept of salary comprises earnings from dependent services as follows:
- salaries, wages and complementary amounts;
- bonuses, incentives and extra pay;
- non-exempt indemnities, pensions and passive income;
- remuneration for representation expenses;
- family grants, subsidies and non-exempt scholarships;
- allowances for travel expenses (excluding those relating to transportation and the exempt subsistance allowance);
- any special rights with an economic entitlement reserved by a company's promotors or founders as remuneration for their services;
- amounts received from private pension plans or alternative schemes unless subject to inheritance tax;
- directors' remuneration derived by individuals in their capacity as members of a corporate management body and any amounts attached to to special (freely negotiated under labour law) contracts (i.e. a part-time manager);
- amounts received by members of the National or Regional Parliaments, town councillors and members of the provincial government bodies for discharge of their duties;
- amounts received by Spanish members of the European Parliament and remuneration of Spanish officials in international organizations, subject to treaty provisions;
- amounts received by ministers of legally recognized religious organizations for the discharge of their duties; and
- non-exempt alimony payments.

Salaries and wages are subject to withholding of IRPF according to the general tax table (see Table A below).

(b) *Benefits in kind*

Benefits in kind comprise the use, appropriation or receipt for private purposes of goods, rights or services either free of charge or at prices below market price, even where there is no actual charge to the employer/supplier. The following are deemed benefits in kind:
- rent-free accomodation by reason of holding an office or a public or private employment;
- free supply or use of a private automobile;
- interest on loans below the prevailing legal rate set by the Ministry of Economy and Finance;
- lodging and pleasure travel allowances and similar allowances;
- insurance premiums or contributions paid by the employer (excluding, however, premiums for work accident insurance or third party civil liability insurance);
- employer's contribution to the employees' private pension plan or alternative schemes imputed to the employees/beneficiaries; and
- study and subsistence allowances for the taxpayer or members of his family (excluding in-house courses directly organized and financed by the employer).

A benefit in kind is computed by its value plus the related withholding made by the employer. The income so calculated is net income; thus it cannot be taken into account in calculating the notional expense deduction (see below).

Benefits in kind are valued at cost for the employer (including related taxes) or at market price with three exceptions:
(i) the rent-free use of residential accommodation is equivalent to the actual rent paid by the employer for leased residences, or two percent of the updated cadastral value of the residence for net wealth tax purposes. The amount of imputed income may not, however, exceed ten percent of the employee's remaining remuneration;
(ii) the free supply or use of a private automobile is equal to the cost (including related taxes) to the employer, in the case of a free supply, or 15 percent of the cost to the employer on an annual basis if the employer owns the vehicle, or the amount paid by the employer to lease the automobile. If the car is first freely used by and then supplied to the employee, the free supply is valued at market price;
(iii) the interest on loans below the legal rate is equal to the difference between the interest actually charged and the prevailing legal interest rate.

(c) *Pensions*

Pensions are generally treated as income from employment and are attributed to the individual beneficiaries. The concept of pension comprises pensions and "passive" benefits paid by the social security fund, employee mutual insurance societies and funds and private enterprises and any state subsidies (e.g. for old age, widows and orphans), regardless of who was originally entitled to receive the pension.

Pensions are subject to withholding of IRPF at rates currently ranging from zero percent (for an annual pension of 993,000 Ptas. or less) to 41 percent (for an annual pension exceeding 16,538,000 Ptas.).

The maximum amount which can be contributed annually by each individual participant in a private pension scheme is 750,000 Ptas. (including any employer's contribution which is then imputed income for that participant). Instalment payments from a private pension plan are taxed as ordinary employment income and a lump-sum payment, as well as any proceeds received upon dissolution or liquidation of a private pension plan, are taxed as irregular income (see above).

(d) *Directors' remuneration*

Fees and any other remuneration earned by resident individuals in their capacity as members of the board of directors or other management bodies are treated as employment income. They are currently subject to a 30 percent withholding tax which is a payment on account of final income tax. Remuneration earned by a director who is employed full-time as a manager is subject to the general withholding table. For remuneration paid under a special (freely negotiated under labour law) employment contract to senior executive officers, the minimum withholding rate is currently 15 percent.

(e) *Travel expense allowances*

Amounts received as compensation for travel expenses are treated as employment income, including any allowance for travel between home and work, even if the travel is between

two different municipalities. However, as from 1 April 1991 the following are not subject to IRPF:
- if the employee proves he has travelled, then the duly documented travel expenses; if he proves he has travelled but does not substantiate the expenses, then 22 Ptas. per km.;
- in respect of daily subsistence expenses, if the expenses are duly documented, a maximum daily allowance of 33,500 Ptas. for travel within Spain, and 55,400 Ptas. for travel abroad. If such expenses are not substantiated, the daily allowances are 11,250 Ptas. and 20,500 Ptas., respectively. The amounts are reduced to 3,250 Ptas. and 7,000 Ptas., respectively, where the employee stays overnight in the municipality in which he normally works or lives.

2. Deductions

In computing net employment income, a taxpayer may only deduct the following:
(a) his compulsory contributions to the social security system;[13]
(b) his contributions to compulsory public employee mutual insurance societies, to orphans' societies and similar institutions, and trade union dues; and
(c) five percent of gross earnings (excluding the employer's contribution to the taxpayer's private pension plan), as notional expenses, up to a maximum of 250,000 Ptas. (15 percent of the gross earnings up to a maximum of 600,000 Ptas. for disabled employees).

The sum of contributions to compulsory mutual insurance societies covering death risks and the total contribution to the taxpayer's private pension plan added together constitute a limited deductible allowance in determining the ordinary assessable base component (see below).

C. *Income from capital*

Income from capital comprises any returns or consideration arising directly or indirectly from assets, property or rights which are held by the taxpayer and which are not attached to the taxpayer's business or professional activity. Income from capital encompasses, more precisely, investment income and income from (urban and rural) immovable property.

If spouses file separate returns, income from capital and related deductions are attributed to the individual owners of the underlying property items according to the marriage regime, as follows:
- under a community property regime, to both spouses on a 50-50 basis, unless another method of apportionment can be substantiated; and
- under a separate property regime, exclusively to the owner or registered holder of the underlying property.

1. Investment income

Investment income includes specifically:
(a) any income attached to a participation in a company's capital;[14]
(b) any income, in cash or in kind, attached to loan capital, including:
– implicit income (the actual difference between the amount paid by the taxpayer at issuance, first transfer or endorsement of securities and the amount to be received by him at maturity), which comprises any securities issued, repaid or redeemed at a premium (premium attached to the issue, repayment or redemption) but excluding any premiums attached to convertible bonds;[15] and
– explicit income (loan-related interest and commissions); and
(c) any other income from movable capital (royalties attached to intellectual works if the taxpayer is not the author; industrial works, technical assistance, unless supplied in the course of business); life or temporary annuities attached to a capital investment by the taxpayer (i.e. if the taxpayer is both the recipient and the investor); and income from life or capital insurance policies of short term or low risk as determined by a forthcoming regulation.

Implicit investment income must be reported in the tax year in which realized by way of transfer or redemption, regardless of the period of accrual. Explicit investment income must be reported in the tax year of accrual, the time of accrual being the earlier of the date on which it is payable to the creditor or the actual time of payment.

Investment income payments in kind are valued at market price (i.e. acquisition price increased by 25 percent), plus the amount withheld (25 percent of market price). The minimum interest rate to be applied on loans between related parties is the prevailing legal interest rate (10 percent for 1991).

(a) *Types of investment income*

(1) *Interest*

In general, a resident individual is liable to IRPF on any Spanish-source interest. The gross interest to be reported is as follows:
- in the case of explicit interest securities, the gross interest in cash and in kind (i.e. including any related withholding taxes); and

13. The Spanish social security system is financed by employers, employees, self-employed persons and the State. All resident employees and self-employed persons must register and pay contributions to the social security system, which consists of a general contribution system and special contribution schemes (e.g. for agricultural workers, domestic servants, seamen and most self-employed individuals).
As far as employees are concerned, the general system classifies employees in professional categories for the purpose of determining their social security contribution. Each category has minimum and maximum contribution bases which are adjusted annually.
The rates for calculating an employee's general social security contributions are, within the minimum and maximum amounts mentioned above, as follows:

– general rate	4.8%
– unemployment insurance	1.1%
– professional education/training	0.1%
	6.0%

A 2% or 4.8% additional charge applies in respect of any overtime pay (including a minimum premium of 75%) for necessary overtime work or other extra work, respectively.
For self-employed individuals (but not soccer players, bullfighters, trade agents and artistes, who fall under the general contribution system), the minimum and maximum monthly bases for 1991 on which the contribution is calculated are 66,780 Ptas. and 306,120 Ptas., respectively; for those who are older than 55 years of age, the maximum monthly base is 162,000 Ptas.
The single rate for self-employed persons calculating their special social security contribution, within the minimum and maximum amounts mentioned above, is 28.8% with a 0.49% reduction on the amount due (i.e. the effective rate is 28.65%).
14. For example, dividends and other distributions, profit-sharing rights and any other income derived from an entity by taxpayers in their capacity as members, shareholders or partners) and the portion of profits derived by a silent partner in a limited partnership.
15. Examples include zero-rated bonds, deep discount or deep gain securities.

- in the case of implicit interest securities involving zero-coupon or deep discount securities or securities at a premium (i.e. securities issued upon the payment of a sum below the amount repayable by the borrower upon redemption or maturity), the positive difference between the consideration paid upon issue, first transfer or endorsement of a security by the taxpayer and the sum repayable by the borrower at maturity.

The standard withholding rate on domestic interest is 25 percent, except for interest paid to residents on Treasury bonds and notes (which is not subject to withholding) and notional interest on AFROs, e.g. deep discount securities (which is subject upon the first transfer by the issuer/borrower to a final withholding of 55 percent calculated on the higher of the actual difference between the consideration received and the sum payable on maturity to the bondholder and the prevailing notional minimum rate of interest fixed by the Ministry of Economy and Finance).

(2) *Dividends and other profit distributions*

Domestic-source dividends and other distributions in cash or in kind (other than stock dividends and proceeds from sales of subscription rights on quoted shares which are tax exempt) declared by companies not subject to the fiscal transparency regime, investment funds and associations are taxed gross, including any withholding by the corporate payer. In the case of a company dissolution, the portion of assets allocated to the taxpayer from retained profits is treated as a dividend or profit distribution.

However, as from 23 March 1989, proceeds from the sale of subscription rights attached to unquoted shares must be declared and computed as a capital gain in the year of transfer.

Gains from the sale of preemptive subscription rights to quoted shares are exempt from tax.

Any corporate entity making a distribution to its individual shareholders, partners or members who are residents of Spain must apply a 25 percent withholding on account of the recipient's income tax. The recipient is, however, granted a 10 percent imputation credit relief (see below).

(3) *Royalties*

Individuals are liable to income tax under category "b" (income from movable property) on payments received in respect of a copyright, patent, trademark or other royalties by a taxpayer who is not the author of the underlying intellectual or industrial work.[16]

The total amount of technical assistance-related payments must be declared without being broken down into the various components.

Any royalties and know-how payments are subject to a withholding tax of 25 percent which is creditable against the recipient's income tax.

Outright sales of patents, trademarks and know-how are subject to 12 percent VAT.

(4) *Annuities*

Only a portion of the annual payment received by a taxpayer under a life or a term annuity contract is exempt from IRPF. Sixty percent of the gross payment of temporary annuities is taxable (investment) income. In respect of payments of life interest, the portion of the gross annuity which is taxable (investment) income ranges from 30 to 70 percent depending on the age of the recipient.[17]

(b) *Deductions*

In computing net investment income, the taxpayer may only deduct administrative and safekeeping charges on securities and the first 25,000 Ptas. of investment income. In addition, the taxpayer may avail himself of a tax-free savings investment plan (maximum 10,000,000 Ptas.) with a maximum annual contribution of 1,000,000 Ptas. (including the capitalized interest) during a ten year period. The taxpayer may withdraw the accrued interest (which is exempt from withholding and IRPF) annually. However, a taxpayer withdrawing any capital before the five year period has expired will lose the exemption (thus triggering all unpaid taxes) and the amount withdrawn will be treated as irregular income if the period of the investment was more than one year. The amount in question is also subject to the pertinent withholding tax. For this purpose, the amount withdrawn is deemed to be the latest amount invested.

In computing net income from rendering technical assistance or from leasing assets, business or mines, the taxpayer may deduct any necessary income-related expenses (including loan-related interest) and depreciation of the underlying assets.

2. Income from immovable property

Income from immovable property includes both actual and imputed rent from real estate not attached to the taxpayer's business or professional activities.

The letting or purchase and sale of immovable property is deemed to constitute a business activity only if the lessor has an office exclusively used as a place of management of the business and the lessor has at least one permanently contracted employee.

(a) *Types of income from immovable property*

(1) *Owner-occupied dwelling*

The amount of income imputed to owner-occupied dwellings is equal to two percent of the updated value of the residence for net wealth tax purposes.

(2) *Other*

The amount of income imputed to any unrented urban buildings (excluding unbuilt sites) which are available to the owner is also two percent of the cadastral value of the building for net wealth tax purposes.

For rented or subleased urban and rural immovable property, the actual amounts (excluding VAT) received by the landlord from the lessee or sublessee (including amounts relating to assets attached to the underlying immovable property) must be included in the owner's taxable income. However, the amount received by the tenant or leaseholder in respect of that sublease or goodwill is treated as a capital gain (see below) instead of income from immovable property.

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16. Note, however, that if the taxpayer is the author of the intellectual or industrial property, the royalties received are treated as business or professional income, as the case may be, and must then be computed as category "c" income (business or professional income).

17. The portion of the gross life annuity which is taxable investment income is
- 70% if the recipient is less than 50 years of age;
- 50% if the recipient is between 50 and 59 years of age;
- 40% if the recipient is between 60 and 69 years of age; and
- 30% if the recipient is more than 69 years of age.

(b) *Deductions*

In computing net income from immovable property, a resident taxpayer may deduct:

(1) in respect of rented or subleased immovable property
   - the related income-related expenses (i.e. maintenance and repair expenses, mortgage interest up to the rent received, local taxes and charges, insurance premiums and general expenses); and
   - a fixed depreciation allowance of 1.5 percent of the value attributed to the building, excluding the related land;[18] and

(2) in respect of unrented urban buildings and owner-occupied immovable property, the relevant municipal immovable property tax and related charges (see below), and for owner-occupied residences a maximum deduction of 800,000 Ptas. (1,000,000 Ptas. for spouses filing a joint return) interest on loans used to finance the purchase or improvement of the taxpayer's first home (mortgage interest for other residences is not deductible).

Rent paid to resident individuals on Spanish-situs immovable property is not subject to any withholding tax.

D. *Business income*

The concept of business income comprises profits from carrying on a trade ("income from entrepreneurial activities") and professional income ("income from professional activities").

1. Types of business income

(a) *Trading income*

Entrepreneurial activities imply the independent conduct by an individual of any economic activity aimed directly at the production or supply of goods or services and include, in particular, farming (agriculture, stock-breeding and forestry), fisheries, mining and quarrying, manufacturing, craftsmanship, construction, commerce and the rendering of services.

The leasing or purchase and sale of immovable property is treated as an entrepreneurial activity only where the real estate lessor or dealer has premises which are used exclusively as the place of management and where he has at least one permanently contracted employee.

(b) *Professional income*

The concept of professional income comprises income derived by an individual in the course of exercising professional or artistic activities.

Professionals are defined as individuals who render independent services in the course of their profession (whether or not they are formally qualified) or who perform a public function without directly deriving public remuneration (e.g. a notary public).[19] Artistes are defined as those persons who either individually or as members of a group perform publicly or privately or constitute or form part of an entertainment or athletic team, as well as those engaging in recreational activities recorded for transmission by radio, television, cinema, tapes or records.[20]

2. Computation of net income

With minor exceptions, the rules on computation of business income are virtually the same for a trader and for an independent professional or artiste.

If the trader or professional is married and the spouses file separate returns, business income is attributed to the individual who regularly and directly conducts the business or exercises the independent profession or vocation (i.e. the spouse who is registered as trader or professional).

As a general rule, business income is computed in accordance with ordinary accounting principles on the basis of the taxpayer's financial statements (i.e. the "direct method" of computation). Under the direct method, traders and professionals may deduct all duly substantiated and necessary income-related expenses, the appropriate allowances for depreciation, doubtful debts, etc. Professionals may deduct one percent of gross receipts as notional expenses and the pertinent tax credits for individual entrepreneurs.

A special computation scheme is available to traders with a low or medium-sized turnover and to professionals.[21]

(a) *Direct method of computation*

Under the direct method, net income must be computed independently in respect of each of the taxpayer's activities. Net income is the balance of gross receipts (including self-consumption of goods or services and any grants or subsidies) less income-related ("necessary") expenses and depreciation of income-related assets. The computation of net income includes capital gains or losses from any assets attached to the taxpayer's business or professional activities and, where applicable, from any inter vivos transfer of the taxpayer's business or professional practice as a whole.

However, an exemption applies to capital gains from the disposal of tangible fixed assets attached to the conduct of the taxpayer's business or professional activities provided the entire proceeds are reinvested in similar assets within the next two years. This period is extended to four years if the taxpayer submits to the tax administration, within the first year following the disposal, a reinvestment plan and he

18. For example, if the officially appraised value of an apartment is 5,000,000 Ptas. and 30% of the value is attributed to the related land, then the annual depreciation allowance would be 1.5% of 3,500,000 Ptas., or 52,500 Ptas.

19. The following are treated as professionals:
- individuals who must register as such for purposes of the municipal tax on economic activities ("IAE"), i.e. lawyers, physicians, engineers, architects, etc.;
- administrators of lotteries, insurance agents, brokers, officials of the National Lotteries and Betting Board, collectors of taxes and rates, representatives and vendors of monopolized products (e.g. tobacco and oil);
- private teachers not receiving a fixed remuneration, and free-lance lecturers; and
- holders of intellectual or industrial property owned by the creator or translator (e.g. painters, sculptors, writers). If the author or translator publishes or sells his intellectual or industrial work himself, the receipts are treated as income from an entrepreneurial activity.

Any remuneration derived by an individual who carries out his functions for an enterprise while on the payroll and who must register with an appropriate professional body is not treated as professional income but as employment income.

20. The following are treated as artistes: individuals who are required to be registered as such for the purpose of the fiscal licence for artistes: singers, actors, dancers, sportsmen and athletes, bullfighters, etc.

21. The current definition of small and medium-sized traders is an annual gross turnover in the preceding year of 50 million Ptas. or less and no more than 12 employees/workers at any time during the year. Low-income professionals are currently those with total gross receipts in the preceding year of 1.5 million Ptas. or less and with no employees/workers.
There is a simplified scheme for very small-scale traders (currently those who in the previous year have no more than two employees nor more than 7,909,000 Ptas. turnover).

reinvests at least 25 percent of the gain within the first two years.

(b) *Special computation scheme*

Traders and professionals who fall under the new scheme (to be regulated by the Ministry of Economy and Finance) must compute their taxable income under the rules of the new scheme unless the special scheme is waived and the taxpayer elects to be taxed according to the direct method.

Under the special scheme, taxable income is computed by reference to factors, modules or parameters (e.g. turnover, persons on payroll, gross purchases, number of square metres or fixed assets used in the premisses) set out either generally or for the listed activities.[22]

E. *Capital gains*

1. Types of capital gains

Capital gains (or losses) are classified into two groups:
(i) ordinary capital gains, i.e. those arising from transfers of property for consideration or by inter vivos gift which has been owned for one year or less, as well as (for tax computation purposes) unsubstantiated capital gains, i.e. unjustified increases of net wealth); and
(ii) irregular capital gains, i.e. those arising from the transfer of property owned for more than one year.

If spouses opt to file separate returns, capital gains or losses are attributed to the individual owners of the property in accordance with the marriage regime.

2. Computation of the taxable amount

(a) *General rules*

The gain or loss on transfers for consideration is computed as the difference between the higher of the transfer price or the market price and the unindexed acquisition cost (i.e. acquisition price plus related expenses (not interest) paid by the purchaser less, if applicable, the accumulated *minimum* depreciation).

The gain or loss on transfers by gift is computed as the difference between the acquisition price and transfer price for inheritance and gift tax purposes.

In other cases, the gain or loss is calculated as the unindexed acquisition price of the related assets or parts thereof.

The gain or loss arising on the transfer of assets attached to the taxpayer's business or professional activity is the difference between the sales price and the net book value. Gain or loss arising on the transfer of assets not attached to the taxpyer's business or professional activity and which are held for more than two years are calculated at a percentage as follows:
- immovable property, rights thereon and shares issued by real estate investment corporations: the net gain is reduced by 5.26 percent for each year of ownership in excess of two years (i.e. only 94.74 percent, 89.48 percent, 84.22 percent, 10.58 percent or 5.32 percent of the net gain is taxable in sales in the 3rd, 4th, 5th, 19th and 20th year, respectively);
- quoted shares, other than those issued by real estate investment corporations: the net gain is reduced by 11.11 percent for each year in excess of two years (i.e. only 88.89 percent, 77.78 percent, 66.67 percent, 22.23 percent or 11.12 percent of the net gain is taxable for sales in the 3rd, 4th, 5th, 9th and 10th year, respectively); and
- other assets, including unquoted shares and participations: the net gain is reduced by 7.14 percent for each year of ownership in excess of two years (i.e. only 92.86 percent, 85.72 percent, 78.58 percent, 14.32 percent or 7.18 percent of the net gain is taxable for sales in the 3rd, 4th, 5th, 14th and 15th year, respectively).

One hundred percent of the gain from assets owned for two years or less are taxable.

Ordinary gains in a year may be used to offset capital losses for that year. If the computation of the taxpayer's annual net ordinary capital gain produces a loss, such loss may be set off, at taxpayer's discretion, against the balance of net irregular capital gain in that year or the next five years.

(b) *Special rules*

(1) *Quoted shares and attached preemptive subscription rights*

The gain or loss arising on the alienation of quoted shares is the difference between
- the official quotation price on the date of alienation (or the last day of quotation in the preceding quarter) or the actual price paid and the average cost of acquisition; and
- the acquisition price (less the amount of any preemptive subscription rights sold). However, where the amount received from sales of preemptive subscription rights exceeds the acquisition price of the underlying shares, the excess is treated as a capital gain in the year in which transfer is effected. In transfers of (fully or partly paid) bonus shares, the acquisition price is the actual cost to the shareholder. In the case of stock dividends, the acquisition price is the actual cost to the taxpayer.

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22. Under the current special computation scheme (which in principle may not be waived for a minimum period of three years), net income must be computed separately for mining/quarrying, manufacturing/construction, services, commerce, fisheries and farming (for traders) or for independently classified activities (for professionals).
Under this scheme, the annual net profit is:
(1) The balance of:
  (i) *total turnover* (excluding any indirect taxes on transactions and receipts), less
  (ii) *deductible expenses* on
    - purchases, local taxes on the conduct of the activity or the ownership of assets allocated to the activity;
    - energy and water, interest on borrowed capital and other financial costs concerning the activity, insurance premiums relating to assets of the activity;
    - rental payments relating to the premises where the activity is carried on;
    - payroll and the employer's social security contributions and contributions to a private pension plan for employees (only for traders because professionals may not have any employees);
    - the actual or imputed remuneration for himself and the actual remuneration of any member of his family unit working regularly in the business and the related social security contributions (for a professional, only his personal social security contributions).
(2) A deductible allowance for (any other) notional expenses may be taken as a percentage of (i) less (ii) above: 20 percent (for manufacturing, construction and mining), 15 percent (for commerce, farming, fisheries and services), or 10 percent (for professional and artistic activities).
(3) Finally, the amount resulting after taking the deductible allowance mentioned in (2) must be increased by the actual or imputed remuneration of the taxpayer (if he files a separate return) or the remuneration of both the taxpayer and the members of his household working in the activity (if they file a joint return).

(2) *Unquoted shares and profit-sharing rights*

For unquoted shares and participations, the gain is the difference between the consideration received by the transferor, less costs and the unindexed acquisition cost. However, an anti-avoidance provision applies where the sales price of unquoted shares does not match an arm's length price. In such a case, the sales price is deemed to be the higher of the book value reflected in the company's last approved balance sheet and the price resulting from capitalizing at the rate of 12.5 percent, the amount of the company's average profits (including any dividends and other distributions and allocations to reserves other than monetary surpluses from authorized revaluations of balance sheet items) over the three previous tax periods.

In respect of transfers of property owned before 1 January 1979 (or preemptive subscription rights on shares owned before that date) by the current transferor, a transitional rule provides that the gain or loss is the difference between the consideration received and the higher of the acquisition price (as dated 1 January 1979) or the market price on 31 December 1978.

With regard to the sale of preemptive subscription rights on unquoted shares, an anti-avoidance measure provides that proceeds from the sale of subscription rights attached to unquoted shares are treated as a capital gain for the transferor in the tax year in which the transfer is effected.

For unquoted stock dividends, the acquisition value is the actual price paid by the taxpayer.

(3) *Profit-sharing rights in transparent companies*

The gain or loss on the disposal of shares or participations in transparent companies is the difference between the sale price and the combined value of acquisition and ownership. This combined value is the unindexed purchase price plus the portion of the company's undistributed profits imputed to the shareholders or partners in the period between the dates of acquisition and sale.

(4) *Exchanges*

The gain or loss on the exchange of assets (not shares or participations) is the difference between the unindexed acquisition price of the item being transferred and the market price of the item received in exchange. In barters of shares or participations, the gain is the difference between the unindexed acquisition cost of the items exchanged under the barter and the value attributed to those items received or converted plus any related cash.

(5) *Insurance proceeds*

The gain on proceeds received by the insured in the form of a lump sum payment by virtue of a life or disability insurance policy is the amount by which the lump sum exceeds the accumulated amount of the unindexed premiums paid by the insured.

(6) *Gains arising on gifts*

For the transferor's income tax purposes, any capital gain disclosed on the occasion of a gratuitous transfer of assets by any inter vivos gift is imputed to him and is subject to IRPF as (ordinary or irregular) capital gain.

In addition, an anti-avoidance measure prevents transfers after 16 April 1989 of assets (mainly immovable property) which have been undervalued. Accordingly, a penalizing tax treatment is triggered where the value ascertained for tax purposes (upon verification by the tax authorities) exceeds by more than 20 percent the value declared in the deed and such excess is more than 2,000,000 Ptas. In such a case the excess (including the first 2,000,000 Ptas.), in addition to being subject to transfer tax,[23] is deemed to be a gratuitous transfer which is taxed for the individual transferor as an imputed capital gain at the appropriate rate of IRPF, and for the individual transferee as a gift under the progressive inheritance and gift tax regime.[24]

3. Exempt capital gains

In respect of transfers for consideration, full rollover relief applies in respect of capital gains from the disposal by a trader, independent professional or artiste of tangible fixed assets or by any taxpayer of his primary residence. The entire proceeds of such transfers must be used to acquire similar fixed assets or another primary residence, respectively, within two years.

In addition, an exemption from IRPF is available in respect of:

(a) long-term capital gains arising from the transfer for consideration of immovable property owned for more than 20 years; quoted shares owned for more than 10 years; and other assets in general, including unquoted shares and participations, owned for more than 15 years;
(b) causa mortis capital gains;
(c) capital gains derived by persons 65 years of age or older upon surrender of the legal ownership of their primary residence in exchange for a life annuity;
(d) capital gains derived from the sale of property where the total value of sales in the year does not exceed 500,000 Ptas.; and
(e) capital gains derived from an inter vivos gift to qualifying donees (e.g. central or local governments, the Spanish Red Cross, public universities and legally recognized churches and charities).

F. *Imputed income under the fiscal transparency regime*

Under the new fiscal transparency regime the profits (whether distributed or retained) of a company are imputed to the entity's (individual or corporate) *resident* members only and taxed as income in their hands.[25] Losses cannot be imputed to the members; they can only be set off against the transparent entity's profits. Any loss remaining after the setoff can be carried over for five years. Accordingly, the portion of the transparent company's positive taxable base imputed to resident members or partners is not subject to corporate income tax at the transparent entity's level.

However, resident EEIGs and duly registered business agreements (joint ventures) are subject to a special fiscal transparency regime, whereby their profits or losses are directly imputed to the members pursuant to the apportionment rules set forth in the grouping formation contract or, in the absence of such rules, in equal parts. The members

23. For details on the transfer tax (ITPAJD), see *Taxation of Individuals in Europe* (Amsterdam: IBFD), Chapter Spain, at Sec. 13.4.
24. For details on the inheritance and gift tax, see *id.*, at Sec. 11.
The new Net Wealth Tax Act in its Additional Provision No. 3 has amended Art. 15 of the existing Inheritance and Gift Tax Act by establishing that, effective 1 January 1992, the minimum value of the deceased's household furnishings and personal belongings is to be calculated at 3% of the remaining estate and that the resulting amount is to be added to the rest of that estate in order to determine the total value.
25. The fiscal transparency regime no longer applies to non-resident members.

are subject to individual or corporate income tax, as the case may be, on their share of the profits or losses.

Income distributed by the transparent company to its resident members or partners out of accumulated earnings from tax periods in which the company was under the fiscal transparency regime (i.e. that were previously imputed) is not taxable under IRPF. Moreover, dividends and income distributed by the transparent company are not included in the acquisition price of shares or participations owned by those shareholders or partners to whom they were imputed. However, if the recipient of such dividends or distributions is a person other than the shareholder or partner to whom they were imputed because he acquired the shares or participations after such imputation, then the value of acquisition must be reduced by the amount of such dividends or distributions.

Resident members are entitled to claim imputation in respect of:
- any tax credits and relief earned by the transparent company in proportion to the positive taxable base imputed. The bases on which tax credits and relief are calculated must be taken in the self-assessment of the members, reducing (where applicable) the tax due pursuant to the IRPF rules; and
- any payments on account and withholding taxes suffered by the company in proportion to their holdings.

The portion of the transparent company's positive taxable base attributed to the non-resident members or partners is subject to normal corporate income tax at 35 percent. Dividends and other profit distributions to the transparent company's non-resident members are taxed at the final rate of 25 percent unless a tax treaty provides otherwise.

The fiscal transparency regime only applies to the following:
(1) certain professional legal entities:
   - those carrying out a professional activity in which all members are directly or indirectly engaged in the conduct of that professional activity, even where there are non-professional members if their total holding is less than five percent; and
   - those in which more than 50 percent of the turnover arises from individuals carrying out artistic or sport activities or from any other artistic or sport-related activities where the artistes/sportsmen together with their relatives hold a substantial participation (i.e. 25 percent);
(2) companies in which more than 50 percent of the capital is owned by a family group or by no more than ten members (provided none is a public legal entity owning more than 50 percent in such companies), namely unquoted portfolio companies and mere holding companies.[26]
(3) civil associations, unincorporated joint ventures and undivided estates.

Entities and companies in (1) and (2) which are members of other transparent entities or companies do not fall within the ambit of the fiscal transparency regime and are taxed instead under the corporate income tax at the top marginal rate (53 percent in 1992 and 50 percent as from 1993) of IRPF.

All shares of transparent companies (other than civil companies with legal personality) must be nominative in order to accurately identify the shareholders. Failure to comply with this requirement may result in a fine of up to 5,000,000 Ptas. for each year of non-compliance. If, as a result of non-compliance, part of the profits cannot be imputed to the (unidentified) members, the unimputed part is taxable under the corporate income tax at the top marginal rate of IRPF.

G. *Losses*

1. Ordinary income

Ordinary losses under the different schedules may be offset with no limitation against ordinary income under the different schedules and the positive balance of imputed income under the fiscal transparency regime.

2. Irregular income

In determining the net total irregular income, any negative remaining portion of each type of irregular income may only be offset against any positive remaining portion. Any outstanding loss may then be carried forward and set off against the eventual positive balance of irregular income over the next five years.

However, losses of a fiscally transparent company other than EEIGs and duly registered business joint ventures[27] are not imputable to its members and are only eligible for offset against the transparent company's profits in the year of loss and the next five years.

Carryback of losses is not allowed.

H. *Assessable base*

The assessable base has two components: the ordinary taxable base component and the irregular taxable base component.

1. Ordinary assessable base component

The ordinary assesable base is the amount of the ordinary taxable base component on which tax is actually imposed. In determining this assessable base, the taxpayer may only deduct:
(a) compulsory contributions to mutual insurance societies covering death risks and contributions to the taxpayer's private pension plan. Such contributions are deductible to an annual maximum of the lower of:
   - 15 percent of the taxpayer's net (employment, business or professional) income (including the employer's contribution to the taxpayer's private

26. These are companies in which more than 50% of the assets are attached to the taxpayer's business or professional activities, excluding those assets held by individual or corporate enterprises directly or indirectly related to the company. The rental or sale of immovable property by a company is deemed to be a business activity, thus excluding such company from the fiscal transparency regime if that company has an office available which is exclusively used as a place of management for the rental or sale, and has at least one permanently contracted employee for that purpose.
Note, however, that, with regard to the classification of a company as merely holding assets, an advance ruling of the tax administration of 13 July 1989 provides that a company carrying out an entrepreneurial activity pursuant to its corporate purpose does not fall under the fiscal transparency regime and temporary inactivity does not imply an interruption in the entrepreneurial endeavour if the enterprise intends to continue such undertaking and if the company intends to resume its real estate business once the commercial or financial climate is propitious. In the meantime, that company must not be classified as a company merely holding assets.
27. These are known in Spain as "Uniones Temporales de Empresas", and to qualify for the special fiscal transparency regime, they must be registered in the special registry of the Ministry of Economy and Finance (Additional Provisions of Law 12/1991 of 29 April on Economic Interest Groupings).

plan which is imputed income), and
- 750,000 Ptas. (including both the taxpayer's and the employer's contributions to the taxpayer's private pension plan and the taxpayer's compulsory contributions to mutual insurance societies;

(b) alimony and compensatory payments to a spouse under court order (child support allowances under a court order constitute exempt income).

The ordinary table base component is taxed at the appropriate progressive rates.

2. Irregular assessable base component

A taxpayer's irregular taxable base component coincides with his irregular assessable base (with no allowance) and is taxed in accordance with the appropriate average rate of tax (see below).

I. *Tax rates*

1. Withholding tax

Spanish-source income from employment, self-employment and capital (not immovable property) derived by resident individuals is subject to a withholding tax which is generally treated as an advance levy against the individual's tax liability.

Employment income is subject to the general withholding rates which vary in accordance with the family status and total annual earnings of the individual. The maximum rate (which applies as of May 1991 on annual income exceeding 16,538,000 Ptas.) is 42 percent for unmarried employees or married employees with no dependent children (41 percent for those with up to four dependent children). For pensions (regardless of who contributed to the pension fund), the applicable withholding rates range between zero and 41 percent.

Income earned under a special (freely negotiated under labour law) employment contract by senior executive officers, commission agents and performing artistes and athletes is subject to the general withholding rates with a minimum withholding of 15 percent.

Gross remuneration paid to Spanish expatriates by resident enterprises engaged in mining, hydrocarbons, construction or assembly work or the export of technology is subject to the general withholding system reduced by 15 percentage points (i.e. such remuneration is subject to withholding only if the applicable rate in the table is more than 15 percent, in which case only the excess is subject to withholding).

Directors' fees earned by resident individuals are subject to a 30 percent withholding tax.

Payments in consideration of independent professional, artistic or sporting activities are subject to withholding at the rate of 15 percent.

The general withholding rate on investment income (i.e. dividends, interest, royalties and similar payments) is 25 percent with two exceptions: interest on Treasury bonds is exempt from withholding tax and (a notional) interest on AFRO bonds is subject to a 55 percent final withholding tax.

Exceptionally, however, a 50 percent reduction in the applicable withholding tax rate applies to taxpayers resident in the Spanish territories in North Africa (Ceuta, Melilla and the dependencies of Alhucemas, Vélez de la Gomera and Chafarinas) in respect of income from dependent or independent services rendered or capital generated in such territories.

2. Progressive rates

The portion of the taxpayer's assesable base comprising the ordinary income component is taxed in accordance with the progressive rates in Tables A and B below.

Table A

General table for taxpayers filing individual returns

Taxable income (Ptas.)	Tax due on the lower limit (Ptas.)	Marginal rate on the excess (%)
400,000 – 1,000,000	0	20 *
1,000,000 – 1,570,000	120,000	22
1,570,000 – 2,140,000	245,000	24
2,140,000 – 2,710,000	382,200	26
2,710,000 – 3,280,000	530,400	28
3,280,000 – 3,850,000	690,000	30
3,850,000 – 4,420,000	861,000	32
4,420,000 – 4,990,000	1,043,400	34
4,990,000 – 5,560,000	1,237,200	36
5,560,000 – 6,130,000	1,442,400	38
6,130,000 – 6,700,000	1,659,000	40
6,700,000 – 7,270,000	1,887,000	42
7,270,000 – 7,840,000	2,126,400	44
7,840,000 – 8,410,000	2,377,200	46
8,410,000 – 8,980,000	2,639,400	48
8,980,000 – 9,550,000	2,913,000	50.5
9,550,000 – and over	3,200,850	53 *

* For tax year 1993 the lowest rate is set at 18 percent and the highest rate, to 50 percent (on taxable income in excess of 10,000,000 Ptas.).

Table B

Special table for spouses filing a joint return

Taxable income (Ptas.)	Tax due on the lower limit (Ptas.)	Marginal rate on the excess (%)
800,000 – 2,000,000	0	20 *
2,000,000 – 2,625,000	240,000	24
2,625,000 – 3,250,000	390,000	26
3,250,000 – 3,875,000	552,500	28
3,875,000 – 4,500,000	727,500	30
4,500,000 – 5,125,000	915,000	32
5,125,000 – 5,750,000	1,115,000	34
5,750,000 – 6,375,000	1,327,500	36
6,375,000 – 7,000,000	1,552,500	38
7,000,000 – 7,625,000	1,790,000	40
7,625,000 – 8,250,000	2,040,000	42
8,250,000 – 8,875,000	2,302,500	44
8,875,000 – 9,500,000	2,577,500	46
9,500,000 – 10,125,000	2,865,000	48
10,125,000 – 11,000,000	3,165,000	50.5
11,000,000 and over	3,606,875	53 *

* For tax year 1993 the lowest rate is set at 18 percent and the highest rate, at 50 percent (on taxable income in excess of 12,000,000 Ptas.).

3. Average rates

The taxpayer's irregular taxable base component is subject to IRPF at the higher average rate of:
- the one resulting from applying the progressive rates to 50 percent of the taxpayer's irregular taxable base portion; or
- the one resulting from applying the progressive rates to the taxpayer's ordinary assessable base (i.e. the amount resulting from dividing the income tax liability assessed on the taxpayer's ordinary taxable income component by such taxable income and multiplying it by 100).

Where the average rate applicable to the trader's or professional's ordinary taxable base exceeds 35 percent (i.e. the current corporate tax rate), the taxpayer's liability is reduced by the amount resulting from applying the excess rate to the capital gains included in the ordinary taxable income from business or professional activities.

Gains from the disposal of other assets privately owned by the individual trader or professional which constitute part of his net wealth are taxed under the general rules on capital gains.

4. Tax due

The amount of tax is the sum of the tax liabilities assessed on both portions (ordinary and irregular) of the taxpayer's assessable base.

J. *Tax credits*

1. Family credits

For 1992, the credits available on the basis of the taxpayer's family circumstances are as follows:

- for each unmarried dependent child under 30 years of age (unless disabled) with an annual income not exceeding the officially fixed annual minimum salary: 20,000 Ptas.;
- for each dependent/ascendent under 75 years of age with an annual income not exceeding the officially fixed annual minimum salary: 15,000 Ptas. (30,000 Ptas. if the dependent/ascendent is 75 years or older);
- for each taxpayer who is 65 or older: 15,000 Ptas.; and
- for each disabled taxpayer and unmarried dependent child or dependent/ascendant with an annual income not exceeding the officially fixed minimum salary: 50,000 Ptas. (this credit may be taken in addition to any other personal allowances).

2. Employment income credit

The new employment income credit is a lump sum of 25,200 Ptas. for each earner in a family household filing a joint return, and for each employee filing an individual return where his annual net earnings from employment exceed 1,800,000 Ptas. (provided that net non-employment income is less than 2,000,000 Ptas.). Formula-based credits apply to lower income.

3. Health expenses credit

Medical costs entitle the taxpayer to a health expenses credit equal to 15 percent of substantiated expenses incurred because of illness, accident or disability of the taxpayer or any dependent, or due to medical care and hospitalization as a result of the birth of a taxpayer's child, as well as premiums paid for medical insurance.

4. Qualifying gifts credit

Credits on qualifying gifts for 1992 are:

- 15 percent of the value of cultural interest assets donated to the State, the Autonomous Regions, local authorities, public bodies or universities which have been officially declared charities of public cultural interest, the Spanish Red Cross, the Catholic Church and legally recognized non-Catholic religious associations; and
- 10 percent of the value of donations to State companies organizing the 1992 Universal Exhibition in Seville and the quincentenary celebrations of the discovery of the American continent, to the Organizing Committee of the Barcelona 1992 Olympic Games or the consortium organizing the events for Madrid, cultural capital of Europe in 1992.

5. Investment credits

(a) *Non-entrepreneurs*

Taxpayers other than businessmen and independent professionals may take the following investment credits for 1992.

(1) On qualifying insurance premiums:
- 10 percent of premiums paid for life and disability insurance (except in the case of deferred capital insurance contracts) paid to entities legally authorized to operate in Spain, provided the beneficiary is the taxpayer or the spouse, or an ascendant or descendant or a member of the family unit which took out the policy; and
- a further 10 percent credit in respect of voluntary contributions to mutual insurance societies or funds covering death or disability risks where such contributions are not deductible for the taxpayer.

(2) On cultural assets: a credit of 15 percent of the cost of acquisition, upkeep, repair, restoration, promotion and exhibition of tangible assets of cultural interest registered with the National Heritage which must be held for at least three years.[28]

(3) On dwelling-houses: 15 percent of the cost incurred during the year for the purchase or restoration of the taxpayer's primary residence (which must be continuously used as the habitual abode of the taxpayer, his spouse or minor children for a minimum period of three years).

For the purpose of these credits, the combined sum of the amount spent on the above investments (referred to in "5") and the value of qualifying gifts may not exceed 30 percent of the taxpayer's assessable base. Accordingly, in order to correctly compute the amount of credits for investments, one must first calculate the taxpayer's taxable base for that year, to take into account the 30 percent limit of such base which is the maximum of the investments (except business investments) qualifying for relief.

(b) *Individual entrepreneurs*

Individual traders and self-employed professionals and artistes determining their taxable base under the direct method enjoy the same investment incentives as are available to corporate entrepreneurs and at the same rates and limits. However, such credit limits are applied to the income tax liability resulting after the family tax credit, the health expenses credit, the investment credit for non-entrepreneurs and the credit for tenancy costs have been taken into account.

In addition to the general investment credit, there are three special credit schemes.[29]

6. Miscellaneous credits

The following additional credits are available:

(a) *Domestic dividends received*

Ten percent of the gross domestic-source dividends and similar distributions received from companies which paid

28. Qualifying assets include Spanish-situs tangible movable and immovable property having artistic, historical, paleontological, archeological, ethnological, scientific or technical interest (including documents and bibliographic assets, archeological zones and deposits, natural sites, gardens and parks with an artistic, historical or anthropological value).

29. As additional investment credits, three special schemes are available for investments carried out in accordance with plans and programmes set

normal corporate tax may be credited against the recipient's income tax. This credit is also available to resident recipients of dividends from quoted portfolio investment companies (which are subject to a reduced corporate tax of one percent).

For foreign-source dividends and similar distributions, the recipient is granted ordinary credit relief (see below).

(b) *Income derived in the Spanish territories in North Africa*
A rebate of 50 percent of the income tax liability attributable to any income (including capital gains) derived from the Spanish territories in North Africa (Ceuta, Melilla and the dependencies of Alhucemas, Vélez de la Gomera and the Chafarina Islands) is granted. This rebate does not apply to taxpayers who are non-resident in such territories, except for dividends and distributions by companies resident and with an exclusive business purpose in such territories and income from permanent establishments therein.

(c) *Tenancy costs*
A new credit equal to the lower of 75,000 Ptas. and 15 percent of the annual rent paid for a residential dwelling is available to tenants whose annual net income does not exceed 2,000,000 Ptas., where the annual rent paid for the home exceeds ten percent of such net income.

(d) *Daycare expenses*
A new credit equal to the lower of 25,000 Ptas. and 15 percent of the expenses incurred by a taxpayer whose annual net income does not exceed 2 million Ptas. (4,000,000 Ptas. if both parents work outside the home) in respect of children under three years of age in daycare centres.

(e) *Municipal urban land appreciation tax*
Seventy-five percent of the amount paid in the tax year concerned for the municipal urban land appreciation tax (see below) is available as a credit, where the appreciation constitutes a capital gain effectively subject to IRPF.

(f) *Advance payments and withholdings*
Advance payments made throughout the year by individual entrepreneurs and any withholding of tax other than the 55 percent withholding tax on AFRO bonds which is a final tax may be set off against the taxpayer's final income tax liability.

7. Double taxation relief

As a unilateral measure for the avoidance of double taxation of income,[30] Spain uses the ordinary credit method, under which a resident taxpayer with foreign-source income may credit against his Spanish IRPF liability the lower of the effective amount of tax paid abroad on the related foreign-source income or capital gain; and the Spanish IRPF attributable to the related foreign-source income and capital gains.

IV. ADMINISTRATION

A. *Assessment*

As a general rule, the tax period coincides with the calendar year. However, the tax period is less than one year:
- for a taxpayer who dies before 31 December of that year;
- for spouses filing a joint return, if the marriage is annulled or a divorce or separation under court order is granted or if either of the unmarried or separated parents dies; and
- for a newly married couple filing a joint return (from the date of the marriage through 31 December of that year).

B. *Advance payments*

Self-employed professionals, artistes and individual entrepreneurs are currently required to file quarterly returns and to make advance payments by 5 May, August and November of the current year and 5 February of the following year; the payments are creditable against the final income tax liability for the current year. The statutory minimum of each prepayment is 20 percent of the net business or professional income derived in each quarter less any related withholdings.

C. Final return

Resident taxpayers must complete and file with the competent local tax office an annual income tax return. However, no return need be filed if the taxpayer's 1992 net employment income alone or together with a maximum of 250,000 Ptas. gross investment income and capital gains totals less than 1,000,000 Ptas. (1,200,000 Ptas. for a pensioner and for taxpayers filing a joint return).[31]

As a general rule, self-assessment of the tax is mandatory for all taxpayers. A joint annual return filed by a household must be signed by all members who are 18 years of age. The tax liability must be paid by 20 June (30 June for taxpayers entitled to a refund) of the next year. Any outstanding tax liability may be paid in two instalments: 60 percent by 20 June and the remaining 40 percent by 5 November of the current year.[32]

Where, upon verification by the tax administration, the withholdings and payments on account exceed the final tax for the current year, the tax administration must complete a provisional assessment within six months of the filing deadline (i.e. by 31 December of that year). Where the amount of tax liability resulting from that provisional assessment is less than the sum of withholdings and prepayments, the excess is automatically refunded within 30 days.

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out (i) by State companies organizing the Seville EXPO '92 and the quincentenary celebrations of the discovery of America, (ii) by the Organizing Committee of the 1992 Olympic Games in Barcelona and (iii) by the consortium organizing the events, in connection with Madrid, the cultural capital of Europe for 1992.
This additional credit is 15% of the total consideration involved (excluding any related interest and indirect taxes). The 15% credit applies separately to investments in new tangible fixed assets; restoration of qualifying buildings and improvement of facades, the environment and public places; creation and design of books and prototypes of films, records or tapes for television; expenses incurred in Spain or abroad on promotion, publicity and marketing over a period exceeding one year; research expenditure on topics related to the discovery of the American continent and expenses related to R & D programmes involving computer technology, telecommunications, construction, transportation and protection of new techniques or products related directly to EXPO '92 and the quincentenary.
The sum of all these additional investment credits is limited to 25% of the individual investor's income tax liability and any unused credit may be carried over to the next four taxable periods, with a 25% limitation in each period.
30. For details on the treaty relief under the Spanish comprehensive tax treaty network, see *supra* note 23, at Secs. 14. and 15.1.2. and 15.1.3.
31. The 2% value of the taxpayer's residence which is imputed (notional) income is excluded from this computation.
32. These are the current rules set forth in the regulation to the former IRPF Act which remains applicable, pursuant to Final Provision 2(2) Para. 2 of the new IRPF, until the new IRPF regulation is published.

If the tax administration does not complete the provisional assessment within a six-month period, then the excess must be refunded *ex officio* within the next month (i.e. in January of the following year).

Interest on late payments of tax due within the voluntary compliance period is 12 percent for 1991. Interest on overdue tax payments is not tax-deductible.

V. TAX LIABILITY OF NON-RESIDENTS

A. *Introduction*

Non-resident individuals are liable to IRPF on any Spanish-source income and capital gains and net wealth tax and immovable property tax if they own Spanish- situs property.

B. *IRPF*

1. Taxable income

A non-resident individual is liable to IRPF in respect of Spanish-source income and capital gains. Spanish-source income comprises, inter alia, income paid by resident individual entrepreneurs or independent professionals, resident legal persons or public or private entities, and permanent establishments situated in Spain.

Unless a tax treaty provides otherwise, the non-resident status of a taxpayer must be proven to the tax administration via evidence that (a) he has remained 183 days or more in that year in another country; or (b) the centre of his vital interests or his business or professional activities are not in Spain; or (c) his (not legally separated) spouse or his minor dependent children do not qualify as residents of Spain.

In the absence of a tax treaty, a non-resident is liable to IRPF if he has a permanent establishment in Spain, in respect of the entire income from Spanish or foreign sources attributable to such establishment; and if he does not operate through a permanent establishment in Spain, separately in respect of each accrual of Spanish-source income and capital gains.

All non-resident individuals who do not have a permanent establishment in Spain, but who derive income from or own property in Spain are required to appoint a local representative in Spain and notify the tax administration within two months of the appointment. Non-compliance may be penalized by an administrative fine ranging from 25,000 to 2,000,000 Ptas. The appointee and, where appropriate, the local payer of income or depository of securities in Spain, are severally liable to the tax authorities.

2. Tax rates

Spanish-source income and capital gains derived by non-resident individuals who reside in non-treaty countries are subject to a final limited income tax at the following rates:

(a) *Income or gains derived through a permanent establishment*

Income of a permanent establishment is classified as business or professional income. The net profit is computed pursuant to the rules applicable to resident taxpayers. Thirty-five percent on net profit (i.e. gross business or professional income less related income-generating expenses); a 25 percent remittance surtax applies to any after-tax profits remitted abroad by a Spanish permanent establishment of a foreign individual or corporate person (i.e. the effective rate on branch profits remitted to the head office is 51.25 percent).

(b) *Income or gains derived directly*

(i) gross income in general (i.e. dividends and similar distributions, interest (excluding interest on public bonds and interest on securities derived by EC residents), royalties, insurance premiums, wages, pensions exceeding 1,500,000 Ptas. per year, professional fees, rents and income imputed to owner-occupied houses: 25 percent;
(ii) gross pensions not exceeding 1,500,000 Ptas. per year and wages of certain personnel servicing Spanish diplomatic missions or consulates abroad: 8 percent;
(iii) overhead expenses allocated by the non-resident head office to its Spanish permanent establishment (which are deemed to be income derived by the head office directly): 14 percent;
(iv) adjusted income (i.e. gross income less expenses paid in Spain on payroll and necessary purchases of goods) from (professional or artistic) services rendered in and/ or paid by a resident of Spain, technical assistance, installation or assembly costs on registered engineering contracts and, in general, business activities in Spain without a permanent establishment: 25 percent;
(v) reinsurance premiums: 4 percent; and
(vi) capital gains: 35 percent.

Non-resident taxpayers deriving Spanish-source income directly are subject to IRPF separately in respect of each item of income and capital gain. They are under a statutory obligation to use Form 210,[33] which must be signed and filed by the local representative or the payer with the local tax office of the representative or payer's fiscal domicile within 25 calendar days after the accrual of income. The date of accrual is deemed to be:

- in respect of income, the date on which payment is due or actually made, if this date is earlier;
- in respect of imputed income on owner-occupied residences, on 31 December of the year concerned; and
- in respect of capital gains, the date of the underlying transfer.

For payments in foreign exchange, the self-assessment must be made by applying the selling rate of exchange prevailing on the latest day of quotation immediately preceding the date of filing Form 210.

In principle, income may be transferred abroad after the local tax authorities have signed and sealed Form 210.

The following items are not taxable in Spain because they are deemed not to be Spanish-source income:

- dividends, interest and capital gains derived directly by non-resident investors from securities issued in Spain by non-residents, regardless of the residence of the financial institution acting as agent in the payment, issuance or transfer of such securities;
- interest and capital gains from public bonds derived

33. Form 210 consists of five major parts:
(a) identification data relating to the local representative and the payor (if this is not the representative);
(b) information regarding the type of taxable income and whether or not a tax treaty applies;
(c) determination of the taxable base and self-assessment of the tax;
(d) payment receipt from a local bank or tax office; and
(e) verification by the tax authorities.

directly by the non-resident bondholders (unless resident in a tax haven);[34]
- income and capital gains arising upon the lease or supply of containers or vessels and aircraft in bare skull, operating in international shipping or air traffic;
- dividends from listed portfolio investment companies and profit distributions from portfolio investment funds derived by residents in other EC countries; and
- interest and capital gains from movable capital (i.e. ownership rights in companies, receivables, deposits and loans) derived directly by residents in other EC countries (unless resident in a tax haven). However, unless a tax treaty provides otherwise, capital gains are deemed to be Spanish source, thus taxable in Spain, where derived by EC residents from the alienation of ownership rights (i.e. shares, participating interests, etc.) in a company or entity, the assets of which mainly consist, directly or indirectly, of Spanish-situs immovable property (*mainly* meaning that the immovable property assets of that company or entity are greater than its movable property assets);[35] or
- in which the taxpayer (or his spouse or close relative) has had, directly or indirectly, a substantial participation (minimum 25 percent) over the 12-month period prior to the alienation.

C. *Anti-avoidance measures*

There are two anti-avoidance measures concerning immovable property.

Resident (individual or corporate) purchasers of Spanish-situs immovable property from non-resident (individual or corporate) owners without a permanent establishment in Spain must withhold as non-resident's tax liability (on the eventual capital gain) 10 percent of the transacted price (but not if the property was owned for more than 20 years prior to the sale and the property was not improved during that period). If the tax is not withheld, the underlying property is liable for the tax due, i.e. the tax administration can place a lien on the property.

A special immovable property tax must be paid annually by any non-treaty country company holding Spanish-situs immovable property or rights in rem or enjoyment thereto of five percent of the updated cadastral value which is deductible for corporate tax purposes. The tax is due by 31 December of each year.[36]

VI. THE (NEW) NET WEALTH TAX

A. *Taxable persons*

Resident individuals are subject to net wealth tax in respect of their worldwide assets. Each resident taxpayer must file a return if his taxable base (i.e. his net wealth) amounts to more than 15,000,000 Ptas. or if his assets are valued at more than 100,000,000 Ptas. Non-resident individuals are liable to net wealth tax only in respect of assets situated or deemed situated in Spain, regardless of the value of their net wealth.

Assets and related deductions are attributed to the individual owners. Spouses are required to file individual returns to be taxed separately. If spouses are married under a community property regime, the assets are attributed to the spouses on a 50-50 basis, unless another method of apportionment can be substantiated; and if they are married under a separate property regime, the assets are attributed exclusively to the owner or registered holder of the underlying property item.

Non-resident individuals are required to appoint a local representative (who is jointly and severally liable for payment of the tax to the tax administration) and to notify the administration within two months of the appointment. Non-compliance may be penalized by a minimum fine of 25,000 Ptas. and a maximum fine of 2,000,000 Ptas. However, as a transition rule, non-resident owners of Spanish-situs property have a compliance deadline of 31 December 1991.

B. *Taxable wealth*

1. Valuation rules

Immovable property in general is valued at the higher of the cadastral value, the value ascertained by the tax administration for other taxes, or the actual acquisition price.

Assets (other than immovable property) attached to business or professional activities are valued according to their book value.

Quoted securities (including shares) are valued according to their average quotation price in the last quarter of the year.[37]

Unquoted securities (not shares) are valued according to their nominal value, including any amortization or reimbursement premiums.

Unquoted shares and participation rights are valued pursuant to the book value reflected in the company's last approved balance sheet provided it has been audited. If the balance sheet has not been audited, such shares and rights are appraised at the higher of:
- the nominal value;

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34. There are 48 tax havens listed in Royal Decree 1,080/1991 of 5 July 1991, effective 15 July 1991:
- In the Americas:

Panama, the Falkland Islands, all of the Caribbean islands and Bermuda (excluding Cuba, Haiti, Dominican Republic, Puerto Rico, the French overseas departments and St. Kitts-Nevis);
- In Europe:

Isle of Man and the Channel Islands, Andorra, Gibraltar, Monaco, San Marino, Malta, Liechtenstein, Cyprus and Luxembourg (only in respect of Luxembourg exempt holding companies);
- In Africa:

Liberia, Mauritious and Seychelles Republic and the Middle East countries Jordan, Lebanon, Bahrain, United Arab Emirates and Oman;
- In Asia and the Pacific:

Macao, Hong Kong, Singapore, Brunei, the Marianas, Nauru, Solomon Islands, Vanuatu, Fiji and the Cook Islands.

35. Note that Spain retains its full taxing right to impose the tax on gains derived by non-residents from the disposition of shares in a foreign company where the assets of that company are mainly Spanish-situs immovable property.

36. This tax is not chargeable to
- foreign States and public entities and international organizations;
- entities which were resident prior to 4 August 1990 in a country with which Spain had a tax treaty including a clause on exchange of information, in respect of immovable property or rights held prior to such date;
- entities carrying on in the regular course of business economic activities different from those of the immovable property items subject to the special tax;
- entities verifying to the tax administration the source of the resources invested in Spain and the identification of the direct or indirect holders of the company's capital, committing themselves to notify the competent authorities of any changes and the reason for such changes.

37. This average quotation is published annually by the Ministry of Economy and Finance.

- the book value reflected in the company's last approved balance sheet; and
- the price resulting from capitalization at 12.5 percent of the company's average profits (including any distributions and allocations to reserve accounts other than surpluses from authorized revaluations of balance sheet items) over the three previous tax periods.

Current/savings accounts and at-sight or term deposits are appraised at the higher of the balance shown on 31 December of the year; and the average balance for the last quarter of the year.[38]

Where a liability arising on a borrowing is paid into any of the above accounts within the last quarter of the year, such liability must not be deducted as a debt or taken into account for computing the average balance.

Life insurance policies are valued at their redemption price.

Annuity contracts are valued according to their capitalization value on 31 December.

Works of art, antiques and collector's items, jewellery, quality skins or furs, cars, and motor cycles of 125 c.c. or more are valued according to market prices on 31 December.

Cars are valued under the rules set forth by the Ministry of Economy and Finance for transfer tax purposes.

Liabilities are valued according to their nominal value on 31 December and are deductible only if they are adequately substantiated.

2. Exempt property

Exemptions from tax are available in respect of the following:

(a) cultural interest assets registered with the National Heritage; qualifying assets comprising Spanish-situs immovable property and tangible chattels having an artistic, historical, paleontological, archeological, ethnological, scientific or technical interest (including documents and bibliographic assets, qualifying archeological zones and deposits, natural sites, gardens and parks with an artistic, historical or anthropological value);
(b) household furnishings and personal belongings in general. The exemption does not apply in respect of jewelry, furs and motor vehicles with a cylinder capacity equal to or exceeding 125 cc and crafts, works of art[39] and antiques,[40] unless they are deposited by the owners for a minimum period of three years with museums or other qualifying charities for exhibition to the general public;
(c) works of art owned by the artist;
(d) consolidated entitlement of each participant in his private pension plan;
(e) intellectual or industrial property rights under author ownership and, in the case of industrial property, not attached to business activities.

3. Taxable base

The taxable base is the net wealth of each taxpayer. The net wealth of a resident taxpayer is determined by adding all his assets and deducting qualifying liabilities not attached to exempt assets (i.e. only those burdens and encumbrances which effectively reduce the value of the underlying assets as well as substantiated debts for which the taxpayer is accountable).

In computing the net wealth of a non-resident taxpayer, he may deduct only those burdens and encumbrances affecting Spanish-situs assets or rights which are situated or may be exercised or fulfilled in Spain, as well as borrowed capital invested in such assets.

4. Assessable base

The assessable base is the amount on which tax is actually imposed.

For a resident taxpayer, net wealth is reduced by a single personal allowance (which functions as a tax-free amount) of 15,000,000 Ptas. No allowance is given to non-residents.

C. *Tax rates*

Net wealth tax is levied in accordance with Table C below.

Table C

Assessable base (million Ptas.)	Tax due on lower limit (Ptas.)	Marginal rate on excess (%)
0– 25	0	0.2
25– 50	50,000	0.3
50– 100	125,000	0.5
100– 200	375,000	0.9
200– 400	1,275,000	1.3
400– 800	3,875,000	1.7
800–1,600	10,675,000	2.1
1,600 and over	27,475,000	2.5

D. *Maximum tax burden vs. statutory minimum tax*

1. Maximum tax burden

The net wealth tax is not a deductible expense for IRPF purposes.

However, the combined amount of IRPF and net wealth tax due by a resident taxpayer may not exceed 70 percent of his total taxable base for IRPF purposes. In determining this 70 percent limit, that portion of the net wealth tax liability which corresponds to unproductive property items for IRPF purposes (i.e. works of art, antiques, collector's items, jewelry, etc.) should not be taken into account.

2. Statutory minimum tax

If the combined amount of IRPF and net wealth tax exceeds the 70 percent limit, the taxpayer may reduce his net wealth tax liability by the excess amount to a maximum reduction of 80 percent of the net wealth tax liability originally calculated. In other words, resident holders of large fortunes with very low income are now subject to a minimum tax of 20 percent of the net wealth tax liability as originally calculated, before application of the 70 percent rule.

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38. Note that the computation of this average balance does not take into account funds withdrawn for purchasing property items included in the taxpayer's net wealth return or paying out or reducing existing liabilities.
39. Namely, paintings and drawings done entirely by hand, and sculptures, engravings, prints and lithographs if they are original.
40. Namely, tangible chattels suitable for use as ornaments – other than works of art and collector's items – which are more than 100 years old and whose original features have not been altered by modification or repair during the last 100 years.

E. *Double taxation relief*

There is a unilateral measure for the avoidance of double taxation of capital,[41] pursuant to which ordinary credit relief is available to resident individual taxpayers owning foreign-situs property. Such taxpayers may credit against their Spanish net wealth tax liability the lower of the effective net wealth (or comparable) tax paid abroad on the foreign-situs property and the Spanish net wealth tax attributable to such foreign-situs property.

VII. LOCAL TAXES

A. *Introduction*

The local tax system contains five municipal taxes:
(1) the immovable property tax (effective 1 January 1990 and which forms the cornerstone of the municipal tax scheme);
(2) the motor vehicles tax (effective 1 January 1990);
(3) the tax on economic (business and professional) activities (to be effective 1 January 1992, replacing the current business and professional licence tax and the business premises location tax);
(4) the (licence) tax on construction and installation projects (effective 1 January 1990); and
(5) the urban land appreciation tax (effective 1 January 1990).

The first three taxes are mandatory for all municipalities; the last two are optional.

To mitigate double taxation of the same event at the State and municipal levels, all local taxes (except the motor vehicles tax) may be treated as income-related expenses and are thus deductible for income tax purposes.

B. *Immovable property tax*

The immovable property tax is levied on the owners of or holders of a life interest in Spanish-situs urban and rural immovable property.

The taxable base is the updated cadastral value. For tax year 1991, the updated cadastral value of urban and rural property is the cadastral value on 31 December 1990 indexed by 5 percent and 50 percent, respectively.

The basic rates are 0.4 percent (for urban immovable property) and 0.3 percent (for rural land). However, these rates may be increased to maximum effective rates of 1.3 percent (for urban real estate) and 1.2 percent (for rural real estate) as follows: those municipalities which have indexed or increased their cadastral values may reduce the basic rates of tax to 0.1 percent and 0.075 percent, respectively. The reduced basic rates may only be applied during the first three-year period after the effective date of indexation or increase. On the other hand, municipalities may apply higher basic rates, based on the population (Table D).

A municipality which (1) is the capital of any of the 50 provinces or 17 Autonomous Communities; (2) provides collective transportation services by land; and/or (3) provides more public services than required by law may increase the above maximum rates by 0.07 percentage points (0.06 percentage points for municipalities in (3)) for each or any of the three qualifying criteria in respect of urban immovable property. For rural land, the increase for each or any of the three qualifying criteria is 0.06, 0.05 and 0.06 percent, respectively. In addition, those municipalities in which rural land occupies more than 80 percent of the total municipal area may increase the rate(s) for rural land by 0.15 percentage points.

Table D

	Rate on urban immovable property (maximum %)	Rate on rural land (maximum %)
up to 5,000 inhabitants	0.85	0.65
up to 20,000 inhabitants	0.95	0.75
up to 50,000 inhabitants	1.0	0.8
up to 100,000 inhabitants	1.05	0.85
more than 100,000 inhabitants	1.1	0.9

C. *Motor vehicles tax*

This tax is chargeable to the registered owners of motor-propelled land vehicles of any type or category. The basic tax for private passenger cars ranges from 2,000 Ptas. (for those under 8 horsepower) to 14,200 Ptas. (for those over 16 horsepower).

Municipalities may increase the basic tax, according to the population, by a maximum of 40 percent (for up to 5,000 inhabitants), 60 percent (for up to 20,000 inhabitants), 70 percent (up to 50,000 inhabitants), 80 percent (for up to 100,000 inhabitants) and 100 percent (for those municipalities with more than 100,000 inhabitants).

D. *Tax on economic activities*

From 1 January 1992 the former business/professional licence tax is replaced by a (similar) tax, the tax on economic activities.

The new tax is levied annually on registered individual and corporate persons conducting business or professional activities within the territory of each municipality. The minimum rates (Tariffs) set by the State may be adjusted by the municipalities. However, the amount of tax resulting from application of the effective rates may not exceed 15 percent of the deemed average net profit notionally attributed to the activity concerned. This local tax is and will be treated as a deductible expense for businessmen and independent professionals.

1. Tariffs

The Tariffs apply according to the classification of economic activities in three sections.

(a) *Section 1*

Entrepreneurial activities are grouped into nine divisions as follows:
(1) energy and water (e.g. extraction of crude oil/gas: 14,100 Ptas. per worker plus 10,300 Ptas. per Kw; distribution of crude oil/gas: quotas in Ptas.: 500,000 (minimum municipal) plus 2,000,000 (provincial) plus 7,000,000 (national);
(2) mining, quarrying and chemical industries (e.g. extraction and preparation of iron: 432 Ptas. per worker plus

41. For details on the treaty relief under the Spanish comprehensive tax treaty network, see *supra* note 23, at Sec. 15.3.2.

407 Ptas. per Kw.; other metals: 510 Ptas. per worker plus 550 Ptas. per Kw.);
(3) metal manufacture and precision mechanics (e.g. manufacture/assembly of automobiles and engines: 720 Ptas. per worker plus 410 per Kw.; precision instruments: 1,160 Ptas. per worker plus 870 Ptas. per Kw.);
(4) other manufacturing industries (e.g. olive oil: 2,820 Ptas. per worker plus 1,610 Ptas. per Kw.; wine: 3,080 Ptas. per worker plus 2,210 Ptas. per Kw.);
(5) construction (e.g. construction, repair, upkeep of buildings):

Table E

	Minimum municipal quota (Ptas.)	Provincial quota (Ptas.)	National quota (Ptas.)
up to 10,000	28,000	510,000	2,550,000
up to 40,000	32,000	id	id
up to 100,000	62,000	id	id
up to 500,000	80,000	id	id
over 500,000	102,000	id	id

(6) trade, hotel/restaurant repairs (e.g. wholesale of any merchandise: quota of 700,000 Ptas.; hotels: 4,000 Ptas. per room (if rated five star grand luxury), 2,800 Ptas. (if rated five stars), and 1,600, 900, 700 and 550 Ptas. per room (if rated four, three, two or one stars, respectively; repair of automobiles: 4,530 Ptas. per worker plus 1,960 Ptas. per Kw.; for industrial machines: 2,500 Ptas. per worker plus 1,570 Ptas. per Kw.);
(7) transport and communications (e.g. international shipping (other than crude oil and gas): national quota of 550 Ptas. per ship and fare's seat (for passengers transport) or 80 Ptas. per ship and ton to a maximum of 2,500 tons; international air transport: national quota per aircraft and seat: 2,900 Ptas. (for passenger transport), or 600 Ptas. for each 100 kg or fraction thereof of transport capacity of each aircraft);
(8) finance, insurance, supply of services to enterprises and rentals (e.g. for each office):

Table F

Town's population	Quota (Ptas.)		
	banks	leasing co.	life insurance co.
up to 10,000	42,000	13,000	17,000
up to 40,000	60,000	18,000	31,000
up to 100,000	154,000	46,000	50,000
up to 500,000	217,000	65,000	85,000
over 500,000	280,700	83,000	110,000

(9) other services (including those relating to farming, sewerage/cleaning, education/research, health/veterinary services, recreational/cultural services, etc.).

(b) *Section 2*

Professional activities are grouped into nine divisions as follows:
(1) farming (comprising agriculture, stock raising, hunting, forestry and fisheries) (e.g. a farming engineer: 32,500 Ptas.);
(2) energy, water, mining and chemical industry (e.g. a mining engineer: 34,000 Ptas.);
(3) aeronautics, telecommunications and precision mechanics (e.g. telecommunications engineer: 43,700 Ptas.);
(4) other manufacturing industries (e.g. industrial/textile engineer: 37,000 Ptas.);
(5) construction (e.g. architect: 47,000 Ptas.);
(6) trade and hotel/restaurant business (e.g. a trade agent: 29,000 Ptas.);
(7) transport and communications (in general: 34,800 Ptas.);
(8) finance, legal, insurance and hiring (e.g. insurance broker: 40,800 Ptas.; lawyer: 42,900 Ptas.; notary: 120,000 Ptas.); and
(9) other services (e.g. higher education professor: 19,300 Ptas.; general physician: 40,000 Ptas.; medical specialist: 47,000 Ptas.; painter/sculptor/craftsman: 18,300 Ptas.).

The total tax consists of the basic quotas (as mentioned above) multiplied by the area in m² of the business/professional premises.

Any professionals commencing their practice as of 1 January 1992 will pay only 50 percent of the appropriate tax (quota) during the first five-year period.

(c) *Section 3*

Artistic activities are broken down into five groups:
(1) cinema/theatre/circus (e.g. any actor: 29,000 Ptas.)
(2) dance (e.g. dancer: 21,000 Ptas.)
(3) music (e.g. singer: 26,000 Ptas.)
(4) sports (e.g. soccer player or trainer: 30,000 Ptas.)
(5) bullfighting shows (e.g. principal bullfighter: 53,000 Ptas.).

2. Quotas

The quotas in the Tariffs are classified in terms of the following:
- municipal minimum quotas (entitling the registered person to conduct activities within the appropriate municipal area);
- provincial quotas (payment of which entitles the registered person to conduct activities within the provincial area without having to pay any municipal minimum quota); and
- national quotas (payment of which entitles the registered person to conduct activities anywhere in Spain without having to pay any municipal minimum or provincial quotas).

The minimum amount of any quotas (excluding activities qualifying for a zero-rated quota) is 6,000 Ptas.

Municipalities may increase the minimum quotas set forth in the Tariffs by applying a single coefficient comprehensive for all activities carried on within its territory as shown in Table G.

Table G

Inhabitants	Maximum coefficient
Up to 5,000	1.4
Up to 20,000	1.6
Up to 50,000	1.7
Up to 100,000	1.8
Over 100,000	2.0

In addition to this coefficient, municipalities may increase the minimum quotas by a minimum index of 0.5 and a maximum of 2.5. The 0.5 minimum is compulsory for municipalities which do not use another scale.

In addition 0.4 percent of the profits from business activities must be paid as an annual registration fee (which is a deductible expense) by all resident individuals carrying on entrepreneurial activities to the appropriate Chamber of Commerce, Industry and Navigation.

E. *Tax on construction and installation projects*

This is a tax levied on the effective cost of works, installation projects or construction activities which require the prior permission of the municipal authorities.

Individual or corporate owners of the works or buildings are liable to the tax. The basic tax rate is two percent, but it can be increased by the municipalities to the maximum rates as shown in Table H.

Table H

Inhabitants	Maximum rate %
up to 5,000	2.4
up to 20,000	2.8
up to 50,000	3.2
up to 100,000	3.6
over 100,000	4.0

F. *Municipal urban land appreciation tax*

This is a local tax which may be levied, at the discretion of the municipality, on the basis of the appreciation in the official value of urban sites and land over a maximum period of 20 years on transfers for consideration or by inheritance or gift. The person liable to the tax is the transferee (in the case of inheritances and gifts) and the alienator (in the case of transfers for consideration).

The taxable base is determined by multiplying the appropriate percentage (which depends on the population of the town and the maximum appreciation period, according to Table I below) by the actual number of complete years involved.

Table I

	Maximum period			
	5 years	10 years	15 years	20 years
up to 50,000 inhabitants	2.2-2.6%	2.0-2.4%	2.1-2.5%	2.2-2.6%
100,000 inhabitants	2.3-2.7%	2.1-2.5%	2.2-2.6%	2.3-2.7%
500,000 inhabitants	2.4-2.8%	2.2-2.6%	2.3-2.7%	2.4-2.8%
1 million inhabitants	2.5-2.9%	2.3-2.7%	2.4-2.8%	2.5-2.9%
over 1 million inhabitants	2.6-3.0%	2.4-2.8%	2.5-2.9%	2.5-2.9%

The tax liability is assessed by applying to the resulting taxable base the appropriate rate (fixed by the municipalities, depending on their population, within the minimum/maximum rates given in Table J:

Table J

	Minimum rate (in %)	Maximum rate (in %)
up to 5,000 inhabitants	16	26
up to 20,000 inhabitants	17	27
up to 50,000 inhabitants	18	28
up to 100,000 inhabitants	19	29
over 100,000 inhabitants	20	30

RESEARCH AND DEVELOPMENT EXPENSES IN SPAIN

KPMG Estudio Jurídico y Tributario

KPMG Estudio Jurídico y Tributario is part of the international organization of KPMG. It is a Spanish law firm with a highly qualified professional staff specializing in fiscal and legal matters.

The term "research and development ('R&D')" was not defined in Spanish law until the new General Accounting Plan was published in the Official State Gazette on 27 December 1990. In that legal text, "research and development" is defined broadly. "Research" is an original and planned investigation, aimed at discovering new knowledge and a better comprehension in technical and scientific fields. "Development" is defined as the concrete application of achievements in research, carried out until commercial production is commenced. No specific activities are mentioned or expressly included in these definitions.

TAX TREATMENT OF R&D EXPENSES

As a general rule companies are subject to corporate income tax ("CIT") at a rate of 35 percent on their gross income, less deductible expenses. To be deductible, expenses must be necessary to obtain income, properly documented and recorded in the year in which they are incurred. Although R&D expenses in principle fall within the scope of deductible expenses, a ruling by the Spanish Tax Authorities has established that such expenses must be recorded as assets in the company's balance sheet until the project is completed or terminated. Consequently, these expenses are not considered to be deductible in the year they are incurred.

Once the R&D project is successfully completed, it becomes an intangible asset for the company which, in principle, can be depreciated according to a special plan that must be filed and approved by the tax authorities. If the R&D project is unsuccessful, all expenses incurred will be amortizable and can be freely depreciated over a maximum period of five years from the date on which the project fails.

In this regard and on the basis of Article 35 of the Spanish "Reconversion and Reindustrialization Law", it can be argued that equipment purchased for use in R&D projects and buildings assigned to R&D activities can be freely depreciated over five years and seven years, respectively. This law does not require the assets to be new, nor does it require that the buildings be exclusively assigned to R&D activities.

Companies which invest in R&D activities are offered certain tax benefits under Spanish tax legislation. According to the 1991 General Budget Law, taxpayers carrying out such activities may deduct both of the following investment tax credits from the tax due:
- 15 percent of intangible expenditures;
- 30 percent of the acquisition value of fixed assets used in R&D activities or programmes for new products or industrial procedures.

Both tax credits will be available if the research is carried out by the taxpayer or by third parties under a research service agreement. To qualify for the tax credit, the research must be carried out by a Spanish resident.

If the research is carried out by the taxpayer, the tax credit base is the direct and indirect expenses involved in the research, and the tax credit must be applied to the CIT return of the years in which the expenses are incurred.

If the research is carried out by a third party, the tax credit base is the amount stated in the agreement. The tax credit must be applied to the CIT return of the year in which the agreement is signed. However, if the term of the agreement is more than two years, the tax credit can be applied to the CIT returns corresponding to the fiscal years during the agreement in question.

In any case, the tax credit base cannot include interest paid on loans incurred to carry out the research, whether directly or through an agreement with a third party.

As mentioned above, CIT regulations do not provide an explicit definition of R&D expenses, but they do establish the cases in which R&D tax credits cannot be applied:
- for amounts incurred in the acquisition or creation of management or administrative systems or procedures;
- for amounts invested in R&D for the benefit of third parties; and
- for the acquisition of R&D programmes which were previously recorded as fixed assets of the seller.

TAX TREATMENT OF TECHNOLOGY TRANSFERS

The transfer of technology is usually made through a licensing agreement or through a sales agreement.

Licensing agreements normally give rise to royalties which must be paid by the licensee to the licensor. Royalties are defined in Spanish CIT Regulations in a similar way to the definition found in the OECD model treaty, i.e. payments of any kind received as a consideration for the use or right to use any copyright of a literary, artistic, informative or scientific work, including cinematographic films, designs or models, plans, secret formulas or processes or for information concerning industrial, commercial or scientific experience.

Regardless of whether the transaction is effected by sale or licence, CIT Regulations mandate that the valuation of transactions between related companies conform to the arm's length principle, that is, according to general market prices.

It is difficult to determine "market price on an arm's length basis" in each specific transaction since Spanish rules on such matters are neither precise nor clear. Rather, they refer to vague and general concepts, such as "prices applied in similar transactions made on a similar date by non-related parties", or "commercial spread in similar transactions", so each operation must be analysed particularly to determine whether or not it conforms to market standards.

The sale of technology by a Spanish resident may give rise to proceeds for the seller which, according to CIT Regulations, are subject to taxation at the normal rate of 35 percent.

In respect of the tax treatment of the licensing of technology, two situations must be distinguished.

First, the amounts received by Spanish resident companies under licensing agreements granted to foreign parties are subject to taxation as ordinary income at the rate of 35 percent. In principle the income tax levied by the licensee's country, if any, is creditable against the Spanish CIT liability, but the amount of the tax credit may not be higher than the tax due in Spain on this royalty if it had been obtained in Spanish territory.

On the other hand, payments made by a Spanish licensee to a foreign licensor for licences or other rights for the use of technology are subject to a withholding tax of 25 percent. However, under the tax treaties concluded by Spain, the withholding tax rate for royalties may be reduced to 5, 6 or 10 percent, depending on the treaty.

Payments made under transfer of technology agreements are deductible expenses for Spanish licensee companies if such expenses meet the requirements discussed above, i.e. the expenses are necessary to obtain income, properly documented in an invoice and recorded in the year in which they are incurred.

Although transfer of technology transactions and payments thereunder are fully liberalized and do not require approval of the tax authorities, such transfers do require advance verification from the exchange control authorities. The exchange control authorities may deny verification if the charge clearly exceeds the real value of the technical assistance rendered.

TAX TREATMENT OF COST-SHARING ARRANGEMENTS

Spanish legislation does not provide any specific definition of cost-sharing arrangements. In principle the parties are entitled to enter this type of arrangement, and they may include in the agreement any provisions they deem convenient.

Payments made by a Spanish company to a foreign company under a cost-sharing arrangement may be subject to withholding tax in Spain at the rate of 25 percent. As in the case of transfers of technology this tax rate may be reduced or avoided if the foreign company is resident in a tax treaty country.

The deductibility of the cost-sharing payments made by a Spanish company is subject to the same rules that apply to R&D expenses.

In order to make payments abroad under a cost-sharing arrangement signed with a non-resident party, advance verification must be obtained from the exchange control authorities.

Payments received by Spanish companies under a cost-sharing arrangement may decrease the value of the intangible asset or the depreciable expenses, thus not being considered as taxable income.

There are no specific methods for cost allocation. The parties to the arrangement may in principle freely negotiate the conditions, although the allocated amounts should be justified.

Finally, Spanish companies involved in a cost-sharing arrangement may deduct 15 percent of the amount paid from the tax due as an investment tax credit under the same conditions as described above for R&D expenses.

THE SPANISH SYSTEM OF TAX APPEALS

Alfonso Rodriguez Sainz

Mr. Rodriguez Sainz is Professor of Law at the Madrid Complutense University and former associate of the International Bureau of Fiscal Documentation, Amsterdam.

I. INTRODUCTION

This article describes the various remedies available to a taxpayer against a decision of the Spanish tax authorities. The article addresses both the administrative and the judicial appeal systems. The term "tax appeal" in this article is defined as the act by which a person challenges a decision of the tax administration and it includes appeals lodged with the tax administration as well as those lodged with the courts.[1]

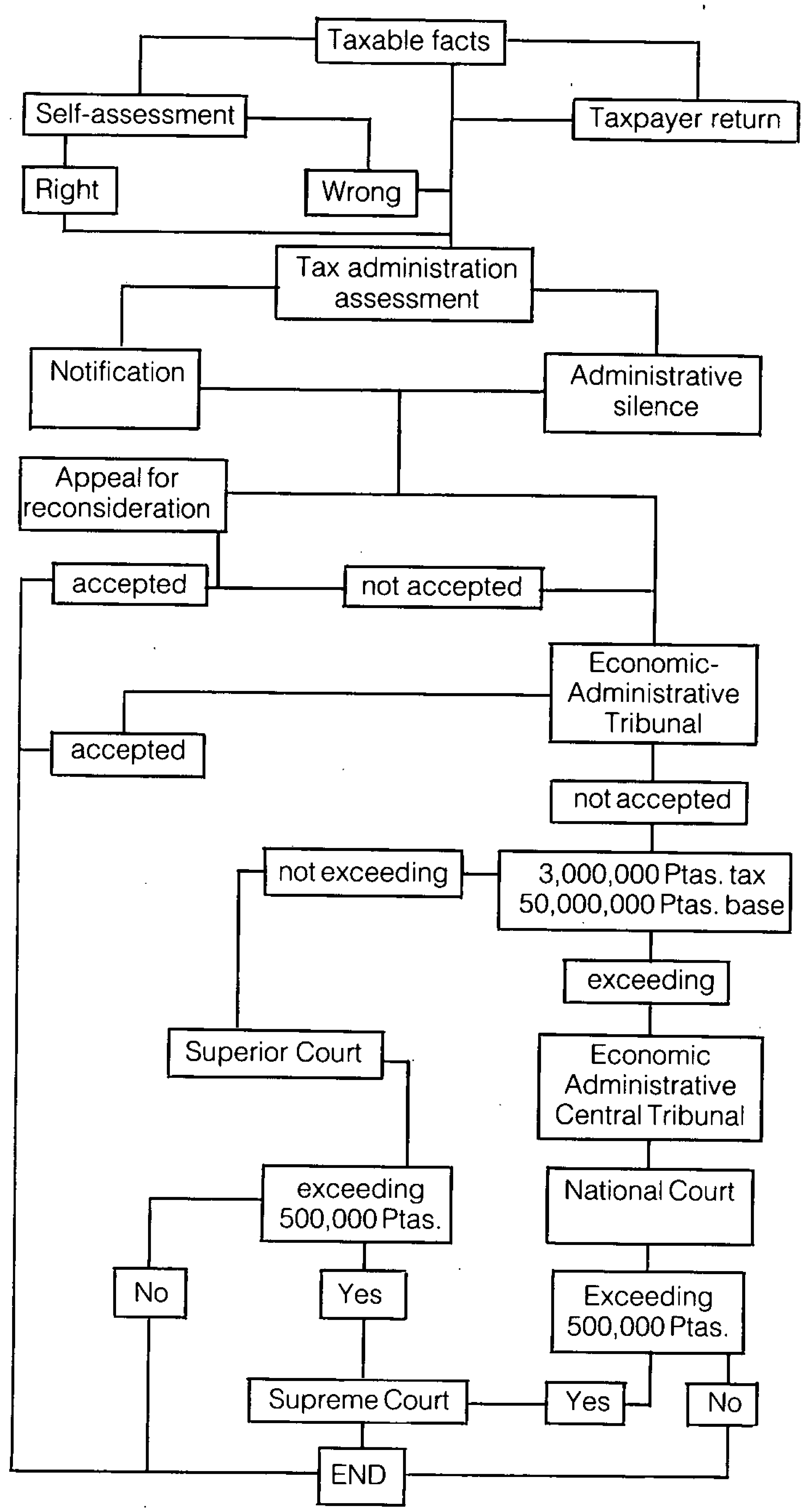
In Spain a tax decision is deemed to have been taken by the competent administrative agency rather than by an individual tax officer. It is the agency which has authority to take decisions whereas the tax officer involved (or a group of tax officers acting as a unit) is only instrumental in making the decision.[2] Therefore, the taxpayer must address any complaints to the tax administration as such, and not to the individual tax officer.

Article 24(1) of the Constitution provides for a coordinated system of taxpayer protection in which the tax administration and the judiciary each play a role. Article 24(1) effectively grants the taxpayer protection of his rights and interests by giving him access to both administrative and judicial appeal systems.

Before a taxpayer can avail himself of the appeal system, however, a tax assessment must be issued. The assessment may be issued by the tax administration or it may concern a case of self-assessment (which may be checked by the tax administration). As a general rule a taxpayer cannot use the judicial appeal system until he has exhausted all available administrative remedies.

Three areas of competence may be distinguished, i.e. that of the central government, the Autonomous Communities[3] and the local authorities. This division of competency results in three parallel appeal systems. However, these systems share many common features so that it is possible to view them as a single system.

First government level tax appeal system



The central government appeal system is first described. This will be followed by a summary of the rules applicable to the Autonomous Communities and the local authorities. The article concludes with an overall evaluation of the Spanish appeal system.

A. *General*

A diagram of the first government level tax appeal system is set forth above.

The diagram commences with "taxable events", which may consist of one or more facts, acts or activities which generate the imposition of a tax. The existence of a "taxable event" triggers an obligation to assess tax. Tax assessments are

1. A narrower definition is found in *Osborn's Concise Law Dictionary* which states that a tax appeal is "any proceeding taken to rectify an erroneous decision of a court bringing it to a higher court".
2. In some countries, such as the United Kingdom, the role of the tax officer is seemingly more predominant.
3. Spain is divided into 17 Autonomous Communities (i.e. autonomous regions).

issued by the tax administration[4] in only a few cases since the Spanish system is primarily based on self-assessment. In cases of self-assessment of tax, the administration should review and approve the self-assessment. If the taxpayer does not make a self-assessment or makes an incorrect one, the tax administration will require the taxpayer to make a self-assessment or to correct the assessment submitted. Failure to comply may result in an *ex officio* assessment by the tax administration.

In those cases where it is primarily the tax administration's responsibility to issue a tax assessment, the taxpayer must file a tax return prior to the assessment.[5]

If the tax administration is satisfied with the taxpayer's return or self-assessment it need not take further action, i.e. in such a case the administration remains "silent". However, if the tax administration does issue an assessment it must notify the taxpayer. If the taxpayer disagrees with the assessment or reassessment he may appeal to the agency of the tax administration which issued the assessment ("appeal for reconsideration"),[6] or alternatively to a Regional ("TEAR") or Local Economic Administrative Tribunal ("TEAL").[7]

If the taxpayer is not satisfied with the decision of the administration on his appeal for reconsideration he has further recourse to the TEAR.

The taxpayer may challenge a decision of the TEAR before the Central Economic Administrative Tribunal ("TEAC") in Madrid, if the claim exceeds 3 million Ptas. or the data relating to the tax base exceeds 50 million Ptas. The taxpayer may appeal to the Superior Court if the above conditions are not met.[8]

A decision of the Superior Court may be appealed to the Supreme Court if the tax amount at issue exceeds 500,000 Ptas. A decision of the TEAC may be appealed to the National Court in Madrid and from there the case may be taken to the Supreme Court (also in Madrid) if the tax amount at issue exceeds 500,000 Ptas.

B. *Types of appealable decisions*

As mentioned above there are two types of tax assessment, i.e. an assessment imposed by the tax administration and one in the form of a self-assessed tax.

In order for a taxpayer to be able to lodge an appeal he must show a decision of the tax administration. Of course, this prerequisite is fulfilled if the tax administration issues a tax assessment. However, the situation is less simple if the taxpayer has paid tax under the self-assessment scheme as is the usual case.

Under the self-assessment scheme the taxpayer must determine which tax provisions are applicable, calculate the amount of tax due and pay that amount to the Treasury. A problem arises because the Spanish Supreme Court has concluded that a self-assessment is not a true assessment, and thus not an appealable assessment.[9]

Under Article 15 of the Economic Administrative Procedure Law, appeals may be brought before the TEAR if:
- the tax administration has taken a decision by which it recognizes or refuses to recognize a right or establishes a taxpayer's obligation or taxable base using indirect means in order to estimate such taxable base (for instance, by comparison or using special criteria);
- tax was erroneously withheld; or
- tax was erroneously shifted onward.[10]

II. ADMINISTRATIVE APPEALS[11]

A. *Application for reconsideration*[12]

An application for reconsideration is a procedure by which the taxpayer requests the tax administration to reconsider a certain decision which the taxpayer feels is contrary to law. The chances of succeeding in such an appeal, however, are slim because the tax administration rarely reverses its decisions. Nevertheless, where the tax administration has demonstrably erred this may be a convenient method of redress.

An application for reconsideration is optional and may be lodged by the taxpayer or any person who has an interest in the tax administration's decision.

The following procedure must be observed:
1. The appellant must submit a written request for reconsideration of the tax administration's decision to the agency which rendered the pertinent decision. This document must contain:
- personal data;
- identification of the contested decision;
- the reason for the appeal and any new facts or documents which are relevant;

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4. Tax assessments are issued by a local agency of the tax administration, which has limited territorial jurisdiction.
5. However, note that where the tax administration issues an *ex officio* tax assessment no tax return is filed. In fact, such a tax assessment is often a correction of an earlier self-assessment.
6. This is not a court but rather a separate administrative division which reviews and, if necessary, revises the decisions of the pertinent tax divisions.
7. The TEAL operates under the same principles and conditions as the TEAR, and thus will not be further expanded upon in this article.
8. A Superior Court is located in each Autonomous Community.
9. This theory finds support in traditional Spanish tax literature. An example of the Court's reasoning may be found in its decision of 31 October 1988 (Aranzadi 10,118/88). In December 1983 tax in an amount exceeding 500,000 Ptas. was paid by two taxpayers under the self-assessment regime. The taxpayers discovered an error and subsequently sought a refund of the amount paid. The Superior Court of Seville held for the taxpayers and ordered a refund. However, the Supreme Court reversed the decision of the Superior Court, reasoning that a self-assessment is not an official assessment so no appeal is available.
I disagree with this decision for the following reasons:
- If Parliament, by virtue of a law, permits taxpayers to calculate the amount of tax to be paid and to pay that amount to the Treasury, that is an assessment. It is immaterial whether the payment is correct or incorrect, definitive or provisional, it is still an assessment.
- Parliament may promulgate a law delegating part of its taxing power to a taxpayer.
- The tax administration is not hindered if self-assessments are considered true tax assessments. The tax administration has ultimate responsibility and may correct any assessment and appeal to a court when a conflict arises.
- An equity argument dictates that it is fair for both the taxpayer and the tax administration to have the right to appeal in cases of self-assessment.
- If the self-assessment regime was introduced to improve the efficiency of the Spanish system, it is consistent with that measure to consider self-assessment a true tax assessment.

10. The shifting of tax takes places where, for instance, a supplier of goods or services charges VAT to his customers.
11. The procedure is based on Law 34 of 21 June 1980, Royal Decree 1547 of 9 July 1982, Legislative Royal Decree 2795 of 12 December 1980 and Royal Decree 1999 of 20 August 1981.
12. Arts. 162-165 of the General Tax Law and Royal Decree 2244 of 7 September 1979.

- a statement that no appeal has been filed with the TEAR (since these procedures are mutually exclusive); and
- an offer of a guarantee covering the amount involved in exchange for the tax administration's agreement not to execute its decision for the duration of the appeal.

An application for reconsideration must be lodged within 15 business days after receipt of notification of the tax administration's decision. During that time the appellant has the right to examine the files upon which the tax administration's decision is based.

2. The tax administration will suspend the execution of its decision, if such a request is made and if the tax administration agrees to accept the guarantee offered by the taxpayer.

3. The tax administration has ten days after submission of the application to request guidance from the State Lawyer's Office.[13] After the expiration of ten days, the tax administration has a further eight days to issue a new decision, after which the taxpayer may appeal to the TEAR. If the tax administration does not issue a new decision within 30 days of the initial application, it is presumed that the response was negative and the taxpayer may then appeal to the TEAR.

An application for reconsideration tolls the statute of limitations for an appeal to the TEAR but any implied or express decision of the tax administration restarts the statute of limitations. This rule is perceived as inconvenient considering the time which is granted to lodge an appeal with the TEAR (i.e. 15 business days after receipt of the decision of the tax administration). This fact, combined with the remote chance of success, explains why so little use is made of the application for reconsideration.

B. *Other appeals*

The administrative bodies which are competent to hear and decide tax appeals are the Ministry of Economy and Finance and the Economic Administrative Tribunals, i.e. the TEAR and the TEAC.

1. Ministry of Economy and Finance

The Ministry of Economy and Finance hears tax cases which are referred to it by the TEAC, cases in which the Council of State must be heard or cases in which the costs of the trial are to be borne by the State. Cases involving the Ministry, however, are rare. An appeal from the decision of the Ministry of Economy and Finance must be made directly to the Supreme Court.

2. Economic Administrative Tribunals

As a general rule, decisions of the tax administration, whether rendered for the first time or after a decision upon an application for reconsideration, must be brought before the Tribunals regardless of the amounts at issue.

As mentioned above there are three types of Tribunals:
- the Regional Economic Administrative Tribunals (TEAR) which are competent to hear cases arising in the Autonomous Communities in mainland Spain;
- the Local Economic Administrative Tribunals (TEAL) in Ceuta and Melilla, the Spanish enclaves in North Africa; and
- the Central Tribunal in Madrid (TEAC) which is competent to hear cases throughout Spain.

The TEAR is composed of a president and at least three members, all of whom are public officers. The TEAL is composed of a president and two members, appointed to office by order of the Ministry of Economy and Finance. The TEAC has a president and 11 members, all of whom are public officers.

All three Tribunals may act as a single instance body, meaning that their decisions exhaust the administrative appeal procedure. Further appeal is only possible to the judiciary. The TEAR and TEAL may also act as a first instance body, so their decisions may be appealed to a higher administrative level, i.e. to the TEAC.

The Tribunals may hear decisions taken by the local or regional tax administrations,[14] decisions taken by agencies which depend on such administrations (e.g. the social security agency), decisions relating to tax matters taken by the Autonomous Communities and cases where the power to levy taxes has been delegated by the State to such Communities.

(a) *TEAR*

The TEAR acts as a single instance body in disputes involving fiscal claims (tax assessments, penalties, etc.) not exceeding 3 million Ptas. or not exceeding 50 million Ptas. where the amount relates to a valuation of the taxpayer's property or any other act prior to and separate from the actual tax assessment. If either party is not satisfied with the decision of the TEAR, he/it may appeal to the Regional Court.[15]

If the dispute involves a tax claim of more than 3 million Ptas. or if the amount relates to a valuation or other acts involving more than 50 million Ptas., the TEAR acts as a first instance body so any appeal must be lodged with the TEAC.

(1) *Persons permitted to appeal*

Under Articles 31 and 32 of the Economic Administrative Procedure Regulations, taxpayers, persons responsible for the payment of a tax and persons having an interest in the payment of a tax may appeal to the TEAR. However, the following persons are excluded: tax officers, agents or representatives of the public administration, informers and persons required to pay tax pursuant to a private agreement.

(2) *Representation*

An appeal may be made in person or through a legal representative. The representative need not be a lawyer. In the case of companies the right to appeal is vested in the directors or any other person with a similar function. If a third person represents the company he must be a lawyer.

(3) *Procedure before the TEAR*

The appeal procedure is initated by a letter to the tax administration. This letter must be sent 15 business days after receipt of the decision of the tax administration.

The letter must set forth the TEAR to which it is addressed, personal data of the taxpayer and a request to recognize the claim. The appellant may (but is not required to) include a summary of the facts, the provisions of the law upon which

13. In practice, however, the administration rarely makes such a request.
14. These are tax administrations established in particular cities, villages, etc. and regions.
15. However, if the TEAR's decision modifies the disputed amount so that it exceeds the jurisdictional ceilings, an appeal may be filed with the TEAC.

the appeal is based and a request to suspend execution of the decision.[16]

The TEAR will request the tax office concerned to send the taxpayer's file. The tax office should send the file within ten days of the request. If the file does not arrive within ten days, the TEAR will issue a second request. The appeal procedure may continue even if the tax office fails to comply with the request (which it sometimes does), provided the appellant submits the required documentation. There is no other way to penalize the tax office.[17]

The TEAR then examines the taxpayer's file. The appellant also has the right to examine his file and to request any documentation which is not included. A request to examine the file and other materials which have not been sent to the TEAR suspends the time period in which the taxpayer must justify his claim.

The taxpayer must justify his claim within 15 days from the notification that his case will be heard or after receipt of the file and supplementary documents. He must do so in writing in a document in which he sets forth the relevant facts, the legal arguments, the decision concerned and (optional) a request for a public hearing. If the appellant provided this information in his initial appeal letter, however, he need not repeat it here.

Next evidence must be proffered. Both the appellant and the TEAR may require that evidence be submitted. It is the task of the TEAR to establish the facts, and in principle no decision can be taken altering these facts at a later stage. However, a court may require additional evidence at a later stage.

A public hearing will be held upon the appellant's request. He may request a public hearing in his initial letter of appeal or in the letter setting forth the grounds for his claim. A lawyer's signature is necessary to request a public hearing. The TEAR has discretion as to whether to grant such a request; in practice it rarely does.

A judgment will be rendered after the TEAR has examined the basis for the claim or after a public hearing. The decision is given in writing and will contain an enumeration of the facts in the appellant's file or submitted by him, and the relevant provisions of law; the decision must address all issues submitted by the appellant or which can be derived from his file.

If no judgment is rendered within one year from the submission of the initial letter the appellant may bypass the TEAR and appeal to the TEAC or the Superior Court as the case may be.[18]

As stated above, any challenge to the decision of the TEAR in cases involving more than 3 million Ptas., or more than 50 million Ptas. where the amount relates to a valuation of the taxpayer's property or any other act prior to and separate from the actual tax assessment, must be brought before the TEAC. Other cases must be appealed to the Superior Court.

(b) *TEAC*

The TEAC in Madrid decides tax disputes either as a single instance body or as a second instance body. The TEAC renders a final administrative decision in cases where the contested decision was issued by an agency of the Ministry of Economy and Finance, regardless of the amount in dispute. As stated above, the TEAC is a second instance body when it hears appeals from the TEAR.

Procedure before the TEAC

The procedural rules for an appeal to the TEAC are similar to those for an appeal to the TEAR.

An initial appeal letter must be submitted to either the TEAR which rendered the judgment or the TEAC within 15 business days after the decision of the TEAR. The letter must contain, inter alia, the provisions of the law upon which the appellant's case rests, a request for permission to submit evidence (if any) which was not accepted by the TEAR and, at the option of the appellant, a request for a public hearing. Any documents which the appellant believes to be relevant should also be enclosed.

The TEAR then transfers the appellant's file to the TEAC. This must be effected within three days if the appeal letter was sent to the TEAR or eight days if the appeal was made directly to the TEAC. A second request will be issued if the TEAR does not comply within the prescribed time. However, even if the TEAR fails to comply after a second request, the procedure may continue if the appellant submits the required documentation.

Evidence is then submitted. Both the appellant and the TEAC may require that evidence be submitted. The submission of evidence which was not accepted by the TEAR or new or ignored facts are particularly important at this stage.

If a request for a public hearing was made the hearing will then take place. Such a request must be signed by a lawyer who is a member of the bar. Again the TEAC has discretion as to whether to allow a public hearing – it generally does not.

Finally, the TEAC will render its decision in writing. This decision will contain the facts as set forth in the appellant's file and in the initial letters to the TEAR and TEAC.

If no decision is rendered within one year the appellant may bring his case before the National Court.

III. JUDICIAL APPEALS[19]

A. *General*

The competent judicial bodies are the following:
- the Superior Courts of appeal;
- the National Court of appeal; and
- the Supreme Court.

A person aggrieved by a decision of the administrative appeal body may bring a challenge in court, but he must first exhaust all of the agency's internal appeal procedures. A decision of the TEAR acting as a single instance body (i.e. where the tax claim does not exceed 3 million Ptas., or if the data relating to the tax base does not exceed 50 million Ptas.), or a decision of the TEAC exhausts the administrative stage of the appeal procedure.

An appeal from an unfavourable decision of the TEAR must be brought before the Superior Court of the same region. An appeal from the TEAC must be lodged with the

16. Administrative appeals do not automatically suspend execution of the administrative decision, including payment of tax, interest and penalties. However, upon application, the appellant may be granted suspension if he provides a guarantee covering the amount involved.
17. For a discussion of this problem, see A.R. Sainz, "La Resolución de Recursos Tributarios sin Expediente", *Actualidad Financeira* (1990), at 1166.
18. The time between the submission of the initial letter and the decision generally exceeds one year and has led to numerous complaints.
19. The judicial appeal procedure is governed by the Administrative Litigation Jurisdiction Law of 27 December 1956.

National Court and the Supreme Court hears appeals from the decisions of the Superior and National Courts (if the amount in dispute exceeds 500,000 Ptas.) or from decisions of the Ministry of Economy and Finance.

B. *Persons allowed to appeal*

Only parties who have a direct interest in the decision may appeal; in principle such parties are the appellant and the tax administration.

C. *Time limits for appeal*

An appeal must be lodged within two months after receipt of the administrative or court decision. In cases where the tax administration has remained silent, the two-month period starts on the date the preceding appeal was deemed to be rejected.

D. *Representation*

The taxpayer must be represented by a lawyer or by a court attorney assisted by a lawyer.

E. *Procedure for judicial review*

1. Superior Courts

The competent Superior Court may act as a single instance body or as a first instance body. If the appealed decision was issued by a local tax authority with limited jurisdiction and the amount at issue is less than 500,000 Ptas., the Superior Court acts as a single instance body so that the Superior Court's decision terminates the *ordinary* judicial appeal process. If the amount at issue exceeds 500,000 Ptas., the Superior Court acts as a first instance body; thus its decision may be challenged by an ordinary appeal to the Supreme Court.

The procedure before the Superior Court is similar to the procedure before the TEAR. An initial appeal document is submitted, which sets forth, inter alia, the challenged decision (together with a copy of the decision), the amount at issue and a request to admit the appeal.

If the appellant fulfils the legal requirements his case will be admitted for the appeal procedure. The Court will request that his files be transferred from the TEAR. These files should be transferred to the Court within 20 business days. If not, a second order will be issued and the TEAR has an additional ten business days to comply. If the TEAR still does not comply its members will be subject to an administrative fine.

Once the Court receives the files the appellant has the right to request them within 20 business days in order to prepare the legal document to initiate the law suit. This document must contain the facts, the legal grounds upon which the appellant's claim rests, the claim itself and any evidence supporting the facts. It is also possible to enclose the relevant documents or to specify where such documents are maintained. The tax administration, which acts through the State Lawyer, will issue a response to the taxpayer's document.

The Court deliberates on the admissibility of the evidence and decides which evidence is admissible.

A public hearing may be held or a conclusion may be drafted which summarizes the facts and legal grounds which the parties have invoked. The Court generally confines itself to writing a conclusion. Finally the Court will render its decision.

2. National Court

The National Court hears appeals which involve administrative decisions rendered by agencies of the Ministry of Economy and Finance. Thus a final decision of the TEAC or the Minister are challenged by an ordinary appeal to the National Court.

The procedure to be followed is essentially the same as for the Superior Court.

3. Supreme Court

Superior or National Court decisions can be appealed to the Supreme Court if the amount at issue exceeds 500,000 Ptas. The appeal must be submitted within five days of receipt of the lower court's decision. The appeal must be addressed to the court which rendered the decision, which will subsequently send the files to the Supreme Court and will summon the parties to appear before the Supreme Court. An "appearance" is effected through the submission of a document. It is possible at this stage to request the admissibility of evidence relating to certain relevant facts if such evidence was ignored or not accepted by the lower court. If the Supreme Court accepts such evidence the case is remanded to the lower court for retrial.

The judicial procedure is exhausted when the Supreme Court renders its decision. Under the Constitution a taxpayer may, as a last resort, appeal to the 12-member Constitutional Court in Madrid if he alleges his constitutional rights have been violated.

IV. THE AUTONOMOUS COMMUNITIES

The appeal system for decisions taken by the Autonomous Communities with respect to regional taxes does not differ significantly from the appeal system for State taxes.

The Autonomous Communities generally have a tax administration composed of divisions, each with their own powers. These divisions may be further sub-divided into administrative departments and departments for review which are the equivalents of the Economic Administrative Tribunals.

At the level of the Autonomous Communities self-assessment is the rule, in particular because their taxes are really State taxes whose imposition is delegated to the Autonomous Communities. The Autonomous Communities rarely impose their own taxes.

In those cases where the taxes of the Autonomous Communities are State taxes or surcharges on State taxes, an appeal may be made to the departments for review and from there to the TEAR. However, if a tax decision is taken by the Autonomous Community Authority, the appeal must be lodged with the TEAC.

If the litigation concerns proper Autonomous Community taxes, an appeal from the decision of the department of review must be lodged with the Supreme Court. A further appeal to the Supreme Court is possible if the amount at issue exceeds 500,000 Ptas.

V. THE LOCAL AUTHORITIES

Local authorities are usually very small organizations with simple administrative structures. The self-assessment scheme is gaining field with respect to local taxation, but as mentioned above, an appeal is only possible if there is an official assessment.

In case of a dispute the taxpayer may take his case to the local authority for reconsideration, but he is not required to do so. He may, if he wishes, take his case directly to the Regional Court and further to the Supreme Court if the amount at issue exceeds 500,000 Ptas.

VI. EVALUATION OF THE SPANISH TAX APPEAL SYSTEM

In theory the Spanish tax appeal system is adequate in respect of the protection it offers taxpayers. In principle, the taxpayer has two, three or four level protection depending on the amount at issue (not counting an application for reconsideration).

However, the protection offered by the TEAR is weak since they are essentially divisions of the tax administration. The TEAC also affords minimal protection although its decisions are generally well founded. However, the TEAC is formal, and the protection it offers is often more to the advantage of the tax administration than to the taxpayer.

Finally, the protection offered by the courts varies. Previously, the Supreme Court evidenced a high degree of concern for taxpayer rights, but the situation has deteriorated. Recent Supreme Court decisions are rather artificial.

The following problem areas may be identified:
1. The time between the beginning of litigation and a final decision is generally four to five years, but may be even longer.
2. There are many delays in the transfer of documents. In some cases, it is impossible to effectuate such a transfer.
3. Courts often render contradictory decisions.
4. Court judges are often former public officers who protect the tax administration with artificial arguments.
5. The judiciary often ignores legal deadlines, while taxpayers are penalized for failure to observe deadlines.

These deficiencies negate the potential taxpayer protection offered by the Spanish tax appeal system.

SPAIN:
THE TAXATION OF CORPORATIONS

The following description of the taxes to which corporations are subject in Spain forms one of the standard publications of the IBFD. This country chapter is extracted from *Supplementary Service to European Taxation*, Section A (Taxation of Corporations), a loose-leaf publication. It contains similar summaries of the tax systems of 31 European countries and is updated monthly. Nineteen of these country chapters are published separately in a hardback edition entitled *European Tax Handbook*. This is an annual publication for desktop use.

I. INTRODUCTION

Corporations are subject in general to a comprehensive corporate tax which is the only tax levied on the income (including capital gains) of companies and other legal entities. However, certain resident legal entities are not subject to corporate tax but rather their profits are directly imputed to the shareholders or partners ("fiscal transparency"). In addition, resident corporate taxpayers are subject to minor local levies.

II. CORPORATE INCOME TAX ("IS")[1]

A. *Type of tax system*

The type of tax system adopted by Spain is the (partial) imputation system. Resident individual shareholders or participators may credit ten percent of the domestic-source dividends received against their tax liability, and corporate shareholders or participators may credit an amount equal to 50 percent of the corporate tax paid by the distributing company on that part of the corporate profits out of which distributions are made.

Further, there is a total elimination of double taxation of domestic-source dividends received by resident corporate shareholders or qualifying participators under the affiliation privilege and other reliefs.

B. *Taxable persons*

Corporate tax is levied on all legal entities resident in or having a permanent establishment in Spain. Resident corporate taxpayers include all types of commercial companies, including corporations ("SA"), limited liability companies ("SRL") and all types of incorporated (i.e. legally formed through a notary) partnerships, unless they are subject to the fiscal transparency regime.[2]

The fiscal transparency regime applies to (1) civil companies, unincorporated joint ventures, EEIGs and those companies carrying on a professional activity in which all the members are directly or indirectly engaged in the conduct of that professional activity, and (2) unquoted portfolio investment companies, portfolio management companies and companies merely holding assets, where more than 50 percent of their capital is owned by either a family group or no more than ten members. The profits (whether distributed or retained) of transparant companies other than EEIGs are directly imputed to their members and taxed in their hands, while losses are not imputed to the members and can only be set off against the transparent company's profits in the year of the loss and the next five tax years. The profits or losses of EEIGs are imputed to the partners pursuant to the apportionment rules laid down in the grouping formation contract or, in the absence of such rules, in equal parts.

Residence

A company is deemed to be resident in Spain if it meets any of the following conditions:
- it is formed under Spanish law;
- its head office is located in Spanish territory; or
- the effective place of administration and management of the business is in Spain.

1. Several important amendments in respect of corporate income tax were made in the new Individual Income Tax Law in the areas of price adjustments in transfer pricing cases, introduction of thin capitalization, the foreign tax credit for substantial participations and the fiscal transparency regime in respect of the company's non-resident members and the tax treatment of chain companies. These changes will be in effect as of 1 January 1992. For a discussion of the changes see M.A.G. Caballero, "Comprehensive Tax Reform: A New Approach to Individual Income Tax, New Wealth Tax and Local Taxes", in this issue, at 411.
2. Id.

Spain comprises mainland Spain, the Balearic and the Canary Islands and the enclaves of Ceuta and Melilla in Northern Africa.

For the taxation of non-resident corporations, see below.

C. *Taxable base*

Resident companies are liable to IS on their worldwide income and capital gains. For IS purposes, the taxable base is calculated as the aggregate of all types of income less allowable deductions, plus capital gains less capital losses. The tax authorities may use the net worth comparison method as an alternative method of assessment. As a general rule, income and expenses are to be consistently allocated to each financial period on an accrual basis.

Business expenses are deductible for IS purposes if they are income-related expenses. The following items are non-deductible: dividends and similar distributions, the IS itself, penalties, fines and related surcharges, non-compulsory severance pay and any gifts except gifts to qualifying donees.

1. Depreciation

Depreciation is allowed in respect of all tangible fixed assets (except land) and intangible fixed assets (other than goodwill) on the basis of their normal useful life. Depreciation applies from the date the underlying asset enters into effective service and it must be calculated on each separate asset and not on groups unless attached to specialized complex installations.

Depreciation is normally calculated in accordance with the straight-line method. However, new qualifying assets (industrial and agricultural machines and installations; communication and data processing equipment; transportation (excluding private cars); hotel installations; and in-house cinematographic productions) with an effective life of more than three years may be depreciated according to the declining balance method.

Rates for depreciation are contained in official tables. Examples of general maximum straight-line depreciation rates are as follows:

Depreciable asset	*Rate (%)*	*Period (years)*
Industrial buildings and warehouses	3	50
Commercial and residential buildings	2	75
Machinery, installations, equipment, air conditioning, elevators	8	18
Ordinary tools	20	8
Laboratory, telex and telephone and office furniture	10	15
Computer hardware	15	12
Office installations (general)	6	25
Trucks	15	10
Automobiles	14	11

Second-hand assets may be depreciated at rates twice those established for corresponding new assets.

Assets which are used intensively (i.e. more than one shift daily) can be depreciated at the maximum rate increased by approximately 33 percent for each additional shift.

Under the declining balance method, the annual depreciation rate is increased by 50 percent (if useful life is less than five years), by 100 percent (if useful life is less than eight years) or by 150 percent (if useful life is eight years or more).

The tax authorities have discretion to accept special depreciation methods with higher annual rates of depreciation for new assets subject to an effective depreciation greater than the one calculated at normal rates. Certain types of industries (mining, forestry and hydrocarbon enterprises and industries in the process of reorganization) may be authorized to depreciate their assets at their discretion (free depreciation).

Intangible fixed assets can be depreciated if they are acquired for consideration and have a limited life, e.g. formation and start-up expenses, research and development costs (over a maximum period of five years), patents and trademarks (over the remaining useful lives). Goodwill is not depreciable for tax purposes, unless its value suffers an irreversible, effective and substantiated depreciation.

2. Valuation of stock

As a general rule, inventory is valued for tax purposes at the lower of historic cost (of acquisition or production) or market price. Financial charges are not allowed as part of the cost. Accepted methods of inventory valuation are the weighted average cost (in practice, the generally applicable method) and FIFO. The LIFO and base-stock methods are not accepted for tax purposes.

3. Reserves and provisions

Only contributions to the following four general types of reserves are a deductible expense for tax purposes.

(a) *Provisions for unrealized losses*

(1) *Doubtful debts*
This provision can be created by making either a maximum allocation to this provision of 0.5 percent (1.5 percent for banks) of the year-end outstanding balances receivable or by an annual allocation calculated on a case-by-case basis as follows:
- 25 percent for debts between 6 and 12 months overdue;
- 50 percent for debts between 12 and 18 months overdue;
- 75 percent for debts between 18 and 24 months overdue; and
- 100 percent for debts more than 24 months overdue.

(2) *Devaluation of stock*
This provision is the difference between the market value of stock-in-trade and its historic cost at the end of the reporting year.

(3) *Marketable securities*
This provision is the difference between the market value in the current year and the previously recorded book value.

(b) *Provision for liabilities*

This provision is for compulsory liabilities the amount of which has not been definitely fixed (e.g. breach of contract, execution of guarantees, employment termination indemnity).

(c) *Provision for ships and aircraft*

A provision for major overhauls and repairs of ships and aircraft may be set aside.

(d) *Provision for mining and hydrocarbon enterprises*

For mining enterprises, the depletion allowance deductible for tax purposes is limited to either 30 percent of net taxable income (before depletion) or 15 percent of the gross revenue from mineral sales; for hydrocarbon enterprises, such percentages are, respectively, 40 percent or 25 percent.

D. *Capital gains*

Capital gains are treated as ordinary income and are generally included in business income and subject to IS at the general rate of 35 percent. The concept of capital gain embraces gains realized on disposals of assets for consideration as well as those derived on a gratuitous transfer.

Generally, the gain is the amount by which the proceeds from alienation exceed the cost of acquisition. The Spanish corporate tax does not permit indexation of the original cost of acquisition.

However, exemption from IS applies in respect of capital gains from disposals of tangible fixed business assets if the entire proceeds are reinvested in similar types of assets within two years. This period is extended to four years if the company submits to the tax administration, within the first year following the disposal, a reinvestment plan and reinvests at least 25 percent of the gain within the first two years.

E. *Tax incentives*

The basic tax incentives regime for corporate tax purposes includes an investment tax credit scheme and a tax relief scheme.

1. Tax credit scheme

The basic tax credit scheme available to resident companies and permanent establishments for any tax period commencing in 1991 is described below.

(a) *Investment credit on new fixed assets*

An amount of five percent of investments in new tangible fixed business assets (excluding real property) in Spain may be credited against the investor's corporate income tax. The newly acquired fixed business assets must be kept in use by the acquirer for a minimum of five years (or the asset's useful life if this period is shorter). This five percent credit is also granted, under the same requirement, for the publication of books and production of films.

(b) *Export-related investment credit*

This credit is 15 percent of the investment made for the formation of foreign permanent establishments, acquisition of at least 25 percent of the capital in existing foreign companies or in newly-created foreign subsidiaries, provided the business activities of such permanent establishments, companies or subsidiaries are directly related to the export activities of that Spanish investor. This 15 percent credit is also available for expenses incurred abroad on promotion, publicity and marketing over a period exceeding one year.

(c) *Research and development ("R&D") credit*

The investment credit is increased to 15 percent of the intangible expenses incurred and 30 percent of the acquisition cost of fixed assets related to R&D programmes or expenditure involving new products or industrial processes.

(d) *Cultural assets credit*

The credit is 10 percent with respect to investment costs in cultural assets (National Heritage).

(e) *Additional investment credits*

An additional credit of 15 percent of the investment in certain promotional activities relating to 1992 is available.

The sum of investment credits (a)-(e) is limited to 25 percent of the corporate income tax liability and any unused credit may be carried forward for five years subject to the 25 percent limitation in each period.

(f) *Investment credits on equity capital*

To promote domestic equity investments, industrial banks and companies whose exclusive business is the promotion of corporations through temporary participation in their equity capital may credit the amount which results from applying the 35 percent company income tax to a percentage of the capital gain from alienation of the shares held, provided the entire gain is reinvested in the same year in similar holdings. The amount of the effective credit is 33.25 percent, 25.25 percent, 17.5 percent and 8.75 percent of such gain, if the alienation takes place in the 8th, 9th, 10th or 11th year of ownership, respectively. No credit is granted after 11 years.

To promote direct investments abroad by means of purchasing equity capital of a company engaged in the exploitation of hydrocarbons in a foreign country, resident companies may credit (in addition to the above) the lesser of:

(i) the Spanish company tax attributable to the foreign-source income in proportion to the Spanish company's holding percentage in the foreign subsidiary; or
(ii) the portion of the foreign company tax effectively paid by the foreign subsidiary and attributable to the Spanish company, in proportion to the holding percentage.

To qualify for this credit, the Spanish company must include in its taxable base the gross amount of foreign profits (including the portion of foreign tax referred to in (ii) above).

(g) *Job creation credit*

Resident employers may credit 500,000 Ptas. for each man-year increase in the average number of full-time Spanish employees in the employer's payroll for any period commencing in 1991 as compared with the preceding financial year. This credit is increased to 700,000 Ptas. for severely handicapped employees. Any unused credit may be carried forward for five years.

2. Tax relief scheme

Tax relief is available, inter alia, for officially authorized holding corporations, mergers and spin-offs, restructuring of industries and regional industrial development companies.

A relief of up to 99 percent of the relevant corporate tax (on income and capital gains) may be granted by the Minister of Economy and Finance to authorized Spanish SAs formed with the exclusive purpose of holding shares and bonds issued by foreign companies not carrying on business in Spain.

A relief of up to 95 percent of the applicable final withholding tax (i.e. 25 percent) on interest from approved foreign loans by qualifying non-resident corporate lenders to finance capital investments in Spain may be obtained from the Minister of Economy and Finance.

F. *Losses*

Ordinary and capital losses are treated in the same manner and may be set off against all income of the same financial period. Any unused loss may be carried forward and set off against profits of the next five years. No carry-back of losses is permitted.

When a company (e.g. an SRL) is converted into another company (e.g. an SA), any loss may be carried over to the new company. However, the accumulated losses of a Spanish branch of a foreign company cannot be carried over if it is converted into a subsidiary.

G. *Rates*

The corporate tax rates applicable with respect to any financial period commencing in 1990 are:

- General rate (for resident companies and permanent establishments in Spain) 35%
- Special rates:
  - rural banks, general mutual insurance institutions, cooperative banks and mutual guarantee companies 26%
  - other cooperative societies 20%
  - recognized non-profit entities 25%
  - quoted portfolio investment companies and portfolio investment funds 11%
  - hydrocarbon enterprises 40%

For rates applicable to non-resident corporations, see below.

H. *Assessment and collection of tax*

As a general rule the tax year coincides with the calendar year, but companies file their return by reference to their financial year. The tax year cannot exceed 12 months. Corporate tax must be computed and paid by the taxpayers under the self-assessment scheme. The annual return is subject to review and audit by the local tax administration.

1. Prepayment

During the current tax year resident companies and permanent establishments must make a tax prepayment of 60 percent of the previous year's corporate tax due in three instalments of 20 percent, by 20 April, 20 October and 20 December. The balance of the tax is payable at the time the annual return is filed.

2. Final return

Corporate taxpayers are required to hold an annual general meeting (primarily to approve the annual accounts) within six months of the closing date of their financial year and to file a final return within 25 days from the date on which the annual accounts are approved. Any outstanding balance must be paid at the time the final return is filed. Any excess tax paid (taking into account the prepayment of tax and withholdings effectively borne by the taxpayer) is automatically refunded. Interest is due on late payments of tax on the outstanding balance.

I. *Groups of companies*

1. Group treatment

Consolidation of accounts for IS purposes is optional for qualifying companies in general, except for banks and their affiliates for which consolidation is mandatory. The parent company must obtain permission from the tax administration to consolidate. A corporate group must prepare consolidated annual financial statements and management reports for financial periods ending after 31 December 1990.

The group must consist of a resident parent corporation and its more than 90 percent (directly or indirectly) owned resident subsidiary corporation(s) for a minimum period of two years prior to the application for consolidation. Companies subject to fiscal transparency are not eligible for consolidation. Permission to consolidate is granted for a three-year period, but may be extended indefinitely. During this period, profits and losses within the group are consolidated, hence only the net income of the group is subject to IS.

Intra-group payments of dividends and other distributions, interest and royalties are exempt from withholding tax.

Outstanding losses of a group member incurred prior to consolidation can be set off only against profits derived by or attributed to the same member within the period of consolidation. Moreover, upon the expiry date of the consolidation period, any remaining losses of the group from the period of consolidation cannot be carried over and set off against profits of the former group members.

2. Intercompany dividends

(a) *Credit for distributions received*

Gross intercompany dividends and similar distributions are included in the recipient company's taxable income. Such distributions are subject to a 25 percent withholding tax which the recipient company can credit. For the foreign tax credit on dividends received from abroad, see below.

Dividends and similar distributions received from another resident company which do not qualify for tax exemption under the affiliation privilege are subject to IS but 50 percent of the effective corporate tax paid by the distributing company on the distribution may be credited against the recipient's own corporate income tax.[3]

(b) *Affiliation privilege*

Under the affiliation privilege and other reliefs, the credit for domestic-source dividends and similar distributions received is increased to 100 percent. Accordingly, the entire corporate income tax attributable to dividends and similar distributions received
- by a resident parent from a more than 25 percent controlled resident subsidiary during the period of the distribution and the preceding financial period;
- by a venture capital corporation or fund (in respect of dividends from unquoted shares); or
- by a company within a joint venture constituting a separate legal entity

can be credited against the corporate recipient's own liability to IS.

From 1 January 1991 quoted portfolio investment companies and portfolio investment funds are subject to corporate income tax at the reduced rate of one percent. However, these entities may only credit ten percent of net domestic dividends or other distributions received and the dividend withholding tax. Any excess credit is refundable.

3. Thin capitalization

Neither corporate tax law nor corporate law contain any specific rules dealing with the thin capitalization of companies.[4]

4. Transfer pricing

According to corporate tax law, income and expenses arising from transactions between associated enterprises must be adjusted to reflect an arm's length price. Enterprises are associated whenever a resident company (or permanent establishment) is related directly or indirectly to a non-resident entity; and an entity owns directly or indirectly 25 percent or more in, or exercises control over, another entity. Accordingly, the value of the transaction must be adjusted to normal market prices and such prices must be applied at both ends of the transaction resulting in an increase of the taxable base in one company and a corresponding reduction in the taxable base of the other company. This is an imperative rule of valuation which applies to any transactions between local enterprises directly or indirectly associated with resident or non-resident enterprises.

Under the Spanish tax treaty network, only the treaties with Canada, Czechoslovakia, Poland, Romania, Sweden and the United States include a mutual agreement provision to eliminate double taxation by means of corresponding adjustments.

J. *Double taxation relief*

As unilateral relief for the avoidance of international double taxation, Spain uses the ordinary credit method.[5] Under this method, a resident corporate taxpayer with foreign-source income may credit against its Spanish corporate tax liability on worldwide income the lower of:
- the foreign tax effectively paid on the related foreign-source income or gains; and
- the Spanish corporate tax liability attributable to such income or gains.

III. OTHER INCOME TAXES

There are no other taxes on income besides the normal corporate tax. However, certain local income-related levies which are deductible for corporate tax purposes warrant mention.

A. *Hydrocarbon enterprises' tax*

Resident companies (and foreign branches) engaged in the exploration and exploitation of hydrocarbons in Spain are governed by the Hydrocarbons Law under which oil-related profits are taxed at 40 percent, instead of 35 percent.

B. *Local surcharge of the Chamber of Commerce*

A 1.5 percent corporate tax surcharge (which is a deductible expense) must be paid as an annual registration fee by all resident companies and permanent establishments to the appropriate Chamber of Commerce, Industry and Navigation.

C. *Business/professional licence tax*

The business or professional licence tax is a local tax payable annually in November by registered individual and corporate persons conducting business or professional activities. The tax consists of a lump-sum charge (which varies annually for each type of activity) increased by a minimum surcharge of 110 percent. From 1 January 1992 this tax will be replaced by a similar tax: the amount of business tax resulting from application of the pertinent tariff (to be set forth by the Government) may not exceed 15 percent of the average profit notionally attributed to the activity concerned.

D. *Urban land appreciation tax*

This is a local tax which may be levied, at the discretion of each municipality, at a rate between 20 and 30 percent on the appreciation in the official value of urban land which is transferred for consideration or by inheritance or gift. The person liable to the tax is the transferee (in the case of inheritances and gifts) and the alienator (in the case of transfers for consideration).

IV. NET WORTH TAX

Spain does not levy any tax on the net worth of companies.

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3. Id.
4. Id.
5. However, in a few treaties (e.g. Brazil) the exemption with progression method is used in respect of dividends and other distributions.

V. PAYROLL TAXES

Spain does not levy any payroll taxes. However, withholdings are to be made from salaries and payments for any services rendered to resident companies and foreign permanent establishments. The withholding on salaries is made, in general, in accordance with a general withholding table and at flat rates in respect of fees and similar earnings by independent professionals and artistes.

VI. SOCIAL SECURITY CONTRIBUTIONS

There is a general social security contribution system as well as special schemes. Unless a special scheme applies, the employer and his employees are subject to the general social security system. Under this system, contributions are made by both the employer and the employee, taking into account the employee's professional category; each category has minimum and maximum monthly bases for determining the amount of the contribution, which are indexed annually. The minimum and maximum monthly bases for 1991 are:
- 62,130 and 172,620 Ptas. for clerks and messengers;
- 76,980 and 306,120 Ptas. for qualified technicians and assistants; and
- 92,820 and 306,120 Ptas. for engineers and university graduates.

The rates for calculating the employer's contributions under the social security system are:

- general rate 24 %
- unemployment insurance 5.2%
- salary guarantee fund 0.4%
- professional education and training 0.6%
- work accident insurance (rate varies per job type, e.g. 1.1% for office work; 8.4% for construction).

A 12 or 24 percent additional charge applies separately to any overtime payment (including a minimum premium of 75 percent) paid by the employer for necessary work or for other extra work, respectively.

The employer's social security contribution may be substantially reduced by hiring personnel in target groups (e.g. severely handicapped, long-time unemployed, youth under 25 years of age, workers over 45 years of age, etc.).

VII. WITHHOLDING TAXES

Spanish-source income derived by companies resident or established in Spain is subject to withholding of IS which is generally treated as a payment on account and is credited as such against the payor's corporate tax liability for the year concerned. The standard withholding rate for investment income, leasing income and directors' fees is 25 percent, and for fees on independent services, 15 percent for residents and a final 25 percent for non-residents.

A. *Dividends*

The withholding rate on any Spanish-source dividends and other distributions is 25 percent. Stock dividends are not subject to tax.

This tax is final for non-residents but creditable for residents.

However, dividends and other distributions by quoted portfolio investment companies and portfolio investment funds to residents of another EC country are no longer taxable in Spain.

B. *Interest*

The standard withholding rate on interest is 25 percent, except for interest paid to residents on Treasury bonds, which is not subject to withholding, and notional interest on AFRO bonds (certain bearer securities, such as zero-rate bonds), which is subject to a final withholding of 55 percent.

Exemption from withholding on account of IS applies to interest on ordinary loans and related commissions payable to financial institutions (including permanent establishments) subject to Spanish corporate tax.

The corporate tax law provides for a maximum relief of 95 percent of the tax on Spanish-source interest paid on qualifying borrowings from foreign sources (ordinary loans and bonds) used for financing capital investments in Spain. Qualifying lenders are international organizations, foreign banks and financial institutions with no permanent establishment in Spain and – in respect of Spanish bond issues – any foreign companies. Qualifying borrowers include Spanish industrial and commercial banks and approved companies and Government agencies. This relief and its amount is determined, upon application by the Spanish borrower, on a case-by-case basis by the Minister of Economy and Finance. Assuming a 95 percent relief, the effective final tax would be 1.25 percent.

The former compulsory interest-free deposit requirement with the Central Bank (equal to 30 percent of the principal on financial loans to Spanish companies) has been abolished.

C. *Royalties*

The withholding tax on industrial royalties and know-how is 25 percent (on account for residents and final for non-treaty country residents).

D. *Treaty chart*

Companies without a permanent establishment in Spain which are resident in countries with which Spain has a tax treaty are generally not taxed in Spain on their Spanish-source business income. Similarly, capital gains accruing to a resident of a treaty country are generally not taxed if they arise on the disposal of securities. However, capital gains on the disposal of shares in real estate companies can be taxed in Spain, under certain treaties (e.g. treaties with Canada, France, Luxembourg, the Netherlands and Sweden).

Dividends from a quoted portfolio investment company and profit distributions from a portfolio investment fund are not taxable in Spain if the recipient is resident in another EC country.

Other types of Spanish-source outgoing income (dividends and other distributions – including income imputed under fiscal transparency – interest and royalties) are taxed at the rates indicated in Table I.

Table I

Country of residence	Dividends (percent)	Interest* (percent)	Royalties (percent)
Non-treaty country	25	25	25 (10 on films)
Austria	15,10[1]	5	5
Belgium	15	15	5
Brazil	15	15,10[2]	10[3],15
Canada	15	15	10[4]
Czechoslovakia	15, 5[5]	0[6]	5[4]
Denmark	15,10[7]	10	6
Finland	15,10[5]	10	5
France	15,10[8]	10[9]	6
Germany (Fed. Rep.)	15,10[5]	10[9]	5
Hungary	15, 5[5]	0[6]	0[4]
Italy	15	12[9]	8, 4[3]
Japan	15,10[10]	10	10
Luxembourg	15,10[8]	10[9]	10
Morocco	15,10[5]	10	10[11], 5[3]
Netherlands	15,10,5[12]	10	6
Norway	15,10[7]	10	5
Poland	15, 5[5]	0[6]	10[4]
Portugal	15,10[1]	15[9]	5
Romania	15,10[5]	10	10
Sweden	15,10[1]	15	10
Switzerland	15,10[5]	10[13]	5
Tunisia	15, 5[7]	10, 5[14]	10
U.S.A.	15,10[15]	10, 0[16]	10, 5, 8, 0[17]
U.S.S.R.	18	0[6]	5
United Kingdom	15,10[18]	12	10

* Notwithstanding the fact that the withholding rate on interest may be reduced to 1.25 percent by virtue of a tax incentive, the tax sparing clause included in some treaties may entitle qualifying lenders resident in the treaty country to a tax sparing credit at the treaty rate.

1. 10 percent if the recipient is a company, other than a partnership, that owns directly at least 50 percent of the paying company's capital for at least one year prior to the distribution; 15 percent in other cases.

2. 10 percent for interest on long-term (ten or more years) borrowings to financial institutions to finance the purchase of capital equipment; zero percent applies to interest paid to the Government or a Government-owned agency or institution.
3. The lower rate applies to copyright royalties from literary, artistic or scientific works, expressly including (under the treaty with Brazil) or excluding (under the treaties with Italy and Morocco) copyright royalties from cinematographic or television films.
4. Spanish-source royalties in general paid to a resident of Hungary and copyright royalties – excluding those on cinematographic and television films – paid to a resident of Canada/Czechoslovakia/Poland are exempt from Spanish tax.
5. The lower rate applies if the recipient is a company, other than a partnership, that owns directly at least 25 percent of the paying company's capital; 15 percent in other cases.
6. Spanish-source interest paid to a resident of Czechoslovakia/Hungary/Poland/U.S.S.R. is exempt from Spanish tax.
7. The lower rate applies if the recipient is a company, other than a partnership, that owns directly at least 50 percent of the paying company's capital; 15 percent in other cases.
8. 10 percent if the French/Luxembourg recipient is a company, other than a partnership, that owns directly at least 25 percent of the paying company's capital for at least one year prior to the distribution.
9. Except for interest paid by the Government or a Government-owned agency; exemption applies in respect of interest payments by Spain to the West German Deutsche Bundesbank or the Kreditanstalt für Wiederaufbau (under the treaty with Germany) and interest on loans made, guaranteed or insured by the Canadian Export Development Corporation (under the treaty with Canada).
10. 10 percent if the recipient is a company that owns at least 25 percent of the paying company's capital for at least six months before the end of the year of the profits out of which the distribution is made.
11. For patent, trademark and know-how royalties and copyright royalties on cinematographic or television films.
12. 10 percent if the recipient is a Dutch company, other than a partnership, that, without being exempt from corporate tax on the distribution received, owns at least 50 percent of the paying company's capital or at least 25 percent while another Dutch company also owns at least 25 percent; 5 percent applies if the Dutch company is exempt from Dutch corporate tax for the distributions received.
13. Exemption applies to Spanish-source interest on long-term (repayable after five years) bank loans paid to Switzerland.
14. 5 percent for interest on long-term (exceeding seven years) loans.
15. The lower rate applies if the recipient is a company that owns at least 25 percent of the paying company (excluding fiscally transparent companies and entities and quoted portfolio investment companies and portfolio investment funds).
16. Exemption applies in respect of Spanish-source interest payments:
   - in general, to the Government or Government institutions;
   - from long-term (repayable after 5 or more years) loans granted by banks or other financial institutions; and
   - from sales on credit of industrial, commercial or scientific equipment.
17. The 10 percent rate applies to royalties in general; the rate of 5 percent applies to copyright royalties on literary, dramatic, musical or artistic work and related technical assistance; the rate of 8 percent applies to copyright royalties on scientific work, film/tape royalties, industrial/commercial/scientific equipment-related royalties and related technical assistance. The exemption applies to royalties from leasing or licensing containers used in international traffic.
18. 10 percent if the recipient is a U.K. company, other than a partnership, that controls directly or indirectly at least 10 percent of the voting power in the paying company.

VIII. NON-RESIDENT CORPORATIONS

Non-resident corporations are defined for IS purposes as companies which have not been incorporated under Spanish law nor have their seat nor central management in Spanish territory.

Generally, the permanent establishment of a non-resident corporation is subject to IS on Spanish-source income and capital gains at the general rate of 35 percent.

Unless a treaty provides otherwise, non-resident companies without a permanent establishment in Spain (or with a permanent establishment carrying on only occasional activities in Spain, where they opt for this limited system of taxation) are subject to the effective rates on their Spanish-source income indicated in Table II.

Effective 1 January 1991, the following items are not taxable in Spain:
- dividends, interest and capital gains derived by non-resident investors from securities issued in Spain by non-residents directly, irrespective of the residence status of the payor;
- interest and capital gains from:
  - public bonds derived directly by a non-resident bondholder (unless resident in a tax haven); and
  - movable property (excluding capital gains from substantial (25 percent) shareholdings and shares and similar rights in real estate companies) derived directly by EC residents (unless resident in a tax haven).

Royalty payments to non-resident companies are limited by the exchange control authorities. For royalties and technical assistance fees, the underlying contract must be registered with the Ministry of Industry and the payment authorized by the exchange control authorities. In general, the maximum authorized payment of royalties is four to five percent of the base on which the payment is calculated (limited usually to five percent of the related sales).

Non-resident companies without a permanent establishment in Spain but deriving Spanish-source income must appoint a resident of Spain to represent them and must file a special return for every accrual. No remittance abroad is allowed unless the full tax is previously paid.

IX. VALUE ADDED TAX

A. *Taxable persons*

Spain imposes a turnover tax on the value added in respect of taxable supplies of goods and services (including self-supplies and private use) by individual or corporate entrepreneurs in mainland Spain and the Balearic Archipelago, as well as in respect of the importation of goods by any person into that territory of imposition.

B. *Taxable base*

The taxable base is the total consideration charged; in respect of imported goods, it is the value of such goods for customs purposes, increased by any import-related taxes (other than VAT itself), duties and charges.

In computing tax liability, input VAT may be credited against output VAT so that in practice only the value added to the entrepreneur's supplies is taxed.

C. *Rates*

– General rate:	12%
– Increased rate (for luxury goods and cars)	33%
– Reduced rate (for basic necessities)	6%
– Zero-rate (virtually only for export-related goods and services)	0%

Table II

Taxable item	Final tax on each accrual
– Gross investment income in general (including dividends and other distributions,income imputed under fiscal transparency, interest and royalties in general)	25%
– Adjusted gross income (i.e. gross income less expenses paid in Spain on payroll and necessary purchases of goods), income from services rendered in Spain or paid by a resident of Spain, technical assistance, installation and assembly costs on registered engineering contracts and, in general, business activities in Spain without a permanent establishment (or with a permanent establishment carrying on only sporadic activities, where it opts for this system of taxation)	25%
– Gross income derived from rentals or use of films and cinematograph productions whether for their commercial exploitation or for use in publicity campaigns and from the use of containers in international trade other than shipping	10%
– Reinsurance premiums	4%
– Gross contractual fees paid by Spanish subsidiaries to parents for services effectively connected with the running of the Spanish business and head office expenses paid by branches	14%
– Gross reimbursement costs incurred by establishments which operate in Spain but use the goods produced or services performed therein for their own purposes (i.e. 35% of 15% of the expenses incurred and non-operating revenues, e.g. interest, rent)	5.25%
– Interest on bank deposits in foreign currency or convertible Ptas.	0%
– Capital gains	35%

INTERNATIONAL:
CUSTOMS UNION AGREEMENT BETWEEN ANDORRA AND THE EEC

AGREEMENT

between the European Economic Community and the Principality of Andorra

THE PRINCIPALITY OF ANDORRA
and
THE EUROPEAN ECONOMIC COMMUNITY,

DESIROUS of introducing, in respect of their trade relations, arrangements to take the place of national arrangements currently in force and respecting the specific situation of the Principality of Andorra,

CONSIDERING THAT, owing to geographical, historical and social and economic factors, Andorra's exceptional situation justifies special arrangements, particularly as regards exemption from import duties, turnover tax and excise duties collected on goods imported by travellers from Andorra into the Community,

HAVE AGREED AS FOLLOWS:

Article 1

Trade between the European Economic Community, on the one hand, and the Principality of Andorra, on the other, shall be governed by the provisions set out below.

TITLE I
Customs Union

Article 2

A customs union shall be established between the European Economic Community and Andorra for the products covered by Chapters 25 to 97 of the Harmonized System in accordance with the procedure and conditions set out under this Title.

Article 3

1. The provisions of this Title shall apply to:
(a) goods produced in the Community or in the Principality of Andorra, including those obtained wholly or in part from products which come from third countries and are in free circulation in the Community or in the Principality of Andorra;
(b) goods which come from third countries and are in free circulation in the Community or in the Principality of Andorra.

2. Products coming from third countries shall be considered to be in free circulation in the Community or in the Principality of Andorra if the import formalities have been complied with and any customs duties or charges having equivalent effect which are payable have been levied, and there has been no total or partial drawback of such duties or charges in respect of the said products.

Article 4

The provisions of this Title shall also apply to goods obtained in the Community or in the Principality of Andorra, in the manufacture of which were used products coming from third countries and not in free circulation either in the Community or in the Principality of Andorra. These provisions shall, however, apply to those goods only if the exporting Contracting Party levies the customs duties laid down in the Community for third country products used in their manufacture.

Article 5

The Contracting Parties shall refrain from introducing between themselves any new customs duties on imports or exports or charges having equivalent effect, and from increasing those already applied in their trade with each other on 1 January 1989.

Article 6

1. Customs duties on imports and charges having equivalent effect in force between the Community and the Principality of Andorra shall be abolished in accordance with paragraphs 2 and 3.

2. On 1 January 1991, the Principality of Andorra shall abolish customs duties and charges having equivalent effect on imports from the Community.

3. (a) From 1 January 1991 the Community, with the exception of the Kingdom of Spain and the Portuguese Republic, shall abolish customs duties and charges having equivalent effect on imports from the Principality of Andorra.

(b) From 1 January 1991 the Kingdom of Spain and the Portuguese Republic shall apply the same customs duties in respect of the Principality of Andorra as they apply in respect of the Community as constituted on 31 December 1985.

(c) In the case of processed agricultural products covered by Chapters 25 to 97 of the Harmonized System and referred to in Regulation (EEC) No 3033/80, subparagraphs (a) and (b) shall apply to customs duties constituting the fixed component of the charge on imports of those products into the Community from the Principality of Andorra, while the variable component provided for in the Regulation shall continue to apply.

(d) By way of derogation from subparagraphs (a), (b) and (c), imports covered by the provisions relating to tax relief for travellers referred to in Article 13 shall be exempt from customs duties from 1 January 1991.

Article 7

1. For products covered by the customs union, the Principality of Andorra shall adopt, with effect from 1 January 1991:
– the provisions on import formalities applied by the Community to third countries,
– the laws, regulations and administrative provisions applicable to customs matters in the Community and necessary for the proper functioning of the customs union.

The provisions referred to in the first and second indents shall be those currently applicable in the Community.

2. The provisions referred to in the second indent of paragraph 1 shall be determined by the Joint Committee provided for in Article 17.

Article 8

1. (a) Over a period of five years, and beyond that period if no agreement can be reached in accordance with (b), the Principality of Andorra shall authorize the Community, acting on behalf of and for the Principality of Andorra, to enter goods sent from third countries to the Principality of Andorra for free circulation. Entry into free circulation will be effected by the Community customs offices listed in Annex I.

(b) At the end of this period, and under Article 20, the Principality of Andorra may exercise right of entry into free circulation for its goods, following agreement by the Contracting Parties.

2. Where import duties are payable on goods pursuant to paragraph 1, these duties shall be levied on behalf of the Principality of Andorra. The Principality of Andorra shall undertake not to refund these sums directly or indirectly to the parties concerned.

3. The Joint Committee provided for in Article 17 shall determine:
(a) possible changes to the list of the Community customs offices competent to clear the goods referred to in para-

graph 1 and the procedure for forwarding the said goods to the Principality of Andorra referred to in paragraph 1;

(b) the arrangements for assigning to the Andorran Exchequer the amounts collected in accordance with paragraph 2, and the percentage to be deducted by the Community to cover administrative costs in accordance with the relevant regulations in force within the Community;

(c) any other arrangements necessary for the proper implementation of this Article.

Article 9

Quantitative restrictions on imports and exports and all measures having equivalent effect between the Community and the Principality of Andorra shall be prohibited from 1 January 1991.

Article 10

1. Should either Contracting Party consider that disparities arising from the other Party's application, in respect of imports from third countries, of customs duties, quantitative restrictions or any measures having equivalent effect, or of any other measure of commercial policy, threaten to deflect trade or to cause economic difficulties in its territory, it may bring the matter before the Joint Committee, which shall, if necessary, recommend appropriate methods for avoiding any harm liable to result therefrom.

2. Where deflections occur or economic difficulties arise and the Party concerned considers that they call for immediate action, that Party may itself take the necessary surveillance or protection measures, notifying the Joint Committee without delay; the Joint Committee may recommend that the said measures be amended or abolished.

3. In the choice of such measures, preference shall be given to those which least disturb the operation of the customs union and, in particular, the normal development of trade.

TITLE II
Arrangements for products not covered by the customs union

Article 11

1. Products covered by Chapters 1 to 24 of the Harmonized System which originate in the Principality of Andorra shall be exempt from import duties when imported into the Community.

2. Rules of origin and methods of administrative cooperation are set out in the Appendix.

Article 12

1. The arrangements applied to goods from third countries imported into the Principality of Andorra shall not be more favourable than those applied to imports of Community goods.

2. Products covered by headings No 24.02 and 24.03 of the Harmonized System which are manufactured in the Community from raw tobacco and which meet the conditions of Article 3(1) shall be eligible, when imported into the Principality of Andorra, for a preferential rate corresponding to 60% of the rate applied in the Principality of Andorra for the same products vis-à-vis third countries.

TITLE III
Common provisions

Article 13

1. Exemptions from import duties, turnover tax and excise duties levied on imports by travellers between the Contracting Parties and applicable to goods contained in the personal luggage of travellers coming from one of the Contracting Parties shall be those currently applicable in the Community in respect of third countries, provided imports of those goods are strictly non-commercial.

2. With regard to the products covered by Title II of this Agreement and listed below, the exemptions referred to in paragraph 1 shall be granted within the following quantitative limits for each traveller entering the Community from the Principality of Andorra:

– milk powder	2.5 Kilograms
– condensed milk	3 Kilograms
– fresh milk	6 Kilograms
– butter	1 Kilogram
– cheese	4 Kilograms
– sugar and confectionery	5 Kilograms
– meats	5 Kilograms

3. By way of derogation from the provisions of paragraph 1 and provided that the goods have been acquired under the domestic market conditions of one of the Contracting Parties and meet the above conditions:

– the total value of the exemptions applicable to goods covered by Title I shall be set per person at three times the value of the exemption granted by the Community to travellers from third countries,

– the following quantitative limits shall apply to the goods listed below:

(a) Tobacco products
cigarettes 300 items
or
cigarillos 150 items
(cigars weighing no more than 3 g each)
or
cigars 75 items
or
smoking tobacco 400 grams

(b) Alcohol and alcoholic beverages
– distilled beverages and spirituous beverages having an alcoholic strength by volume of more than 22% vol; undenatured ethyl alcohol of 80% vol or more
1.5 litres total
or
– spirituous distilled beverages, aperitifs based on wine or alcohol, taffia, sake or similar beverages with an alcoholic strength by volume not exceeding 22% vol, sparkling wine, dessert wine
3 litres total
and
– still wine 5 litres total

(c) Perfume 75 grams
and
toilet water 3/8 litres

(d) Coffee 1000 grams
or
extracts and essences of coffee 400 grams

(e) Tea 200 grams
or
extracts and essences of tea 80 grams

4. Within the quantitative limits laid down in the second indent of paragraph 3, the value of the goods listed therein shall not be taken into consideration for determining the exemptions referred to in paragraph 1.

Article 14

The Contracting Parties shall refrain from any domestic tax measure or practice leading directly or indirectly to discrimination between the products of one Contracting Party and similar products from the other Contracting Party.

Products sent to the territory of one of the Contracting Parties shall not be eligible for a refund of domestic charges which is higher than the charges which have been levied directly or indirectly.

Article 15

1. In addition to the cooperation provided for in Articles 11(2) and 17(8), the administrative authorities of the Contracting Parties responsible for implementing the provisions of this Agreement shall assist each other in other cases so as to ensure compliance with the provisions.

2. Arrangements for the application of paragraph 1 shall be determined by the Joint Committee referred to in Article 17.

Article 16

The Agreement shall not preclude prohibitions or restrictions on imports, exports or goods in transit justified on grounds of public morality, public policy or public security, the protection of health and life of humans, animals or plants, the protection of national treasures possessing artistic, historic or archaeological value, the protection of industrial or commercial property or controls relating to gold and silver. Such prohibitions or restrictions shall not, however, constitute a means of arbitrary discrimination or a disguised restriction on trade between the Contracting Parties.

Article 17

1. A Joint Committee shall be set up with responsibility for administering this Agreement and ensuring that it is properly implemented. To that end, it shall formulate recommendations. It shall take decisions in the cases provided for in the Agreement. The decisions shall be executed by the Contracting Parties in accordance with their own regulations.

2. Which a view to the proper performance of this Agreement, the Contracting

Parties shall carry out exchanges of information and, at the request of either party, shall consult together in the Joint Committee.

3. The Joint Committee shall draw up its own rules of procedure.

4. The Joint Committee shall be composed, on the one hand, of representatives of the Community and, on the other, of representatives of the Principality of Andorra.

5. The Joint Committee shall take decisions by common accord.

6. The Joint Committee shall be chaired by each of the Contracting Parties in turn in accordance with the arrangements to be laid down in its rules of procedure.

7. The Joint Committee shall meet at the request of either of the Contracting Parties, to be lodged at least one month before the date of the intended meeting. Where the Joint Committee is convened under Article 10, it shall meet within eight working days from the date on which the request is lodged.

8. In accordance with the procedure laid down in paragraph 1, the Joint Committee shall determine methods of administrative cooperation for the purposes of applying Articles 3 and 4, taking as a basis the methods adopted by the Community in respect of trade between the Member States; it may also amend provisions in the Appendix, referred to in Article 11.

Article 18

1. Any disputes arising between the Contracting Parties over the interpretation of the Agreement shall be put before the Joint Committee.

2. If the Joint Committee does not succeed in settling the dispute at its next meeting, each Party may notify the other of the designation of an arbitrator; the other Party shall then be required to designate a second arbitrator within two months.

The Joint Committee shall designate a third arbitrator.

The arbitrator's decisions shall be taken by a majority vote.

Each Party involved in the dispute shall be required to take the measures needed to ensure the application of the arbitrator's decision.

Article 19

In trade covered by this Agreement:

- the arrangements applied by the Principality of Andorra vis-à-vis the Community may not give rise to any discrimination between the Member States, their nationals or their companies,
- the arrangements applied by the Community vis-à-vis the Principality of Andorra may not give rise to any discrimination between Andorran nationals or companies.

TITLE IV
General and final provisions

Article 20

This Agreement is concluded for an unlimited duration. Within five years of its entry into force, the two Parties shall begin consultations to examine the results of its application and, if necessary, to open negotiations on its amendment in the light of that examination.

Article 21

Either Contracting Party may denounce this Agreement by notifying the other Contracting Party in writing. In that case, the Agreement shall cease to have effect six months after the date of such notification.

Article 22

This Agreement shall apply, on the one hand, to the territories in which the Treaty establishing the European Economic Community is applied and under the conditions laid down in that Treaty and, on the other, to the territory of the Principality of Andorra.

Article 23

Annexes I and II and the Appendix to this Agreement shall form an integral part thereof.

Article 24

1. This Agreement shall enter into force on 1 July 1990, on condition that the Contracting Parties have notified each other before that date of the completion of the procedures necessary to that effect.

2. After the date provided for in paragraph 1, this Agreement shall enter into force on the first day of the second month following notification.

3. If paragraph 2 applies, the date 1 January 1991 contained in various provisions of this Agreement shall be replaced by the date 1 July 1991.

Article 25

The provisions of this Agreement shall replace those applied by the Community, and in particular by France and Spain, prior to the Agreement's entry into force, under the 1967 Exchange of Letters with the Principality of Andorra.

Article 26

This Agreement is drawn up in two originals in the Danish, Dutch, English, French, German, Greek, Italian, Portuguese, Spanish and Catalan languages, each text being equally authentic.

ANNEX I

List of customs offices referred to in Article 8(1)

- TOULOUSE PORTET
- L'HOSPITALET-PAS DE LA CASE
- LA TOUR DE CAROL
- PERPIGNAN
- MADRID
- BARCELONA
- ALGECIRAS
- TUY
- FARGA DE MOLES

ANNEX II

As regards the provisions of trade policy adopted by the Principality of Andorra under the Agreement, and in order that imports of the products consumed in Andorra should not be affected by these provisions, derogations may be decided by the Joint Committee at the request of the Principality of Andorra; these derogations may include aspects of common commercial policy which do not apply to all the Member States of the Community.

The Commission shall communicate to the Andorran authorities any relevant information concerning the arrangements applicable to the Community's external trade.

Statement by the Community concerning agricultural and processed agricultural products

This Agreement shall not affect the Community's refund arrangements for exports of Community agricultural products or processed agricultural products.

Joint Statement

In so far as provisions of this Agreement, such as, in particular, the provisions governing customs duties, charges having equivalent effect, quantitative restrictions, measures having equivalent effect, prohibitions on imports, exports or goods in transit, are similar to the provisions of the Treaty establishing the European Economic Community, the Contracting Parties' representatives within the Joint Committee shall undertake to interpret the former, within the scope of this Agreement, in the same way as the latter are interpreted in trade within the European Economic Community.

Statement by the Principality of Andorra

The Principality of Andorra undertakes not to operate any discrimination as regards import duties and taxes levied on whisky, absinth and aniseed-based aperitifs, on the one hand, and other alcoholic beverages and aperitifs, on the other hand.

Joint Statement

The Joint Committee shall examine, and endeavour to find a solution to, any problems which arise in trade between the Contracting Parties as regards the monitoring and certification of technical standards.

APPENDIX

concerning the definition of "originating products" and methods of administrative cooperation

TITLE I
DEFINITION OF THE CONCEPT OF ORIGINATING PRODUCTS

Article 1

For the purpose of implementing the provisions of Article 11(1) of the Agreement, the following shall be regarded as products originating in the Principality of Andorra:
(a) vegetable products which are harvested in the Principality of Andorra;
(b) live animals born and raised in the Principality of Andorra;
(c) products obtained from live animals born and raised in the Principality of Andorra;
(d) products from hunting or fishing in the Principality of Andorra;
(e) products obtained in the Principality of Andorra by working or processing products referred to in points (a) to (d), even if other products have been used in their manufacture, provided that the products which were not obtained in the Principality of Andorra play only a subsidiary part in manufacture.

TITLE II
ARRANGEMENTS FOR ADMINISTRATIVE COOPERATION

Article 2

1. Originating products within the meaning of this Appendix shall when imported into the Community be covered by the Agreement on presentation of:

(a) an EUR.1 movement certificate, hereinafter referred to as an "EUR.1 certificate". A specimen of the EUR.1 certificate is given in Annex 2 to this Appendix;*
(b) an invoice bearing the exporter's declaration as given in Annex 3 to this Appendix, made out by any exporter for any consignment of one or more packages containing originating products whose total value does not exceed ECU 2820.

2. The following originating products within the meaning of this Appendix shall when imported into the Community be covered by the Agreement without it being necessary to present either of the documents referred to in paragraph 1:

(a) goods sent as small packages from private persons to private persons, whose total value does not exceed ECU 200;
(b) goods forming part of travellers' personal luggage whose value does not exceed ECU 565.

These provisions shall apply only provided that such goods are not imported by way of trade and have been declared as meeting the conditions required for the application of the Agreement, and where there is no doubt as to the veracity of such declaration.

Imports which are occasional and consist solely of goods for the personal use of the recipients or travellers shall not be considered as imports by way of trade if it is evident from the nature and quantity of the goods that no commercial purpose is in view.

3. Up to and including 30 April 1991 the ecu to be used in terms of any given national currency shall be the equivalent in that national currency of the ecu as at 3 October 1988. For each successive period of two years thereafter it shall be the equivalent in that national currency of the ecu as at the first working day in October in the year immediately preceding the two-year period.

4. Amounts in the national currency of the exporting State equivalent to the amounts expressed in ecus shall be fixed by the exporting State and communicated to the other parties. When these amounts are greater than the corresponding amounts fixed by the importing State, the importing State shall accept them if the goods are invoiced in the currency of the exporting State.

If the goods are invoiced in the currency of another Member State of the Community, the importing State shall recognize the amount notified by the State concerned.

Article 3

1. An EUR. 1 certificate shall be issued by the Andorran customs authorities when the goods to which it relates are exported. It shall be made available to the exporter as soon as actual exportation has been effected or ensured.

2. The EUR. 1 certificate shall be issued by the Andorran customs authorities if the goods to be exported can be considered as products originating in the Principality of Andorra within the meaning of Article 1 of this Appendix.

3. An EUR. 1 certificate may be issued only where it can serve as the documentary evidence required for the purpose of implementing the preferential arrangements provided for by the Agreement.

The date of issue of the EUR. 1 certificate must be indicated in the part of the certificate reserved for the customs authorities.

4. In exceptional circumstances an EUR. 1 certificate may also be issued after exportation of the goods to which it relates if it was not issued at the time of exportation because of errors or involuntary omissions or special circumstances.

Certificates issued retrospectively must be endorsed with one of the following phrases:

"EXPEDIDO A POSTERIORIT", "UDSTEDT EFTERFØLGENDE", "NACHTRÄGLICH AUSGESTELLT, EKDOTHEN EK TON YSTEPON", "ISSUED RETROSPECTIVELY", "DELIVRE A POSTERIORI", "RILASCIATO A POSTERIORI", "AFGEGEVEN A POSTERIORI", "EMITIDO A POSTERIORI", "EMES A POSTERIORI".

5. In the event of the theft, loss or destruction of an EUR. 1 certificate, the exporter may apply to the Andorran customs authorities which issued it for a duplicate made out on the basis of the export documents in their possession. The duplicate issued in this way must be endorsed with one of the following:

"DUPLICADO", "DUPLIKAT", "DUPLIKAT", "ANTIGRAPHO", "DUPLICATE", "DUPLICATO", "DUPLICAAT", "SEGUNDA VIA", "DUPLICAT".

The duplicate, which must bear the date of issue of the original EUR. 1 certificate, shall take effect as from that date.

6. The endorsements referred to in paragraphs 4 and 5 shall be entered in the Remarks box on the EUR. 1 certificate.

7. For the purpose of verifying whether the conditions stated in paragraph 2 have been met, the Andorran customs authorities shall have the right to call for any documentary evidence or to carry out any check which they consider appropriate.

Article 4

1. An EUR. 1 certificate shall be issued only on application having been made in writing by the exporter or, under the exporter's responsibility, by his authorized representative, on the form of which a specimen is given in Annex 2 to this Appendix; it shall be completed in accordance with this Appendix.

2. It shall be the responsibility of the Andorran customs authorities to ensure that the form referred to in paragraph 1 is duly completed. In particular, the Andorran customs authorities shall check whether the space reserved for the description of the goods has been completed in such a manner as to exclude all possibility of fraudulent additions. To this end, the description of the goods must be given without leaving any blank lines. Where the space is not completely filled a horizontal line must be drawn below the last line of the description, the empty space being crossed through.

3. Since the EUR. 1 certificate constitutes the documentary evidence for the application of the preferential tariff provided for by the Agreement, it shall be the responsibility of the Andorran customs authorities to take any steps necessary to verify the origin of the goods and to check the other statements on the EUR. 1 certificate.

* Editor's note: Annexes 2 and 3 are not reprinted.

4. When a certificate is issued in accordance with Article 3(4) of this Appendix, after the goods to which it relates have actually been exported, the exporter must in the application referred to in paragraph 1:
- indicate the place and date of consignment of the goods to which the certificate relates,
- certify that no EUR. 1 certificate was issued at the time of exportation of the goods in question, and state the reasons.

Article 5

1. EUR. 1 certificates shall be made out on the form of which a specimen is given in Annex 2. This form shall be printed in one or more of the languages in which the Agreement is drawn up. Certificates shall be made out in one of these languages and in accordance with the provisions of the domestic law of the Principality of Andorra; if they are handwritten they shall be completed in ink and in capital letters.

2. Each certificate shall measure 210 × 297 mm. A tolerance of up to plus 8 mm or minus 5 mm in the length may be allowed. The paper used must be white writing paper, sized, not containing mechanical pulp and weighing not less than 25 g/m^2. It shall have a printed green guilloche pattern background making any falsification by mechanical or chemical means apparent to the eye.

3. The Principality of Andorra may reserve the right to print the certificates itself or may have them printed by approved printers. In the latter case, each certificate must include a reference to such approval. Each certificate must bear the name and address of the printer or a mark by which the printer can be identified. It shall also bear a serial number, either printed or not, by which it can be identified.

Article 6

1. An EUR. 1 certificate must be submitted, within four months of the date of issue, by the Andorran customs authorities to the customs authorities of the importing State where the goods are entered in accordance with the procedures laid down by that State.

2. An EUR. 1 certificate which is submitted to the customs authorities of the importing State after the final date for presentation specified in paragraph 1 may be accepted for the purpose of applying preferential treatment, where the failure to submit the certificate by the final date set is due to reasons of *force majeure* or exceptional circumstances.

In other cases of belated presentation, the customs authorities of the importing State may accept the certificates where the goods have been submitted to them before the said final date.

3. The discovery of slight discrepancies between the statements made in the EUR. 1 certificate and those made in the documents submitted to the customs office for the purpose of carrying out the formalities for importing the goods shall not *ipso facto* render the certificate null and void if it is duly established that the certificate does correspond to the goods submitted.

Article 7

The declaration referred to in Article 2(1)(b) shall be drawn up by the exporter in the manner specified in Annex 3 to this Appendix, in one of the languages in which the Agreement is drawn up.

It shall be typed, or printed by means of a stamp and signed by hand. The exporter must retain a copy of the invoice bearing this declaration for at least two years.

Article 8

1. The exporter or his representative shall submit with his application for an EUR. 1 certificate any appropriate supporting document proving that the goods to be exported qualify for the issue of an EUR. 1 certificate.

He shall undertake to submit, at the request of the appropriate authorities, any supplementary evidence they may require for the purpose of establishing the correctness of the originating status of the goods eligible for preferential treatment and shall undertake to agree to any inspection of his accounts and to any check on the processes of the obtaining of the above goods, carried out by the said authorities.

2. Exporters must keep for not less than two years the supporting documents referred to in paragraph 1.

3. The provisions of paragraphs 1 and 2 shall apply *mutatis mutandis* in the case of the use of the declaration referred to in Article 2(1)(b).

Article 9

1. Goods sent from the Principality of Andorra for exhibition in another country and sold after the exhibition for importation into the Community shall benefit on importation from the provisions of the Agreement on condition that the goods meet the requirements of this Appendix entitling them to be recognized as originating in the Principality of Andorra and provided that it is shown to the satisfaction of the customs authorities that:

(a) an exporter has consigned the goods from the Principality of Andorra to the country in which the exhibition is held and has exhibited them there;
(b) the goods have been sold or otherwise disposed of by that exporter to a consignee in the Community;
(c) the goods have been consigned during the exhibition or immediately thereafter to the Community in the State in which they were sent for exhibition;
(d) the goods have not, since they were consigned for exhibition, been used for any purpose other than demonstration at an exhibition.

2. An EUR. 1 certificate must be submitted to the customs authorities in the normal manner. The name and place of the exhibition must be indicated thereon. Where necessary, additional documentary evidence of the nature of the goods and the conditions under which they have been exhibited may be required.

3. Paragraph 1 shall apply to any trade, industrial, agricultural or crafts exhibition, fair or similar public show or display which is not organized for private purposes in shops or business premises with a view to the sale of foreign goods, and during which the goods remain under customs control.

Article 10

1. In order to ensure the proper application of this Title, Member States of the Community and the Principality of Andorra shall assist each other, through their respective customs administrations, in checking the authenticity and accuracy of EUR. 1 certificates and the declarations by exporters made on invoices.

Representatives of the Commission of the European Communities may on request take part in this checking.

2. The Andorran customs authorities shall forward to the customs authorities of the Member States, via the Commission of the European Communities, specimen impressions of the stamps used in their offices for issuing EUR. 1 certificates.

3. Penalties shall be imposed on any person who, in order to enable goods to be accepted as eligible for preferential treatment, draws up, or causes to be drawn up, a document which contains incorrect particulars.

Article 11

1. Subsequent verification of EUR. 1 certificates and of exporters' declarations made on invoices shall be carried out at random or whenever the customs authorities of the importing State have reasonable doubt as to the authenticity of the document or the accuracy of the information regarding the true origin of the goods in question.

2. For the purposes of implementing the provisions of paragraph 1 the customs authorities of the importing State shall return the EUR. 1 certificate, and the invoice if it has been submitted, or the invoice bearing the exporter's declaration or a copy of those documents, to the Andorran customs authorities, giving, where appropriate, the reasons of substance or form for an inquiry.

The customs authorities of the importing State shall forward, in support of the request for subsequent verification, any documents and information that have been obtained suggesting that the particulars given on the EUR. 1 certificate or the invoice are inaccurate.

If the customs authorities of the importing State decide to suspend the application of Article 11 pending the results of the verification, they shall offer to release the goods to the importer subject to any precautionary measures judged necessary.

3. The customs authorities of the importing State shall be informed of the results of the verification as soon as possible. The results must be such as to make it possible

to determine whether the documents which are referred to in paragraph 2, and which have been returned, apply to the goods actually exported and whether these goods can in fact qualify for the application of the preferential arrangements.

When such disputes cannot be settled between the customs authorities of the importing State and the Andorran customs authorities, or when they raise a problem of interpretation of this Appendix, they shall be submitted to the Customs Committee.

For the purpose of subsequent verification of EUR. 1 certificates, the export documents or copies of EUR. 1 certificates provided in their place must be retained for at least two years by the Andorran customs authorities.

TITLE III
FINAL PROVISIONS

Article 12

The Community and the Principality of Andorra shall each take the measures necessary for the implementation of this Appendix.

Article 13

The Annexes to this Appendix shall form an integral part thereof.

ANNEX 1
EXPLANATORY NOTES

Note 1
In order to determine whether goods originate in the Principality of Andorra, it shall not be necessary to establish whether the power and fuel, plant and equipment, machines and tools used to obtain such goods originate in third countries or not.

Note 2
In order to determine the origin of products falling within Chapters 1 to 24 of the Combined Nomenclature, no account shall be taken of any packaging.

Note 3
Products which do not make up more than 10% by quantity of those referred to in Article 1(a) to (e) of the Appendix shall be regarded as 'playing a subsidiary part' in manufacture.

Conference Diary

SEPTEMBER 1991

U.S. Accounting Course – "Working with U.S. Financial Statements". Dublin, 16-17 September (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel.: (071)9257502; Fax: (071)9356951.

U.S. and European Reorganisations. Lenham, Kent, United Kingdom, 18-20 September (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel.: (071)9257502; Fax: (071)9356951.

The Tax Effective Management of an International Treasury. London, 19-20 September (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: (071)6374383; Fax: (071)3234298.

International Conference on Property Taxation and its Interaction with Land Policy. Cambridge, Massachussetts, 22-26 September; Technical Workshop 27-28 September (English):
Lincoln Institute of Land Policy, Attn.: Mrs. Ann Long, Registrar, 26 Trowbridge Street, Cambridge, MA, 02138, U.S.A. Tel.: 617-661-3016; Fax: 617-661-6596.

I.T.P.A. Monte-Carlo Workshop. Monte-Carlo, 23-24 September (English):
Ms. Elisabeth Husband, I.T.P.A., Membership and Conference Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

Fiscale Concernstructuren. Zeist, 26-27 September (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Fax: 040-449895.

OCTOBER 1991

Leasing. Brussels, 1-4 October (English):
Customer Service Department, Management Centre Europe, Postbus 95, 3417 ZH Montfoort, The Netherlands. Tel.: 32/2/516.19.11, ext. 934; Fax: 32/2/513.71.08.

Commissie Stevens: Inhoud en Consequenties Rapport. Amsterdam-Duivendrecht, 3 October (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Fax: 040-449895.

Optimale Successieplanning. Amsterdam, 3 October (Dutch):
Kluwer Seminars, Antwoordnummer 424, 7400 VB Deventer, The Netherlands, Tel.: 05700-47190; Fax: 05700-13630.

45th Congress of the International Fiscal Association; Subjects: The Determination of the Tax Base for Real Property; Protection of Confidential Information in Tax Matters. Barcelona, 6-11 October (English, French, German, Spanish):
Wagons Lits Viajes, Central de Congresos, Madrid; Virgen de los Peligros, 2, 1º – 28013 Madrid, Spain. Tel.: (1) 532 99 09/531 27 20; Fax: (1) 532 50 80.

Accounting & Taxation Techniques: Conference 1: France; Conference 2: U.S.A. London, 17 October (Conference 1) and 18 October (Conference 2) (English):
Conference Organiser, Business Research International Ltd., IBS House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: (071) 6374383; Fax: (071) 6313214.

International Taxation Management Techniques: Transfer Pricing, Mergers and Acquisitions, Financing Techniques, EC Tax Harmonization. Brussels, 24-25 October (English):
Customer Service Department, Management Centre Europe, Postbus 95, 3417 ZH Montfoort, The Netherlands. Tel.: 32/2/516.19.11, ext. 934; Fax: 32/2/513.71.08.

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Rijksuniversiteit Limburg, Vakgroep Publiekrecht, Postbus 616, 6200 MD Maastricht, The Netherlands.

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IBDF International Tax Academy, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: 31 20 6267726; Fax: 31 20 6209397.

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CCH International Seminars, 701 Seabird House, 22-28 Wyndham Street, Central Hong Kong. Tel.: (852)5267614; Fax: (852)5217874.

New Legislation in Australia on Offshore Companies and Trusts; Asset Protection trusts; Immigration; Developments in New Zealand. Sydney, 18-19 November (English):
Ms. Elisabeth Husband, Conference Director I.P.T.A., Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

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Conference Organiser, Tolley Publishing Co. Ltd., FREEPOST, Tolley House, 2 Addiscombe Road, CR9 9 EA, United Kingdom. Tel.: (081) 6869141; Fax: (081) 6863155.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1991 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Africa

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London, Europa Publications Limited, 1990, pp. 984. £ 105.-.
Revised and updated edition of comprehensive reference work. Part I consists of essays on topics and issues of contemporary interest, contributed by some of the foremost authorities on Middle Eastern and North African affairs. Part II contains information on the major organizations active within the Middle East and North Africa, their aims and functions, and a directory of principal officials. Part III is devoted to an individual survey of each country in turn. Chapters include: essays on geography, recent history and economy, statistics, a directory of essential names and addresses and other key information covering constitution, government, legislature, finance, trade and industry.
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Lagos, JAA Nigeria Limited, 113 Apapa Road, Ebute Metta, P.O. Box 3313, Festac Town, Lagos, Nigeria, 1988, pp. 265.
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Vienna, BMF – Bundesministerium für Finanzen, Himmelpfortgasse 8, 1010 Wien, 1991. Schriftenreihe No. 1, pp. 129.
Booklet issued by the Ministry of Finance on the 2nd stage of the Austrian tax reform.
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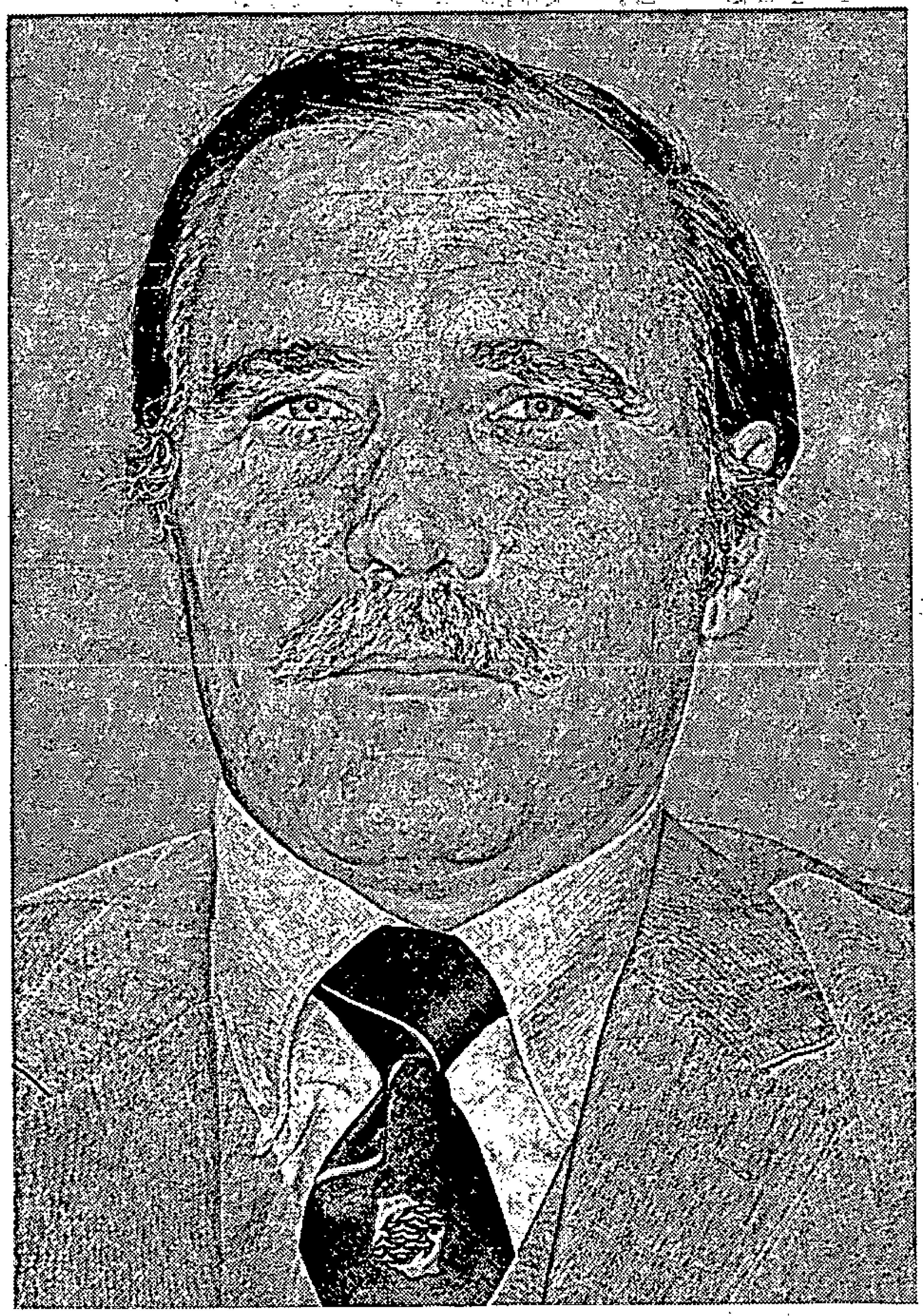

JAN CHRISTIAANSE
(8 February 1932 – 2 October 1991)

It is with great sorrow that we announce the death of Dr. Jan Christiaanse on 2 October 1991, at the age of 59. Jan Christiaanse was Professor of Fiscal Law at Erasmus University in Rotterdam. As Secretary of the International Fiscal Association (IFA) from 1969-1988, he was known and highly respected by IFA members worldwide.

During his tenure at IFA, Jan Christiaanse, with the steady support of his assistants, inspired IFA to exceptional heights by using his gift for motivating people.

From 1986, at the request of the Board of Trustees of the International Bureau of Fiscal Documentation (IBFD), of which he was a member, Jan Christiaanse devoted himself to cementing the bond between IFA and the IBFD. His cooperative relationship with Mr. H. Hamaekers, chief executive of the IBFD, is witness to the success of his efforts.

After completing his studies at the State Academy of Fiscal Studies, Jan Christiaanse joined the corporate tax department of the Tax Inspectorate in Rotterdam. In the early 1950s, the renowned head of the department, Mr. A.F. Tuk (who had known Jan Christiaanse as a young student), remarked: "We shall hear more from this young man". And so we have.

Jan Christiaanse earned his Doctor's degree in Law from the Free University of Amsterdam. After working at the Ministry of Finance in The Hague, he became a professor at Erasmus University in 1965. For ten years Jan Christiaanse was a member of the Rotterdam City Council, and later, for 16 years, the Dutch Senate.

His interests were broad and diversified. A keen rower and tennis player, Jan Christiaanse was Chairman of the Dutch Christian Sports Association, the Dutch Youth Community, and he occupied a place on the Advisory Committee for professional soccer. No doubt this list is incomplete. It is no exaggeration to say that he was an extremely gifted and talented individual.

On the closing day of the 1988 IFA Congress in Amsterdam, the general meeting gave him a standing ovation for his influential efforts on behalf of IFA. I shall never forget his impressive, dignified and moving speech of thanks during this meeting that was to mark his resignation for health reasons.

Jan and I first met at the State Academy of Fiscal Studies, and I vividly recollect the occasion of his engagement to Ms. Wies Dorrenboom. Our paths separated after our student days, but we met again, and this time more often, while he worked for IFA. During the last years of his life, Jan continued his work with a resolution which commanded everyone's respect. Comforted by the nearness of their children and grandchild, Jan and Wies shared their lives in the true sense of the word.

Jan Christiaanse will be sadly missed by all those who loved him and will be remembered with great respect and affection by IFA, which owes so much to him.

Adriaan Nooteboom
Chairman, Dutch Branch of IFA

INTERNATIONAL:

A NEW INTERNATIONAL TAX ORDER – RESPONDING TO THE CHALLENGE

A.J. Easson*

I. INTRODUCTION

The impetus for this paper derives from an exchange of views between Professors Richard Bird and Leif Mutén that appeared in this journal in 1988.[1] Professor Bird condemned the present tax treatment of international capital flows as inefficient and inequitable and concluded that radical reform of the existing system was needed. In particular, he advocated the adoption of worldwide unitary taxation as the only appropriate way to deal with the problems caused by foreign direct investment. Professor Mutén, while agreeing with many of Bird's criticisms of the existing system, doubted whether any of the proposed alternatives would be better, and concluded that the adoption of unitary taxation was both impracticable and undesirable.

This exchange poses a challenge. If the existing system is so defective as to require radical change, yet every proposal for such a change is dismissed as utopian, it ought to be possible to devise less radical proposals that could conceivably be adopted and that would result at least in substantial improvements. It seems a counsel of despair to conclude that the system that presently exists is, despite all its faults, the best that can be achieved.

II. DEFECTS OF THE EXISTING SYSTEM

There is fairly general agreement that the existing system of international taxation, insofar as there can be said to be a "system" at all, displays the following major defects:
- it fails to completely eliminate double taxation;
- it fails to achieve capital export neutrality;
- it fails to achieve capital import neutrality;
- it encourages tax avoidance, in particular by failing to deal effectively with transfer pricing;
- it does not achieve inter-nation equity;
- it imposes an excessive administrative and compliance burden on governments and on enterprises.

Thus the need for major reform is widely accepted, but it is generally agreed that any significant reform will be very difficult to achieve. However, a number of factors combine to suggest that if there is to be established a new international tax system for the 21st century, then circumstances combine to make the present time an auspicious one for attempting such reform. First, a new version of the OECD model treaty is already in course of preparation. Second, the EEC has, after a gestation period of 21 years, finally adopted the directives on the tax treatment of cross-border mergers and parent-subsidiary relations, and has embarked upon a comprehensive study of the harmonization of corporate income taxation. Finally, there has been a marked change of attitude in the United States, coinciding with its transformation from the most important capital-exporting country to the world's largest capital-importer, which indicates a willingness to re-examine the fundamental principles upon which its international system is based – principles that have had an important influence upon the evolution of the present system.

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III. AN OPTIMAL SYSTEM OF INTERNATIONAL TAXATION

Attempts to devise an optimal system, remedying all of the above defects, have usually taken one of two quite distinct forms – harmonization and unitary taxation. There is a further alternative, that of switching from income-based to

* Alex Easson is Professor of Law at Queen's University, Kingston, Canada and presently Visiting Professor at Monash University, Melbourne, Australia.
This article is a substantially revised version of a paper presented on 9 July 1990 to the Institute for Policy Studies of Victoria University and the Wellington Branch of the International Fiscal Association, Wellington, New Zealand.

1. See R.M. Bird, "Shaping a New International Tax Order", 42 *Bulletin for International Fiscal Documentation* (July 1988), at 292; and L. Mutén, "A New International Tax Order?", 42 *Bulletin for International Fiscal Documentation* (November 1988), at 471.

consumption-based taxation. If adopted universally, and with a harmonized tax base, this would seem to achieve both capital export neutrality and capital import neutrality without requiring uniform tax rates (McLure, 1990). However, such a change would involve the complete reform of both corporate and individual taxation and would raise almost insuperable transitional problems. Moreover, if adopted only by some countries, rather than universally, it would probably aggravate existing problems rather than alleviate them. It is consequently assumed, for the purposes of this article, that income-based taxation will continue to be a feature of the tax landscape well into the 21st century.

A. *Harmonization*

Probably the only way of achieving both capital export neutrality and capital import neutrality within the existing income-based taxation system is to have identical tax rules in all countries. Since foreign investment is mostly undertaken through the medium of corporations, realistically it would seem to be necessary only to harmonize the corporate income tax ("CIT") and the treatment of dividends and interest paid by corporations to individuals. Nevertheless, this would require the harmonization of:

- CIT systems (classical or imputation);
- CIT rates;
- rules for determining the tax base; and
- rules governing the flow-through of dividends to shareholders.

Such a harmonized system should also succeed in eliminating any advantage to be gained from artificial transfer pricing, since with uniform effective tax rates around the world there would be no fiscal advantage to be gained from shifting income from one jurisdiction to another. Harmonization would not necessarily ensure the achievement of inter-nation equity or of administrative simplicity, but would not present an obstacle to achieving either of those goals. In particular, it should facilitate simplification by removing those disparities between systems that are the causes of many of the present complexities.

The benefits of harmonization, then, are considerable and obvious. The difficulties of achieving it are equally apparent. Despite a worldwide trend towards lower rates of CIT, base-broadening and the adoption of imputation systems, little consensus exists on the features of an ideal system. In any event, the adoption of a common system involves too great a surrender of fiscal autonomy on the part of nations. Experience in the EEC demonstrates that tax harmonization is possible; it also demonstrates that, even among 12 closely integrated economies, it is an extremely difficult and lengthy process. Thus a comprehensive "GATT for Taxes" seems highly unlikely to evolve within the next several decades (Slemrod, 1990).

B. *Unitary taxation*

The alternative solution, that of global unitary taxation, or formula apportionment, most persuasively advocated by Professor Bird (1986, 1988, Bird & Brean, 1986), is perceived primarily as a method of taxing foreign direct investment and as a solution to the transfer pricing problem; that is to say, unlike harmonization, it is not intended as a complete solution to all international tax issues. It is also perceived by some as a means of securing improved inter-nation equity (Musgrave, 1979).

Since tax rates and bases of assessment would continue to vary from country to country, unitary taxation would not in itself result in enhanced capital export neutrality (though it should achieve capital import neutrality). Nor, if one assumes that one important element of any apportionment formula would be comprised of gross sales or turnover, does it entirely eliminate the possibility of transfer pricing, though it would clearly be a considerable improvement on the present system. Whether or not it would produce greater inter-nation equity depends on the precise formula selected as the basis for apportioning world income of a group among those nations in which the group does business.

In contrast to the harmonization approach, unitary taxation has the considerable advantage that it permits states to retain their own rates and systems of corporate income tax, thereby requiring a far lesser degree of surrender of fiscal sovereignty. However, since it is the apportionment formula that would determine how the total tax paid by a multinational group is to be shared between countries, agreement upon a single formula would be a formidable task, yet without it double taxation would be inevitable. Additionally, as the California experiment demonstrated, such a system imposes enormous compliance costs upon enterprises (Finch, 1984; Kooijman, 1984), and these would be compounded if the system were to be adopted globally, by problems of currency conversion (Crawford, 1986; Mutén, 1988). These difficulties, and the almost universally hostile reaction to the California tax, suggest that general agreement upon the adoption of unitary taxation is most unlikely to be achieved, though its adoption within the EEC, applying a "water's edge" limitation, remains a possibility.

IV. A REALISTIC APPROACH TO REFORM

If the options of universal consumption-based taxation, tax harmonization and unitary taxation are rejected as impracticable, it seems that we must settle for something less than a complete solution to the existing problems. This necessitates accepting a number of constraints:

(a) Something less than a global solution must be aimed for. No solution can be found that will be acceptable to all countries and one can scarcely expect tax haven countries to legislate themselves out of existence.

(b) A single coherent system of international taxation, embracing individuals and corporations, direct and portfolio investment, is probably not attainable even in theory and certainly will not be achieved in practice. Different situations may require different solutions, and one should therefore commence with the problems that are most pressing.

(c) Reforms that concern only the taxation of international income and capital flows, and that can be implemented without touching upon the taxation of purely domestic situations, are far more likely to be acceptable.

(d) Widespread, simultaneous implementation of reforms is very difficult to achieve, as experience in the EEC has clearly demonstrated. Ideally, a reform should be one that can be adopted unilaterally, or at least bilaterally on a reciprocal basis.

(e) To be acceptable, any reform must be as nearly as possible revenue-neutral. It is unlikely to be acceptable by states if it results in an appreciable reduction in their tax revenues. On the other hand, if it results in an increase in the tax burden on enterprises, it will be difficult for a state to adopt the reform unilaterally without risking a reduction in investment.

Taking the above factors into account, it would appear that the greatest challenge is that of improving the existing system of taxing direct investment by multinational enterprises. It is reasonably apparent that the multiplication of international tax problems over the past decade is directly related to the rapid growth in foreign direct investment (Alworth, 1988). Consequently, to eliminate those characteristics of the present international tax system that distort direct investment decisions would secure the greatest benefit in terms of economic efficiency. This is not to deny the importance of cross-border portfolio investment, by individuals or by corporations, but is simply an assertion that, in terms of sheer volume, direct investment has become by far the more important and that, consequently, the efficiency costs occasioned by tax-induced misallocation of resources are so much more serious. Moreover, a more neutral system of taxing direct investment is itself a prerequisite for enhanced neutrality of shareholder investment (Devereux & Pearson, 1990).

A further consideration is that, virtually by definition, foreign direct investment is undertaken by multinational enterprises ("MNE"); the establishment by an enterprise of one country of a branch or subsidiary in the territory of another country automatically constitutes that enterprise an MNE if it was not already one. Since, by implication, international transfer pricing is an activity conducted between branches or affiliates of MNEs, any attempt to reform the system of taxing foreign direct investment must of necessity also tackle the transfer pricing problem.

V. NEUTRALITY CONSIDERATIONS

In the absence of full harmonization or a switch to consumption-based taxation, it would seem to be impossible to achieve both capital export neutrality ("CEN") and capital import neutrality ("CIN"). One or the other has to be sacrificed, or a compromise reached that achieves a satisfactory degree of each. It is therefore necessary to consider which is the more important goal.

A. *Capital export neutrality*

The objective of CEN is to secure that, from the point of view of the investor, the tax system is neutral as between investing at home or in some other country; wherever the investment is made, the total tax burden should be the same. CEN is consequently primarily a function of the residence country's tax system and can in theory be achieved unilaterally.

The merits of CEN are readily apparent, yet not all countries attempt to achieve it. There are a few countries that tax their residents on foreign-source income without recognizing the tax that has been paid in the country of source, though this situation is now rather uncommon since tax treaties invariably contain provisions for the elimination of double taxation, which require the residence country to give a credit for tax paid in the country of source if it seeks to tax foreign-source income.[2] On the other hand are those countries that do not tax foreign-source income at all or, more commonly, tax only certain types of foreign-source income. Whilst complete exemption of foreign-source income is relatively unusual outside Latin America, it is fairly common for foreign-source business income, or inter-corporate dividends, to be exempted.[3] Even in countries that purport to adhere to the CEN principle, true CEN is rarely if ever achieved.

In order to achieve CEN there are two basic requirements; first, the country of residence (or citizenship) should tax foreign-source income at the same rate as income from a domestic source, but should give a credit for the tax paid on that income in the country of source and, second, foreign-source income should be taxed in the same manner as domestic income, which is normally taken to mean that it should be taxed as it accrues.

1. Foreign tax credits

The rules for the granting of foreign tax credits are, in most countries, fairly restrictive; there is segregation of different types of income, or income from different countries, by means of separate basket or per-country limitations, and the carryforward of excess credits is commonly restricted. Most important, any foreign tax credit is invariably restricted to the amount of residence country tax that would be payable on the same amount of income, for otherwise the effect would be the same as a transfer from the treasury of the residence country to that of the source country. Consequently, true CEN can only be achieved where effective tax rates in the source country do not exceed those of the country of residence. That state of affairs has become considerably less common in recent years, following rate reductions in the United States and other important capital-exporting nations.

2. Taxation on an accrual basis

A still more serious derogation from the CEN principle results from the separate legal entity principle, whereby a corporation is generally taxed on profits earned by its foreign subsidiaries only when those profits are repatriated in the form of a dividend or some other payment. This opportunity to defer payment of residence country tax, by holding foreign-source income offshore, seriously undermines CEN, and discriminates in favour of operating abroad through a subsidiary rather than a branch.

Neither of the above defects is easily remedied. Restrictions could be eased on the granting of foreign tax credits, but to abandon the "tax otherwise payable" limitation would be perceived as an out-and-out subsidy to investment abroad and, in effect, to source country governments. The worst effects of deferral are now commonly countered by controlled foreign corporation rules, such as the U.S. Sub-Part F, but such rules normally apply only to passive investment income.[4] For a country to extend them unilaterally to apply to income from active business would be to place its own multinational corporations at a competitive disadvantage in world markets (Arnold, 1986). As a result, true CEN is far more difficult to achieve than at first sight would seem to be the case.

B. *Capital import neutrality*

The aim of CIN is to ensure that, within a particular tax jurisdiction, investments from different countries receive the same treatment. Investors from countries X and Y, investing in country Z, should pay the same amount of tax on income earned there, and should pay the same tax as investors from country Z. The result is competitive neutrality; all investors in country Z are taxed the same and compete on equal terms.

2. Some countries give only a deduction for source country tax, rather than a credit, where income derives from a country with which they do not have a tax treaty.
3. Some countries adopt a remittance rule, taxing foreign-source income, or certain types of income, only when actually received in the residence country.
4. The recent New Zealand reforms are an exception in this regard; see Prebble (1990).

Unlike CEN, which in theory can be achieved unilaterally by the country of residence, CIN requires the cooperation of both the source and residence country.

1. Equal treatment in the source country

The first requirement is that the source country should tax foreign and domestic investment in the same way. In the case of direct investment, equality of treatment is generally secured in the initial phase, in that branches and subsidiaries of foreign enterprises are normally subject to the same corporate income tax as domestic corporations, though not infrequently there are some advantages (e.g. reduced rates for small businesses) that are not granted to foreign investors. The most serious departure from CIN occurs with the imposition of withholding tax (or branch profits tax) on dividends, interest, royalties and similar payments remitted to the foreign parent or head office. For portfolio investment there is usually no attempt made to achieve CIN at all; foreign investors are subject to flat-rate withholding tax on dividends, interest, rents and royalties, rather than paying domestic personal or corporate income tax. Another common cause of non-neutrality, in countries employing the imputation system of CIT, is the denial of imputation tax credits in the case of dividends paid to non-residents.

2. Exemption in the country of residence

The second requirement of CIN is that the country of residence should not impose its own tax on foreign-source income. It is true that CIN would be achieved if the following conditions were met:

(a) the source country taxed foreign investors less heavily than domestic investors (e.g. imposed a low, flat-rate withholding tax); and
(b) the residence country taxed foreign-source income with a credit for source country tax paid; and
(c) the effective tax rates of the two countries were the same, or the country of residence taxed the income at the rate appropriate to the source country.

Condition (c) is most unlikely to be met. Consequently, for practical purposes, CIN requires the elimination of additional withholding tax in the source country and the exemption of foreign-source income in the residence country.

C. *CEN or CIN? – the choice*

Since one cannot have both CEN and CIN without comprehensive harmonization of effective tax rates, a choice has to be made. Three situations need to be distinguished:

1. Portfolio investment by individuals

Considerations of equity clearly require application of the CEN principle. This involves the inclusion of foreign-source income in the tax base, the granting of a foreign tax credit, and the adoption of CFC rules to prevent avoidance or deferral by channeling foreign investment through personal investment companies. Whether or not the source country should impose withholding tax on investment income is not a question of neutrality (provided the withholding tax is not so high as to totally eliminate the residual residence country taxation), but rather a question of the allocation of tax revenue between source and residence countries.

2. Portfolio investment by corporations

The respective merits and demerits of CEN and CIN are much more evenly balanced in the case of investment by widely-held corporations. Since the primary concern of this article is with direct investment, it is not proposed to examine the issue here.

3. Direct investment

In the case of direct investment, a much stronger case can be made for adhering to the CIN principle. Within a given market, domestic and foreign enterprises should compete on equal terms; more important to a business enterprise than how much tax it pays is whether or not it pays more tax than its competitors. If, because country X attempts to achieve CEN, an enterprise from country X suffers a heavier overall tax burden than a competing enterprise from country Y, when investing in country Y, it may be deterred altogether from entering that market, even where the tax rates of country Y are no higher than those of country X. By contrast, where CIN exists, enterprises will not necessarily invest in countries where tax rates are lower than at home, since pre-tax profit margins will tend to adjust to the tax rate under conditions of competitive neutrality. Thus, whereas attempts to secure CEN may have the result of destroying CIN, the achievement of CIN does not necessarily undermine true CEN. Consequently, one can conclude that, with respect to direct investment, CIN is the more important goal (Vogel, 1989).

D. *The implications of achieving CIN*

If one accepts the goal of achieving CIN for direct investment, two steps must be taken:

1. Withholding tax

Since the source country should not tax foreign investment more heavily than domestic investment, this implies that additional withholding tax (or branch profits tax) should not be levied (Devereux & Pearson, 1989). It must be remembered that we are, by definition, considering the multinational enterprise and, specifically, payments from branch or subsidiary to parent. In the case of payments of dividends or the repatriation of branch profits, it is clear that no additional tax should be levied, since, in a purely domestic situation, such payments are (or should be) made without tax consequences. As for payments of interest, rents, royalties, management fees and the like, it appears at first sight that, when made from subsidiary to parent, such payments should be fully taxed (i.e. at normal CIT rates), since in a purely domestic situation they would form part of the taxable income of the recipient parent. By contrast, as between branch and head office, payments of that nature are normally made without tax consequences. The reality, however, is that even between parent and subsidiary such payments ought not to affect the tax liability of the enterprise as a whole, since a taxable receipt of the parent is matched by a deductible expenditure of the subsidiary.[5] Consequently, withholding tax should be eliminated for all intragroup transfers in order to secure CIN. In principle, this is already acknowledged in some tax treaties, where normal withholding tax rates are reduced in inter-affiliate circumstances and, of course, it constitutes the foundation of the recent EEC parent-subsidiary directive and the new withholding tax proposal. Nevertheless, if adopted generally it would result in serious revenue losses for capital-importing countries.

2. Exemption

Direct investment CIN, as defined above, would also require the adoption by the residence country of the exemption method of relieving double taxation in the case of

5. Even where the result is to create a loss for one member of the group there ought to be no tax consequence so long as consolidated accounting is permitted, which it should be.

business income from a foreign source. In practice, this would not be a particularly difficult step to take. A significant number of countries already exempt foreign-source business income entirely, or at least where it is earned in countries that impose "normal" rates of tax. Still more countries exempt inter-affiliate dividends earned in such countries. The cost of moving to complete exemption of income from direct investment would be small. The foreign tax credit already ensures that where the effective tax rate in the source country is no lower than that of the residence country, no additional tax is levied. By contrast, where the residence country has the higher rate of tax the effect of permitting tax deferral until profits are actually repatriated by a foreign subsidiary may be the same as if those profits were exempted (Hartman, 1977). Indeed, the residence country might actually gain revenue from changing to the exemption method since there would no longer be any incentive to defer repatriation of profits, which might consequently be more promptly distributed to shareholders or be reinvested in the home economy.

VI. INTER-NATION ALLOCATION OF TAX REVENUE

Thus far, the discussion has paid little attention to the question of how the total tax yield should be divided between source and residence countries. A frequent criticism of existing arrangements is that they fail to achieve inter-nation equity (Musgrave, 1979; Palmer, 1989). However, there is little agreement as to what would constitute an appropriate division of the tax base, nor is there any obvious principle of fairness that can be invoked to justify any particular distribution of revenue. Given that the existing system has come into being largely at the instigation of the more developed countries, it is not unreasonable to assume that any bias in the system is likely to favour capital-exporting countries. Certainly, most developing countries take the view that the system should be revised in favour of the country of source – a view to which the United States has become somewhat more receptive in recent years than had previously been the case.

Nevertheless, a reform proposal that would have the effect of radically altering the existing allocation of revenue between nations has very little chance of being adopted by those nations that would stand to lose revenue. For this reason, it seems that any reform should be broadly revenue neutral. The principal object of reform should be to achieve greater neutrality, thereby removing conditions that distort the efficient allocation of resources. However, insofar as efficiency gains produce increased revenue, it seems appropriate that the greater share of such increase should go to source countries. Judged on that basis alone, the proposal to adopt the exemption method would have very little effect, either on total revenue yield or upon the inter-nation allocation of that revenue; by contrast the abolition of withholding tax would have serious revenue consequences and these would be to the detriment of source countries and, in particular, of lesser-developed countries, which tend to impose withholding tax at relatively high rates.

VII. TRANSFER PRICING

A further objection to the proposed elimination of withholding tax in intra-affiliate transactions is that it does nothing to minimize transfer pricing abuses; indeed, it would be likely to aggravate the problem. This objection must be taken extremely seriously since, to judge from the volume of literature devoted to the subject, it is artificial transfer pricing that presents the most serious threat to the existing system of international taxation.

The transfer pricing problem is sufficiently well understood that an extensive review would be superfluous here. It may nevertheless be worth making two brief observations. First, transfer pricing abuse is not restricted to the artificial pricing of inter-affiliate supplies of goods; indeed, the most intractable problems arise in the case of payments for services, since it is here that the establishment of an "arm's length" price is most difficult. Second, transfer pricing may operate either in what may be termed bilateral or in trilateral situations. In the bilateral situation, the transaction involves a branch or subsidiary in one country (the source country) and a head office or parent in the other (residence) country; transfer pricing takes the form of manipulating the price paid for goods or services so that profit is over-stated in the lower-tax country and under-stated in the country with the higher effective tax rate. In the trilateral situation, a third entity – usually a subsidiary established in a tax haven country – is interposed; the aim is then to manipulate the price charged between source country and haven, or between haven and home country, so that profit is under-stated in either the source country or the residence country, or both, and over-stated in the tax haven.

The importance of withholding tax, in countering transfer pricing abuse, can be demonstrated very simply.

EXAMPLE

Corporation A, resident in Country X, establishes a subsidiary, B, in Country Y, to carry on an active business there. It has another subsidiary, C, in a tax haven country, Z. A transfers certain patent and trademark rights to C, which in turn licenses them to B, on payment of royalties. It is obvious that the larger the royalty payment, the greater will be the profit of C, and (so long as it is treated as a deductible expense) the smaller will be the profit of B. Since the tax rate in haven country Z is lower than that in country Y, there will be a tax saving to the group as a whole. However, if country Y imposes a withholding tax on the royalty, the amount of CIT saved as a result of the inflated deduction is offset, at least in part, by the tax withheld. Indeed, if withholding tax were to be levied at the full CIT rate, there would no longer be any advantage to be gained from this type of transfer pricing.

It has become increasingly apparent, in recent years, that the traditional method of countering artificial transfer pricing – namely the making of adjustments by tax authorities based upon a notional "arm's length" price – has proved inadequate to prevent sophisticated manipulation by MNEs (Granfield, 1989; Kaplan, 1989); particularly is this so for the tax administrations of developing countries, which, as capital importers, are especially severely affected by transfer pricing.[6] Thus, relatively high rates of withholding tax are seen as particularly important, both as a means of increasing source country revenue from foreign investment and as a protection of the tax base against transfer pricing (Irish, 1987).

VIII. THE DEDUCTIBILITY OF INTRA-GROUP PAYMENTS

The proposal to eliminate withholding tax on intra-group payments in order to improve CIN consequently has two

6. For a variety of reasons, it is source countries that seem to be most adversely affected by transfer pricing.

serious drawbacks. It reduces the share of revenue of the source country, and may thus not be consistent with notions of inter-nation equity, and it enhances the benefits to be derived from artificial transfer pricing.

To be acceptable, any proposal for reform must respond to these objections and contain at least one further element. The solution, it is suggested, lies in making those intra-group payments that would be relieved of withholding tax non-deductible in computing branch or subsidiary profits. In other words, a subsidiary or affiliate of a foreign corporation would not be permitted to deduct interest, rental payments, royalties, management fees and similar payments made to its foreign parent or affiliate, in computing its profits for the purposes of source country taxation. Similarly, no such deductions would be made in computing income attributable to a branch or permanent establishment of a foreign corporation. Arm's length payments to non-affiliates would, of course, continue to be deductible in the normal way.

This raises an immediate objection that CIN is destroyed; the subsidiary of a domestic parent is permitted such deductions (though a branch is not), and would consequently have an advantage over subsidiaries of foreign parents. On reflection, this objection is not well founded. To the extent that an amount is deducted by the subsidiary, it is taxed in the hands of the domestic parent; CIN therefore requires either that a foreign parent is also taxable, at source country CIT rates, or that the payment is not deductible.[7]

A further possible objection is that the combination of non-deductibility in the source country and exemption in the country of residence would result in the residence country allowing the parent to deduct expenses incurred in order to earn income that would be taxed only in the source country. For example, the parent would normally claim a deduction for interest on money borrowed and re-loaned to its subsidiary, research and development expenses incurred in creating a patent subsequently licensed to the subsidiary, depreciation on machinery leased to the subsidiary, and so on but, as proposed here, the interest, royalties or rents received from the subsidiary in return would not be taxed in its hands. One answer to this objection is that income earned abroad would not really go untaxed in the home country, since ultimately it will flow through to home country shareholders and be taxed in their hands. A further justification can be found by regarding transactions such as loans, licences and leases to a subsidiary as a contribution of equity capital by the parent, so that profits transmitted to the parent in the form of interest, rents and royalties should be treated in the same manner as are dividends. In any event, it is difficult for the residence country to restrict the deduction of expenses incurred to earn foreign-source business income of a particular kind, since to do so may simply result in the parent corporation changing the way in which its foreign subsidiary is financed.

The advantages of a rule of non-deductibility, combined with the elimination of withholding tax, are many:

(1) it eliminates those transfer pricing abuses that are most difficult to counter and that produce the greatest revenue losses;
(2) administration is simplified, since there is less need to monitor transfer pricing and no need for measures such as thin capitalization rules;
(3) by restricting transfer pricing, the unfair advantage that MNEs enjoy over local competitors is reduced;
(4) there is a major gain in terms of CIN, with no real sacrifice of CEN;
(5) improved neutrality should yield efficiency gains, improved allocation of resources and an overall increase in foreign direct investment; and
(6) there is also greater neutrality as between
   - branches and subsidiaries of foreign enterprises,
   - equity and debt financing, and
   - different methods of transferring technology.

IX. IMPLEMENTATION

The aim of this article has been to examine whether significant reforms to the existing system of international taxation are possible. It has been suggested that any such reforms would have to be capable of unilateral implementation, or at least of bilateral adoption on a reciprocal basis. Ideally, any reform should also have no, or minimal, impact upon purely domestic systems of taxation. The proposals advocated in the preceding parts of this paper involve three steps:
(1) elimination of withholding tax on intra-group payments;
(2) restriction on deductibility of such payments; and
(3) exemption of those payments in the hands of the recipient.

The first two steps affect the source country and the third must be taken by the residence country. It also seems clear that the impact upon the enterprises themselves must be considered. Finally, it is necessary to consider whether or not the proposals raise any serious difficulties of a technical nature.

A. *Source country implementation*

From a jurisdictional point of view, the abolition of withholding tax on intra-group dividends and other payments presents no problem.[8] Restricting deductions in computing income likewise is within the competence of source countries, and would not seem to be contrary to treaty provisions based upon Articles 7 and 9 of the OECD model convention, though this is a question that merits further consideration.

From a revenue point of view, the combined effect of eliminating withholding tax and restricting deductions is difficult to predict. There would be a loss for most countries from the abolition of withholding tax on dividends, though it is already common for inter-affiliate dividends to be taxed at lower than normal rates. The loss from withholding tax on interest, rents, royalties and similar payments would also be substantial, but in this case would be more than compensated for by the additional CIT derived from the restriction on deduction of such payments. Assuming CIT rates in the 30 to 40 percent range, and withholding tax from 10 to 20 percent, those payments would probably yield more than twice as much revenue to the source country than they do at present. Whether this would offset the loss of tax from dividends, where there is no compensating gain, depends upon the equity/debt mix of each foreign investor. Overall, dividends probably represent a fairly small part of total remittances by overseas subsidiaries, largely because other payments afford the opportunity for transfer pricing, so that the net effect would probably be a modest increase in revenue to most source countries.

7. It is evident that the same result could be achieved by permitting deduction and imposing withholding tax at the full CIT rate. There are, however, practical objections to this course; see infra.
8. The alternative, of raising withholding tax rates to the level of the CIT rate, would require re-negotiation of most tax treaties and therefore could not be implemented unilaterally.

B. *Residence country implementation*

Adoption of the exemption method, in place of the foreign tax credit, poses no jurisdictional problems and can be done unilaterally. Many countries already exempt foreign-source business income and inter-affiliate dividends and, as already suggested, a change from credit to exemption could be made with very little cost to most residence countries. Indeed, exemption may actually be more productive than credit plus deferral, since there will no longer be any reason to postpone repatriation of foreign earnings and these will be available for distribution or reinvestment in the residence country.

C. *Implications for investors*

Ultimately, the acceptability or otherwise of any reform proposal is likely to be determined by the reaction of the international business community. Professor Bird (1986) has remarked upon "the almost Pavlovian reaction of most tax professionals and multinational firms" in defence of existing international tax principles. If a reform requires to be adopted multilaterally, and is strongly opposed by the MNEs, pressure will be brought upon both home and host governments to resist implementation, and some governments will undoubtedly bow to that pressure. If the reforms are ones that can be adopted unilaterally, governments will be reluctant to take the first step if they fear that the result might be a flight of foreign capital or a reduction in future investment.

The reforms outlined here ought not to encounter violent opposition. MNEs would clearly benefit from exemption in the country of residence; countries that were reluctant to adopt the exemption method would thus come under increased pressure from their own MNEs to do so, in order to remove a competitive disadvantage from those enterprises. The elimination of withholding tax would likewise be to the advantage of the MNEs, and would incur no opposition. Only the non-deductibility issue would be controversial. The tentative conclusion reached in the previous part of this article was that, on balance, the combined effect of non-deductibility and the elimination of withholding tax would be a small increase in revenue for source countries which would have to be at the expense of MNEs. Capital-importing countries might consequently hesitate to introduce such a package unilaterally. However, as we have seen, those investors that extract more of their earnings in the form of dividends would gain from the changes; the real losers would be those that presently pay very little tax to the source country, largely on account of transfer pricing or under-capitalization. Responsible MNEs would stand to gain from increased neutrality and the removal of unfair competition, and ought to welcome such a reform. The only investment that might be lost would be that of enterprises that are currently paying very little tax to source countries and that are, frequently, bringing relatively little benefit to their hosts.

D. *Technical considerations*

No tax reform can be implemented without technical problems. The proposals outlined above require clear distinctions to be drawn between:

(1) active business income and passive investment income;
(2) direct investment and portfolio investment;
(3) transactions between affiliates and those made at arm's length; and
(4) payments that are deductible in computing source country profits and those that are not.

Precise drafting of legislation and clear definitions are essential. However, no novel problems are raised by the proposals, since under the existing system all of these distinctions must already be drawn.

X. CONCLUSION

The aim of this article has been to demonstrate that valuable improvements can be made to the existing system of international taxation without having recourse to such radical solutions as universal consumption-based taxation, comprehensive harmonization or worldwide unitary taxation. No attempt has been made to present a coherent theory of international taxation or to advocate reform of the entire system. Nor are the reforms suggested here in any way novel. What has been attempted is to assimilate a number of suggestions made by other commentators and to combine them into a single reform package that relates to one aspect, albeit a most important aspect, of international taxation, namely the treatment of direct investment by multinational enterprises.

The principal benefits that have been sought are the achievement of greater neutrality and the reduction of transfer pricing abuse.

An attempt has been made to find a way of achieving those benefits, whilst at the same time ensuring that

- the existing allocation of tax revenue between states is not fundamentally altered;
- the necessary changes could be made unilaterally without significant detriment; and
- those changes would have no impact upon the way in which purely domestic situations are taxed.

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Conference Diary

NOVEMBER 1991

New Legislation in Australia on Offshore Companies and Trusts; Asset Protection trusts; Immigration; Developments in New Zealand. Sydney, 18-19 November (English):
Ms. Elisabeth Husband, Conference Director I.P.T.A., Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

IPTA Hong Kong Seminar. Hong Kong, 18-19 November (English):
Ms. Elisabeth Husband, Conference Director I.P.T.A., Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks Kent TN15 6SZ, United Kingdom. Tel.: (0732) 62910; Fax: (0732) 63762.

Seminar on International Planning Opportunities in Austria and Switzerland. London, 19 November (English):
British Branch of IFA, Att. Mr. Eric Tomsett, Touche Ross, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Tel.: 071-936 3000.

Pays-Bas-Luxembourg-France. Holdings et Joint-Ventures. Opportunités fiscales et juridiques. Paris, 19 November (French):
Mme Marie-Ange Faugérolas, BFCE, 21, boulevard Haussmann, 75427 Paris Cedex 09 France. Tel.: 48004561.

Tax Planning for International Treasury Operations In Europe (intensive training course). London, 19-22 November (English):
Peter Sabine, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom. Tel.: 071-779 8787; Fax: 071-7798599.

Harmonisatie Vennootschapsbelasting in de EG. Utrecht, 20 November (Dutch):
Euroforum, Antwoordnummer 27, 5600 VB Eindhoven, The Netherlands. Fax: 040-449895.

Actuele Fiscale Aspecten van Ondernemen in België. Antwerpen, 20 November (Dutch):
Kluwer Seminars, Antwoordnummer 424, 7400 VB Deventer, The Netherlands. Tel.: 05700-47190; Fax: (05700) 13630.

U.S. International Tax Planning and Compliance under Subpart "F" and The Foreign Tax Credit Provisions. London, 21-22 November (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom. Tel.: (071) 935 7502; Fax: (071) 935 6951.

Tolley Taxation Conference 1991. London 21-22 November (English):
Conference Organiser, Tolley Publishing Co. Ltd., FREEPOST, Tolley House, 2 Addiscombe Road, CR9 9 EA, United Kingdom. Tel.: (081) 6869141; Fax: (081) 6863155.

European Corporate Tax (Advanced Course). 21-22 November (English):
International Tax Academy, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31-20-626 7726; Fax: +31-20-620 9397.

Practical Tax Planning – Recent Developments. London, 22 November (English):
The Institute of Taxation, London Branch, Miss D. Annells, Littlejohn Frazer, 1 Park Place, Canary Wharf, London E14 4HJ, United Kingdom.

Canadian Tax Foundation 1991 Annual Conference. Toronto, 25-27 November (English):
Conference Secretary Canadian Tax Foundation, 1 Queen Street East, Suite 1800, Toronto, Canada M5C 2Y2. Fax: (416) 863-9585.

Die unbeschränkte Steuerpflicht im internationalen Steuerrecht der Schweiz. Muri/BE, 26 November (German):
Kammer-Seminar, Postfach 892, 8025 Zürich, Switzerland.

Transfer Pricing. Antwerpen, 27 November (Dutch):
Euroforum, Frankrijklei 16, 2000 Antwerpen, Belgium. Tel.: 03/226.21.80; Fax: 03/226.21.75.

European Tax and Estate Planners' Forum. London, 29 November (English):
Key Haven Publications PLC, 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. Tel.: (081) 780 2522; Fax: (081) 780 1693.

First Annual Conference of the European Tax and Estate Planners Forum. London, 29 November (English):
Key Haven Publications PLC, 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom.

DECEMBER 1991

Effective International Tax Management. Brussels, 2-3 December (English):
Management Centre Europe, rue Caroly 15. B-1040 Brussels, Belgium. Tel.: 32/2/516.19.11; Fax: 32/2/513.71.08.

Liquidation, Vente ou Autres Formes de Cession d'une Société de capitaux. Lausanne, 3-4 December (French):
Séminaire de la Chambre, Case Postale 892, 8025 Zürich, Switzerland. Tel.: 01/252 32 12; Fax: 01/252 3911.

International Tax Planning Techniques (Intermediate Course). Amsterdam, 16-17 December (English):
International Tax Academy, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31-20-626 7726; Fax: +31-20-620 9397.

Nordic International Tax Planning. London, 9-10 December (English):
Legal Studies & Services Limited, IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom. Tel.: (+44)71 637 4383; Fax: (+44)71 631 3214.

Tax-Efficient Treasury Management. London, 12-13 December (English):
IIR Ltd., P.O. Box 293, 28th Floor, Centre Point, 103 New Oxford Street, London WC1A 1DD, United Kingdom. Tel.: (071) 412 0141; Fax: (071) 412 0145.

Efficient Management of VAT in Financial Institutions. London, 16 December (English):
IIR Ltd., P.O. Box 293, 28th Floor, Centre Point, 103 New Oxford Street, London WC1A 1DD, United Kingdom. Tel.: (071) 412 0141; Fax: (071) 412 0145.

CANADA'S INTERNATIONAL BANKING CENTRES

Ingrid Sapona

Ingrid Sapona, J.D., of Price Waterhouse's National Tax Office, Toronto, Canada. *The author wishes to thank Richard S. Carson, F.C.A., John F. Robinson, C.A., and Jean-Pierre Morier, C.A., for their thoughtful comments and input.*

"International banking" has traditionally encompassed the provision of cross-border banking services such as payments and receipts arising from international trade originating in the country in which a bank operates, as well as foreign exchange operations. The increased flow of capital between countries since the 1950s has given rise to a new phenomenon – so-called "international banking centres". The channelling of capital between countries (for example, through the Euro-dollar market) is the primary work of international banking centres.[1]

London and New York have always been the primary centres of activity for international banking. By the mid-1980s, however, about 85 percent of such activities were carried on through centres in just eight countries.[2] In an effort to foster the development of international banking centres ("IBCs") in Canada,[3] since 1987 Canada has offered tax incentives to corporations operating IBCs in Vancouver and Montreal. In addition to the federal tax incentives, both British Columbia and Quebec also offer tax concessions on provincial taxes payable by such establishments.

I. HISTORY

The push for the establishment of IBCs in Canada began in 1981 when a joint committee of the Montreal Board of Trade and Montreal Chamber of Commerce began lobbying the federal and provincial governments for tax incentives for the establishment of IBCs in Montreal. The committee recommended exemptions from income taxes (both federal and provincial) for IBCs and for certain employees transferred from overseas to work for such IBCs.[4] The proposals were supported by the Quebec government as early as 1983, when the province offered various tax incentives, on the stipulation that the federal government follow suit.[5] At that point, however, the federal Liberal government rejected the idea, expressing concern that the incentives would significantly erode the tax base and would be of little benefit to the country's economy.[6]

The issue was revisited in 1985 when the Progressive Conservative government was elected. A government study was conducted and a report was issued in March 1986.[7] The report was generally negative, concluding that "[n]either the costs nor the benefits of an initiative of this kind would be great".[8] Despite the report's recommendation against tax incentives that would totally or substantially exempt international banking activities from federal and provincial taxes, in 1987 the federal government and the provinces of British Columbia and Quebec enacted legislation offering significant tax incentives for corporations carrying on IBC businesses in Montreal and Vancouver.

This article will highlight some of the main features of the federal legislation and then briefly discuss the applicable provincial legislation.

II. INCOME FROM AN INTERNATIONAL BANKING CENTRE BUSINESS

A taxpayer's income or loss from an IBC business is not subject to federal income tax if certain criteria are met. To qualify for the special tax treatment a taxpayer must be a prescribed financial institution, i.e. a member of the Canada Payments Association,[9] throughout the year and must have filed a prescribed form (within 90 days of commencement of its year)[10] designating a branch[11] or office in the metropolitan area of Montreal or Vancouver as the place at which it carries on an IBC business. The taxpayer's IBC business must be treated as a separate business, with separate books of account maintained, and an information return must be filed within six months of the IBC business' year end.[12]

1. See Rasminsky, L. and Lawson, R.W., *Canada as an International Banking Centre: A Report to the Department of Finance,* (Ottawa: Supply and Services, March 1986)[hereinafter referred to as the "Rasminsky/Lawson Report"], at 1.
2. According to a report by the Bank of International Settlements released in 1984, Japan, France, Switzerland, Germany, Italy, Canada, the United States and the United Kingdom account for 85 percent of the Euro-currency market; see Rasminsky/Lawson Report, *supra* note 1, at 3.
3. See 28 January 1987 Press Release by the Hon. Michael Wilson, the Minister of Finance [hereinafter referred to as the Press Release of 28 January 1987].
4. See McKie, A.B., *Canada: Canadian International Banking Centres,* 27 *European Taxation* (September 1987), at 275 [hereinafter referred to as "McKie"].
5. See 1983-1984 Quebec Budget Speech of 10 May 1983 (Official Budget Papers), at 24.
6. See McKie, *supra* note 4, at 276.
7. See Rasminsky/Lawson Report, *supra* note 1.
8. *Id.*, at 19.
9. The Canada Payments Association is the statutorily created body that is charged with establishing and operating a national clearinghouse and settlements system. See Sec. 5 of the Canada Payments Association Act, R.S.C. 1980-81-82-83, c. 40, s. 54. Under Sec. 4 of the Canada Payments Association Act, "every bank" must be a member. See also Reg. Sec. 7900 of the Income Tax Act Regulations, Consolidated Regulations of Canada, c. 945 [hereinafter referred to as the "Income Tax Act Regs."].
10. See Sec. 33.1(3) of the Income Tax Act, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63, and as subsequently amended [hereinafter referred to as the "Income Tax Act"].
11. It should be noted that under the Sec. 302(1)(b) of the Bank Act, R.S.C. 1980-81-82-83, c. 40, s. 2, "[a] foreign bank shall not, directly or indirectly, maintain a branch in Canada for any purpose." So, for a foreign bank to operate an IBC business it would have to do so through a subsidiary. Banks incorporated under the laws of Canada may operate an IBC business through a branch.
12. See the Income Tax Act, *supra* note 10, at Sec. 33.1(12). The information return is prescribed form T781-A.

Though the Canadian Income Tax Act ("the Act") does not specifically define the expression "international banking centre business", the Act defines activities that may give rise to income or loss that would be eligible for the exemption and describes the method of computing income from the IBC business. Only expenses that may reasonably be regarded as applicable to the IBC business may be deducted in calculating income.[13] The only interest expense that may be claimed by the IBC business on money borrowed for the purpose of earning income must be attributable to amounts payable by the taxpayer on so-called "eligible deposits".[14]

A. *Eligible deposits*

Two types of deposits qualify as eligible deposits under the Act.[15] The first type of deposit is one made by an arm's length non-resident and recorded in the books of account of an IBC business of the taxpayer (hereinafter "the taxpayer").[16] It is important to note, however, that in order for such a deposit to qualify, the taxpayer must not be obligated to repay any part of the deposit to a person resident in Canada. The second type of eligible deposit is a deposit from another prescribed financial institution with whom the taxpayer is dealing at arm's length, so long as the arm's length depositing institution notifies the taxpayer that the deposit was made from deposits recorded in the books of account of an IBC business of the depositor, and so long as the taxpayer pays a reasonable rate of interest on such a deposit.[17]

B. *Eligible loans*

The Act specifies the types of loans that qualify as "eligible loans". Eligible loans are essentially loans (or deposits) made by the taxpayer to a non-resident borrower, including those made to another prescribed financial institution. No person resident in Canada or with whom the taxpayer is not dealing at arm's length may be obligated to pay any amount to the taxpayer in respect of the loan. The loan must be timely recorded in the books of account of the taxpayer's international financial centre business.[18] The taxpayer must obtain a statement from the borrower that the loan is not being used, directly or indirectly, for the purpose of earning income in Canada or by a person other than a non-resident.[19]

In addition, a deposit made by the taxpayer to another arm's length prescribed financial institution can qualify as an eligible loan if it is made from deposits recorded in the taxpayer's IBC business and the depositing taxpayer so notifies the arm's length prescribed financial institution.[20]

C. *Computing income of an IBC*

Only income (or loss) from eligible loans is included in an IBC business' income.[21] The exempt income from an IBC business is limited, however, where the IBC's eligible deposits are less than 96 percent of eligible loans on any given day. To determine the amount of an IBC business' income that qualifies for exemption, the IBC's income is multiplied times the ratio of: (a) the lesser of (i) 96 percent of the IBC's eligible loans at the end of any given day and (ii) the total eligible deposits at the end of that day, divided by (b) 96 percent of the IBC's total outstanding eligible loans recorded at the end of that day.[22] According to the Department of Finance, the purpose of the rule requiring a determination on a day-by-day basis is to ensure that "excessive deposits" on one or more days in the year will not balance a shortfall arising on other days.[23] In other words, a taxpayer gets a full exclusion of income only when the eligible deposits equal or exceed 96 percent of eligible loans on every day of the year.

Special provisions permit a taxpayer with more than one IBC business to transfer eligible deposits from one such business to another so that, on any given day eligible deposits at least equal 96 percent of eligible loans.[24] If a taxpayer's income from an IBC business exceeds that permitted under the Act, then the additional income is subject to normal federal income tax (so-called Part I tax).[25]

The Act sets forth a formula[26] for calculating the minimum interest expense incurred by a taxpayer for purposes of earning income for a taxation year from the IBC business. The effect of the formula is to impute additional interest expense if eligible deposits are less than 96 percent of loans on any given day.[27]

At least 90 percent of the revenue from loans recorded in the accounts of the IBC business must be derived from loans that employees of the IBC actively participated in soliciting, negotiating, analyzing or managing while employed at the branch or office designated as the location of the IBC.[28] The apparent rationale for this rule is to insure that a certain minimal level of activity is carried on at the IBC.

Regarding the federal tax on large corporations (Part I.3 Tax) and the tax on capital of financial institutions (Part VI Tax), it appears that an IBC's aggregate eligible loans are effectively excluded from the definition of Canadian assets, and therefore IBCs will not be liable to those taxes.[29]

III. PROVINCIAL INCENTIVES

As noted, under the federal legislation IBCs can be established in the metropolitan areas of Montreal or Vancouver. Montreal was chosen in an effort to attract business that normally goes to the Channel Islands; Vancouver was selected to attract business from the Pacific Rim.[30] The

13. See Technical Notes accompanying Bill C-64, 5 June 1987 [hereinafter referred to as the "Technical Notes"], regarding Sec. 33.1(4).
14. See the Income Tax Act, *supra* note 10, at Sec. 33.1(4)(b).
15. *Id.*, at Sec. 33.1(1).
16. *Id.*, at Sec. 33.1(1)(a).
17. *Id.*, at Sec. 33.1(1)(b).
18. *Id.*, at Sec. 33.1(1), definition of eligible loan.
19. *Id.*, at Sec. 33.1(1), item (iv) under the definition of eligible loan.
20. *Id.*
21. *Id.*, at Sec. 33.1(4)(a).
22. *Id.*, at Sec. 33.1(5).
23. See the Technical Notes, *supra* note 13, regarding Sec. 33.1(5).
24. See the Income Tax Act, *supra* note 10, at Sec. 33.1(6).
25. See the Technical Notes, *supra* note 13, at Sec. 33.1(5).
26. The formula, as set out in the Income Tax Act, *supra* note 10, at Sec. 33.1(4)(a) and explained in the Technical Notes, *supra* note 13, accompanying the legislation, is:

$A + (B \times A/C)$,

Where,

A is the total amount of interest for the year on eligible deposits recorded in the accounts of the IBC business;

B is the total of amounts each of which is the amount by which 96 percent of eligible loans recorded in the accounts of the IBC business at the end of a day in the year exceeds the eligible deposits recorded in the accounts of the business at the end of that day; and

C is the total amount of eligible deposits recorded in the accounts of the taxpayer's IBC business at the end of all days in the year.

27. See the Technical Notes, *supra* note 13, regarding Sec. 33.1(4).
28. Income Tax Act, *supra* note 10, at Sec. 33.1(9).
29. See Sec. 8602 of the Draft Income Tax Act Regs. released by the Department of Finance on 30 November 1990.
30. See the Press Release of 28 January 1987, *supra* note 3.

decision to exclude Toronto, the country's main financial centre, caused a stir in the Toronto business and political community, but the federal government felt that establishing such centres in Montreal and Vancouver would not effect any of the banking activities carried on in Toronto, while at the same time would attract business currently done offshore.[31]

Shortly after the federal provisions were enacted, both British Columbia and Quebec passed legislation offering provincial tax incentives for taxpayers establishing IBCs in their respective provinces. The provincial legalisation is more generous than the federal legislation in that it encompasses a wider range of activities and also provides relief from personal income tax paid by certain employees of IBCs.

The highlights of the provincial legislation will be discussed separately.

A. *British Columbia*

British Columbia ("B.C.") enacted two pieces of legislation in 1988 to encourage the development of Vancouver as an International Financial Centre ("IFC") – the International Financial Business Act ("the IFB Act")[32] and the International Financial Business (Tax Refund) Act ("the Tax Refund Act").[33] B.C.'s legislation permitting the creation of international *financial* centres in Vancouver is broader in scope than the federal legislation concerning international banking centres. B.C.'s legislation is designed to encourage investment banking, merchant banking, trade financing, private banking, insurance and reinsurance, as well as investment management.[34]

Basically, a "financial institution" may receive special tax concessions on its international financial businesses carried on in Vancouver. The term financial institution, for purposes of the IFB Act and the Tax Refund Act, includes a bank, trust company, investment dealer or insurer and a corporation registered under the Securities Act.[35] An existing financial institution, essentially a corporation incorporated under the various laws of Canada and continued in British Columbia, may operate a separate branch that carries on its international financial business in Vancouver, or it may incorporate a separate, wholly-owned subsidiary to carry on such a business in Vancouver. In addition, a brand new corporation may be incorporated and licensed under the IFB Act to carry on international financial business ("IFB") activities in Vancouver.[36] The effect of being licensed under the IFB Act is that the provisions of the provincial Insurance Act, Securities Act and Trust Company Act do not apply with respect to the international financial activities specified in the licence, therefore permitting the business to be operated under a less stringent regulatory regime.[37]

Only income from certain types of activities carried on by an IFB with arm's length parties[38] will qualify for special tax treatment. Among the permitted activities are:[39]

(a) accepting deposits in any currency from non-residents or from a person carrying on a prescribed business (prescribed businesses include an IFB business under the B.C. legislation, an IBC business under the federal Act and an international financial business under the Quebec legislation);
(b) making loans in any currency to non-residents or to a person carrying on a prescribed business;
(c) a variety of activities for or on behalf of non-residents, including various activities related to documentary letters of credit and standby letters of credit, where the ultimate obligation of payment rests with a non-resident;
(d) providing fiduciary services;
(e) dealing in securities, other than securities of the capital stock of the financial institution so dealing in the securities or of the capital stock of an affiliate of the financial institution;
(f) insuring or reinsuring prescribed risks of, or relating to, non-residents and relating to property situated or events occurring outside Canada;
(g) acting as a financial adviser to non-residents;
(h) dealing in foreign exchange for or on behalf of non-residents;
(i) managing investments for or on behalf of non-residents;
(j) preparing stock market or other financial research for the exclusive use of non-residents; and
(k) financial leasing.

In addition, as under the federal legislation, the licence holder must make reasonable inquires to ensure that all activities it undertakes are for or on behalf of non-residents.[40]

1. The Tax Refund Act

The Tax Refund Act sets forth a registration system for IFBs and sets forth rules regarding the taxation of such entities, as well as special rules regarding certain of their employees. Under the B.C. Income Tax Act there are no rules for the computation of income or taxable income. The B.C. Income Tax Act defines taxable income earned in the province as the amount determined under the federal Act and allocated to the province.[41] Therefore, to the extent

31. See McKie, *supra* note 4, at 276, and the 28 January 1987 Press Release, *supra* note 3.
32. The International Financial Business Act, S.B.C. 1988, c. 16 [hereinafter referred to as the "IFB Act"].
33. The International Financial Business (Tax Refund) Act, S.B.C. 1988, c. 17 [hereinafter referred to as the "Tax Refund Act"].
34. See Robinson, J.F., "International Financial Business Centres in Vancouver", 37 *Canadian Tax Journal* (March-April 1989), at 420, 424 [hereinafter referred to as "Robinson"].
35. See definition of financial institution under Sec. 1 of the IFB Act, *supra* note 32, and Sec. 3(4) of the IFB Act Regulations, B.C. Reg. 439/88 of 4 November 1988 [hereinafter referred to as the "IFB Act Regs."]; see also the definition of financial institution under Sec. 1 of the Tax Refund Act, *supra* note 33, and Sec. 2(4) of the Tax Refund Act Regulations, B.C. Reg. 440/88, of 4 November 1988 [hereinafter referred to as the "Tax Refund Act Regs."].
36. Sec. 3 of the IFB Act, *supra* note 32 and Sec. 2 of the IFB Act Regs., *supra* note 35.
37. Incorporation under the IFB Act has advantages because the regulatory regime under that act is less stringent than under other acts. See the IFB Act, *supra* note 32, at Secs. 2 and 3; see also Robinson, *supra* note 34, at 424. As Robinson points out, the option of incorporating and becoming licensed under the IFB Act will probably appeal to parent corporations such as foreign corporations that are not already subject to Canadian regulatory supervision. It should be noted, however, that under the IFB Act only corporations may be licensed and the only business that may be carried on by a corporation licensed under that act is an international financial business; see IFB Act, *supra* note 32, at Secs. 8(b) and 3.
38. Tax Refund Act, *supra* note 33, at Sec. 6.
39. Tax Refund Act, *supra* note 33, at Sec. 1, definition of international financial activity and Tax Refund Act Regs., supra note 35, at Sec. 2.
40. The IFB Act, *supra* note 32, at Sec. 8.
41. See Sec. 5 of the British Columbia Income Tax Act, R.S.B.C. 1979, c. 190 [hereinafter referred to as the "B.C. Income Tax Act"]. The rules for allocating taxable income earned in the year in a province can be found in the Income Tax Act, *supra* note 10, Sec. 124(4), and Part IV of the Income Tax Act Regs., *supra* note 9. See also Robinson, *supra* note 34, at 424-425.

that an IFB's income is excluded from income for federal tax purposes under the rules regarding IBCs, there is no B.C. income tax on such amounts and no tax refund is available in B.C. But, because fewer activities are permitted under the federal rules than under the B.C. IFB legislation, a mechanism was needed to refund provincial corporate income tax paid by financial institutions on their IFB income. The Tax Refund Act is the legislation whereby B.C. corporate income tax is reduced to zero for income from qualifying activities of an IFB.[42] Registrants, like licensees under the IFB Act, are required to obtain a declaration from non-residents to ensure that the activities are being carried on for or on behalf of non-residents.[43]

Registration under the Tax Refund Act is restricted to financial institutions. Financial institution is defined in the Tax Refund Act to include banks, trust companies, investment dealers, insurers, corporations licensed under the IFB Act and corporations registered under the B.C. Securities Act as an advisor.[44] To register under the Tax Refund Act, the financial institution must carry on such activities from a designated branch or office in Vancouver. The initial application fee is C$ 5,000 and must be paid at the time of application.[45] There is no annual fee thereafter.

2. The IFB Act

As noted above, an IFB may be carried on by a branch of an existing corporation or a wholly-owned subsidiary of an existing corporation. However, to permit corporations not already incorporated under the laws of Canada to carry on an IFB, B.C. enacted the IFB Act, which essentially permits incorporation of a wholly-owned subsidiary for the purposes of carrying on an IFB in Vancouver without having to meet all the regulatory requirements to which corporations are normally subject.

A subsidiary incorporated for purposes of the IFB Act must be licensed under that Act and may carry on only activities specified in its licence, i.e. the IFB activities listed above. Corporations seeking to be licensed under the IFB Act must pay an initial application fee of C$ 10,000 and an annual fee of C$ 5,000 on renewal.[46]

3. B.C. tax consequences

Under the Tax Refund Act, a registered financial institution may obtain a refund computed on the basis of income generated by the corporation that is attributable to its IFB. To obtain its tax refund, the financial institution must file an annual return of claim, with a copy of its federal corporate tax return[47] within six months of its taxation year-end, setting forth the income that is attributable to its IFB.[48]

The tax refund for a taxation year is calculated as the lesser of: (a) all amounts of "international financial business tax" (a defined term) for the current year, and all preceding years, minus the aggregate of all tax refunds paid or payable for all preceding years, and (b) the amount of tax assessed and paid under the B.C. Income Tax Act for the taxation year. The "international financial business tax" is based on taxable income, as calculated for federal income tax purposes. The IFB's adjusted taxable income is then calculated by deducting from taxable income 65 percent of interest revenue, minus interest expense. Then, to arrive at the IFB tax[49], the IFB's adjusted taxable income is multiplied by the B.C. corporate tax rate in effect for the year.[50]

4. Tax treatment of employees of B.C. IFBs

As noted, the B.C. legislation also offers special tax concessions for certain employees of IFBs. The Tax Refund Act provides a tax refund to two categories of employees – "specialists" and "eligible employees".

(a) *Specialists*

Specialists may receive up to a 100 percent refund of provincial income tax. Only individuals can qualify as specialists. Specialists designated by the IFB must, in fact, be specialists in the field of IFB activities. Greater than 70 percent of a specialist's duties must be devoted to work for the IFB. Specialists must have been non-resident immediately before commencing employment duties for the IFB. The maximum length of time that an individual may qualify as a specialist is 24 months.

The maximum refund a specialist may receive is the amount of B.C. income tax paid. A specialist may receive less than a 100 percent refund if his total income exceeded his income earned as a specialist in the calendar year.[51]

A registered financial institution may not designate more than five specialists in a taxation year.[52]

(b) *Eligible employees*

Eligible employees may receive a refund of up to 30 percent of their B.C. income tax. As with specialists, eligible employees must be individuals and greater than 70 percent of their work must relate to the IFB. Unlike a specialist, however, an eligible employee need not be a specialist in IFB, nor must the employee have been a non-resident prior to commencing employment. There is no time limit regarding how long a person may be designated an eligible employee.[53]

The maximum refund an eligible employee may receive is

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42. International financial activities permitted under Sec. 1 of the Tax Refund Act, *supra* note 33, are almost identical to those listed under permitted activities found in Sec. 5 of the IFB Act, *supra* note 32. A recent, significant amendment to the Tax Refund Act, however, also permits managing, for or on behalf of residents, investments in securities issued by a non-resident. See Sec. 19 of the amendments to the Tax Refund Act found in Bill 46, Miscellaneous Statutes Amendments Act, 1990. This activity has not been added to the list of permitted activities in the IFB Act.
43. Tax Refund Act, *supra* note 33, at Sec. 7.
44. See definition of financial institution in Sec. 1 of the Tax Refund Act, *supra* note 33, as well as Sec. 2(4) of the IFB Act Regs., *supra* note 35.
45. Sec. 14 of the Tax Refund Act Regs., *supra* note 35.
46. Sec. 7 of the IFB Act Regs., *supra* note 35.
47. The T2 return.
48. Tax Refund Act, *supra* note 33, at Sec. 8.
49. Since the IFB tax may be positive or negative, to prevent significant start-up losses from diminishing a future tax refund claim, in the first five years of registration under the Tax Refund Act, negative amounts are deemed to be zero; see Sec. 12(3) of the Tax Refund Act Regs., *supra* note 35.
50. The current B.C. corporate tax rate is 15 percent; see Sec. 5(1) of the B.C. Income Tax Act, *supra* note 41.
51. The formula for determining a specialists tax refund, as set out in Sec. 9 of the Tax Refund Act Regs., *supra* note 35, is:

$IFBI/TI \times PIT$

Where,

IFBI	is the amount of employment income from a registered financial institution that was earned during the period or periods during the year when the individual was a specialist;
TI	is the amount of total income as reported on the individual's federal income tax return;
PIT	is the amount of tax assessed and paid for the taxation year under the federal income tax act after application of all tax credits to which the individual was entitled.

52. The Tax Refund Act, *suprà* note 33, at Sec. 5(4).
53. See definition of eligible employee in Sec. 1 of the Tax Refund Act, *supra* note 33.

30 percent of B.C. income tax paid by the individual. As with a specialist, an eligible employee may receive less than the maximum refund if his total income exceeds his income earned as an eligible employee in the calendar year.[54]

B. *Quebec*

Nearly a year-and-a-half before the federal government enacted the IBC provisions of the federal Income Tax Act, Quebec had enacted legislation containing provincial tax incentives aimed at "encouraging the growth of centres of financial excellence in an international market with Montreal as its specific geographical centre".[55]

The Quebec legislation, like the B.C. legislation, is much broader in scope than the federal IBC legislation and it offers income tax relief to corporations operating an international financial centre ("IFC") business in Montreal, and personal income tax relief to certain employees of such businesses. The Quebec legislation even offers corporations relief from the provincial capital tax.

1. Corporate tax incentives

To qualify for the special tax treatment as an IFC under the Quebec legislation, IFC activities must be carried on through a corporation incorporated under domestic or foreign law.[56] All the activities carried on by a corporation or branch of a corporation through an IFC must be related to eligible international transactions. The activities of a corporation's IFC must be managed entirely in Montreal, and carried out in an area separate from the corporation's other activities. Separate books of account must be maintained for the IFC business. Furthermore, to qualify for the tax concessions a corporation must have been issued a certificate by the Quebec Minister of Finance.[57]

2. Qualifying activities

Preferential tax treatment is given to IFCs on income derived from a wide variety of activities under the Quebec statute. Income from the following activities may qualify for special tax treatment if carried on by an IFC:

(a) activities as an investment dealer, so long as the activities are carried on only for non-residents. Or, if such activities are carried on for a Canadian resident, the securities must be:
  (i) listed on the International Options Market, or the Mercantile or International Divisions of the Montreal Exchange and executed on that exchange; or
  (ii) securities of a Canadian corporation and the transaction must be executed at an organized securities market situated outside Canada; or
  (iii) securities of a Canadian government (federal or provincial) and not governed by Canadian law; or
  (iv) securities of a foreign government, government-owned entity or non-Canadian corporation;[58]
(b) underwriting securities for a foreign entity, or, when issued to a non-resident, underwriting securities for a Canadian government (federal or provincial) or a Canadian corporation;[59]
(c) advising on investments for non-residents or for a person resident in Canada with respect to securities of a foreign entity;[60]
(d) depositing money made or received on behalf of a non-resident;[61]
(e) lending and depositing money between corporations operating IFCs, where the money is lent as part of the operations of the lender's IFC business and borrowed for the purposes of the operations of the borrower's IFC business;[62]
(f) issuing or accepting letters of credit, so long as the parties are non-residents and the goods are not in Canada and have no relationship with Canada, nor will they be imported or exported from Canada;[63]
(g) financing or refinancing an operation or transaction between corporations that are financial institutions having no place of business in Canada or between financial centres;[64] and
(h) trading in foreign currency.[65]

A corporation carrying on an IFC business may deduct from its taxable income an amount that can reasonably be considered to be attributable to the carrying on of that IFC business.[66] Losses from an IFC business may be offset against income from such a business, but losses in excess of income from such a business cannot be used to offset income from other sources.[67]

Corporations that carry on an IFC business exclusively are exempt from Quebec's capital tax, including the minimum capital tax.[68] Corporations that carry on other activities in addition to an IFC business have a partial exemption from paid-up capital.[69]

In addition, employer's contributions to the Quebec health insurance plan are waived with regard to employees working exclusively for IFCs.

3. Tax treatment of employees of Quebec IFCs

Under the Quebec legislation employees of IFCs may be eligible for a total exemption from provincial income tax, or may receive a non-taxable allowance of up to one-third of their annual remuneration from the IFC.

Employees of an IFC who specialize in international financial transactions and who were not resident in Canada immediately prior to their employment with the IFC are eligible for a total exemption from provincial income tax on remuneration for up to two years. The work of such individuals must be almost exclusively for the IFC business and

54. The refund formula, as set out in Sec. 10 of the Tax Refund Act Regs., *supra* note 35, is as follows:
30% × IFBI/TI × PIT
Where,
IFBI is the amount of employment income from a registered financial institution that was earned during the period,
TI is the amount of total income as reported on the individual's federal income tax return, and
PIT is the amount of tax assessed and paid for the taxation year under the federal Income Tax Act after application of all tax credits that the individual was eligible for.
55. See "Salient Points Regarding the Creation of an International Financial Centre in Montreal (Quebec) Canada", a paper published by the International Financial Centres Organization of Montreal.
56. See the Quebec Taxation Act, R.S.Q., c. 1-3, Sec. 737.13 and Sec. 1, definition of corporation [hereinafter referred to as the "Quebec Act"].
57. *Id.*, at Sec. 737.13.
58. See Quebec Taxation Act Regulations Sec. 737.13R2 and Sec. 737.13R3 [hereinafter referred to as the "Quebec Regs."].
59. *Id.*, at Sec. 737.13R3(b).
60. *Id.*, at Secs. 737.13R2(c) and 737.13R4.
61. *Id.*, at Sec. 737.13R2(d).
62. *Id.*, at Sec. 737.13R2(f).
63. *Id.*, at Sec. 737.13R2(g).
64. *Id.*, at Sec. 737.13R2(h).
65. *Id.*, at Sec. 737.13R2(i).
66. Quebec Act, *supra* note 56, at Sec. 737.14.
67. *Id.*, at Sec. 737.17.
68. *Id.*, at Sec. 1135.
69. *Id.*, at Secs. 1136 and 1137.

the individual must have a certificate issued by the Quebec Minister of Finance.[70]

In addition to the exemption for specified persons as described above, other employees of an IFC (including persons who were resident in Canada immediately prior to their employment with the IFC) are eligible for a non-taxable allowance of up to one-third of their annual remuneration for amounts received for personal, living or other taxable benefits.[71]

4. Fees

Corporations must pay a C$ 10,000 registration fee to obtain an IFC certificate, and a fee of C$ 500 per employee eligible for a tax exemption outlined above. A C$ 2,000 annual renewal fee is due thereafter for the certificate, as well as an annual fee of C$ 200 per employee eligible for a tax exemption.[72]

IV. IMPACT OF THE FEDERAL AND PROVINCIAL LEGISLATION ON NON-RESIDENTS

While the federal and provincial legislation concerning IBCs and IFBs provide domestic tax relief, it is important to remember that foreign taxpayers must still be concerned with the tax consequences of repatriating income earned in Canada by IBCs and IFCs. The legislation does not give any relief from withholding taxes. Depending on whether there is a tax treaty, withholding taxes on dividends, interest and a variety of other payments made to a foreign parent corporation can range from 10 to 25 percent (the rate if no treaty is applicable).

V. CONCLUSION

It is too early to tell whether, in fact, the tax incentives discussed herein have brought to Canada the amount of international financial business that the government thought would otherwise have been concluded offshore. There is only limited evidence concerning the impact the federal and provincial incentives have had in encouraging corporations to establish IFCs in either Vancouver or Montreal. To date, 27 IFCs have been registered in Montreal and 48 international financial businesses have been registered in Vancouver.[73]

To encourage further development of IFBs in their respective cities, both Montreal and Vancouver have established organizations to help corporations work through the legislative formalities. Vancouver has established the IFC Vancouver Society, whose mandate includes promoting and developing Vancouver as an IFC and advising the provincial government on matters relating to IFC initiatives.[74] Montreal has established the IFC Organization of Montreal, whose mandate includes advising financial institutions and facilitating the process of accreditation by Quebec's Department of Finance.

70. *Id.*, at Secs. 737.15 and 737.16.
71. *Id.*, at Sec. 79.0.1.
72. Policy, as administered by the International Financial Centres Organization of Montreal.
73. These numbers are as of 10 April 1991, according to sources at the International Financial Centre Organization of Montreal and at the British Columbia Ministry of Finance and Corporate Relations.
74. See Robinson, *supra* note 34, at 437.

THE BAHAMAS ADDS NEW INFRASTRUCTURE AND A SERIES OF NEW PRODUCTS*

Bruce Zagaris**

I. INTRODUCTION

The Bahamas has taken major strides to refurbish and add to its already hopped-up engines and has already embarked on some new cruises in the offshore competition. In particular, The Bahamas has established a Financial Services Secretariat and enacted a series of new laws that enable it to offer new financial products. Its relations with the towering northern elephant have improved and the improved relations provide enhanced stability for its offshore financial sector. This article reviews these changes.

II. FINANCIAL SERVICES SECRETARIAT

In August 1990 the Government of The Bahamas established within the Ministry of Finance a Financial Services Secretariat. Owen S-M. Bethel, who was formerly assistant to the Executive Director at both the International Monetary Fund and the World Bank, is the new director of the Financial Services Secretariat. The purpose and objectives of the Secretariat are as follows:

(1) to identify and define all areas and types of financial services available within The Bahamas whether in banking, law, accounting, insurance, corporate and trust services and tax avoidance;

(2) to collect and collate all information relevant to the promotion of such services; to publicize and promote such information to the international community;

(3) to target promotional information at both individual and corporate entities, highlighting the advantages of conducting business from The Bahamas;

(4) to facilitate the smooth entry of interested respondents into The Bahamas' business sector;

(5) to foster the growth of the financial services sector as an industry in The Bahamas; and

(6) to act as a "clearing house" of interested respondents ensuring that background checks are conducted on their financial stability and business integrity.

The Financial Services Secretariat already has five persons and is scheduled to increase to 20 before long.

To assist the Financial Services Secretariat, a Financial Services Advisory Board has been appointed by the Minister of Finance on the advice of the Financial Services Secretariat. The Governor of the Central Bank serves as Chairman of the Board. The six members of the Board include an attorney, an accountant, two directors of trust companies, the manager of an offshore bank and the manager of a captive insurance company.

The Board meets every three months or every alternate month, as deemed necessary. Additionally, an expanded more informal version of an advisory group meets with the Financial Services Secretariat to discuss a wide range of matters, including the operation of existing financial sector laws, difficulties in implementation, developments in other jurisdictions with offshore financial sectors, and proposals for new laws and mechanisms.

The Financial Services Secretariat has hired a public relations firm in New York, which is publishing a bimonthly newsletter, entitled *The Bahamas Financial Insight.*

* The author is grateful for the assistance of the Ministry of Foreign Affairs and the Bahamas Embassy in the United States in arranging a visit in January 1991, which served as the basis for some of the information. In particular, the author is grateful for the assistance in gathering information and explaining the laws from the Governor of the Central Bank, the Attorney General, and the Financial Services Secretariat, as well as several professionals in the private sector, including Mr. Reno Brown, former CEO, Royal Bank of Scotland, Hermann-Josef Hermanns, Hermanns, Coutts & Co. (formerly Nat West International Trust Group), and Michael Barnett, Pres. of The Bahamas Bar Association, and to Mr. Owen S-M. Bethel, Executive Director, Financial Services Secretariat, for his comments on a draft of the manuscript.

** Oppenheimer Wolff & Donnelly, Washington, D.C.; chair, Committee on International Tax Law, Section of International Law & Practice, American Bar Association; member, editorial board, *Caribbean Law & Business.*

III. INTERNATIONAL BUSINESS COMPANIES ACT

On 15 January 1990 the International Business Companies ("IBC") Act came into effect.[1] An IBC is a company that does not carry on business with persons resident in The Bahamas nor owns any interest in real or leasehold property located in The Bahamas, except that it may lease premises for use as an office.[2] The law has been so successful that as of 14 June 1991 5,767 IBCs have been incorporated.

The Act provides for the simple incorporation of the IBC with the power and ability to enable a natural person or groups of persons to do through the vehicle of a corporate entity anything that an individual person may do or may want to do. The owner of the IBC has the benefit of the limited liability of the shareholder for the obligations of the company.

An IBC requires only two shareholders. Incorporation occurs upon the filing of the Memorandum of Association. The Articles of Association may but need not accompany the Memorandum of Association.

The Registrar General's Department, which issues the certification of incorporation, promises that such certification will be issued within 24 hours of the registration of the Memorandum. The office has two telefaxes and registration can be done by telefax and can occur within one hour.

An IBC adversely affected by the exercise of a confiscatory or penal power by a foreign government, such as an expropriation order, or in connection with the imposition of any confiscatory tax, assessment or other governmental charge, may apply to the Supreme Court of The Bahamas for an order that the company be entitled to ignore the acts of the foreign government and continue to treat the situation as if the status quo had never changed.[3] This novel provision will undoubtedly attract persons concerned about investments in a country whose future stability may be uncertain.

An IBC must keep such accounts and records as the directors consider necessary or desirable in order to reflect the financial position of the company. In particular, the IBC must keep minutes of all meetings of directors and members or any committee of the same and of all resolutions of directors and members or any committee of the same and a register of all of its directors and officers. These documents must be kept at its registered office in The Bahamas. The latter requirement has been criticized by some persons who have complained that the cost of the additional workload of keeping the records in The Bahamas may offset the favourable fee structure.[4] Articles of continuation and a certificate of good standing are necessary.

The Act does not require the filing of annual returns. Only a shareholder can inspect the books and records. This minimizes the cost of maintaining an IBC, both in terms of fees to the government and for professionals who would otherwise have to prepare and file such reports. An IBC can exist without the identity of its beneficial owner ever being disclosed to any person, including The Bahamas Government. The shares of an IBC may be bearer shares or may be placed in the names of nominee shareholders who may be residents of The Bahamas. Hence, the IBC will be especially attractive to persons desiring confidentiality.

The fees upon incorporation of an IBC range from $ 100 if its authorized capital is $ 5,000 or less, to $ 1,000 if its authorized capital is $ 50,000 or more. The annual licence fee is the same except that it is $ 350 if the IBC has no authorized share capital and all of its shares have no par value and where its authorized capital does not exceed $ 50,000 and some of its shares have no par value.

An IBC and its shareholders are exempted from the payment of business licence fees, income taxes, corporation taxes, capital gains taxes or any other taxes on income or distributions in connection with any transaction to which the IBC or the shareholder is a party. No estate, inheritance, succession or gift tax is due in The Bahamas with respect to shares, debt obligations or other securities of an IBC. No stamp duty is chargeable on the transfer of property to or by an IBC or on transactions in respect of shares, debt obligations or other securities of an IBC or on any other transaction concerning the business of an IBC. The exchange control regulations do not apply to an IBC or to any transactions relating to securities of or in an IBC between holders of such securities.

IV. INTERNATIONAL MARITIME PROGRAMME

The Bahamas Government has revised and strengthened its "International Maritime Programme".[5] Its basic law is the Merchant Shipping Act,[6] aimed at encouraging the use of The Bahamas registry by foreign shipowners.[7] Amendments were made in 1979, 1982, 1983, 1989 and 1990. In 1976, The Bahamas joined the International Maritime Organization ("IMO") and became a party to the principal conventions on the safety of life at sea and the protection of the marine environment.

Its ship registration programme is coordinated through the London office, with Nassau providing the central registry office depositary.[8] Vessel registration, mortgage registration and cancellation of the same can occur through either the Nassau, London or New York offices of the Maritime Division. Once it registers a vessel, the Registrar concerned becomes the "original registrar" and thereafter administers the ship.

1. Act No. 2 of 1990, An Act to Provide for the Incorporation, Registration and Operation of International Business Companies (11 January 1990).
2. For an excellent and comprehensive review of the Act, see Barnett, "IBC's – A New Vehicle for Business from The Bahamas", (Address to the Eighth Bahamas Int'l Financial Conference, 5 February 1990).
3. IBC Act Sec. 32.
4. Dean, "Eleven Months After IBC", *Second Annual Bankers' Week Supplement* 15, Col. 1 (The Bankers Association of The Bahamas).
5. For additional information, see Commonwealth of The Bahamas, "International Maritime Programme".
6. Merchant Shipping Act, Chapter 246.
7. The open maritime registry of The Bahamas has been expanding. In 1977, there were 60 ships of over 100 gross tons on The Bahamas register, amounting to a total of 58,460 gross tons. At the end of 1981, the fleet had grown to 96 vessels totalling 432,502 gross tons. At the end of the following year, 118 vessels were registered, giving a fleet of almost 600,000 gross tons. Continuing to build on a foreign clientele of highly respected owners with first rate ships, The Bahamas flag fleet had reached 129 ships totalling 806,000 gross tons by early 1983. It reached 572 ships totalling 5,273,174 gross tons by the end of 1985. At the end of 1985, there were 370 ships of some 5 million gross tons. By the end of 1990, The Bahamas had 1,145 ships of 16,896,040 gross tons.
8. Initial registration fees are:
(i) for ships of 2,000 net register tons or less at US$ 1.20 per net register ton, or $ 2,400 whichever is greater;
(ii) for ships of not less than 2,001 net register tons, but not more than 5,000 net register tons at $ 1.20 per net register ton;
(iii) for ships of 5,001 net register tons but not more than 24,999 net register tons at $ 1.10 per net register ton;
(iv) for ships of 25,000 net register tons and over are charged as if they were 25,000 net register tons:
$25{,}000 \times \$\,1.10 =$ US$ 27,500 (maximum registration fee).
The Act was amended to remove the restriction whereby a registrar had to be physically present in the same port as a ship in order to issue a Provisional Certificate of Registry.

Since The Bahamas does not impose any tax on income, capital gains or similar financial revenues, the operation and income of a ship registered under the Bahamian flag, or any capital gain on her sale, are completely tax-free in The Bahamas, whether the ship is owned directly by a foreign person or entity or by a Bahamian company.

Foreign-owned ships registered in The Bahamas are exempt from customs duties and documentary stamp taxes whether or not they call at Bahamian ports, provided they are over 150 gross tons.

V. ECONOMIC INVESTMENT INCENTIVES PROGRAMME FOR HIGH-NET WORTH INDIVIDUALS

On 24 September 1990 The Bahamas Government initiated an investment promotion programme, entitled "An Investment Promotion Programme for the Twenty-first Century" ("IPP"), whereby persons investing in government-approved industrial or business enterprises will be guaranteed freedom from personal and corporate income tax, capital gains tax and personal death duties for a minimum period of 20 years from the date of their investment. Eligibility for permanent residence in The Bahamas is a key component of the IPP.[9] The IPP is directed primarily at individuals who intend to establish specialized industrial or business enterprises or otherwise invest in The Bahamas in a way that will increase the capacity of The Bahamas to take advantage of the benefits available under the Caribbean Basin Initiative of the United States and the Lomé Convention of the European Economic Community, and contribute significantly to the expansion and diversification of the Bahamian economy with special emphasis on the establishment of employment and joint venture business opportunities for Bahamian nationals.

The IPP provides for four categories of investors:

(1) the individual investor, based on an individual with a minimum net worth who makes a minimum investment;

(2) the group investor, i.e. a privately administered investment syndicate that has been approved by and registered with the Central Bank of The Bahamas and provides capital to establish, purchase, expand or maintain in The Bahamas a business or industrial enterprise approved by the National Economic Council;

(3) the entrepreneur who intends and has financial resources and the ability to invest in and operate for a minimum of five years a business or industrial enterprise which will contribute significantly to the Bahamian economy and employ five Bahamians; and

(4) the independent specialist, who is a person that intends to establish a highly-specialized business or vocational undertaking smaller in scale than that of the entrepreneur, but which nevertheless will make a significant contribution to the economy or the cultural, artistic or social life of The Bahamas.

VI. BAHAMAS INVESTMENT INCENTIVE ACT

A bill, entitled "The Bahamas Investment Incentive Act" is now pending. It divides The Bahamas into four zones and creates investment boards for each zone. Investors may apply for various incentives. Criteria are set forth for approving the application. In approving an investment application, the Board must consider the desirability of entering into an agreement with the applicant providing for the benefits to be conferred on the applicant and specifying the terms and conditions to which those benefits are subject.

The purpose of the bill is to grant a wide range of incentives to investors similar to those granted in the development of Freeport, Grand Bahama. However, the Bahamian Government is attempting to maintain more authority over the investment than it previously retained in the development of Freeport.

VII. OTHER NEW LAWS

The Bahamas has been continuing to improve its captive insurance law and industry.

Other recent legislation includes the act relating to domicile of trusts, which enables the settlor to declare the jurisdiction in which settlements can occur, thereby safeguarding trusts established in The Bahamas from attack by other jurisdictions.[10]

The enactment of the Fraudulent Dispositions Act, 1991 overrides the Statute of Elizabeth[11] and makes it difficult for creditors to set aside the disposition of property that is situated in or subject to the jurisdiction of The Bahamas. This law facilitates the establishment of offshore protection of asset trusts in The Bahamas.

An amendment to the Stamp Act imposes a fee cap at 0.25 percent of a manager's or issuer's fee or a maximum of $ 2,500 coupled with a more precise definition of a Eurodollar issue so it will be more economic to underwrite these issues.[12] With increased activities relating to securitization in global markets, the amendment is likely to bring additional Eurodollar issues.

VIII. IMPROVED RELATIONS WITH THE UNITED STATES

During the last year or so, relations between the United States and The Bahamas have improved immeasurably.[13] Enforcement in combating illicit narcotics trafficking has been satisfactory and is succeeding in dramatically slowing the use of The Bahamas as a transit country for drug shipments to the United States.

During the first year in which the U.S.–Bahamas Mutual Legal Assistance Treaty ("MLAT") has been in existence, The Bahamas Government has reported receiving and responding to several requests without any problems, either from a law enforcement perspective or from a perspective impacting on its international financial sector.[14] The Bahamas has also concluded an extradition treaty with the United States. The treaty awaits ratification and is not yet in effect.

[continued on p. 502]

9. "Communication of the Honorable House of Assembly" by the Honorable Sire Clement Maynard, Deputy Prime Minister, 19 September 1990.
10. No. 33 of 1989, An Act to provide for a Choice of Governing Law in the Creation of Trust and for matters connected therewith (date of assent, 29 December 1989).
11. A statute against conveyances made in fraud of creditors.
12. Act No. 4 of 1990, An Act to Amend The Stamp Act (date of assent: 22 August 1990; date of commencement: 27 August 1990).
13. For additional background on this subject, see Zagaris, "Developments in U.S.–Bahamas Enforcement", 7 *Int'l Enforcement Law Rptr.* (5 January 1991).
14. For a discussion of the controversy over the inability of the U.S. Government to ratify the MLAT after pressuring the Bahamian Government to negotiate it, see Zagaris, "Bahamas Government Criticizes Inability of U.S. Government to Ratify the U.S.–Bahamas MLAT", *Int'l Enforcement Law Rptr.* (1988), at 346.

PEOPLE'S REPUBLIC OF CHINA:

THE NEW INCOME TAX ON FOREIGN INVESTMENT

Jinyan Li*

The Income Tax Law of the People's Republic of China Concerning Foreign-Invested Enterprises and Foreign Enterprises (Consolidated Tax Law) was enacted by the National People's Congress on 9 April 1991, and became effective on 1 July 1991.[1] It has consolidated and replaced two previous tax laws governing taxation of foreign investment in China – the Joint Venture Income Tax Laws ("JVITL") introduced in 1980[2] and the Foreign Enterprise Income Tax Law ("FEITL") introduced in 1981.[3] The Consolidated Tax Law will provide foreign investors with a more comprehensive system of taxation of their activities in China than the previous regime. Moreover, the consolidation of the tax treatment of all forms of foreign investment may enable foreign investors to base their investment choice among equity or cooperative joint ventures, or wholly foreign-owned enterprises, on factors other than taxation.

PROBLEMS UNDER THE PREVIOUS SYSTEM

The introduction of the Consolidated Tax Law was considered necessary to overcome the problems that existed under the previous system:

(a) Foreign enterprises were taxed differently depending upon the legal form in which the investment was conducted. Equity joint ventures incorporated under the Joint Venture Law[4] between Chinese and foreign firms were taxed on their worldwide income under the JVITL. Cooperative joint ventures incorporated under the Cooperative Joint Venture Law,[5] wholly foreign-owned enterprises established under the Foreign Enterprise Law,[6] and foreign enterprises with or without branches, representative offices or other establishments in China were treated as "non-residents" of China for tax purposes, and taxed only on income derived from sources in China under the FEITL. There seems to be little justification for treating equity joint ventures differently from cooperative joint ventures and wholly foreign-owned enterprises considering that both cooperative joint ventures and wholly foreign-owned enterprises are legal entities established under Chinese laws and can be considered as "residents" of China in accordance with the general principles of international taxation.

(b) Tax rates were different under the JVITL and the FEITL: under the JVITL, equity joint ventures were subject to tax at a flat rate of 33 percent, including a national tax of 30 percent, and a local tax equal to 10 percent of the national tax payable. Under the FEITL, cooperative joint ventures, wholly foreign-owned enterprises and foreign enterprises which set up establishments in China were subject to tax at progressive rates ranging from 20 percent (on annual net income of less than 250,000 yuan) to 40 percent (on annual net income in excess of 1 million yuan), in addition to a local tax of 10 percent. The marginal rate of 50 percent is higher than that in many of the investors' home countries, and has been considered unfavourable to attract foreign investment to China. Such a rate structure and the discriminatory tax incentive regulations (see below) resulted in less favourable tax treatment of cooperative joint ventures and wholly foreign-owned enterprises than equity joint ventures.

(c) Rules concerning tax exemptions and reductions were promulgated in a piecemeal fashion under the JVITL, FEITL and the regulations of the State Council. They applied differently to foreign enterprises depending upon the investment vehicle and location of the foreign investment.

* Assistant Professor at the Faculty of Law, The University of Western Ontario, Canada; and Consultant to the Toronto Office of the international law firm of Baker & McKenzie.

1. See Appendix for the author's translation of this law.
2. "The Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment" was promulgated by the Third Session of the Fifth National People's Congress on 10 September 1980; and the "Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment" were issued by the State Council on 10 December 1980. For an English translation of this JVITL and Regulations, see A.J. Easson and Jinyan Li, *Taxation of Foreign Investment in the People's Republic of China* (Deventer: Kluwer, 1989), at 179-186.
3. "The Income Tax Law of the People's Republic of China Concerning Foreign Investment" was promulgated by the Fourth Session of the Fifth National People's Congress on 13 December 1981; and the "Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises" were approved by the State Council on 17 February 1982. For an English translation, see Easson and Li, *supra* note 2, at 187-198.
4. "Law of the People's Republic of China on Chinese-Foreign Joint Ventures", adopted by the Second Session of the Fifth National People's Congress on 1 July 1979.
5. "Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures" was adopted by the First Session of the Seventh National People's Congress on 13 April 1988.
6. "Law of the People's Republic of China on Enterprises operated exclusively with Foreign Capital" was adopted by the Fourth Session of the Sixth National People's Congress on 12 April 1986.

For instance, the JVITL provided for a two-year tax exemption and a three-year 50 percent reduction in tax for all equity joint ventures scheduled to operate for ten years or more without distinguishing the nature of their business (Article 5 of JVITL). For cooperative joint ventures and wholly foreign-owned enterprises, on the other hand, the tax holiday was less favourable – a one-year tax exemption plus a two-year tax reduction – and was available only to those engaged in farming, forestry, husbandry or other low-profit occupations (Article 5 of the FEITL). All enterprises with foreign investment, including equity and cooperative joint ventures and wholly foreign-owned enterprises, which were established in the Special Economic Zones ("SEZs") of Shenzhen, Shantou, Zhuhai, Xiamen, Hainan Province, and Pudong New Area, were subject to tax at a reduced rate of 15 percent. For enterprises established in the Economic and Technological Development Zones ("ETDZs") of the 14 coastal cities and the "old urban areas" of the cities of Shantou, Zhuhai and Xiamen (outside the SEZs of these three cities), and in the Open Coastal Economic zones ("OCEZs"), which cover large areas of China's coastal provinces, the income tax rate was reduced by 20 percent. Both Hainan SEZ and Pudong New Area offered a five-year additional tax exemption followed by a five-year 50 percent tax reduction for infrastructure development projects.[7]

The 20 percent withholding tax charged under the FEITL was often reduced by subsequent regulations of the State Council to 10 percent, and in some cases fully waived, with respect to interest income derived by foreign companies from Chinese sources, certain kinds of rental income and royalties paid for the transfer of proprietary technologies.[8]

(d) Owing to the fact that most foreign investment in China is conducted through a wholly-owned or, in the case of a joint venture, a partly-owned subsidiary of a multinational corporation, it is not surprising that problems of transfer pricing have arisen and have attracted the attention of the Chinese tax authorities. There has been little power given under the prior legislation to the tax authorities to deal with the issue of transfer pricing, although some measures were taken by the local government of the Shenzhen SEZ in 1988.[9]

MAJOR CHANGES IN THE NEW LAW

The Consolidated Tax Law was intended not only to maintain the substantial provisions under the JVITL and FEITL for the sake of continuity and consistency in China's foreign tax policy, but also to overcome the above-mentioned problems by introducing new provisions.

Basis of Taxation

The Consolidated Tax Law now applies to all forms of foreign investment in China, including equity joint ventures, cooperative joint ventures, wholly foreign-owned enterprises, establishments maintained by foreign companies in China to carry on business activities, as well as foreign companies which have not set up establishments in China but derive Chinese-source income.

In principle, China (like many countries) exercises its jurisdiction to tax on the basis of the taxpayer's residence and/or the source of income. Persons who are residents in China are subject to Chinese tax on their worldwide income; non-residents are subject to Chinese tax only on income derived from Chinese sources. The term "resident" is normally defined to include any person who is liable to pay tax by reason of domicile, residence, place of management or place of incorporation. Although the word "residence" *per se* is not used in the Consolidated Tax Law, Article 3 does provide that foreign-invested enterprises which maintain their head office (i.e. a place of management) in China are taxable on their worldwide income. The term "foreign-invested enterprises" is defined in Article 2 to include equity and cooperative joint ventures and wholly foreign-owned enterprises established in accordance with Chinese laws. The principle of source jurisdiction is reflected in Article 19 of the Consolidated Foreign Income Tax Law by charging a withholding tax on some Chinese-source income derived by foreign enterprises. The term "foreign enterprises" refers to foreign companies, enterprises and other economic organizations which have set up establishments in China engaged in production and business operations or which have not set up such establishments but nevertheless obtain income from sources in China. Chinese-source income includes income from dividends (mostly profits distributed by joint ventures and wholly foreign-owned enterprises), interest, rentals and royalties. There is no specific mention of withholding tax on management fees paid to a foreign enterprise. Such fees may, however, fall into the category of "income from other sources" for the purposes of the withholding tax. Management fees are normally treated as business profits under tax treaties,[10] and are not taxable in China if the foreign enterprise does not have a permanent establishment there.

Tax Rates

The Consolidated Tax Law adopts the rate structure of the JVITL – a flat rate of 33 percent (30 percent national tax plus 3 percent local tax) – to apply to all joint ventures, wholly foreign-owned enterprises and the amount of income attributable to the establishments in China established by foreign enterprises. It also maintains the basic 20 percent withholding tax for designated items of income from Chinese sources. The 10 percent withholding tax charged on profits distributed by an equity joint venture to a foreign investor under Article 4 of the JVITL has been abolished.

In order to unify the various incentives that had been promulgated over the past decade, the Consolidated Tax Law specifies that the withholding tax on certain investment income shall be waived or reduced. Article 19 exempts profits distributed by a joint venture or wholly foreign-owned enterprise from withholding tax. The withholding tax is also waived on interest from loans extended to the Chinese Government or State banks by international financial organizations, or from loans given by foreign banks to China's State banks at preferential rates. The withholding tax rate is reduced to 10 percent on royalties from transfer-

7. For instance, "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 Port Cities" were promulgated on 15 November 1984; "Provisions of the State Council on Encouraging Investment to Promote the Development of Hainan Island" were promulgated on 4 May 1988; and "Interim Provisions 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 the Open Coastal Economic Zones" were issued on 15 June 1988.
8. See Easson and Li, *supra* note 2, at 97-100.
9. "Provisional Measures for the Administration of Taxation of Transactions and Business Operations between Enterprises with Foreign Investment in the Shenzhen Special Economic Zone and Their Affiliates", entered into force on 1 January 1988. For further comments, see A.J. Easson and Jinyan Li, "People's Republic of China: Foreign Tax Update", 44 *Bulletin for International Fiscal Documentation* (January 1990), at 26.
10. By the end of 1990, China had concluded income tax treaties with 30 countries; see *China Daily*, 11 April 1991, at 2.

ring or licensing technology relating to scientific research, energy development, agricultural production, transportation and communications.

Taxable Income

The Consolidated Tax Law does not change the rules on computing taxable income prescribed under the JVITL and FEITL, except that it now clearly provides in Article 8 that capital gains realized upon liquidation be treated as taxable income.[11] The amount of taxable gains is the portion of the balance of the net assets of the taxpayer obtained after deduction therefrom of the enterprise's undistributed profits, its various funds and the liquidation expenses which exceeds the amount of paid-up capital.

Transfer Pricing

A new clause on transfer pricing was created in the Consolidated Tax Law. In accordance with Article 13, joint ventures, wholly foreign-owned enterprises and foreign enterprises with an establishment in China are required to deal at arm's length with their affiliated companies. If non-arm's length prices are charged or paid by a taxpayer for the purposes of reducing taxable income, the tax authorities can make adjustments to its income and expenses.

Prior to the promulgation of the Consolidated Tax Law, interim rules had been issued by the State Taxation Bureau to deal with the issue of transfer pricing ("the Transfer Pricing Rules"),[12] which are expected to be incorporated into the Detailed Implementing Rules for the Consolidated Tax Law to be issued by the State Council. The term "affiliated companies of a foreign-invested enterprise" is defined in Article 9 of the Transfer Pricing Rules to include companies, enterprises and individuals that directly or indirectly control, or are controlled by, the foreign-invested enterprise with respect to capital, purchase and sales, operation, management or other aspects of business. There is no definition of "control", particularly indirect control. A majority interest in a joint venture would appear to be sufficient to constitute "control". On the other hand, the tax authorities may insist that a foreign party has sufficient control where it does not have a majority interest, but has the power to appoint the general manager or chairman of the board of directors.

Where a foreign-invested enterprise deals with its affiliates at non-arm's length prices, the tax authorities may adjust the prices on a reasonable basis for income tax purposes. The basis of adjustment can be market price, prices charged by the enterprise to unrelated third parties or a cost-plus method allowing for reasonable profit. The choice of method is left to the discretion of the tax authorities, who may also employ other similar methods. It is not clear whether "market price" refers to domestic or international market price. Where one of the parties is situated outside China, international market price would probably be used.

Transfer pricing is a difficult loophole to plug even in developed countries. Owing to the lack of experience and expertise on the part of administration and the shortage of database resources, the Chinese tax authorities may only go after the most flagrant offenders at the beginning. The burden of proving that an arm's length price is adopted lies on the taxpayer. The information submitted by the enterprise on its pricing may be used by the tax authorities to compile the database necessary to attack transfer pricing on a large scale.

Tax Incentives

The tax incentives granted under the JVITL, FEITL, and the regulations of the State Council have been largely incorporated in the Consolidated Tax Law as follows.

Tax Holidays

Cooperative joint ventures and wholly foreign-owned enterprises are now entitled to the same tax holiday as equity joint ventures. Article 8 of the Consolidated Tax Law provides for a tax exemption for the first two profit-making years and a 50 percent tax reduction for the third, fourth and fifth years on income earned by joint ventures and wholly foreign-owned enterprises if they are scheduled to operate for ten years or more and engaged in production. A further reduction of 15 percent to 30 percent for an additional ten years may be granted if the enterprise operates in farming, forestry, animal husbandry or is located in remote, economically underdeveloped areas. Tax holiday is no longer available, however, to enterprises engaged in non-productive activities, such as commerce, tourism and services.

Tax Refund for Reinvestment

A foreign investor in a foreign-invested enterprise, which reinvests in China its share of profits obtained from the enterprise for a period of not less than ten years, is entitled, under Article 10 of the Consolidated Tax Law, to a refund of 40 percent of the income tax already paid by the enterprise on the reinvested portion. A foreign investor is eligible for the refund if he invests in the same enterprise by way of increasing its registered capital, or invests in other ventures. It is only the national tax, not the local tax, that is refunded.

Incentives in Designated Special Regions

The national tax rate of 30 percent is reduced by Article 7 of the Consolidated Tax Law to 15 percent and applicable to (i) foreign-invested enterprises established in the SEZs; (ii) foreign enterprises which have set up establishments engaged in production and business operations in the SEZs (an incentive unavailable under the prior legislation); and (iii) foreign-invested enterprises established in the ETDZs, but limited to enterprises engaged in production, which is a deviation from the prior legislation. The 30 percent tax rate is reduced to 24 percent for foreign-invested enterprises engaged in production in the OCEZs and in the "old urban areas" of the coastal cities with ETDZs and SEZs. The Consolidated Tax Law also specifies that foreign-invested enterprises established in the "old urban areas" of the coastal cities, OCEZs and other special zones designated by the State Council, which are engaged in infrastructure and other projects carried on by the State, may be entitled to pay income tax at a reduced rate of 15 percent. Foreign-invested enterprises engaged in infrastructure development projects in Hainan SEZ and Pudong New Area may continue to enjoy the five-year exemption plus a five-year 50 percent

11. Such gains were previously taxed in accordance with the Ministry of Finance Notice *(87) Cai Shui Wai Zi, No. 33,* issued on 22 February 1987. Also included in "other income" were certain exchange gains and losses due to exchange rate fluctuation; see "Supplemental Provisions on Accounting For Foreign Currency Transactions by Joint Ventures Using Chinese and Foreign Investment", issued by the State Council on 31 December 1987.

12. State Taxation Bureau, "Provisional Rules Regarding Administration of Taxation on Transactions between Foreign Investment Enterprises and Their Affiliated Companies", became effective from 1 November 1990.

reduction by virtue of Article 8 of the Consolidated Tax Law. Article 8 provides that if the prior legislation granted more generous tax benefits to production ventures or key non-production projects, the prior legislation shall remain in force after the implementation of the Consolidated Tax Law.

Incentives to Designated Enterprises

Although the Consolidated Tax Law contains no special provisions regarding export-oriented enterprises and technologically-advanced enterprises,[13] it is reasonable to anticipate such enterprises may continue to be taxed at the reduced rate of 15 percent and to enjoy the 50 percent tax reduction at the expiry of the normal tax holiday by reference to Article 8. In the case of a technologically-advanced enterprise, the tax reduction may continue for an additional three years, and in the case of an export-oriented enterprise, for so long as it continues to qualify as such.

Transitional Rules

In order to maintain stability in tax policy with respect to existing enterprises, Article 27 of the Consolidated Tax Law provides that where joint ventures or wholly foreign-owned enterprises established prior to 9 April 1991 were subject to lower tax rates, or eligible for better tax benefits under the prior legislation, the previous laws and regulations shall continue to apply to such enterprises during their scheduled operation period. Consequently, a cooperative joint venture or a wholly foreign-owned enterprise may still be taxed at 20 percent under the FEITL if the annual taxable income is below 250,000 yuan. An equity joint venture in the service field established before 9 April 1991 is still entitled to the two-year tax exemption, followed by the three-year 50 percent reduction, even though this benefit has now been eliminated. Naturally, existing foreign-invested enterprises and establishments set up by foreign enterprises are entitled to take advantage of any favourable treatment provided under the Consolidated Tax Law, which is more advantageous than they previously enjoyed.

Comparisons between the Consolidated Tax Law and the JVITL and FEITL indicate that the tax incentives extended by the Consolidated Tax Law are fairly modest, particularly as regards enterprises located in the SEZs, ETDZs and OCEZs. It has, however, eliminated a certain amount of confusion generated by the existing system. Furthermore, the abolition of the progressive rates under the FEITL and the expansion of the tax incentives to all forms of foreign investment will increase the attractiveness of cooperative joint ventures and wholly foreign-owned enterprises as vehicles for potentially high-profit ventures. For example, cooperative joint ventures earning more than one million yuan annually will, if not eligible for any incentive benefits, be taxed at 33 percent instead of 50 percent under the FEITL. The introduction of the principle of "residence" and the provisions on transfer pricing will certainly move the Chinese tax system closer to the international tax norm.

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13. "Export-oriented enterprises" refer to "production enterprises whose products are mainly for export, which have a foreign exchange surplus after deducting from their total annual foreign exchange revenues the annual foreign exchange expenditures incurred in production and operation and the foreign exchange needed for the remittance abroad of the profits earned by foreign investors".
"Technologically-advanced enterprises" refer to "production enterprises possessing advanced technology supplied by foreign investors which are engaged in developing new products, and upgrading and replacing products in order to increase foreign exchange generated by exports or for import substitution"; see "Provisions of the State Council for the Encouragement of Foreign Investment, issued on 11 October 1986.

APPENDIX

The Income Tax Law of the People's Republic of China Concerning Foreign-Invested Enterprises and Foreign Enterprises

(Adopted by the Fourth Session of the Seventh National People's Congress and promulgated on 9 April 1991)

Article 1

Income tax shall be levied in accordance with this Law on the income derived from production, business and other sources by any foreign-invested enterprise operating in the People's Republic of China.

Income tax shall be levied in accordance with this Law on the income derived by any foreign enterprise from production, business and other sources within the territory of the People's Republic of China.

Article 2

"Foreign-invested enterprises" as mentioned in this Law refer to Chinese-foreign equity joint ventures, Chinese-foreign cooperative joint ventures, and wholly foreign-owned enterprises established in China.

"Foreign enterprises" as mentioned in this Law refer to foreign companies, enterprises and other economic organizations which have set up establishments or sites in China engaged in production and business operations, or which have not set up such establishments or sites in China but derive income from sources in China.

Article 3

Foreign-invested enterprises which have established their head office in China shall pay income tax both on the income derived from sources in China and the income derived from sources outside China. Foreign enterprises shall pay income tax on the income derived from sources in China.

Article 4

The amount of taxable income of foreign-invested enterprises, and establishments or sites in China established by foreign enterprises and engaged in production and business operations, shall be their net income in each tax year after deduction of costs, expenses and losses in that year.

Article 5

The enterprise income tax on foreign-invested enterprises and on foreign enterprises on the income derived by establishments or sites in China engaged in production and business operations, shall be computed on the basis of the taxable income, at a rate of 30 percent; the local income tax shall be computed on the amount of their taxable income, at a rate of 3 percent.

Article 6

Pursuant to the national industrial policy, the State may channel new foreign investment and encourage the establishment of foreign-invested enterprises which use advanced technology and equipment, and/or which export all or most of their products.

Article 7

Enterprise income tax shall be levied at a reduced rate of 15 percent on foreign-invested enterprises established in the Special Economic Zones, on foreign enterprises which have set up establishments or sites in the Special Economic Zones engaged in production and business operations, and on foreign-invested enterprises established in the Economic and Technological Development Zones engaged in production.

Enterprise income tax shall be levied at a reduced rate of 24 percent on foreign-invested enterprises established in the Open Coastal Economic Zones, or in the "old urban areas" of the coastal cities where the Special Economic Zones or Economic and Technological Development Zones are located, and which are engaged in production.

Enterprise income tax may be levied at a reduced rate of 15 percent on foreign-invested enterprises which have been established in the Open Coastal Economic Zones, and in the "old urban areas" of the coastal cities where the Special Economic Zones or Economic and Technological Development Zones are located, or in other zones designated by the State Council, and which are engaged in energy, transportation, port and pier projects or other projects encouraged by the State. The specific measures therefore shall be formulated by the State Council.

Article 8

Foreign-invested enterprises scheduled to operate for a period of ten years or more and engaged in production, except those projects for the exploitation of resources such as petroleum, natural gas, rare metals and precious metals which are governed by separate regulations of the State Council shall, commencing with the first profit-making tax year, be exempt from enterprise income tax in the first and second years and be allowed a 50 percent reduction in tax in the third, fourth and fifth years. A foreign-invested enterprise shall pay back the enterprise income tax exempted or reduced if its actual operation period is less than ten years.

Where the regulations issued by the State Council prior to the implementation of this Law provide for preferential treatment of energy, transportation, port and pier construction and other important production projects by granting exemption and reduction of enterprise income tax for a period longer than that set forth in the preceding paragraph, or preferential treatment of certain important non-production projects by granting exemption and reduction of enterprise income tax, such regulations shall continue to be effective after the implementation of this Law.

Foreign-invested enterprises engaged in agriculture, forestry, animal husbandry, and foreign-invested enterprises which are located in remote, economically underdeveloped outlying areas may, upon approval of the State Council's department in charge of taxation of an application filed by the enterprise, be allowed a 15 to 30 percent reduction in enterprise income tax for a period of ten years following the expiration of the term for exemptions and reductions mentioned in the preceding paragraphs.

Subsequent to the implementation of this Law, if provisions for tax exemptions and reductions of enterprise income tax in the preceding three paragraphs need to be modified, such modification shall be submitted by the State Council to the Standing Committee of the National People's Congress for a decision.

Article 9

The People's Governments of the provinces, autonomous regions and municipalities directly under the Central Government may, in accordance with actual circumstances, decide to waive or reduce local income tax for trades and projects in which foreign investment is encouraged.

Article 10

If a foreign investor in a foreign-invested enterprise directly reinvests its share of profits in the enterprise by way of increasing registered capital, or uses the same as capital investment for the establishment of another foreign-invested enterprise for a period of not less than five years, the foreign investor may, upon approval of the tax authorities for an application filed by such foreign investor, obtain a refund of 40 percent of the income tax paid on the reinvested amount. Where the State Council has different regulations of preferential treatment, matters shall be handled in accordance with such regulations. If the reinvestment is withdrawn within five years, the refunded tax shall be paid back.

Article 11

Losses incurred in a tax year by a foreign-invested enterprise, or an establishment or site in China established by a foreign enterprise and engaged in production or business operations, may 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 such losses, the balance may be made up with further deductions from income year by year over a period not exceeding five years.

Article 12

A foreign-invested enterprise shall be allowed, when paying tax on its worldwide income, to deduct from its amount of tax payable the amount of income tax paid by it in other countries on income derived from sources outside China. The amount deductible shall not exceed the amount of income tax payable assessed on the income derived outside China in accordance with the provisions of this Law.

Article 13

When foreign-invested enterprises, or establishments or sites in China established by foreign enterprises and engaged in production and business operations conduct business transactions with their affiliated companies, they shall charge and pay prices and expenses as in business transactions conducted at arm's length. Where the prices and expenses charged or paid are not at arm's length for the purposes of reducing taxable income, the tax authorities shall have the power to make adjustments reasonable in the circumstances.

Article 14

When foreign-invested enterprises and establishments or sites established in China by foreign enterprises and engaged in production and business operations, are established, change their address, merge, are divided, close down, terminate or change a major item of their registration, they shall register with or amend or cancel the registration with the General Administration Bureau for Industry and Commerce, and on the strength of relevant certificates, register with or amend or cancel their registration with the local tax authorities.

Article 15

Enterprise income tax and local income tax shall be levied on an annual basis and prepaid in quarterly installments. Such prepayment shall be made within 15 days after the end of each quarter. The final settlement shall be made within five months after the end of each tax year. Excess payments shall be refunded by the tax authorities or deficiencies shall be made good by the taxpayer.

Article 16

Foreign-invested enterprises and establishments or sites in China established by foreign enterprises and engaged in production and business operations, shall file their provisional income tax returns with the local tax authorities within the period prescribed for prepayments of income tax. They shall file the final annual income tax return together with its final accounting statements within four months after the end of a tax year.

Article 17

The method of financial management and accounting of foreign-invested enterprises and of establishments or sites in China established by foreign enterprises and engaged in production and business operations, shall be submitted to the local tax authorities for reference. All accounting records shall be accurate and complete, and shall have lawful vouchers as the basis for entries.

If the method of financial management and accounting of foreign-invested enterprises, and establishments or sites established in China by foreign enterprises and engaged in production and business operations, contradict the tax regulations of the State Council, tax shall be assessed and paid in accordance with the provisions of the tax regulations of the State Council.

Article 18

When a foreign-invested enterprise is being liquidated, the portion of the balance of its net assets or remaining property obtained after deduction therefrom of undistributed profit, its various funds and the liquidation expenses which exceed the paid-up capital, shall be income from liquidation, on which income tax shall be paid in accordance with the provisions of this Law.

Article 19

Income tax shall be levied at the rate of 20 percent on the income derived from profits, interest, rentals, royalties and other sources in China by foreign enterprises which have no establishments or sites in China, or by foreign enterprises which have establishments or sites in China, but the above mentioned income is not attributable to the establishments or sites.

For the payment of income tax according to the provisions in the preceding paragraph, the beneficial owner of the income shall be the taxpayer, and the paying unit shall be the withholding agent. The income tax shall be withheld by the paying unit in each of its payments made. Taxes withheld on each payment by the withholding agent shall within 15 days be turned over to the State Treasury and the statement on the income tax withheld submitted to the local tax authorities.

Income tax shall be waived or reduced in the following circumstances:
(1) Income from profits received by a foreign investor from a foreign-invested enterprise shall be exempt from income tax;
(2) Income from interest on loans extended to the Chinese Government and China's State banks by international financial organizations shall be exempt from income tax;
(3) Income from interest on loans extended at a preferential interest rate by foreign banks to China's State banks shall be exempt from income tax; and
(4) Income from royalties for proprietary technology provided for scientific research, the exploitation of energy resources, the development of transportation and communications, production relating to agriculture, forestry and animal husbandry, and the development of important technologies may, upon approval by the State Council's department in charge of taxation, be taxed at a reduced rate of 10 percent. If such proprietary technology is advanced or provided on preferential terms, royalties may be exempt from income tax.

If preferential treatment in the form of exemption or reduction of income tax other than set forth in this Article needs to be granted for profits, interest, rentals, royalties and other income, the State Council shall formulate regulations therefore.

Article 20

The tax authorities shall have the power to investigate the financial affairs, accounting books and payment of tax of foreign-invested enterprises and establishments or sites established by foreign enterprises in China and engaged in production or business operations, and shall have the power to investigate the state of affairs of the withholding and payment of tax of withholding agents. Taxpayers and withholding agents under investigation must report according to the facts and provide relevant information and may not refuse to cooperate, or conceal any facts.

Officials sent by the tax authorities to investigate the financial, accounting and tax affairs of a taxpayer shall produce identification cards and undertake to keep secret.

Article 21

Income taxes levied under this Law shall be computed in terms of Renminbi. Income in foreign currency shall be assessed according to the exchange rate quoted by the State General Administration of Exchange Control and shall be taxed in Renminbi.

Article 22

In case of failure to pay tax by taxpayers or to withhold and turn over tax by withholding agents within the prescribed time limit, the appropriate tax authorities shall, in addition to setting a deadline for payment of the tax, surcharge overdue payments at 0.2 percent of the amount of tax overdue for each day in arrears, starting from the first day of default in tax payment.

Article 23

If a taxpayer fails to register with or to amend or conceal its registration with the tax authorities within the prescribed time limit, or fails to submit its tax returns, final accounting statement or statement on the income tax withheld to the tax authorities within the prescribed time limit, or fails to submit its financial and accounting records to the tax authorities for reference, the tax authorities shall order it to register or to submit the documents within a specified time limit and may impose on it a fine of 5,000 yuan or less.

If a person which has been ordered by the tax authorities to register or to submit documents within a specified time limit fails to register with or to amend its registration with the tax authorities, or fails to submit its income tax return, final accounting statement or statement on the income tax withheld to the authorities, within the specified time limit, the tax authorities shall impose on the person a penalty of 10,000 yuan or less. In cases of gross violation, its legal representatives and person(s) directly responsible shall be prosecuted under Article 121 of the Criminal Code.

Article 24

If a withholding agent fails to perform the obligations under this Law by failing to withhold the amount of tax to be withheld or by withholding less than the full amount of tax to be withheld, the tax authorities may, in addition to specifying a deadline for payment of the tax which should have been withheld, impose a penalty of not more than the amount that should have been withheld.

If a withholding agent fails to turn an amount of tax withheld over to the State Treasury within the prescribed time limit, the tax authorities shall order it to turn over the amount within a specified time limit and may impose on it a fine of 5,000 yuan or less. If the withholding agent fails to turn over the amount within the specified time limit, the tax authorities shall press for payment of the amount according to law and impose on it a penalty of 10,000 yuan or less. In cases of gross violation, its legal representatives and person(s) directly responsible shall be prosecuted under Article 121 of the Criminal Code.

Article 25

If a taxpayer evades tax through concealment or deceit or fails to pay tax within the time limit prescribed in this Law, and if such a person has been reminded by the tax authorities to pay tax but fails to do so within the specified time limit, the tax authorities shall press for payment of the amount of tax payable by it and impose a penalty of not more than five times the amount of tax owed. In cases of gross violation, the legal representatives and person(s) directly responsible shall be prosecuted under Article 121 of the Criminal Code.

Article 26

In case of disputes with the tax authorities about tax payment, foreign-invested enterprises, foreign enterprises or withholding agents must pay tax according to the relevant regulations first before applying to higher tax authorities for reconsideration. Upon payment it may, within 60 days after the date of receipt of the tax certificate issued by the local tax authorities, apply to the tax authorities one level higher for reconsideration. Such tax authorities one level higher shall make a decision on reconsideration within 60 days after the date of receipt of application. If the foreign-invested enterprise, foreign enterprise or withholding agent does not accept the decision on reconsideration, it may bring the matter before the local people's court within 15 days after the date of receipt of the decision on reconsideration.

In case of disputes with the tax authorities about a penalty, a person may, within 15 days after the date of receipt of the notification of such penalty, apply for reconsideration to tax authorities one level higher than the authorities which imposed the penalty. If such a person does not accept the decision on reconsideration, it may bring the matter before the local people's court within 15 days after the date of the receipt of the decision on reconsideration.

Alternatively, such a person may directly bring the matter before the local people's court within 15 days after the date of receipt of the notification of the penalty. If such a person neither applies for reconsideration or brings the matter before the local people's court within the prescribed time limit nor performs the decision on the penalty, the tax authorities which made the order of penalties may apply to the people's court for enforcement thereof.

Article 27

In cases where foreign-invested enterprises have been established prior to the promulgation of this Law, and the tax rates under this Law are higher or the tax benefits under this Law are not as favourable as those under the laws and regulations of the State Council in force prior to the implementation of this Law, those laws and regulations shall remain applicable to such enterprises during their scheduled operation period after this Law has become effective. If the enterprise has no scheduled operation period, the laws and regulations issued by the State Council in force prior to the implementation of this Law shall remain applicable to the enterprise for the period as specified by the State Council. The specific measures therefore shall be formulated by the State Council.

Article 28

If an income tax agreement between the Government of the People's Republic of China and the government of a foreign country contains provisions different from the provisions of this Law, matters concerning tax payment shall be handled in accordance with the provisions of such agreement.

Article 29

Detailed Rules and Regulations for the implementation of this Law shall be formulated by the State Council.

Article 30

This Law shall go into force as of 1 July 1991. At the same time, the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment and the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises shall be repealed.

(Appendix: Article 121 of the Criminal Code: Anyone who evades or resists tax in violation of the tax laws and regulations, if the case is serious, shall make up the tax evaded or resisted and may be fined in accordance with the tax laws and regulations. In addition, the persons directly responsible shall be sentenced to not more than three years of fixed-term imprisonment or criminal detention.)

JAPAN PASSES NEW TAX LAW

Toshikazu Tagawa and Thomas E. Anderson*

In March and April 1991 the Japanese Diet passed legislation resulting in a series of changes to the tax law. The principal change was the establishment of a new land value tax (*chikazei*) on the holding of land. Measures were also passed which generally increase corporate and individual taxation resulting from the transfer of land.

This article focuses on aspects of the new legislation which might be of special interest to non-Japanese businesses and individuals. Of special importance to those currently planning transactions would be the effective dates.

I. SPECIAL SURTAX FOR SUPPORTING THE PEACE EFFORTS IN THE GULF REGION

A surtax of 2.5 percent is imposed on corporate tax liabilities of over ¥ 3 million for tax years ending on or after 1 April 1991 and before 1 April 1992.

II. LAND VALUE TAX

A. *General*

Essentially all individuals and corporations holding non-exempt land and land leasehold rights in Japan on or after 1 January 1992 with a valuation greater than a standard deduction will be subject to the new land value tax which is applied to land held on 1 January of each year.[1]

In formula form, the new land value tax is calculated as follows:

Assessed value of land located in Japan	xxxx
Less: assessed value of land specifically exempted	(xxxx)
Less: standard deduction	(xxxx)
Subtotal	xxxx
Times: tax rate	%
Tax payable	xxxx

The assessed value used for land and land leasehold rights is that used for inheritance tax purposes,[2] which is normally currently about 50 percent of the fair market value.

B. *Exempt land*

The types of land (and land leasehold rights) which are generally wholly exempt from taxation include:
- land held by governmental entities and non-profit organizations;[3]
- up to 1,000 square metres of land held for residential buildings, except for the residences of company directors;[4]
- land used by medical and other social welfare establishments;[5]
- land used for cultural and educational activities;[6]
- land held for various public uses such as roads, utilities and sewers;[7]
- land with an assessed value (as if it were vacant) of less than ¥ 30,000;[8]
- land used for foreign embassies and consulates.[9]

Other types of property may be partially exempt. For example, only one-fifth of the value of land used for the development of residential property is subject to the tax.[10] Also, only one half of the value of land used for certain specifically designated purposes (e.g. environmental, agricultural and cultural purposes) is subject to the tax. Moreover, as a result of lobbying by certain groups, one half of the value of other types of land (such as that used for a gasoline stand) are also excluded from the tax base.[11]

* Messrs. Tagawa (Partner) and Anderson (Manager) are associated with Ernst & Young in New York, specializing in international taxation.

1. Land Value Tax Law ("LVTL") Arts. 4, 5.
2. LVTL Art. 23.
3. LVTL Art. 6(1)(2).
4. LVTL Art. 7.
5. LVTL Art. 6(5).
6. *Id.*
7. *Id.*
8. LVTL Art. 6(6).
9. LVTL Art. 8.
10. LVTL Supplemental Art. 10; Special Measures Tax Law ("SMTL") Art. 71-4.
11. LVTL Art. 17, Table 2.

TABLE 1
EXAMPLE OF NEW LAND VALUE TAX*

J-CO is a listed corporation with paid-in capital of ¥ 10 billion. It is engaged in the transportation, gasoline stand and manufacturing business. Its land value tax for 1992 would be computed as follows:

Property	Area (1,000)sq. metres	Value per square metre (¥ 1,000)	Non-taxable	Taxable	Note
1. Bus garage	3	1,000	3,000,000,000		Land held for public uses.
2. Gasoline stand	1	2,000		1,000,000,000	One half specifically exempted.
3. 1 Factory location	800	100		80,000,000,000	Fully subject to tax.
4. 2 Factory location	100	70		4,200,000,000	Special allocation for land rights held by J-CO (equivalent to 60% of value of land).
5. Employee housing	2	1,500	3,000,000,000		Residential property not subject to tax.
6. Headquarter office	2	2,500		5,000,000,000	Fully subject to tax.
7. Unused land	100	25	2,500,000,000		Value is less than ¥ 30,000; therefore exempt from taxation.
8. Unused land	100	50		5,000,000,000	Fully subject to tax.
Totals	1,108		8,500,000,000	95,200,000,000	

Calculation of standard deduction			
Greater of (A) or (B)			
Monetary basis	1,000,000(A)		
Area basis			
	.(3)	800	
	.(6)	2	
	.(8)	100	
	.(2)	0.5	1 × ½
	.(4)	60.0	100 × 60%
		962.5	
× 1,000 × ¥ 30,000	28,875,000,000 (B)		
Calculation of tax			
Amount subject to tax	95,200,000,000		
Standard deduction	28,875,000,000		
Net taxable amount	66,325,000,000		
× 0.2%	132,650,000	(0.3% rate in later years)	

* Adopted and modified from *Zeikin Tsushin* (Tax Communications), 2/91.

C. *Standard deduction*

The standard deduction is the greater of (1) ¥ 1 billion (¥ 1.5 billion for individuals and corporations with a paid-in capital of ¥ 100 million or less), or (2) ¥ 30,000 per square metre of land subject to the tax.[12]

D. *Filing and payment*

The land value tax return should be filed between 1 October to 31 October with respect to land held on 1 January.[13] However, for the first year in which the tax applies (i.e. 1992), the return should be filed between 16 November and 15 December 1992.[14] The tax rate is 0.3 percent of the assessed value, except that the tax rate applicable to land held on 1 January 1992 is 0.2 percent.[15] The tax should be paid in two equal instalments, with the first due by the tax return filing date (i.e. 31 October) and the second by 31 March of the following year.[16]

For corporate and individual income tax purposes, the new land value tax is deductible against the taxable income derived from a trade or business of corporations and individuals. Table 1 shows an example of the calculation of the new land value tax.

III. INDIVIDUAL INCOME TAXATION

Table 2 compares the new and old law in summary form. Again, particular focus should be placed upon the effective dates.

12. LVTL Art. 18.
13. LVTL Art. 25(1).
14. LVTL Supplemental Art. 6.
15. LVTL Art. 22 and Supplemental Art. 5.
16. LVTL Art. 28.

TABLE 2
INCOME TAXATION

Description	Old law	New law		Effective dates
Individuals				
Gain from sale of land held long-term	Gain equal to or less than ¥ 40,000,000: National tax: 20%		30%	1/1/92
	Local tax: 8%		9%	
	Gain greater than ¥ 40,000,000: National tax: 25%		30%	
	Local tax: 7.50%		9%	
Gain from the sale of personal residence	Amount subject to reduced rate up to ¥ 40,000,000: National tax: 10%	Amount subject to reduced tax rate up to ¥ 60,000,000	10%	1/1/92
	Local tax: 4%		4%	
Special reduced rates applicable to disposal of residential property	National tax: 20%		15%	1/1/91
	Local tax: 6%		5%	
Corporations				
Gain from sale of land held more than five years	Subject to regular taxation	Surcharge applicable to the sale of land other than that held for the construction of residential property	10%	1/1/92
Gain from sale of land held less than two years	Subject to regular taxation plus a separate surcharge of 30%	The gain would be subject to separate taxation at a rate of 67.5%		1/1/92
Gain from sale of land held more than ten years	80% of gain deferred to the extent of reduction of basis in depreciable replacement property	Abolished		1/1/92
Gain on sale of property within the Tokyo, Osaka, and Nagoya regions and replacement with fixed assets outside such regions	Deferral of 80% of gain	Deferral of 60% of gain		1/1/92
Gain on sale of land on replacement with depreciable assets	Deferral of 80% of gain	Abolished		1/1/92

A. *Reduction of benefits on the sale of land or buildings held long-term*

Gains from the sale of land or buildings held more than five years are currently subject to beneficial taxation at a combined national and prefectural tax rate of 32.5 percent, separate from other income (26 percent up to ¥ 40 million of capital gain). This contrasts with the regular combined national and local tax rate which can reach 65 percent. Under the new law, such gains will be subject to taxation at a combined national and local tax rate of 39 percent. However, the new law expands the existing special tax benefits for the sale of a personal residence.[17] This rule applies to sales of land or buildings on or after 1 January 1992.

B. *Limitation on interest deduction*

Under the old law, individual taxpayers were able to offset losses arising from investments in real estate against other types of income, such as salary income. The new law limits the ability of individual taxpayers to offset losses from real estate investments against other types of income through a disallowance of the interest expense attributable to the holding of land and land leasehold rights. The disallowed interest expense is not carried over to future years.

The disallowed interest expense deduction is calculated in two steps. The first step involves an allocation of interest expense attributable to the holding of land if the loan proceeds are used for the purchase of land and buildings.

$$\text{Interest expenses} \times \frac{\text{(Loan amount less the costs attributable to the building)}}{\text{Loan amount}}$$

Thus if the loan amount is less than the cost of the building, the interest is fully deductible.

The second step consists of the computation of the disallowance of real estate losses:

(1) If the interest expenses attributable to the holding of land as calculated above exceed the amount of losses generated from real estate investments, the disallowed losses equal the losses generated from the real estate investments.

(2) If the losses generated from real estate investments exceed the interest expenses as calculated above, the disallowed losses should equal the interest expenses attributable to the holding of land as calculated above.[18]

17. SMTL Art. 31.
18. SMTL Art. 41-6 and SMTL Enf. Order 26-6.

Example:

Mr. A acquires an apartment which is rented. The following facts apply:

Acquisition price of land	¥ 28,000,000
Acquisition price of building	36,000,000
Loan with an interest rate of 8%	60,000,000
Rental income	3,200,000
Interest expense	4,800,000
Depreciation (60 year guideline life)	550,800
Other expenses	600,000
Salary income of Mr. A	20,000,000

The income from real estate is computed as follows:

Revenue		¥ 3,200,000
Interest expense	4,800,000	
Depreciation	550,800	
Other expenses	600,000	(5,950,800)
Real estate losses		(2,750,800)

Interest expense attributable to the holding of land:
4,800,000 × [(60,000,000 – 36,000,000)/60,000,000] = 1,920,000
Disallowed losses:
1,920,000 < 2,750,800. Therefore, ¥ 1,920,000.

The losses from the real estate investment which can be offset against the salary income are ¥ 830,800 (2,750,800 – 1,920,000).[19]

This rule is effective for tax years beginning in 1992.

IV. CORPORATE INCOME TAXATION

A. *New surtax on the gain from the sale of land*

Gains from the sale of land and land leasehold rights held more than five years (long-term gains) are currently taxed the same as other ordinary business income. However, gains from the sale of land held less than two years are subject to an additional 30 percent surtax (super short-term gains) with other gains from the sale of land held less than five years being subject to a 20 percent surtax.

The new law provides that a ten percent surtax be applied to gains from the sale of land held more than five years. The gain is computed after the deduction of carrying costs such as interest and administrative costs. The taxpayer can elect to use, for purposes of convenience, six percent and four percent of the tax book value of the land to make a deemed calculation of interest and administrative costs, respectively. This ten percent surtax also applies to a corporation which is in a net operating loss situation.[20] This provision is effective on or after 1 January 1992.

Example:

On 15 April 1985 J-CO acquires land for ¥ 72 million which it sells on 20 February 1992 for ¥ 130 million. The new surtax would be computed as follows:

Step 1 Computation of interest and administrative carrying charges using the deemed method:
[(72 million × 9/12) + (72 million × 12/12 × 6) + (72 million × 2/12)] = 498 million
(498 million) × (6% + 4%) = 49.8 million

Step 2 Computation of taxable gain:
130 million – (72 million + 49.8 million) = 8.2 million

Step 3 Computation of surtax:
8.2 million × 10% = ¥ 820,000[21]

Gains from the sale of land held less than two years will be subject to separate taxation at a tax rate of 67.5 percent (which consists of 37.5 percent of regular national tax and the 30 percent surtax). This 67.5 percent separate tax will apply even if the corporation is in a net operating loss position and is effective for transfers made on or after 1 January 1992.[22] If the gain exceeds taxable income, the excess is treated as a net operating loss to be carried over the following five years.

B. *Contributions of real estate to newly-formed corporations*

The current rule is that corporations can contribute assets on a tax-free basis to a newly-formed corporation 95 percent or more of whose shares are acquired by the transferor shareholder.

However, under the new law only 80 percent (instead of the current 100 percent) of the gain attributable to the transfer of land will be eligible for deferral as long as the following two conditions are met:

– the transferor corporation maintains a minimum 95 percent investment in the transferee corporation for more than five years;
– the transferee corporation continues the line of business associated with the transferred land.

This provision is effective for transfers made on or after 1 January 1992.[23]

C. *Other deferrals of gains*

Japanese law currently provides for the deferred taxation of gains arising from certain types of like-kind exchanges or where certain types of replacement properties are acquired. For example, if land used for business is sold and the sales proceeds are used to acquire depreciable replacement property, the gain on a sale can be deferred if the depreciable basis of the replacement property is reduced by the amount of the gain. The new law eliminates or greatly restricts these benefits.

V. PROVISIONS AFFECTING INTERNATIONAL TRANSACTIONS

A. *Transfer pricing*

1. Extension of the statute of limitations

Under the old law the tax authorities had three years (five years if a return is not filed) from the due date of the original filing to adjust a tax where income was under-reported. With respect to overseas transfer pricing adjustments, the new law extends this statute of limitations to six years for a number of reasons, such as the need for additional time to:

19. Adopted and modified from *Zeikin Tsushin* (Tax Communications), 3/91.
20. SMTL Art. 62-3.
21. See *supra* note 19.
22. SMTL Art. 63-2.
23. SMTL Art. 66.

- digest the information required to analyse complex international business transactions;
- obtain required information held overseas; and
- obtain information spread throughout a multinational group of companies.[24]

This provision applies to tax years with respect to which the statute of limitations period expires on or after 1 April 1991. The new law also increases the time limit for the tax authorities to collect the tax from five to six years.[25]

2. Specific authority to obtain information on comparables

In making transfer pricing adjustments, the Japanese tax authorities emphasize the use of comparables rather than functional analysis. Comparables can be internal (i.e. derived from transactions between the company itself and independent third parties) or external (i.e. derived from similar transactions between parties unrelated to the taxpayer). The new law grants specific authority to the tax authorities to obtain information from non-related taxpayers which are engaged in similar lines of business in order to determine external comparables. This provision applies to audit inquiries arising on or after 1 April 1991.[26]

3. Disallowance of donation expenses to foreign-related parties

The Japanese transfer pricing law only applies to certain transactions between Japanese and related non-Japanese persons. Transactions falling outside the purview of the transfer pricing law are subject to a separate set of rules which characterize a benefit going from one company to another without compensation as a donation expense (*kifukin*) which is deductible if the amount falls within a certain limitation. With respect to many transactions between Japanese persons and non-Japanese related parties, the current law is not altogether clear as to whether the transfer pricing or donation rules apply. As a result, certain businesses have taken the position that with respect to non-arm's length transactions with overseas related parties, the difference between the arm's length and non-arm's length amounts should be characterized as a donation expense. The new law provides that donation expenses with respect to overseas related parties are not deductible. However, taxpayers should still be able to fully deduct losses which are not deemed to be donations where specifically provided (e.g. bad debts). The new law applies to transactions arising on or after 1 April 1991.[27]

4. Record maintenance

The general rule is that a corporation must retain its books and records, such as ledgers, financial statements and receipts for at least seven years. However, the retention period for the underlying documentation such as purchase orders, invoices and receipts is five years. In line with the other extensions of the statute of limitations for transfer pricing purposes, the records retention requirements for related party transactions (with the exception of invoices associated with the purchase and sale of inventory) have been extended to six years for small corporations (i.e. corporations with paid-in capital of less than ¥ 100,000,000). This rule applies to documentation associated with tax returns submitted on or after 1 April 1991.[28]

5. Reporting requirements

The old law requires a Japanese person to submit a report (Schedule 16-3, "Detailed Statement Concerning Foreign Affiliated Persons") giving information with respect to transactions with related foreign persons with the regular tax return. Included in the report is information such as the name, address of head office, stated capital, main line of business, and types and amounts of transactions between the taxpayer and the overseas related party. The new law provides that the taxpayer must also submit information as to the operating revenues, expenses and net profits for the most recent year-end of the related parties. These new requirements apply to tax years ending on or after 1 April 1991.[29]

B. *Tax haven rules*

The general rule is that Japanese corporations and individuals are subject to taxation on their worldwide income. However, income derived from shareholdings in a foreign corporation normally is not subject to taxation until a dividend is actually received. An exception to this rule applies to certain types of undistributed income earned by Japanese controlled corporations located in low-tax jurisdictions specifically designated by the Ministry of Finance.[30]

Certain countries not on the tax haven list, such as the Netherlands, do not tax the income earned by branches in other jurisdictions. For example, a Dutch corporation may earn income from a branch located in a jurisdiction not on the Ministry of Finance list, such as the Netherlands Antilles. It has been possible for Japanese shareholders to avoid taxation on undistributed earnings from its shareholdings in a Dutch corporation with a branch in the Netherlands Antilles, even though the earnings are not subject to Dutch tax since they were attributable to the branch.

The new law provides that if the main place of business of a corporation which is incorporated in a jurisdiction which does not tax the income earned by branches is in a designated tax haven jurisdiction, the corporation will be deemed to be resident of the tax haven jurisdiction regardless of its formal place of incorporation. This provision is effective in the first tax year in which the last day of the two-month period following the end of the foreign corporation's tax year ending on or after 1 April 1991 falls.[31]

24. SMTL Art. 66-5(16).
25. SMTL Art. 66-5(17).
26. SMTL Art. 66-5(1) – (14).
27. SMTL Art. 66-5(3).
28. Corporate Tax Law ("CTL") Enf. Order 59, 67.
29. SMTL Enf. Rule 22(11).
30. SMTL Art. 66-6.
31. SMTL Art. 66-6(5).

MACAU: AN INTRODUCTION TO THE TAX SYSTEM

Jefferson P. VanderWolk and Baldwin Hui*

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I. INTRODUCTION

Macau, the tiny Portuguese-administered enclave in south China, has recently begun to emerge from under the shadow of its relatively large and wealthy neighbour, Hong Kong. Both colonies are integral parts of the economy of Guangdong province, which has grown by leaps and bounds over the past decade. Macau is now building an international airport that will be completed long before the planned new airports in Hong Kong and Shenzhen. As a result Macau will transform from a backwater, accessible only by ferry from Hong Kong, to a gateway to south China. Even travellers to Hong Kong will in some cases land at the Macau airport and then make their way by sea or air to Hong Kong.

Like Hong Kong, Macau will become a special administrative region of the People's Republic of China by the end of the current decade.[1] The agreement between Portugal and China provides that Macau's current legal system will remain in place for at least 50 years after the change in sovereignty.

Macau's tax regime is similar to that of Hong Kong, in that there is no comprehensive income tax, but rather three separate income taxes: one primarily on business profits, one primarily on salaries and one on income from property. In addition, there are various duties and fees, as well as certain tax incentives. However, being derived in part from the Portuguese tax system rather than from English concepts, Macau's tax system differs from Hong Kong's in many respects.

This article will review the various taxes in Macau briefly and then discuss in more detail the taxes on business profits and salaries and Macau's tax administration.

II. OVERVIEW OF TAXES

A. *Complementary tax*

Complementary tax is imposed on all forms of business entities (i.e. sole proprietorships, partnerships and corporations) in respect of taxable profits that accrue in Macau from commercial or industrial activities or from personal services. The maximum effective rate is 15.75 percent, which results from the addition of a 5 percent stamp duty surtax onto the maximum tax rate of 15 percent.

Complementary tax is discussed in more detail later in this article.

B. *Professional tax*

Professional tax is imposed on individuals in respect of employment income and income from a professional practice to the extent that such income arises in or is derived from Macau. As with the complementary tax, the maximum effective rate of professional tax is 15.75 percent (including the 5 percent stamp duty surtax). Individuals subject to professional tax are also subject to complementary tax. Professional tax and its interaction with complementary tax are discussed in more detail later in this article.

C. *Property tax*

Property tax is imposed annually on owners of buildings in Macau. The tax is generally assessed at an effective rate (including the 5 percent surtax) of 16.8 percent of the net rental income from the property. If rental income is not received throughout the year, a rental value is substituted. The tax rate (including the 5 percent surtax) is reduced to 10.5 percent where net rental value is used and the property's value was assessed after 14 July 1988.

A statutory deduction of 10 percent of rental income (or rental value, as the case may be) is allowed, as are a limited number of defined expenses relating to the operation of the building.

New residential and commercial buildings are exempt from property tax for a period of either four years (if located on the mainland) or six years (if located on the islands of Taipa or Coloane). New industrial buildings are granted a five-year exemption if on the mainland and a ten-year exemption

* Jefferson P. VanderWolk is a lecturer in law at the University of Hong Kong and a consultant to Baker & McKenzie, Hong Kong.

Baldwin Hui is a lecturer in the Faculty of Business Administration at the University of East Asia, Macau.

1. China will resume sovereignty over Macau on 20 December 1999.

if on Taipa or Coloane. In addition, industrial buildings used by the owner for industrial purposes are tax-exempt, as are buildings owned and used by charitable organizations.

D. *Business tax*

The business tax is a flat tax in the nature of an annual fee on all commercial and industrial activities. The amount of the tax ranges from around US$ 20 up to around US$ 10,000 (for banks), depending on the type of activity. Except for banks, this tax is not significant.

E. *Real estate transfer tax*

A purchaser of Macau real property must pay a transfer tax at an effective rate (including the 5 percent surtax) of 6.3 percent of the purchase price (4.2 percent if the property is on Taipa or Coloane). These rates are reduced to 4.2 percent and 2.1 percent, respectively, if the transfer occurs during the period of exemption from property tax.

F. *Inheritance and gift tax*

Inheritance and gift tax is imposed on the value of property passing on death and lifetime gifts. The effective rate of tax (including the 5 percent surtax) ranges from 5.25 percent to 37.8 percent, depending on the value of the transferred property and the relationship between the donor and the donee.

G. *Stamp duty*

There are two types of stamp duty in Macau. One is a 5 percent surtax on direct taxes such as complementary tax, professional tax, property tax, business tax, real estate transfer tax and inheritance and gift tax. (As indicated, this stamp duty has been included in the effective rates of tax stated above.)

The other form of stamp duty is a tax on instruments such as certain types of contracts and other documents. The duty is imposed in accordance with detailed regulations at varying rates.

H. *Miscellaneous*

1. Tourist tax

A 5 percent tax is added to the cost of hotel rooms, meals and certain forms of entertainment.

2. Import duties

Import duties are levied, in the form of a so-called "consumption tax", on a limited number of items, such as alcoholic beverages, tobacco, oil and motor vehicles.

3. Export duty

Goods made in Macau and exported abroad are subject to export duty at the rate of 0.2 percent of FOB value (1.4 percent of FOB value if exported to a quota-limited country, i.e. most countries in Western Europe and North America).

4. Registration and licence fees

There are various registration and licence fees, including a company registration fee that is expressed as a percentage of the capital of the company, starting at 0.55 percent on the first US$ 12,500 (approximately) and decreasing to a marginal rate of 0.33 percent on capital in excess of about US$ 1,250,000. The capital in question, for a foreign company, would be the capital invested in the company's Macau branch.

III. COMPLEMENTARY TAX

A. *Scope of charge*

Complementary tax is imposed on income accruing in Macau from commercial and industrial activities and from personal services. The tax can therefore apply to corporations, partnerships, sole proprietorships and employees.

Income from property is excluded from the charge to complementary tax. Included in the charge is all income accruing in Macau from sales, services and other operations undertaken for the purpose of gain.

B. *Accrual in Macau*

Generally, income is considered to accrue in Macau if the income arises from the taxpayer's activities in Macau.[2] In addition, income derived by a Macau resident company from investments outside Macau has been held to be subject to complementary tax.[3]

C. *Taxable activities in Macau*

Technically, complementary tax applies (or may apply) whenever income arises and accrues in Macau as a result of commercial or industrial activities or the performance of personal services. Thus, income from long-term investments is not subject to complementary tax when received by the investor. However, virtually any form of business activity in Macau, including the performance of personal services, is potentially taxable under the complementary tax.

D. *Calculating the tax*

The rate of complementary tax ranges from 2.1 percent (on the first US$ 2,500, approximately) to 15.75 percent (on profits in excess of about US$ 37,500).

Normal business expenses are deductible. Depreciation deductions may be claimed according to published rates which vary for different classes of assets. In addition, profits which are reinvested in the Macau business may be written off over the following three years with the approval of the Governor and the Finance Department. Losses incurred in Macau may be carried forward for three years.

Dividends paid by a corporation and distributions of profit by a partnership are deductible for complementary tax purposes. Thus the tax is on retained profits only. However, the recipients of such distributions are subject to complementary tax on the gross amount received.[4]

Individuals may deduct various personal allowances, and may claim a credit for the amount of professional tax paid.

In practice, the tax calculation is dictated by standards of accounting practice in Macau. Larger enterprises must sub-

2. Complementary Tax Law (Law 21/78M of 9 September 1978, as amended), Art. 2.
3. Case 1675, Supreme Administrative Court of Lisbon, construing Art. 19 of the Complementary Tax Law.
4. Complementary Tax Regulations, Art. 20(d).

mit audited accounts of the Macau business to the Finance Department.[5] These accounts provide the basis for the assessment of complementary tax. Smaller taxpayers may choose to forgo the submission of audited accounts, in which case the Finance Department will assess tax on presumed profits, based on the taxpayer's turnover.

E. *Non-residents*

Technically, the complementary tax provisions do not distinguish between residents and non-residents of Macau. Rather, the focus is on income accruing in Macau from commercial or industrial activities or personal services.

As a practical matter, however, non-residents investing in Macau may structure their investment so as to minimize taxation in Macau. Normally this would be done by establishing a Macau branch of an offshore company and providing for offshore accrual of a portion of the profits relating to the Macau investment.

In this regard, it is notable that Macau does not impose any withholding taxes on royalties, interest, or service fees (for offshore services) paid to non-resident affiliates.

IV. PROFESSIONAL TAX

A. *Scope of charge*

Professional tax applies to personal income arising in or derived from Macau. Income is deemed to arise in or derive from Macau if it is received in consideration of services performed in Macau. There are two categories of taxpayers: employees (including company directors) and professional practitioners. The latter are also subject to complementary tax.

B. *Taxable income*

Employees are generally taxable on all forms of remuneration, including perquisites. However, specified fringe benefits are taxed on a limited basis only. For example, the taxable value of housing provided by the employer is limited to 10 percent of the employee's monetary remuneration.

Self-employed persons are subject to tax on net profits from the business.

C. *Calculating the tax*

The first 50,000 Ptc. (about US$ 6,250) of income is tax-free. Thereafter, professional tax applies at effective rates ranging from 10.5 percent to 15.75 percent (including the 5 percent stamp duty surtax). The top rate takes effect when income exceeds 260,000 Ptc. (about US$ 32,500).

D. *Non-residents*

Remuneration paid to a non-resident for services performed in Macau is subject to withholding tax at the rate of 5.25 percent of the gross amount paid.

V. TAX ADMINISTRATION

The administration of Macau's tax system is the responsibility of the Finance Department. Although the procedures for filing returns and paying taxes due have been regularized and enforced by the Finance Department over the course of the past decade or so, the system remains relatively informal. Registered auditors and accountants prepare tax returns which are submitted to the Finance Services division. If the Finance Services division has any queries, the matter is generally resolved through discussions with the registered auditor. Bureaucratic procedures are minimal and past experience has shown that resort to legal formalities in Macau tax matters is extremely rare.

As noted earlier, for all but the smallest businesses, the taxpayer's audited accounts of the Macau business form the basis on which the Finance Department assesses complementary tax. The accounts must be filed with a tax return between April and June each year.

Professional tax on salaries is collected by way of withholding on wages. Quarterly tax payments by employers are required.

VI. TAX INCENTIVES

Macau has not developed a range of tax incentives such as those offered by countries such as Thailand, Malaysia and Singapore. In part this is due to the low tax rate and territorial tax system of Macau. As is the case in Hong Kong, taxation in Macau *without* special incentives is generally less onerous than taxation in Singapore, Malaysia or Thailand *with* incentives.

Certain tax exemptions are available, however. Qualifying "tourist utilities" are exempt from property tax for ten years and from real estate purchase tax. Property tax is also not applied to new property developments and industrial buildings used by the owner, as noted earlier.

Macau is not covered by any of Portugal's income tax treaties, nor has it entered into any tax treaties on its own.

VII. CONCLUSION

Macau's tax system is relatively unsophisticated. The colony has not been the recipient of much outside investment, and thus has not been faced with many of the tax issues that bedevil the authorities in other jurisdictions, such as transfer pricing and earnings stripping through related party loans and licensing. Essentially the Government relies on the local accountants to ensure that a reasonable amount of taxable profit from Macau-based business is reported.

As Macau becomes more a part of the world of international business, its tax system will inevitably become more refined. Many gaps which currently exist will have to be filled – not necessarily to protect the revenue, but to provide more certainty to foreign investors who will want to know how they will be taxed in Macau.

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5. The threshold amounts of equity capital and earnings of the Macau business (either a Macau-incorporated company or a Macau branch of an offshore company) that trigger the requirement of audited accounts are, respectively, 1,000,000 Ptc. (about US$ 125,000) of equity capital and 300,000 Ptc. (about US$ 37,500) of total earnings during the preceding three-year period.

COOK ISLANDS:

OFFSHORE CENTRE LEGISLATION

AN OVERVIEW

A.R. Miller*

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I. INTRODUCTION

The Cook Islands lie roughly due west of French Polynesia and south of Hawaii. Rarotonga, the most populous island, is 3,200 kilometres northeast of New Zealand and 960 kilometres southwest of Tahiti. The 15 islands comprising this independent nation total about 240 sq. km in area. Rarotonga, the largest at 67.2 sq. km, is surrounded by a lagoon and has a bush-clad, rugged interior rising to over 2,000 feet. The administrative and commercial centre is Avarua, on Rarotonga.

The Cook Islands is now in its tenth year as an offshore centre, throughout which time a firm emphasis has been placed on quality and the full utilization of the capacity to legislate quickly in response to the needs of professionals in the industry.

A. *History*

The island of Rarotonga was the departure point from which the great Maori voyages were made to New Zealand and historians now believe that the Polynesian migrations moved through the islands in the 5th century A.D.

Recorded history dates from the arrival of Europeans. The Spanish explorers Alvaro de Mendana and Pedro Quiros are believed to have been the first to sight islands in the group in 1595. In his expeditions of 1773 and 1777, Captain James Cook explored much of the group. Mutineers on HMS Bounty alighted on Aitutaki in 1789.

B. *Population*

The population of approximately 18,000, 9,000 of whom live on Rarotonga, is predominantly Polynesian. English is the official language, and most of the Islanders are bilingual in English and Cook Islands Maori. Cook Islanders are British subjects and citizens of New Zealand.

C. *Economy and facilities*

Tourism is the main industry, although agriculture provides employment for much of the labour force. The offshore jurisdiction and activities of the financial centre play an important part in the country's economic development.

New Zealand and Cook Islands currencies are both legal tender in the Cook Islands, and there are no exchange controls.

Comprehensive international telephone, facsimile and telex services are available, including a direct dialling system, as are reliable postal and courier services. Rarotonga International Airport is served regularly by Air New Zealand, Cook Islands International Airline and Hawaiian Airlines, providing direct links with Auckland, Sydney, Fiji, Honolulu, Los Angeles, Tahiti and Samoa.

Cook Islands standard local time is ten hours behind Greenwich Mean Time.

D. *Legal system*

English common law as at January 1840, except where inconsistent with the Act itself or "inapplicable to the circumstances of the islands", was applied by the Cook Islands Act 1915. Certain New Zealand Acts of Parliament (prior to 1965) still apply, but the Cook Islands Parliament is now the sole lawmaker. There is an independent judiciary with a High Court of the Cook Islands and an Appeal Court. Final appeal lies to the Privy Council of the United Kingdom.

* Miller & Howard Solicitors, Cook Islands – Offshore International Corporate and Trust Law.

E. *Constitutional status*

In 1965 the country became a self-governing democracy, with Her Majesty the Queen as Head of State. The 24-seat Parliament is modelled on Westminster. The Cook Islands has a written constitution and a Bill of Rights, introduced by legislation in 1981.

A special relationship is maintained with New Zealand whereby that country handles external relations and defence in consultation with the Cook Islands government.

Elections are held every five years and are contested principally by the Democratic Party and the Cook Islands Party. These two parties do not differ greatly in their philosophy. Both are committed to democratic government and endorse the role played by the offshore financial centre in the development of the country.

II. OFFSHORE JURISDICTION OF THE COOK ISLANDS

A. *General scheme*

A separate legislative regime for offshore entities runs parallel to the onshore legislation. It is the offshore jurisdiction that provides the benevolent tax-free environment within which international companies, partnerships and trusts may operate freely. There are no taxes, stamp or other duties or imposts within the offshore regime, nor are any exchange controls or withholding taxes imposed. The High Court of the Cook Islands has jurisdiction to deal with legal matters in both onshore and offshore jurisdictions. Only licensed trustee companies may register and manage offshore entities.

1. Confidentiality

Confidentiality is protected by severe penal provisions and inspection and search of registers is restricted to company officers, members, debenture holders and others who have the written consent of a director, liquidator or (in certain circumstances) the registrar. Government officials are subject to these restrictions in respect of international entities. There is also provision for court proceedings (other than criminal proceedings) to be held in camera.

2. Guarantee against expropriation

There is a Crown guarantee against compulsory acquisition or appropriation of the property of offshore entities.

B. *Offshore legislation*

The following statutes provide the structure of the offshore jurisdiction. They do not form a self-contained code but must be read in conjunction with certain domestic and New Zealand statutes having application in the Cook Islands:

- Trustee Companies Act 1981-82
- International Companies Act 1981-82
- OffShore Banking Act 1981
- OffShore Insurance Act 1981-82
- International Trusts Act 1984
- International Partnerships Act 1984

C. *Tax treaties*

A historical legal analysis might suggest that certain treaties survived the separation of the Cook Islands from New Zealand. However, the countries involved are unlikely to consider they have any treaty with the Cook Islands, and the Cook Islands government does not consider itself to have any tax treaty arrangements with any other country.

III. INTERNATIONAL AND FOREIGN COMPANIES

The International Companies Act 1981-82 ("ICA") contains highly flexible provisions in relation to "international companies" incorporated under its provisions. These companies may, for example, repurchase their own shares, issue bearer debentures, make gifts, issue bearer shares, distribute profits to non-shareholders and transfer their domicile to and from the Cook Islands. International companies are specifically empowered to guarantee the obligations of third parties, and the rule in *Re Charge Card Services Limited* is negated, enabling a valid charge to be taken by a lending institution over a deposit lodged with it by the chargor.[1] Provision is made for Registered Listed Companies (see below), and Hong Kong Stock Exchange and Securities Commission approval of such companies was given earlier this year. The Cook Islands becomes the third approved jurisdiction, following Bermuda and the Cayman Islands.

A. *Taxation and reporting requirements*

There are no taxes and no reporting requirements. The ICA specifically provides that no Act of the Cook Islands may:

(a) impose –
  (i) any liability, duty, responsibility, obligation or restriction;
  (ii) any fee, impost, tax, levy, dues, duty or excise; or
  (iii) any fine or penalty on an international or foreign company; or
(b) require –
  (i) the deposit of any moneys in any public account by;
  (ii) the filing of any accounts, returns, reports or records by; or
  (iii) the licensing or registration of,

an international company or a foreign company, other than this Act, the Cook Islands Monetary Board Act 1981, the OffShore Banking Act 1981, the OffShore Insurance Act 1981-82 or the Trustee Companies Act 1981-82.

B. *Incorporation*

1. General

Standard forms of Memoranda and Articles are set out in the ICA. These may be adopted with or without amendment to suit individual requirements.

2. Share capital

No minimum requirement as to share capital is imposed, and normally only one shareholder is required. Shares need not have a par value and may be designated in one or more major world currencies. The terms on which shares may be issued are flexible, as is the manner in which a redemption of or an alteration in share capital may be effected. Redemption of redeemable shares may be effected from capital except where the company is insolvent. Fully paid shares may be cancelled and the charges issued to bearer.

An international company may purchase its own shares or lend for that purpose but only out of earned surplus. Shares purchased in this way may be cancelled if the directors so determine.

3. Directors, secretary and registered office

Only one director need be appointed. Resident directors are not obligatory but are frequently employed. A resident secretary, who must be an officer of a licensed trustee company, is a requisite. The registered office must be at the office of a trustee company.

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1. (1986) 3 All ER 289. This case cast doubts on the ability of a bank to take a charge over a deposit with itself and "owed" to the chargor on the grounds that this gives rise to a conceptual impossibility.

4. Registration as foreign company

A company incorporated outside the Cook Islands is not required to register as a foreign company for the purpose of conducting an isolated offshore transaction which is completed within 31 days.

A company incorporated outside the Cook Islands seeking to register as a foreign company pursuant to the ICA must lodge certain basic information with the Registrar, together with a memorandum of appointment or power of attorney stating the name of a trustee company authorized to accept service of notices and giving a registered office which must be the principal office of a trustee company.

5. Auditors

Auditors are required to be appointed. However, shareholders may resolve at the annual meeting not to appoint an auditor, where no invitation is made to the public to subscribe for shares or debentures or to deposit money. Auditors must be duly registered pursuant to the ICA.

6. Redomiciliation

Companies incorporated outside the Cook Islands may transfer their domicile to the Cook Islands and vice versa. Prior approval (valid for 36 months) for a transfer of domicile to the Cook Islands may be obtained and acted upon at any time.

7. Debentures

Provision is made for bearer debentures, which may be converted to ordinary debentures (convertible into shares in the company). Perpetual debentures may be issued and redeemed debentures may be re-issued.

8. "Chargecard" negated

Where a person is owed a debt situated in the Cook Islands and creates a charge over that debt in favour of the debtor, the charge is deemed to be a charge over an asset and as valid as if given over that debt to any other person. The Act sets out the circumstance in which a debt will be deemed to be situated in the Cook Islands.

9. Annual general meeting and annual returns

Annual general meetings must be held, but this requirement may be met by a resolution signed by all members. Pro-forma annual returns are required but accounts need not be filed.[2]

10. Arrangements and reconstructions

The International Companies Amendment Act 1990 has inserted into the ICA provisions enabling two or more companies, at least one of which is an international company and all of which are registered in the Cook Islands (including holding and subsidiary companies), and subject to the consent of the Court, to amalgamate and continue as one international company. Provision is also made for short form amalgamation of a holding and subsidiary company without consent of the Court where both are international companies.

11. Dissolution

An international company may be wound up voluntarily pursuant to a special resolution. There is provision for compulsory winding up and for the appointment of liquidators in generally familiar terms. The Registrar may strike off companies considered to be defunct.

12. Issue of shares and debentures to the public

A prospectus must be registered in the case of certain offers to the public.

IV. REGISTERED LISTED COMPANIES

A. *Registration*

By virtue of the International Companies Amendment Act 1990, an international company or a foreign company listed or proposed to be listed on an Approved Stock Exchange may be registered as a Registered Listed Company pursuant to the ICA. Special requirements include stricter provisions than apply to ordinary International Companies in respect of share premiums, redemption of shares, dealing in own shares, power to issue shares at a discount, reduction of share capital, debentures, compromises, reconstructions, capital maintenance, investigation and deregistration. The Hong Kong Stock Exchange and Securities Commission have approved the Cook Islands jurisdiction.

B. *Fees*

It is important to note that fees are approached on an all-inclusive basis (see Schedule below). No taxes, levies or fees are payable to government following registration, other than annual renewals. Consequently, there are none of the hidden costs frequently found in other jurisdictions.

FEES AND DISBURSEMENTS SCHEDULE

	US$	
International and Foreign Companies:		
Incorporation/Registration, provision of nominee shareholder, directors, Resident Secretary, registered office, establishing and maintaining statutory registers, formal management for year one	1500	Trust
Registration fee (Govt)	1000	Govt
Annual Renewal of registration, statutory services, etc.	1000	Trust
Registration fee (p.a.) (Govt)	500	Govt
Provision of Individual Director (basic fee)	250	Trust
International Trusts:		
Settlement of Trust	500	Trust
Provision of Trustee (p.a.)	700	Trust
Registration (p.a.) (Govt)	100	Govt
Provision of Protector (basic fee)	250	Trust
Acting as Alternate Trustee	250	Trust
Banking Licences:		
Obtaining "A" Class Licence	(by negotiation)	
Licence fee (p.a.) (Govt)	1000	Govt
Obtaining "B" Class licence, a minimum of	2000	Trust
Renewal of "B" Class licence, a minimum of	1000	Trust
Licence fees (p.a.) (Govt)		
One currency	2000	Govt
2-5 currencies	4000	Govt
Unlimited currencies	6000	Govt
Insurance Licences:		
Obtaining licence, minimum of	2000	Trust
Licence fee (Govt)	1000	Govt
Renewal of licence (p.a.), minimum of	1000	Trust
Licence fee (p.a.) (Govt)	500	Govt
Administration and Transactions:		
(Guide) per hour	50–130	Trust
Registration and licence fees are prescribed by Regulation.		
All fees and charges are as at 2 June 1991.		
All of these fees are "typical charges".		

2. The annual return will simply disclose whether or not the company "has or has not entered into any transactions" in the preceding year. No details are required.

V. INTERNATIONAL TRUSTS

International Trusts ("ITs") are created by registration pursuant to the International Trusts Act 1984 ("ITA"). At least one of the trustees, donors or holders of a power of appointment, maintenance or advancement must be an international or foreign company or a trustee company. An international trust is registered by filing with the Registrar a certificate from a trustee company certifying that on registration the trust will be an international trust and a notice of the name and registered office of the trust. The registered office of an IT must be located at the registered office of a company which is a trustee.

The ITA modifies or cancels certain laws generally applicable to trusts in common law jurisdictions:
(a) a perpetuity period, not exceeding 100 years, may be specified;[3]
(b) dispositions which may infringe the rule against perpetuities are to be treated as valid until it is certain that a breach of the rule will occur;[4]
(c) the rule against double possibilities is abolished;[5]
(d) the rule against accumulations is abolished;[6]
(e) the rule in *Saunders v. Vautier* is modified;[7]
(f) certain trusts are deemed to be charitable which might otherwise fail.[8]

A. *Asset protection trusts*

The ITA contains provisions specifically aimed at removing uncertainties in the following areas:

1. Bankruptcy
An IT is not void or voidable in the event of the settlor's bankruptcy, irrespective of any provisions in the laws of a settlor's country of domicile and the fact that an IT is voluntary.

2. Fraud
Where a creditor proves that an IT was settled with the principal intent of defrauding that creditor and that the settlement rendered the settlor insolvent or without property by which the creditor's claim could have been satisfied, the settlement is not void or voidable. However, the IT is liable to satisfy the creditor's claim out of property which would have been available but for the settlement. In determining whether a settlement rendered a settlor insolvent regard is had to the fair market value of his property (not the subject of the trust) immediately after settlement took place.

An IT is not fraudulent as against a creditor where settlement or disposition takes place after two years from the time the creditor's cause of action accrued, or where the trust is settled within two years and the creditor fails to bring an action within one year of the date of settlement. Nor is an IT fraudulent as against a creditor where the settlement took place before the cause of action accrued or arose.

Finally intent to defraud a creditor is not imputed to a settlor simply because he settles an IT within two years from the date of cause of action accruing, or retains, possesses or acquires the powers or benefits specified under "retention of control" (see below).

Where an IT is liable to satisfy a creditor's claim but cannot because property has been disposed of (other than to a bona fide purchaser for value), the disposition is treated as void.

The onus of proof of a settlor's intent to defraud a creditor lies with the creditor.

3. Retention of control
An IT is not invalidated because the settlor retains, possesses or acquires:
(a) power to revoke the trust;
(b) power to make a disposition of property;
(c) power to amend the trust;
(d) any benefit from the time of disposition;
(e) power to remove or appoint a trustee or protector;
(f) power to direct a trustee or protector;
(g) a beneficial interest.

B. *Enforcement of foreign judgments*

There is no legislation providing for the enforcement of a foreign judgement in the Cook Islands, although it is possible for a foreign judgment to be registered in New Zealand and moved thence to the High Court of the Cook Islands. Under common law, a foreign judgment may be enforced in accordance with certain basic conflicts of laws principles.

The ITA is intended to prevent the enforcement of a foreign judgment in respect of an IT, forcing a litigant to commence his action *de novo* in a Cook Islands Court. Thus, irrespective of the provisions of any treaty or statute, or any rule of law or equity, no proceedings for the enforcement or recognition of a foreign judgment against an IT, a settlor, a trustee, a protector, a beneficiary or any person appointed by an instrument in connection with an IT, or against the property of an IT, or of a trustee or a beneficiary, will be entertained by any Court in the Cook Islands if the judgment is based on any law inconsistent with the provisions of the ITA or relates to a matter governed by the law of the Cook Islands.

C. *Heirship rights*

Certain civil jurisdictions permit a disinherited heir to challenge a trust if it interferes with his right to succeed to assets of his antecedents. The ITA precludes such a possibility in the Cook Islands.

The legislation establishes that no IT nor any aspect of an IT governed by the laws of the Cook Islands is to be void or defective in any way, nor is the capacity of any settlor to be questioned on the grounds that the trust may void a right held by reason of a personal relationship (e.g. a blood or marriage relationship) to the settlor or by way of heirship rights.

D. *Protective trusts (spendthrift beneficiary)*

An instrument may provide that an interest in property given to a beneficiary for his life or a lesser period is not to be alienated or pass by bankruptcy or be taken in execution. In such a case neither the right to income nor the income itself may pass by bankruptcy or be liable to be taken in

3. Normally, a life in being plus 21 years will be the maximum recognized perpetuity period.
4. That is, a necessity to wait and see (as to whether a breach of the rule against perpetuities will occur) is imposed.
5. The rule against double possibilities is the rule of law prohibiting the limitation, after a life interest of an unborn person, of an interest in land to the unborn child of an unborn person is abolished.
6. Where property is settled so that the income thereof may be accumulated, the power to accumulated is valid if the disposition of the accumulated income is valid.
7. (1841) 4 Beav 115.
8. Trusts are deemed charitable where they are substiantially for the relief of poverty, advancement of education or religion or for purposes beneficial to the community notwithstanding a lack of a "public nature" or the fact that they may benefit private individuals.

execution. Provision may be made in the instrument for removal of these restrictions.

E. *Governing law*

Regard is had to the terms of the trust deed. A term expressly selecting the law of the Cook Islands is conclusive. The governing law may be changed to or from the laws of the Cook Islands in certain defined circumstances.

F. *Matters determined by governing law*

All questions in regard to an IT governed by the laws of the Cook Islands, including matters of capacity, validity, administration and powers, are determined according to the laws of the Cook Islands, without reference to the laws of any other jurisdictions with which an IT may be connected. This rule does not validate any disposition of property not owned by the settlor, nor does it affect the recognition of foreign laws in determining whether the settlor is the owner of the property. The rule also applies subject to any express contrary term of the trust and, as regards the capacity of a corporation, does not affect recognition of the laws of its place of incorporation. Nor does the legislation affect the recognition of foreign laws relating to the formalities for the disposition of property. Trusts of real property situated in jurisdictions other than the Cook Islands, which are void *ab initio* according to the laws of the jurisdiction concerned, are not validated by the ITA. The same applies to testamentary trusts or dispositions which are invalid according to the laws of the testator's country of domicile.

G. *Exclusion of foreign law – concept of trusts*

The legislation provides that no IT governed by the laws of the Cook Islands is void, voidable or defective, nor is the capacity of any settlor to be questioned, on the grounds that the laws of any foreign jurisdiction do not recognize the concept of a trust.

H. *Guarantee by Crown*

The Crown guarantees that the property of ITs situated in the Cook Islands will be safe from compulsory acquisition or expropriation. Exceptions to this guarantee are made where the acquisition would be in accordance with the due process of law, for a public purpose defined by law, or in payment of compensation as defined by law.

VI. INTERNATIONAL PARTNERSHIPS

International partnerships must register under the provisions of the International Partnerships Act 1984 ("IPA") through a trustee company. One partner must be a foreign or international company under the ICA, or a trustee company. Registration is effected on receipt of a certificate from a trustee company to that effect. Annual renewals are required, and the registered office must be in the care of a trustee company. General rules on partnerships apply. Limited partnerships are subject to similar registration requirements but may not be entered into for more than 51 years.

VII. OFFSHORE BANKING

Offshore banking licences are granted by the Monetary Board of the Cook Islands, and are issued under Part II of the Offshore Banking Act 1981 ("OBA"). Three classes of licence are offered – "A" Class, "B" Class and "C" Class – the capital requirements varying according to the particular class.[9]

Licences are granted only to corporate entities. Application for a licence may be made by a foreign company or an international company. The Offshore Banking Regulations 1982 require certain basic information to be included in the application. Further, the application must be accompanied by a certified copy of the act, charter, deed of settlement, memorandum of association and articles of association of the company, or other document or documents by which it is constituted and the prescribed fee.[10]

The Secretary of the Cook Islands Monetary Board may require additional evidence of compliance with the laws of the jurisdiction in which the company is incorporated and of the nature and character of the company's business, financial standing, stock ownership, shareholding and management. An address for service of process within the Cook Islands is also required.

The Board may grant licences on such terms as it thinks fit. Licences are not transferable: changes in the effective control of companies holding licences amount to a transfer and are therefore prohibited.

A. *"A" Class licences*

An "A" Class Offshore Banking Licence is valid for five years from the date it is granted. Holders of "A" Class licences may only transact offshore banking business, although the licensee may apply to the Monetary Board to establish a company to transact onshore banking business pursuant to the Banking Act 1969 (which governs "domestic" or "onshore" banking). Subject to compliance with the Entry Residence and Departure Act 1971-72 the holder of an "A" Class licence will be permitted to maintain a permanent establishment in the Cook Islands.

1. Asset backing

An applicant for and a holder of an "A" Class offshore licence must have the following asset backing:

(a) where the applicant is not an international company under the ICA at all relevant times it must have a surplus of tangible assets over liabilities of not less than US$ 10 million;

(b) where the applicant is an international company it must have *either* a paid-up capital of not less than US$ 10 million or a bank guarantee (in a form and from a bank acceptable to the Monetary Board) of the applicant's obligations for not less than US$ 10 million.

2. Annual report and audit

The holder of an "A" Class licence must submit audited accounts, to the Monetary Board within six months of the end of its financial year. The accounts must be in a prescribed form and the auditor must be approved by the Board.

9. Although technically available, "C" Class licences have not been granted in recent years. This article will confine itself to discussing "A" Class and "B" Class licences.

10. The fee is:
- for an "A" class licence US$ 10,000; and
- for a "B" class licence:
  US$ 2,000 where the application is to transact offshore banking in one currency;
  US$ 4,000 where the application is to transact offshore banking in two to five currencies;
  US$ 6,000 where the application is to transact offshore banking in an unrestricted number of currencies.

B. *"B" Class licences*

"B" Class Offshore Banking Licences are valid for one year from the date on which they are granted and are renewable on application. The holder of a "B" Class licence may only transact offshore banking business and only in the currency or currencies specified in the licence. It may transact business only through a trustee company registered under the Trustee Companies Act 1981 unless it maintains a permanent establishment in the Cook Islands.

A "B" Class licence must specify one currency *or* two, three, four or five currencies, or an unrestricted number of currencies in which the offshore banking business is to be transacted.

1. Asset backing

If an applicant for and a holder of a "B" Class licence is not an international company under the ICA, it must have a surplus of tangible assets over liabilities of not less than US$ 2 million. If the applicant is an international company, either the paid-up capital must be not less than US$ 2 million or it must have a bank guarantee of its obligations for not less than US$ 2 million.

2. Annual report and audit

The holder of a "B" Class licence must submit audited accounts in a prescribed form within six months of the end of its financial year. The auditor must be approved by the Monetary Board.

C. *Taxation of offshore banks*

No income tax nor any other direct or indirect tax or impost is levied in the Cook Islands on the profits or gains of a licensee, or on interest earned by a licensee or paid to a depositor by a licensee, in respect of the offshore banking it conducts from within the Cook Islands. Also specifically exempted are dividends and interest earned by a licensee or paid to a depositor by a licensee where the dividends or interest are attributable to shares or securities of the licensee which are beneficially owned by another licensee or by a non-resident.

VIII. OFFSHORE INSURANCE

The offshore insurance industry of the Cook Islands is governed by the Offshore Insurance Act 1981-82 ("OIA"). The OIA has been substantially amended by the Offshore Insurance Amendment Acts of 1984, 1986 and 1987.[11]

"Insurance business" is defined in reasonably standard terms. "Offshore insurance business" is defined in terms of the insured, i.e. the person to whom policy moneys are payable, and the owner of the policy, both of which must be:
(a) not domiciled in the Cook Islands; and
(b) not ordinarily resident in the Cook Islands; and
(c) an international company or a foreign company under the ICA (i.e. the offshore jurisdiction); *or*
(d) a trustee company.

A. *Licensing of insurance companies*

A licence must be obtained in order to operate an insurance business. Only an international company incorporated under the ICA or a foreign company registered under the ICA will be granted a licence. No licence is necessary for offshore insurance business transacted between companies deemed to be related under the ICA.

Applications for licences are made to the Monetary Board and must be accompanied by:
(a) a certified copy of the act, charter, deed of settlement, memorandum of association and articles of association of the company, or other document or documents by which the company is constituted;
(b) the prescribed fee; and
(c) evidence manifesting compliance with the laws of the jurisdiction under which the company is incorporated and the nature and character of the business, financial standing, stock ownership and shareholding and management.

B. *Asset backing*

An applicant for and a holder of an offshore insurance licence must have a surplus of tangible assets over liabilities of a prescribed amount. The required surplus, the amount of which may be varied from time to time, currently stands at US$ 100,000. Offshore insurance licence holders must also be able to demonstrate their financial security to the Monetary Board whenever requested to do so.

For newly-established entities the Monetary Board will approve the licence in principle before the required asset backing needs to be established.

C. *Conditions*

A licence may be granted on such terms and conditions as the Monetary Board sees fit, may from time to time be varied or revoked, and is not transferable.

D. *Place of business*

The holder of a licence may transact business only through the office of a Trustee Company or at its registered office in the Cook Islands.

E. *Annual report and audit*

The holder of a licence must submit audited accounts to the Monetary Board within six months of the end of its financial year. The audit must be carried out by an auditor approved by the Monetary Board. Accounts are treated as confidential by the Monetary Board and are not filed with the registrar of International and Foreign Companies or any other official.

F. *Establishment of statutory funds*

A provision inserted by the Offshore Insurance Amendment Acts of 1984 and 1987 allows a licensee to establish and maintain one or more statutory funds under an appropriate name in respect of such part or parts of its offshore insurance business as it chooses.[12]

The effect of establishing such a statutory fund is twofold. First, no assets of the licensee, other than those comprising and constituting the statutory fund, are available to meet any liabilities in any way referable to the offshore insurance businesses to which the statutory fund relates. Secondly, no proceedings seeking to recover any assets or amounts other than the statutory fund or its value may be taken in any way against or in respect of the licensee in any Court. Nor may a judgment of any Court issue or be enforced in the Cook Islands against the licensee for any monies or assets other than those of the statutory fund.

11. All references to the OIA are to the Act as it stands at January 1991.
12. OIA Sec. 17A. The section sets out detailed provisions relating to statutory funds.

G. *Reinsurance*

A licensee may effect reinsurance in respect of any offshore insurance business undertaken by it and may assign to the owner of a policy the rights of the licensee against the reinsurance in respect of any particular policy.[13] If such an assignment is made, the owner of the policy continues to have rights against the licensee only to the extent that the risks covered by the policy issued by the licensee have not been reinsured. An assignment is valid only if the owner of the policy has consented in writing to the application of the relevant section of the law. Licensees may also effect reinsurance without such an assignment.

H. *Taxation of offshore insurance companies*

No stamp duty, income taxes, company taxes, withholding taxes or other imposts apply to insurance entities operating in the offshore jurisdiction.

IX. CONCLUSION

A common law jurisdiction outside the European Community with sound connections and an evident determination to provide upmarket facilities has obvious attractions. A Central Pacific location accessible to the United States, Australasia and the Asian Pacific region has clear advantages. The Hong Kong Stock Exchange approval is seen as an endorsement of standards of practice and quality of legislation. It would seem that the appeal of the Cook Islands will inevitably become increasingly apparent to European-based professionals and indeed trust companies report an upsurge of interest from the Northern Hemisphere.

13. OIA Sec. 17B (inserted 1984).

THE BAHAMAS / BRUCE ZAGARIS

[continued from p. 481]

Although the United States has pressured The Bahamas to also conclude a tax information exchange agreement, The Bahamas has resisted, believing that such an agreement would irretrievably compromise its confidentiality.[15] Several internal measures have been taken to guard against criminal elements in its offshore financial sector. In the last two years the Government of The Bahamas did not renew the licences of several entities in order to eliminate undesirable entities from the international financial sector. In addition, the Association of International Banks and Trust Companies in The Bahamas has promulgated a code of conduct that requires persons in the international financial sector to follow a "know your customer" set of principles.

Another area in which The Bahamas Government has acted and which affects the offshore financial sector is its action to combat illicit drug activity through the enactment of the most comprehensive asset forfeiture law of any developing government. The law is limited to drug-related forfeiture and enables The Bahamas to give assistance to foreign governments provided the property of Bahamian nationals is not involved.[16]

IX. SUMMARY AND CONCLUSION

The combination of the new financial products, the establishment of the Financial Services Secretariat and improved relations with the United States have all breathed new life into The Bahamas offshore financial sector. The financial products enable investors to utilize at incredibly economical rates a sophisticated offshore sector that has experienced professionals. The number of new investors indicates that especially in the short run many persons will want to cruise in the beckoning Bahamian offshore waters.

15. For a Caribbean perspective of the tax information exchange agreement programme, see Zagaris, "The Caribbean Basin Tax Information Exchange Agreements Programme of the United States: Eat Softly and Carry a Big Stick", 43 *Bulletin for International Fiscal Documentation* (March 1989), at 115.

16. Bahamas Laws, Chapter 86, Tracing and Forfeiture of the Proceeds of Drug Trafficking; for a discussion of the Bahamian laws, see Zagaris and Kingma, "Asset Forfeiture International and Foreign Laws", *Forfeitures and Asset Freezes: A Comprehensive Survey of Asset Forfeiture, Restraints and Third-party Rights,* at 46-48.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 49-52 of the January 1991 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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(B. 111.140)

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(B. 111.006)

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Primarily intended for internal use by the assessment authorities. It is also available to the general public.
(B. 111.131)

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(B. 111.181)

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(B. 111.086)

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(B. 111.112)

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(B. 111.133)

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(B. 110.996)

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(B. 111.199)

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(B. 110.718)

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(B. 111.132)

Sweden

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INTERNATIONAL

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(B. 57.604)

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First published in 1946, the *Bulletin* aims to report on matters of importance to the international tax community and to provide a forum for discussion of worldwide developments in tax policy, law and reform. The *Bulletin* is the official journal of the International Fiscal Association and publishes the reports of its national branches.

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Stanley C. Ruchelman

Internal Revenue Code Section 163(j) is designed to limit the opportunities of foreign-based multinational groups to benefit from highly leveraged capital structures involving related party debt. In June 1991 the IRS proposed regulations implementing a limitation on the deduction that may be claimed for interest expense. This article explains the regulations and how they will affect multinational groups.

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Several major changes to the international and corporate tax regimes were announced in the 1991 Budget, including abolition of the general exemption for intercorporate dividends, the possibility for corporate groups to elect for full consolidation for tax purposes where they have 100 percent common beneficial ownership and introduction of a "qualifying company" regime which will allow certain companies to be taxed more like partnerships than companies. A discussion paper was released on budget night outlining possible options for reform of the international tax regime. The recommendations in the paper reflect the need for reform particularly in respect of the international income of New Zealand residents and non-residents investing in New Zealand.

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UNITED STATES:
RULES LIMITING INTEREST EXPENSE DEDUCTIONS ARE PROPOSED BY IRS

Stanley C. Ruchelman*

On 18 June 1991, the IRS proposed regulations implementing a limitation on the deduction that may be claimed for interest expense. The limitation appears in Section 163(j) of the Internal Revenue Code (hereinafter referred to as "the Code") enacted by Section 7210(a) of the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239). Under that provision, no deduction is allowed in the current year for excessive amounts of interest expense paid by a corporation to a related person that is not taxable in the United States. A foreign corporation resident in a jurisdiction that has an income tax treaty in effect with the United States is considered to be a person that is not taxable in the United States if the treaty exempts the payment of interest from U.S. withholding tax. This article will explain those regulations and the manner in which multinational groups are affected.

BACKGROUND

In Congressional testimony in 1989, the Treasury noted that many U.S. subsidiaries of foreign corporations remain in business for many years without reporting a taxable profit. In part, that reflected opportunities within a multinational group to carve up an intercompany transaction among constituent parts so that deductible expenses are allocated to the U.S. subsidiary and income that is not subject to U.S. tax is allocated to a foreign group member.[1] The resulting operating losses could be funded through intercompany debt.

Congress believed that the opportunities for abuse were greatest as a result of the planning directed to the capital structure of the U.S. members, i.e. the amounts of shareholder capital, retained earnings and related party debt. Under this view, the provision of capital among related parties is inherently different from the provision of goods and services or technology. In those latter circumstances, the market could control the price. However, in the circumstances of a capital structure, no similar built-in, market-related force exists in planning for the debt/equity structure. Both the debtor and the related foreign tax-exempt creditor benefit from capital structures heavily weighted towards debt. The debtor benefits because of the deduction allowed for interest expense. The creditor benefits because the repayment of the loan principal does not, by itself, result in U.S. tax. In comparison, the equivalent transaction for equity – a redemption of shares – is often treated as a dividend for U.S. tax purposes.[2] Because no market-related force exists, Congress felt that industry norms more properly serve as a guide with regard to capital structures and limit abusive opportunities within the multinational group to reduce U.S. tax. This culminated in the enactment of the earnings stripping provision of Code Section 163(j) and the recently proposed regulations.

GENERAL SCOPE

The basic principles appear in proposed §1.163(j)-1(a)(1) of the regulations. The primary operative rule is that no deduction is allowed for interest expense (i) which is considered to be "excess interest expense" (i.e. the excess of net interest expense over the sum of 50 percent of adjusted taxable income plus 100 percent of the excess limitation carryover), and (ii) which is paid or accrued directly or indirectly by a corporation to a "related person" that is exempt from U.S. tax with regard to that interest income. Both conditions must be met for the disallowance rules to apply. As a result, the amount of the interest expense actually disallowed is the lesser of the "exempt related person interest expense" and the "excess interest expense" of the year.[3]

* Mr. Ruchelman is a partner of Ruchelman & Felgoise, a law firm in New York City that advises multinational clients in commercial and tax matters. Mr. Ruchelman has authored numerous articles, and has lectured often, on the subject of international taxation. Mr. Ruchelman received a B.A. degree from Brooklyn College and a J.D. degree from George Washington University.

1. The overall Congressional concern expressed in 1989 was articulated in hearings held in 1990. The Oversight Subcommittee of the House Ways and Means Committee conducted public hearings in July 1990 on the transfer pricing practices of Foreign Controlled Domestic Corporations ("FCDCs") and their affiliates and shareholders abroad. The hearings focused on specific industries (motor vehicles at the manufacturing, wholesale and retail levels,household appliances, consumer electronics, and electronic components at the manufacturing level, and sporting goods and electrical goods at the wholesale level) and foreign groups based in specific countries (Canada, Japan, the United Kingdom and Germany). Statistical data accumulated by the IRS and presented at the hearing indicated that FCDCs were substantially less profitable in the aggregate than all other U.S. corporations when certain relationships are computed. These relationships included adjusted taxable income as a percentage of receipts, adjusted taxable income as a percentage of assets, the gross income as a percentage of operating costs and gross income as a percentage of receipts.
2. Sec. 302 of the Code evaluates whether a redemption should be viewed to be the equivalent of a purchase of stock by the corporation effecting the transaction or is more properly viewed to be the equivalent of a dividend. In broad terms, the principal difference is that only in a redemption does the shareholder receiving payment see its interest in the corporation reduced in a meaningful way by reason of the payment.
3. Proposed §1.163(j)-1(a)(2) of the regulations.

The manner in which the disallowance is applied is illustrated by an example in the proposed regulations.[4] In the example:

> A is a domestic corporation that is a wholly-owned subsidiary of F, a foreign corporation. In its fiscal year ending 31 December 1990, A's adjusted taxable income is US$ 100, which includes US$ 20 of interest income. Its interest expense for the year is US$ 90, of which US$ 60 is paid or accrued to F. F is resident in a jurisdiction that has in effect an income tax treaty that exempts residents of F from U.S. tax with regard to their receipt of interest income. The example illustrates that:
>
> (1) A's net interest expense is US$ 70 (i.e. US$ 90 − US$ 20);
> (2) A's related person exempt interest expense is US$ 60;
> (3) 50 percent of A's adjusted taxable is US$ 50 (i.e. US$ 100 × 0.5);
> (4) A's excess interest expense is US$ 20 (1) (US$ 70) − (3) (US$ 50)); and
> (5) A's disallowed interest expense is US$ 20 (i.e. the lesser of related person exempt interest expense (US$ 60) and excess interest expense (US$ 20)).

Disallowed interest expense may be carried forward indefinitely to succeeding years.[5] The amount carried forward may be deducted in a subsequent year if sufficient "excess limitation" exists in that year.[6] Any amount of excess limitation that remains after being applied against disallowed interest expense of prior years may be carried forward for three years and used to offset disallowed interest expense in those years.[7]

There are instances in which the limitation will not be applied even though both excess interest expense and exempt related person interest expense exist. A safe harbour is provided in proposed §1.163(j)-1(b) of the regulations under which disallowance of excessive interest is waived for a year if the debt/equity ratio of the payor corporation does not exceed 1.5 to 1. The debt/equity ratio is measured on the last day of the year and certain anti-abuse rules are applied to prevent build-ups of equity at year end.[8] While application of the safe harbour rule in a particular year protects excessive interest arising in that year, amounts of disallowed interest expense carryforward from preceding years do not benefit from the safe harbour.[9]

Also, the disallowance rules do not apply to a payor corporation that is either an S-corporation[10] or a foreign corporation with no effectively connected income subject to U.S. tax. As a result, a foreign corporation that initiates branch operations in the United States does not have to review its borrowings for periods that precede operations in order to comply with Section 163(j) of the Code. Once the foreign corporation operates in the United States, it is subject to Section 163(j) of the Code.[11]

DEFINITIONS

While the operative rules appear to be simple, their application depends on technical terms and computations that are relatively complex. These include terms such as "exempt related person interest expense", "excess interest expense", "net interest expense", "excess limitation", "adjusted taxable income" and "debt to equity ratio". An understanding of these terms is required for the proper application of the provision.

Exempt Related Person Interest Expense

As mentioned above, the disallowance provision is designed to limit the opportunities of benefitting from an abusive capital structure that generates deductible interest expense payable to a related person that is not subject to U.S. tax. Thus, the seminal term under Code Section 163(j) is "exempt related person interest expense". That term means interest paid or accrued by a corporation to a related person when no U.S. tax is imposed on the receipt or accrual of such interest.[12]

If interest income is subject to U.S. withholding tax at a reduced rate under an income tax treaty, the interest will be treated in part as interest subject to tax and in part as tax-exempt interest.[13] The part that is deemed to be subject to tax is determined by dividing the withholding tax rate by the statutory rate under U.S. domestic law, currently 30 percent. The resulting fraction is then multiplied against the related person interest expense for the year to determine the portion that is considered to be subject to tax. The balance of the related person interest expense is considered to be exempt. This may be illustrated by the following example:

> Foreign corporation A, a resident of Japan, is a related person with respect to domestic corporation D. Under the Japan–U.S. income tax treaty, interest derived by a Japanese corporation from U.S. sources is subject to U.S. tax of 10 percent of the gross amount paid. D pays US$ 100 of interest to A. Of that amount, US$ 33.33 is deemed to be taxable and US$ 66.67 is deemed to be exempt under the following computation:

(1)	Withholding tax rate under treaty	10%
(2)	U.S. statutory rate of withholding	30%
(3)	Interest paid to A	US$ 100
(4)	(1) ÷ (2)	33%
(5)	Taxable interest (4) × (3)	US$ 33.33
(6)	Exempt interest (3) − (5)	US$ 66.67

The determination of whether interest is subject to U.S. tax is made on the date the interest is received or accrued by the recipient under tax principles applicable to it.[14] Ordinarily, foreign persons account for interest that is not effectively connected with a trade or business in the United States at the time of the interest payment.[15]

Interest paid to a controlled foreign corporation ("CFC") may be treated as being subject to U.S. tax even if the CFC itself pays no U.S. tax on the receipt of the interest. The interest is considered to be taxable where and to the extent it is included in its net foreign person holding company income and results in an actual inclusion in income of a U.S. shareholder.[16] A similar rule is provided for interest paid to

4. Proposed §1.163(j)-1(g), *Example (1)* of the regulations.
5. Proposed §1.163(j)-1(a)(3) of the regulations.
6. Proposed §1.163(j)-1(c)(1) of the regulations.
7. Proposed §1.163(j)-1(d) of the regulations.
8. These rules appear in proposed §1.163(j)-3(b)(4) and (c)(5) of the regulations and the rules for computing the debt/equity ratio are discussed more fully in the text at note 49.
9. Proposed §1.163(j)-1(c)(2) of the regulations.
10. Under Code Sec. 1363, an S-corporation is not a taxpayer in its own right. Rather it is treated as a conduit to its shareholders. Limitations are placed on the types of corporations that can be treated as S-corporations and the identities of its shareholders under Code Sec. 1361(b). As a result, an S-corporation cannot be a foreign corporation and cannot have as shareholders either corporations or foreign individuals.
11. Proposed §1.163(j)-8 of the regulations contains rules relating to foreign corporations operating in the United States.
12. Proposed §1.163(j)-2(a) of the regulations.
13. Proposed §1.163(j)-4(b) of the regulations.
14. Proposed §1.163(j)-4(c) of the regulations.
15. Code Secs. 871(a)(1)(A), 881(a)(1), 1441 and 1442. However, the IRS may determine tax as if a payment of interest was made between related persons through an adjustment pursuant to the arm's length transfer pricing rules of Code Sec. 482.
16. Proposed §1.163(j)-4(d)(1) of the regulations.

a foreign corporation classified as a foreign personal holding corporation[17] and to a passive foreign investment company with regard to which an election has been made to be treated as a qualified electing fund.[18]

Related Person

The term "related person" means any person who is related to the debtor corporation within the meaning of Code Sections 267(b) or 707(b)(1).[19] These provisions describe various relationships, but emphasize relationships in which greater than 50 percent common ownership exists among various entities. Thus, for example, an individual is related to a corporation in which he owns more than 50 percent of the value of the outstanding stock; two corporations are related if they are members of the same controlled group determined by reference to more than 50 percent common ownership; and a corporation and a partnership are related if the same persons own more than 50 percent of the value of the outstanding stock of the corporation and more than 50 percent of the capital or profit interests in the partnership.[20]

Under these rules, interest paid to shareholders by a corporation owned equally by two corporations that are exempt from U.S. tax cannot be exempt related person interest because neither shareholder is considered to be related to the payor corporation. This is explained in the following example in the proposed regulations:

> Domestic corporation A is owned equally by D and F, both of which are exempt from U.S. tax on the receipt of interest income. D is a domestic tax-exempt organization and F is resident in a jurisdiction that has in effect an income tax treaty with the United States under which interest from U.S. sources is exempt from tax. Neither D nor F are related to A because neither owns more than 50 percent of the shares of A. Accordingly, none of the interest paid by A to D or F is subject to disallowance under Code Section 163(j).[21]

In determining whether the recipient of interest is related to the payor corporation, an anti-abuse rule is provided under which an arrangement to shift formal voting power or formal ownership of shares will be disregarded if the purpose of the arrangement is the avoidance of Code Section 163(j).[22] The determination is to be made under the principles of §1.957-1(b)(2) of the regulations. These rules are designed to prevent mere formalisms as to voting power from obscuring economic ownership of a CFC for purposes of Subpart F.[23] Thus, when applied in the foregoing example, D's ownership of 50 percent of the shares of A could be disregarded by the IRS if, notwithstanding the capital structure of A, D fails to exercise its voting power, and as a result, an implied agreement to that effect is deemed to exist.

In comparison to the rule for determining whether interest is exempt from tax, the date for determining an exempt person's relationship to the payor corporation is the date on which the item of interest expense accrues.[24] Thus, changes in the relationship between the payor corporation and the recipient after the accrual date, but before the payment date, are irrelevant. Interest is deemed to accrue on a daily basis under the rule of Code Section 1272(a) for this purpose irrespective of the taxpayer's method of accounting. The effectiveness of this rule is open to question because of another rule which provides that interest expense is taken into account only at the time a deduction would otherwise be allowed.[25] Presumably, if the creditor of a domestic corporation is a related foreign exempt person and interest on an intercompany loan is accrued but not paid until the following year, original issue discount is deemed to exist with regard to the obligation[26] and Code Section 163(e)(3) defers the deduction until the year of payment. This would seem to mean that the interest expense (in the form of original issue discount) accrues only on the date of payment. If such payment occurs after a change of ownership of the payor corporation, the interest would seem to be taken into account when the recipient is no longer related.

Excess Interest Expense/Excess Limitation

Once exempt related party interest is defined, the meaning of the terms "excess interest expense" and "excess limitation" become important. The disallowance provision applies only if both exempt related party interest and excess interest expense are deemed to exist. The effect of excess interest expense can be ameliorated by excess limitation, which absorbs excess interest expense of other years.

Excess interest expense means the excess of the debtor corporation's "net interest expense" over the sum of 50 percent of its "adjusted taxable income" and the amount of any "excess limitation carryforward".[27] Excess limitation is defined to mean the excess of 50 percent of a corporation's adjusted taxable income over its net interest expense.[28] For both terms, the concepts of "net interest expense" and "adjusted taxable income" must be defined.

Net Interest Expense

The term "net interest expense" means the excess of a corporation's interest expense over its interest income for the taxable year.[29] Net interest expense is computed without regard to any disallowed interest expense carryforward. "Interest income" is determined under provisions that otherwise apply throughout the Code and includes original issue discount,[30] acquisition discount on short-term obliga-

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17. Proposed §1.163(j)-4(d)(3) of the regulations. Under Code Sec. 552, a foreign personal holding company is a foreign corporation of which more than 50 percent of the value of its shares or 50 percent of its voting power is owned by five or fewer U.S. citizens or resident individuals and more than 60 percent of its income is classified as personal holding company income. In comparison to Subpart F, which is designed to prevent U.S.-based multinational groups from engaging in tax-motivated transactions within the group, the foreign personal holding company provisions are designed to prevent U.S. individuals from using foreign corporations as offshore "pocket books". Once a foreign corporation is classified as a foreign personal holding company, Code Sec. 551(b) provides that all of its undistributed earnings are taxable to its shareholders that are U.S. persons.
18. Proposed §1.163(j)-4(d)(2) of the regulations.
19. Proposed §1.163(j)-2(g)(1) of the regulations.
20. Code Sec. 267(b)(2), (b)(3) and (b)(10).
21. Proposed §1.163(j)-2(g)(5), *Example (2)* of the regulations.
22. Proposed §1.163(j)-2(g)(2) of the regulations.
23. Under Subpart, U.S. shareholders of a CFC may be taxed in the United States on the earnings of the corporation that arise from certain tainted activities even if those earnings are not distributed as dividends.
24. Proposed §1.163(j)-2(g)(3) of the regulations.
25. See discussion in the text at note 37.
26. Proposed §1.1273-1(b)(ii) of the regulations provides that in determining whether original issue discount exists, all payments at maturity other than qualified payments are taken into account in computing the redemption price at maturity. For a payment to be qualified, it must, inter alia, be one of a series of payments equal to the product of the outstanding principal balance of the debt instrument and a single fixed rate of interest that is actually and unconditionally payable at fixed, periodic intervals of one year or less during the entire term of a debt instrument (including short periods).
27. Proposed §1.163(j)-2(b) of the regulations.
28. Proposed §1.163(j)-2(c) of the regulations.
29. Proposed §1.163(j)-2(d) of the regulations.
30. Code Sec. 1273.

tions by taxpayers computing income under the accrual method of accounting or that are financial institutions,[31] amounts treated as original issue discount in the case of stripped bonds[32] and gain that is treated as ordinary income under the market discount rules.[33] "Interest expense" is determined in accordance with Section 163(a) of the Code and includes original issue discount.

Interest expense that is permanently disallowed as a deduction[34] is not taken into account as interest.[35] Similarly, if the interest expense is capitalized, it is not treated as interest for purposes of Code Section 163(j).[36] If the deduction is deferred, the interest expense is taken into account only at the time the deduction is allowed.[37]

Partnerships are treated not as separate entities, but as an aggregate of all the partners.[38] Thus, if a partnership is comprised in part of corporate partners, each such partner is treated as having paid or accrued its distributive share of the partnership expense[39] and is treated as having received its share of partnership income.[40] A similar rule appears in the recently finalized regulations relating to the reporting obligations of 25 percent foreign-owned corporations.[41]

Adjusted Taxable Income

The term "adjusted taxable income" means a corporation's taxable income computed without regard to any carryforwards or disallowances under Code Section 163(j) and modified by adding back certain items and by subtracting others.[42] The items that are added back or subtracted are (i) income or gain items that do not involve the inflow of cash, (ii) expense or loss items that do not involve the outflow of cash, and (iii) items that are specifically required by Code Section 163(j). The adjustments are intended to modify taxable income in a way that more closely reflects cash flow. By adding certain items to taxable income to arrive at adjusted taxable income, the limitation on the deduction for interest expense is increased. More exempt related party interest can be deducted. By subtracting other items, the limitation on the deduction for interest expense is reduced. A smaller amount of exempt related party interest can be deducted.

Among the items added back are:
- Net interest expense;
- net operating loss deductions;
- depreciation deductions;
- deductions for the amortization of intangibles and other items such as start-up costs;
- depletion;
- carryovers of excess charitable contributions from prior years;
- increases or decreases in accounts payable (other than interest) measured at the opening and the close of the year that are included in the computation of taxable income;
- interest income which is excluded from gross income under Code Section 103;[43]
- dividends received that are deducted by the recipient under Code Section 243;
- amounts recaptured and treated as income under the last-in first-out ("LIFO") method of accounting; and
- deductions for capital loss carrybacks or carryovers.[44]

Among the items subtracted are:
- with respect to the sale or disposition of property, any depreciation, amortization or depletion deductions which were allowed or allowable for years beginning after 1986;
- with respect to the sale or disposition of stock of a member of a consolidated group that includes the selling corporation, an amount equal to its investment adjustments attributable to depreciation, amortization or depletion deductions;
- with respect to the sale or disposition of an interest in a partnership, an amount equal to its distributive share of depreciation, amortization or depletion deductions with regard to property held by the partnership at the time the partnership interest is disposed of;
- increases or decreases in accounts receivable (other than interest) measured at the opening and the close of the year that are included in the computation of taxable income;
- amounts that would be deductible but for Section 265 (regarding expenses and interest that relate to tax-exempt income) and Section 279 (regarding interest on indebtedness to acquire shares of stock or assets of another corporation that is not an affiliate);
- the amount of any charitable contribution made during the year that is not deductible by reason of Code Section 170(b)(2) because it exceeds a limitation that is based on gross income;
- the decrease in the LIFO recapture amount between the end of the preceding taxable year and the end of the current taxable year; and
- the amount of any net capital loss for the year.[45]

If, after making all of the foregoing adjustments, the corporation has an adjusted taxable loss for the year, its adjusted taxable income is deemed to be zero.[46] The adjusted taxable loss does not affect the determination of a corporation's adjusted taxable income for any other year.[47] However, the adjusted taxable loss reduces excess limitation carryforward that may be carried to another year.[48] The proposed regula-

31. Code Sec. 1281(a).
32. Code Sec. 1286.
33. Code Sec. 1278.
34. The Code disallows an interest expense deduction when the expense relates to an item of tax-exempt interest income (Sec. 265) or exceeds a lifetime ceiling of $ 5 million and relates to the purchase of shares of stock of a corporation that is not an affiliate (Sec. 279).
35. Proposed §1.163(j)-7(b)(1) of the regulations.
36. Proposed §1.163(j)-7(b)(4) of the regulations.
37. Proposed §1.163(j)-7(b)(2) of the regulations.
38. For tax purposes in the United States, partnerships are sometimes treated as entities and at other times are treated as mere conduits to the partners. The former treatment is generally known as the entity rule of partnerships and the latter treatment is generally known as the aggregate view of partnerships. An example of the entity rule involves the sale of a partnership interest. In the strictly domestic context, a partnership interest can be sold and the sale generally will not be treated as a sale of the underlying assets of the partnership. The application of this rule to foreign partners is not clear at the present time. For example, FIRPTA applies to gain from the sale of a partnership interest in a partnership that owns a U.S. real property interest to the extent that the gain is attributable to an underlying U.S.real property interest. See also Rev. Rul. 91-32, under which the IRS ruled that gain from the sale of a partnership interest by a foreign person is to be treated as gain from the sale of the individual assets of the partnership for purposes of determining the foreign person's tax liability. These are examples of the aggregate view of partnerships.
39. Proposed §1.163(j)-2(e)(4) of the regulations.
40. Proposed §1.163(j)-2(e)(5) of the regulations.
41. §1.6038A-1(e)(2) of the regulations.
42. Proposed §1.163(j)-2(f) of the regulations.
43. Code Sec. 103 excludes interest paid by a state or local government body from the computation of income but, in the case of private activity bonds, not from alternative taxable income. See Code Sec. 57(a)(5).
44. Proposed §1.163(j)-2(f)(2) of the regulations.
45. Proposed §1.163(j)-2(f)(3) of the regulations.
46. Proposed §1.163(j)-2(f)(4) of the regulations.
47. Proposed §1.163(j)-2(f)(4)(iii) of the regulations.
48. Proposed §1.163(j)-2(f)(4)(ii) of the regulations.

tions propose no operating rules illustrating the manner in which the reduction in the excess limitation carryforward is to be effected in various scenarios. Thus, it is not clear whether any type of ordering rule applies calling for carryback or carryforward of adjusted taxable losses. Nor is it clear whether adjusted taxable losses reduce available excess limitation only if derived in preceding years or succeeding years. Presumably, final regulations will elaborate on these points.

Debt/Equity Ratio

As mentioned above, proposed §1.163(j)-1(b) of the regulations provides a safe harbour under which disallowance is waived if the debt/equity ratio of the payor corporation does not exceed 1.5 to 1. The term "debt/equity ratio" means the ratio that the debt of the corporation bears to its equity.[49] Debt is determined in accordance with generally applicable tax principles rather than generally accepted accounting principles.[50] As a result, an item that is reported as a contingent liability for financial accounting purposes that has not accrued for tax purposes will not be treated as a liability for purposes of Code Section 163(j). In addition, certain short-term liabilities and commercial financing liabilities are excluded from the debt characterization for purposes of computing the debt/equity ratio.[51] Short-term liabilities include accrued operating expenses, accrued taxes payable and any account payable (other than an interest-bearing payable) for the first 90 days of its existence. Commercial financing liabilities include secured inventory financing (such as automobile floor plan financing) arrangements carried out at arm's length.

Equity means the sum of money and the adjusted basis of all other assets of the corporation reduced by debt.[52] In computing equity, debt cannot reduce equity to less than zero, and the term "debt" is given the same meaning that is provided for computing the debt portion of the debt/equity ratio, except that short-term liabilities and commercial financing liabilities reduce the adjusted basis maintained in assets. If a corporation owns shares of stock of another corporation that is not an includible corporation for purposes of filing a consolidated return, the basis of the shares in the other corporation is adjusted to reflect its accumulated earnings.[53] The adjustment is to be made under principles of Code Section 864(e)(4).[54]

Three anti-avoidance provisions are provided in the proposed regulations to prevent distortions of the debt/equity ratio. First, under an anti-rollover rule, decreases in a corporation's aggregate debt during the last 90 days of its taxable year are to be disregarded to the extent that the corporation's aggregate debt is increased during the first 90 days of the succeeding taxable year.[55] In computing the increased amount of debt during the first 90 days of the succeeding year, the proposed regulations are silent as to whether the increase is to be based on the average amount of debt for the 90-day period, the debt that is outstanding on the 90th day, or the greatest amount of debt outstanding at any time within the 90-day period. Presumably, the final regulations will elaborate on this point.

The second anti-avoidance provision is a general rule under which assets are disregarded if the corporation's principal purpose for the acquisition is the reduction of the debt/equity ratio.[56] It is important to note that this rule applies only if avoiding the limitation is the most important reason for the acquisition. Presumably, the existence of a valid business reason other than one related to the debt/equity ratio will cause this provision to be inapplicable if that reason, by itself, would have caused the corporation to effect the acquisition.

The third anti-avoidance provision is an anti-stuffing rule. Under this rule, transfers of assets made by a related person to the corporation during the last 90 days of its taxable year are to be disregarded to the extent that there is a transfer of the same or similar assets by the corporation to a related person during the first 90 days of the succeeding year.[57] However, the anti-stuffing rule is inapplicable to the extent that full consideration is provided for a transfer in money or property. In the final regulations, consideration should be given to broadening the rules so that the anti-stuffing rule will apply to the excess of the adjusted basis maintained in the acquired asset over the consideration provided by the related person, even if the consideration is not "full consideration". That excess amount is the limit of the abuse to which the anti-stuffing rule is directed and should be the limit of the anti-abuse rule.

AFFILIATED GROUPS OF CORPORATIONS

Proposed §163(j)-5 of the regulations carries out the directive of Code Section 163(j) that all members of the same affiliated group of corporations are to be treated as a single taxpayer.[58] For this purpose, it does not matter that the group does not join in the filing of a consolidated return.

Ownership by Attribution

In comparison to the ordinary rules of Code Section 1504, rules of attribution in Code Section 318 apply in determining whether an affiliated group exists among includible corporations.[59] Under the attribution rules, a shareholder that owns at least 50 percent of the value of the shares of stock in a corporation is deemed to own a pro rata portion of the stock owned, directly or indirectly, by or for the corporation.[60] In addition, the corporation is deemed to own a pro rata portion of shares of stock of other corporations that are owned directly or indirectly by a shareholder that owns at least 50 percent of its shares.[61] As a result, two domestic corporations that are owned by the same foreign corporation are deemed to be members of the same affiliated group for purposes of Code Section 163(j) even though the foreign corporation that is the common shareholder is not an includible corporation. This is illustrated by the following example:

> X and Y are wholly-owned domestic subsidiaries of F, a foreign corporation. X and Y are not members of an affiliated group under Section 1504(a) because F is not itself an includible corporation under Code Section 1504(b)(3). However,

49. Proposed §1.163(j)-3(a) of the regulations.
50. Proposed §1.163(j)-3(b)(1) of the regulations.
51. Proposed §1.163(j)-3(b)(2) of the regulations.
52. Proposed §1.163(j)-3(c) of the regulations.
53. Proposed §1.163(j)-3(c)(2) of the regulations.
54. Under that provision, a U.S. corporation must allocate and apportion expenses to various classes of income and the apportionment is carried out in accordance with the relative basis maintained in various assets. For that purpose, the basis in a foreign corporation is increased to reflect accumulated earnings.
55. Proposed §1.163(j)-3(b)(4) of the regulations.
56. Proposed §1.163(j)-3(c)(5)(i) of the regulations.
57. Proposed §1.163(j)-3(c)(5)(ii) of the regulations.
58. Proposed §163(j)-5(a)(2) of the regulations.
59. Proposed §163(j)-5(a)(3) of the regulations.
60. Code Sec. 318(a)(2)(C).
61. Code Sec. 318(a)(3)(C).

under proposed §163(j)-5(a)(3) of the regulations, X and Y are treated as members of an affiliated group since X is treated as owning indirectly 100 percent of Y and Y is treated as owning indirectly 100 percent of X by reason of the attribution rules of Section 318(a)(3)(c).[62]

Because of attribution, a corporation may be viewed potentially to be a member of more than one affiliated group. In this case, the corporation will be treated as member of only one group. The determination will be based on principles of the regulations issued under Code Section 1563(b)(4).[63] Under these principles, priority is given to the person who owns stock directly rather than by attribution constructively. Thereafter, the stock of a corporation is treated as owned only by the person who owns directly and with attribution stock possessing the greatest percentage of the total value of all shares of all classes of stock. If the matter remains unresolved, the decision is made by the District Director with audit jurisdiction over the corporation's tax return for that period or by an election filed by the corporation.[64]

Consolidated Return Group

If all members of the affiliated group file a single consolidated return, the computations of Code Section 163(j) are generally to be made on a consolidated basis.[65] Thus, the group's taxable income is the consolidated taxable income, the group's net interest expense is the excess of the group's aggregate interest expense over the group's aggregate interest income, the group's excess interest expense is determined by reference to the group's net interest expense, and the group's disallowed interest expense carryforward and excess limitation carryforward are determined on a consolidated basis.

Certain adjustments are required to account for deferrals and restorations of gain involved in an intragroup transaction.[66] Under the consolidated return regulations, gain on certain intercompany transactions is deferred until the property leaves the group or another event occurs. Deferred intercompany transactions include the sale or exchange of property, the capitalization of service fees performed by another member and any other expenditures which are capitalized by the purchasing member in an intercompany transaction.[67] The deferred gain must be recognized in any year in which the acquiror of the property adjusts the basis and receives a tax benefit in excess of that which would have been available to the selling member. The adjustments required in the proposed regulations eliminate the restoration in these circumstances. In addition, depreciation deductions claimed by the purchaser are eliminated.

In determining the group's exempt related person interest expense, interest paid by a member of the group will be treated as paid to a related person if the recipient is related to any member of the group.[68] Thus, the recipient need not be related to the actual payer of the interest.

If a member leaves the group, the disallowed interest expense carryforward of the group is apportioned to the departing member based on the ratio of the member's exempt related person interest expense to the group's exempt related person interest expense.[69] The departing member is not entitled to carry forward any portion of the group's excess limitation carryforward to separate return years.[70]

Other Groups

For groups that do not join in the filing of a consolidated return, the regulations establish a multi-step procedure for applying Code Section 163(j).[71] These rules likely will have wide application as they apply when a foreign parent owns more than one chain of corporations in the United States. Where this occurs, each separate subgroup that joins in the filing of a consolidated return will follow the rules set forth above in determining items on a consolidated basis. The subgroup is then treated as a single member for the balance of the computations.[72]

Under the proposed regulations, the computations are made in the following manner. First, the exempt related person interest expense, interest income, interest expense and adjustments to taxable income (i.e. the additions and subtractions discussed above) are determined separately for each member.[73] Then, the separately determined amounts of interest income and interest expense for each member is aggregated and netted to determine the group's net interest expense.[74] The separately determined taxable income of each member and adjustments thereto other than net interest expense are aggregated and the group's net interest expense is added to that amount.[75] Next, the separately determined amounts of exempt related person interest expense for each member is aggregated.[76] For this purpose, interest paid by a member of the group will be treated as paid to a related person if the recipient is related to any member of the group. Finally, the amount of the group's excess limitation carryforward or disallowed interest expense carryforward from prior years is determined by aggregating each member's separate excess limitation or disallowed interest expense carryforward.[77]

After the foregoing computations have been completed, the group's excess interest expense and either disallowed interest expense or excess limitation are determined on an aggregate basis.[78] If disallowed interest expense exists, it is allocated to each member based on the ratio which the member's exempt related person interest expense bears to that of the group.[79] If excess limitation exists, the disallowed interest expense carryforward from prior years that is brought forward and deducted must be allocated among the members of the group. The allocation is computed on a pro rata basis.[80] Similar allocations are made for disallowed interest expense carryforwards from prior years that have not been absorbed currently and excess limitation that has not been absorbed.[81]

In comparison to the rules for a group filing a consolidated return, a member that leaves the group is entitled to carry forward any excess limitation or disallowed interest expense allocated to it under the foregoing rules.[82]

62. Proposed §163(j)-5(a)(3)(ii), *Example*, of the regulations.
63. Proposed §163(j)-5(a)(4) of the regulations.
64. §1.1563-3(d)(2)(ii) of the regulations.
65. Proposed §163(j)-5(b) of the regulations.
66. Proposed §163(j)-5(b)(4) of the regulations.
67. §1.1502-13(a)(2) of the regulations.
68. Proposed § 163(j)-5(b)(3) of the regulations.
69. Proposed §163(j)-5(j)(b)(6)(i) of the regulations.
70. Proposed §163(j)-5(b)(6)(ii) of the regulations.
71. Proposed §163(j)-5(c) of the regulations.
72. Proposed §163(j)-5(c)(1)(ii) of the regulations.
73. Proposed §163(j)-5(c)(2)(i) of the regulations.
74. Proposed §163(j)-5(c)(2)(ii)(A) of the regulations.
75. Proposed §163(j)-5(c)(2)(ii)(B) of the regulations.
76. Proposed §163(j)-5(c)(2)(ii)(C) of the regulations.
77. Proposed §163(j)-5(c)(2)(ii)(D) & (E) of the regulations.
78. Proposed §163(j)-5(c)(2)(iii) of the regulations.
79. Proposed §163(j)-5(c)(2)(iii)(C)(*1*) of the regulations.
80. Proposed §163(j)-5(c)(2)(iii)(C)(*2*) of the regulations.
81. Proposed §163(j)-5(c)(2)(iv) of the regulations.
82. Proposed §163(j)-5(c)(2)(iv)(D) of the regulations.

DEBT/EQUITY SAFE HARBOUR

The debt/equity safe harbour of 1.5 to 1 is applied on a group basis.[83] If a consolidated tax return is not filed, the debts and assets of the group members are aggregated. A member's debt is reduced by the amount of its liabilities owed to another group member.[84] Debt is also reduced if it duplicates debt of another group member and therefore distorts the computations. Finally, assets that reflect intragroup relationships are adjusted. In general, intragroup stock ownership or debt of other group members held as an asset is eliminated; the basis of any asset involved in a deferred intercompany transaction is decreased to the extent of the deferred intercompany gain that has not been taken into account; and assets that duplicate an asset of another group member are eliminated.[85]

QUALIFIED STOCK PURCHASES

An election is provided that addresses distortions in the debt/equity ratio that may arise in a qualified stock purchase within the meaning of Code Section 338(d)(3) if no election is made to step up the basis of the assets of the target corporation and its affiliates.[86] Distortions could exist in these circumstances because the affiliated group rules of Code Section 163(j) look through to the underlying assets of the target and eliminate the basis maintained by the acquirer in the target's shares. As a result, the premium paid for the shares will not result in a stepped-up basis in assets and the amount of the affiliated group's debt could far exceed the adjusted basis maintained in the group's assets.[87]

To remedy the problem, the acquiring corporation may elect to treat the acquired stock of the target corporation and its affiliates as an asset. The assets of the target are then disregarded in computing the debt/equity ratio of the group. The basis of the stock is the purchase price plus the amount of the liabilities of the target and its affiliates as of the close of the acquisition date.[88] This special basis is amortized on a monthly schedule over a period of time. This is referred to in the regulations as the "fixed stock write-off method". In general, the amortization period is 96 months but is extended to 180 months if more than 50 percent of the value of the target corporation's assets and those of its affiliates are comprised of long-lived assets.[89] Long-lived assets include inventory, goodwill, other non-wasting assets, depreciable property having a recovery period in excess of 25 years, amortizable assets having an amortization period in excess of 25 years and depletable property having a recovery period for cost depletion purposes in excess of 25 years.

A taxpayer is entitled to elect out of the fixed stock write-off method and to use the adjusted tax basis of the assets of the target and its affiliates to determine its debt/equity ratio in any year. However, once a taxpayer elects out, the election is binding on all future years with regard to the target and its affiliates. Presumably, the election out will be made in a year when the amortization method reduces the equity portion of the debt/equity ratio for purposes of applying the safe harbour below the amount that would be determined under the general rule.[90]

FORMATION OF GROUPS

Upon the formation of an affiliated group, opportunities exist to take advantage of the excess limitation carryforwards of the new member or to allow such carryforwards by the group to absorb disallowed interest expense carryovers from the new member. The proposed regulations adopt rules intended to prevent taxpayers with excess loss carryforwards or disallowed interest expense from obtaining a tax benefit as a result of the formation of a group or the acquisition of a new group member with excess limitation carryforward.[91]

Initially, the regulations provide that if a corporation becomes a member of an affiliated group, the amount of any disallowed interest expense carryforward from a non-affiliation year that may be deducted by the member of the group may not exceed the amount of the current year's excess limitation.[92] Similarly, if a transaction occurs that is described in Section 381(a),[93] the amount of disallowed interest expense carryforward from a non-affiliation year of a transferor or distributor corporation may not exceed the amount of the current year's excess limitation. The limitations of the consolidated return regulation relating to built-in deductions and separate return limitation year rules and the limitation for built-in deductions under Code Section 382(h) are also applicable.[94]

If the corporation that becomes a member of an affiliated group has excess limitation carryforwards from a non-affiliation year, the amount that may be used by the other group members may not exceed the excess of the corporation's separately computed net interest expense over 50 percent of its separately computed adjusted taxable income.[95] If a corporation transfers or distributes its assets to another corporation in a transaction described in Section 381(a), the excess limitation carryforward of the transferor from a non-affiliation year is reduced to zero immediately after the transaction.[96] This rule does not apply to an F-reorganization.

Finally, an anti-abuse rule is provided that limits the opportunity to place borrowing among the members of an affiliated group that have excess limitation carryforward from non-affiliation years. Interest expense paid or accrued with respect to loans that have been incurred or assumed in connection with or after becoming a member of a group are to be disregarded unless the loan proceeds are actually utilized by the member in its preaffiliation business.[97] Similarly, interest on a loan used for the acquisition of the stock of a corporation which is incurred by the acquired corporation may be disregarded if the facts indicate that one of the purposes of the acquired corporation's incurring of the loan was to avoid the limitation on carryforwards from non-affiliation years.

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83. Proposed §163(j)-5(d)(1) of the regulations.
84. Proposed §163(j)-5(d)(2) of the regulations.
85. Id.
86. Proposed §163(j)-5(e) of the regulations.
87. To make an election, the target is required to recapture certain tax benefits and to pay tax. Since the cost of the recapture is borne by the new shareholder, the election is made only when the current value of the step-up in the basis exceeds the costs associated with the recapture.
88. Proposed §163(j)-5(e)(1)(i) of the regulations.
89. Proposed §163(j)-5(e)(5)(vi) of the regulations.
90. Proposed §163(j)-5(e)(3) of the regulations.
91. Proposed §163(j)-6 of the regulations.
92. Proposed §163(j)-6(a)(1) of the regulations.
93. Under Code Sec. 381, a corporation's tax attributes carryover to another corporation if its assets are acquired in a qualifying complete liquidation of a controlled subsidiary or in an A-, C-, nondivisive D-, F- or G-Reorganization.
94. Proposed §163(j)-6(a)(3) of the regulations.
95. Proposed §163(j)-6(b)(1) of the regulations.
96. Proposed §163(j)-6(b)(2) of the regulations.
97. Proposed §163(j)-6(e)(3) of the regulations.

GUARANTEED DEBT

At the time Code Section 163(j) was adopted, the Treasury Department was authorized to issue regulations addressed to back-to-back loans and other devises designed to limit the scope of the proposal, such as guarantees. The proposed regulations do not yet address guaranteed debt or back-to-back loans. However, the IRS has announced that such regulations are imminent and that when published, the rules will have prospective application. Nonetheless, the current view of the IRS is that back-to-back loans and guaranteed loans in circumstances where the guarantee is the principal reason for the extension of the credit can be recharacterized into a two-step transaction. In the first step, the third party is viewed to have made a loan to the shareholders of the purported borrower. In the second step, the shareholders have infused equity to the corporation.[98]

CONCLUSION

When Congress enacted Code Section 163(j), it intended to limit the opportunities of foreign-based multinational groups to benefit from highly leveraged capital structures involving related party debt. The issuance of the proposed regulations clearly adds complexity to this area of the law. When combined with the final reporting regulations under Code Section 6038A, the opportunity of aggressively using intercompany debt as a tax planning vehicle has been significantly reduced.

98. *Plantation Patterns, Inc. v. Commr.*, 462 F.2d 712 (5th Cir., 1971), *cert. denied*, 409 U.S. 1076 (1972); Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; and Rev. Rul. 87-89, 1989-2 C.B. 195.

INTERNATIONAL:

THE NEW CANADA–MEXICO TAX TREATY

Jinyan Li*

The Canada–Mexico Tax Treaty (the "Treaty")[1] was signed on 8 April 1991. This is the first comprehensive double taxation treaty signed by Mexico. Similar treaties are being negotiated by Mexico with the United States and other OECD member countries. The Treaty is patterned after the OECD model[2] as well as the U.N. model.[3] The purpose of this article is to discuss briefly the provisions of the Treaty, compare them with the two model conventions, and comment on the tax treaty policy of Mexico and Canada. As in many treaties signed by Canada with developing countries, this Treaty grants more jurisdiction to tax by the source country than the OECD model, but less than the U.N. model. A tax sparing clause, although very limited, is included to avoid the transfer of any tax incentives offered by Mexican Government from the Canadian investors to the Canadian treasury.

TAXES COVERED

In addition to income taxes levied in Mexico and Canada, Article 2 of the Treaty provides that it also covers the Mexican assets tax.[4] The assets tax is based on the average yearly value of assets of legal entities and individuals resident in Mexico. Although it has been argued that this tax may not be characterized as an income tax for purposes of the U.S. foreign tax credit,[5] Revenue Canada, Taxation seems to have adopted a policy that where a tax that is specifically identified as being subject to the provisions of a tax treaty automatically qualifies as an income or profits tax for the purpose of Canadian foreign tax credit rules.[6]

PERSONAL SCOPE

Article 1 states that the treaty applies only to residents of Mexico and/or Canada. Under the domestic tax laws, residents are taxed on worldwide income in both countries.

Article 4(1) contains a standard definition of "residence" to include any person who, under domestic law, is liable to pay tax by reason of the person's domicile, residence, place of management or place of incorporation. With respect to individuals, Mexican law provides that an individual is resident in Mexico if he or she has established a principal home in Mexico, unless the individual remains outside the country for more than 183 days during the calendar year and has established residence elsewhere.[7] Mexican nationals are deemed to be residents of Mexico. The Canadian Income Tax Act (the "Act") does not define the term "residence", but Section 250(l)(a) deems a person to be resident in Canada if he or she sojourns in Canada for more than 183 days in a calendar year. The meaning of "residence" is left to be determined by the courts. Citizenship is irrelevant in determining the residency of an individual. Individuals who have a dwelling in Canada, and familial and social ties with Canada, are normally found by the courts to be residents of Canada.

Under the domestic laws of both countries, corporate residence is determined by reference to the place of incorporation. A corporation is deemed to be resident in Canada or Mexico if it is incorporated in Canada or Mexico. A company incorporated outside the relevant jurisdiction may also be resident if the "central management and control" (for Canadian tax purposes) or the "main place of management" (for Mexican tax purposes) is situated in that jurisdiction.

* Faculty of Law, The University of Western Ontario, Canada, and affiliated with the Toronto Office of Baker & McKenzie. Ms. Li wishes to thank Prof. A.J. Easson of Queen's University for his comments on the draft of this article.

1. The Convention between the Government of Canada and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income was signed on 8 April 1991 by Michael Wilson, Canada's then Minister of Finance and by Pedro Aspe, Secretary of Finance and Public Credit for Mexico. Prior to this, Canada and Mexico had signed a Convention for the Exchange of Information with respect to Taxes on 16 March 1990.
2. *Model Double Taxation Convention on Income and Capital,* Paris, OECD, 1977 (hereafter "OECD model").
3. *United Nations Double Taxation Convention between Developed and Developing Countries,* 1980 (hereafter U.N. model).
4. The Mexican Assets Tax Law ("MATL") imposes a tax based on the average annual value of assets of Mexican legal entities and of business assets of individuals resident in Mexico. The rate is two percent. Taxpayers may credit toward their assets tax liability for the taxation year an amount equivalent to the income tax paid in the same taxation year. Any assets tax paid in excess of the income tax for that year is deemed payable under the MATL. Any portion of income tax paid that cannot be used as a credit in the current year may be carried back five years. For further discussion, see *Tax Management: Foreign Income Portfolios Business Operations in Mexico,* No. 972 (Washington, D.C., 1990), at A-29-31.
5. The Internal Revenue Service ("IRS") of the United States has ruled that the imposition of the assets tax will not affect the creditability of the income tax under Sec. 910 of the Internal Revenue Code. Because the assets tax is imposed on the average annual value of business assets, rather than on an "income" basis, the IRS has concluded that the tax is not an income tax for Sec. 901 purposes. See Vol. 1, *Tax Notes International Weekly News,* No. 1 (2 September 1991), at 6.
6. Revenue Canada, Taxation, *Interpretation Bulletin IT-27OR,* 9 July 1984, para. 9.
7. Art. 9 of the Mexican Federal Fiscal Code. For further discussion, see P. Chevez, (1989) LXXIVa *Cahiers de Droit Fiscal International,* 381; and R.C. Sanchez, (1987) LXXIIa *Cahiers de Droit Fiscal International,* 403.

Article 4(2) contains customary tiebreaker rules for settling cases of dual residency. If an individual is found to be a resident of both countries under the respective domestic law, the individual will be considered resident of Mexico or Canada based on the following factors (in the order listed): the country where a permanent home is available, the country to which personal and economic ties are closer (the "centre of vital interests"), the country in which an habitual abode is available and the country of nationality. In the absence of these factors, it will be determined by the competent authorities through mutual agreement. Article 3 defines the term "competent authority" to mean, in the case of Canada, the Minister of National Revenue, or the Minister's authorized representative; and in the case of Mexico, the Ministry of Finance and Public Credit.

Under Article 4(3), the problem of dual residency of a corporation is solved by the competent authorities through mutual agreement; the test of place of incorporation will probably be followed since both countries adopt such a test in their tax laws.

Article 4 is virtually identical to both model conventions except the rule with respect to corporate dual residence. The Treaty is less specific than the model conventions, which use the place of effective management to establish corporate residence.

PERMANENT ESTABLISHMENT

The basic definition of "permanent establishment" ("PE") in Article 5(l) is identical to the model conventions to mean a "fixed place of business" through which the business of a non-resident is wholly or partly carried on. A PE is deemed to include a place of management, branch, office, factory, workshop, mine, oil or gas well, or any other place of extraction of natural resources.

Article 5(3) states that a PE also encompasses a building site, a construction, assembly or installation project; and supervisory activities in connection therewith if the site, project or activities continue for more than six months. This provision is different from the OECD model in that the latter does not include supervisory activities in the definition and requires a 12-month period minimum for the site or project to constitute a PE. Article 5(3) also differs from the U.N. model in that it does not extend to services other than supervisory services, such as consultancy services.

Article 5(4) clarifies that facilities used solely for the storage, display or delivery of goods, as well as for the maintenance of a stock of goods for such purposes, and the maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character do not constitute a PE. This rule is the same as in the model conventions. Moreover, Article 5(4)(e) provides that a PE does not arise from the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for preparations relating to the placement of loans or for similar activities which have a preparatory or auxiliary character.

Article 5(5) provides that a dependent agent is deemed to be a PE of the principal if the agent has an authority and habitually exercises the authority to conclude contracts in the name of the principal. If, however, the agent's activities are limited to those of a preparatory or auxiliary character, such as the purchase or delivery of goods, the principal is not thereby deemed to have a PE. This rule is identical to that in the OECD model, but more restrictive than the U.N. model. The U.N. model further provides that a PE is deemed to exist even when the agent has no authority to conclude contracts, but habitually maintains a stock of goods or merchandise from which he or she regularly delivers goods or merchandise on behalf of the principal.

Article 5(6) is an exception to the rule in Article 5(5), and has no counterpart in the OECD model. It provides that an enterprise of one state is deemed to have a PE in the other state if it collects premiums in that state or insures risks situated there through a representative (other than an agent of independent status), even if such representative does not habitually exercise authority to conclude contracts in the name of the enterprise. This rule does not apply to re-insurance.

Article 5(7) states that an enterprise is not deemed to have a PE if it relies on the services of an independent agent, such as a broker, general commission agent or any other agent of an independent status. To meet the requirements of this exception, the independent agent must carry out the activities in the ordinary course of business. This provision is identical to the OECD model. Like the U.N. model, however, the Treaty further provides that an agent loses its status as an independent agent if he or she is an exclusive or almost-exclusive agent of a resident of the other state.

Article 5(8) is identical to the model conventions and provides that the fact that a company that is resident in one state controls or is controlled by a company that is resident or carrying on business in the other state shall not of itself constitute either company a PE of the other.

The definition of PE contained in the Treaty is broader than that in the OECD model, but narrower than that in the U.N. model, which is typical in treaties between a developing and a developed country. A broad definition gives a source country a lower threshold for jurisdiction to tax business profits. To secure jurisdiction to tax and tax revenue, most developing countries insist on a broad definition of PE in both their domestic laws and tax treaties. Mexican tax law, for instance, has a definition of PE similar to that found in the Treaty.[8] Since investment is largely a one-way traffic from Canada to Mexico, the lower threshold is in the best interest of Mexico. Canada has been fairly flexible in its treaty policy with developing countries, and a similar definition is also found in most of Canada's treaties with developing countries.

INCOME FROM IMMOVABLE PROPERTY

Article 6 is identical to the model conventions. It permits taxation by the country of situs of income from immovable property,[9] which includes income derived from direct use, letting, or use in any other form, as well as income from the immovable property used for the performance of independent personal services.

BUSINESS PROFITS

Pursuant to Article 7(1), business profits of an enterprise are taxable only in the state where the enterprise is a resi-

8. See E.C. Nicolau, "Mexican Taxes on Foreign Investment and Trade", 12 *Houston Journal of International Law* (1990), 265, at 268-72.

9. Art. 6(2) provides that the term "immovable property" is defined according to the domestic laws of the country of situs.The term includes property accessory to immovable property, livestock, and equipment used in agriculture and forestry. It also includes certain rights relating to land, the usufruct of immovable property, and rights to variable or fixed payments as consideration for the exploitation of or the right to exploit mineral deposits, sources and other natural resources.

dent, unless a business is carried on in the other state through a PE. In that case, the business profits attributable to the PE are taxed in the other state.

Under Mexican tax law, income is considered attributable to a PE if it results from business activities of the PE; this is also the case under Article 7(1) and Canadian tax law. However, Mexican law also contains a "force of attraction" rule which extends the attribution rule to cover any sales of real or personal property located in Mexico, even if the sales are not conducted through the PE.[10] Canadian tax law has no similar provisions. The Treaty strikes a balance between the divergent approaches taken by the two countries by providing that income is attributable to a PE in Mexico only when the income is derived from sales of property that are identical or similar to property sold through the PE, and only when the Canadian resident fails to establish that the transaction is a bona fide business transaction. This attribution rule is not found in the OECD model, and is different from the U.N. model in that it does not extend to other business activities carried on in the other state of the same or similar kind as those effected through the PE.

Article 7(2) follows the model conventions and provides that the profits allocatable to a PE are to be calculated as if the PE were a separate arm's length person engaged in the same or similar activities.

For purposes of calculating taxable income of the PE, Article 7(3) allows a deduction for expenses incurred for the purposes of the PE, including executive and general administrative expenses regardless where they are incurred. This rule is identical to the OECD model. Like the U.N. model, however, Article 7(3) departs from the OECD model by disallowing the deduction of payments paid by a PE (other than as a reimbursement of actual expenses) to the head office or any other office of the enterprise as royalties, commissions, management fees, or, except in the case of a bank, as interest on moneys lent to the PE. Unlike the U.N. model, the Treaty does not deal with the situation when the PE receives these payments from the head office.

The rest of the provisions in Article 7 are identical to the model conventions, except that Article 7 does not mention the apportionment method for determining profits of a PE as in the case of the U.N. model. Article 7(4) provides that no profit to be attributed to a PE by reason of its use for the purchase of goods for the non-resident. Article 7(5) requires consistency from year to year in the determination of profits attributed to the PE. A change in method may be justified if there is a "good and sufficient reason". Article 7(6) provides that articles dealing with specific items of income prevail over Article 7.

SHIPPING AND AIR TRANSPORTATION

Article 8 does not follow either of the model conventions closely. Article 8(1) provides that profits from the operation of ships or aircraft in international traffic are taxable only in the contracting state where the enterprise is a resident, not the place of effective management as in the model conventions. Thus, there is no provision dealing with the place of effective management of an enterprise when such a place is aboard a ship or boat.

Article 8(2) provides that, notwithstanding Article 8(1) and Article 7, profits from the operation of ships or aircraft used principally to transport passengers or goods exclusively between places in a contracting state may be taxed in that state.

Article 8(3) is identical to the model conventions by providing that Article 8 applies to profits from participation in a pool, joint business or international operating agency.

Article 8(4) has no equivalent in the model conventions. It defines the terms "profits" and "operation of ships or aircraft". "Profits" include profits from the rental of ships or aircraft operated in international traffic, and interest on sums generated directly from the operation of ships or aircraft in international traffic provided that such interest is incidental to the operation. The term "operation of ships or aircraft" refers to the charter or rental of ships or aircraft, the rental of containers and related equipment, and the alienation of ships, aircraft, containers and related equipment.

ASSOCIATED PERSONS

Article 9 is identical to the model conventions, except in paragraphs (3) and (4). Paragraph (1) provides for an adjustment to the calculation of an enterprise's profits of an amount that would have accrued to it but for the non-arm's length relationship between the parties. In order to prevent double taxation that may arise as a consequence of a one-sided adjustment under paragraph (1), paragraph (2) provides for a two-sided adjustment. Where one state taxes the amount of profits of an enterprise that is deemed to have accrued to the enterprise by virtue of paragraph (1), the other state has an obligation to allow an associated enterprise resident there to reduce the income of this enterprise by the same amount. The adjustment, however, is to be made only to the extent that the profits would have accrued to the other enterprise if conditions between the two had been those that would have been made between independent enterprises.

The model conventions do not contain any time limitation for the application of these provisions, nor any limitation for tax fraud. Paragraph (3) provides that the first adjustment must be made before the expiry of domestic limitation periods, but not later than five years from the end of the year in which the profits would have accrued to the subject enterprise. Paragraph (4) makes it clear that the corresponding adjustment mentioned in paragraphs (2) and (3) does not apply in the case of fraud, wilful default or neglect.

INVESTMENT INCOME

Like all tax treaties, this Treaty largely follows the model conventions and reduces the rate of withholding tax imposed by the source country on investment income. With respect to dividends, Article 10 reduces the rate to ten percent for intercorporate dividends (ten percent equity ownership at minimum), and to 15 percent in all other cases.[11] Such a split-rate withholding tax is very common in Canada's tax treaties. The Canadian income tax law has complex rules dealing with dividends received from non-resident corporations. Dividends received by a Canadian corporation are exempt from tax in Canada if the dividends are paid out of "exempt surplus" of a "foreign affiliate".[12] A

10. See *supra* note 4, at A-22.

11. Under the current tax laws of Mexico, however, no withholding tax is levied on dividends paid out of after-tax profits of a Mexican company to its Canadian parent.

12. For more discussion of this, see B.J. Arnold, *Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Foundation Paper No. 78, at 149-160; and K.J. Dancey, et al., *Canadian Taxation of Foreign Affiliates* (CCH Canadian Limited, 1986), at 1-77.

"foreign affiliate" is a non-resident corporation in which the equity percentage of a taxpayer resident in Canada is at least ten percent. The "exempt surplus" generally consists of income from active business derived by a foreign affiliate from a "listed" country – a country with which Canada has a tax treaty.[13] Dividends are taxable in Canada if they are paid out of "taxable surplus", which includes active income earned by a foreign affiliate in a non-listed country. The Canadian shareholder may obtain a credit for underlying foreign tax as well as foreign withholding tax paid on the dividends. Individuals are taxed on dividends received from abroad, and may claim credit for foreign taxes paid. The tax credit, however, is restricted to 15 percent of the gross amount of the dividends. To the extent that the foreign tax exceeds 15 percent, it may be deducted in computing an individual's taxable income. For that reason, Canada's tax treaties generally prescribe the maximum withholding rate for dividends to be 15 percent.

Under Mexican tax law, dividends paid by a Mexican company to non-resident shareholders may be subject to withholding tax depending upon the type of earnings out of which the dividends are paid. In the case of dividends paid out of earnings that have been subject to Mexican corporate tax (i.e. dividends paid out of the *Unilidad Fiscal Neta account),* there will be no withholding tax. In the case of dividends paid out of earnings that have not been subject to corporate tax, a withholding tax is imposed at the rate of 35 percent.

Articles 11 and 12 reduce the withholding tax on both interest and royalty payments to 15 percent. Because the withholding tax rate under Mexican domestic laws is high (35 percent in most cases), and Mexico is a net capital importing country, it is in Mexico's interest to retain jurisdiction to tax investment income as a source country in its tax treaties with developed countries. Canada, on the other hand, is a capital-exporting nation in relation to Mexico, and prefers a low rate. Therefore it accepted the 15 percent withholding tax rate in the Treaty with some reluctance. In the event that Mexico agrees to a rate lower than 15 percent on interest and royalties in a treaty with another OECD member country (for example, the United States), Canada will receive "most-favoured-nation" treatment, and the lower rate will apply to this Treaty.[14]

As in the model conventions, the Treaty defines the terms "dividends", "interest" and "royalties" for the purpose of the Treaty. Dividends, interest and royalties are taxable as part of the profits of a PE or fixed base in a contracting state if (a) the beneficial owner of the income is a resident of the other state and is carrying on business through that PE or performing independent personal services from that fixed base, and (2) the amounts paid are effectively connected with the PE or fixed base. The source of the investment income is deemed to be the place where the payer is a resident or, if the payment is effectively connected with a PE or fixed base, the place where the PE or fixed base is located. With respect to interest and royalties, where a special relationship between the payer and the payee or between both of them and some other person results in the payment of excessive interest, paragraph (7) of Articles 11 and 12 provide that Articles 11 and 12 do not apply to the excess and it remains taxable according to the law of each state.

Exemptions from the taxation by the source country are allowed on certain interest and royalty income received by a resident of the other state. Article 11(3) provides that (a) interest is exempt from tax in the source state if the payer or payee is the Government of Canada or Mexico or a political subdivision or local authority thereof; (b) interest is exempt from tax in Mexico if it is paid in respect of a loan for a period of not less than three years made, guaranteed or insured, by the Export Development Corporation; and (c) interest is exempt from tax in Canada if it is paid in respect of a loan for a period of not less than three years made, guaranteed or insured, or a credit for such period extended, guaranteed or insured, by *Banco Nacional de Comercio Exterior, SNC.* Article 12(3) states that copyright royalties and other like payments in respect of the production or reproduction of any cultural, dramatic, musical or other artistic work (but not including royalties in respect of motion picture films and works on film or videotape or other means of reproduction for use in connection with television) are exempt from tax in the source country.

BRANCH TAX

Neither of the model conventions has provisions concerning branch tax. Canadian tax law[15] imposes a tax on the after-tax profits of a branch of a non-resident corporation carrying on business in Canada. This tax generally stands in the place of a withholding tax on dividends; the withholding tax is normally exigible where the payee is a non-resident. The purpose of the branch tax is to equate the total tax liability of a subsidiary and a branch of a foreign corporation. Article 10(6) of the Treaty, therefore, is inserted to preserve the right of Canada to impose the branch tax on the earnings of a PE. The tax rate is ten percent under the Treaty. Unlike some of Canada's treaties, the Treaty provides for no exemption from the tax.[16]

Mexican law does not impose a branch tax, although under the Treaty, Mexico is entitled to do so.

CAPITAL GAINS

Article 13 provides that gains from the alienation of immovable property may be taxed in the state of situs. Gains from the alienation of movable property that either forms part of the business property of a PE or pertains to a fixed base available for the purpose of performing independent services, including gains from the alienation of the PE or fixed base, may be taxed by the state where the movable property is situated.[17] Gains from the alienation of ships and aircraft operated in international traffic are taxable only in the state where the enterprise is a resident. These provisions are similar to the two model conventions.

13. Once Mexico becomes a "listed" country for Canadian income tax purposes, earnings derived from an active business carried on in Mexico by a Mexican subsidiary of a Canadian company will be considered to be exempt earnings; consequently, dividends paid from the subsidiary will be exempt from tax in Canada. Mexico will become a listed country when the Treaty enters into force, probably sometime this year.

14. Protocol between the Government of Mexico and Canada, signed on 8 April 1991. A rate of 15 percent might be too high for the United Stated to accept since the United States generally favours low rates. The issue of withholding tax rates is apparently one of the most contentious issues in the U.S.–Mexico treaty negotiations.

15. Sec. 219 of the Act.

16. The treaties with the United States and the Netherlands exempt the first $ 500,000 from branch tax, the Canada–U.K. Treaty exempts £ 250,000.

17. Under the domestic laws of Mexico, gains realized by a non-resident from selling real estate located in Mexico are subject to 20 percent withholding tax on the gross proceeds unless the taxpayer elects to be taxed on the net gain at a rate of 30 percent. Gains from sales of shares of Mexican corporations are taxed in the same manner. The cost of the real property and shares is adjusted for inflation.

Article 13(4) adopts the principle in the U.N. model and provides that gains from the alienation of shares (other than publicly-traded shares) forming part of a substantial interest in the capital stock of a company are taxed in the state where the company is a resident if the value of the shares is derived principally,[18] directly or indirectly, from immovable property situated in that state. Similarly, gains from alienation of a substantial interest in a partnership, trust or estate the value of which is derived principally, directly or indirectly, from immovable property are taxed in the state of situs of the immovable property. For the purpose of this paragraph, immovable property does not include any property, other than rental property, in which the business of the company, partnership, trust or estate is carried on.

Other capital gains not mentioned in Article 13 are taxed only in the state where the alienator is a resident. However, if the alienator has been a resident of the other state at any time during the six years immediately preceding the alienation of the property, this state may levy, according to its law, a tax on such gains.

Article 13(5) is an unusual provision for a treaty with a developing country. It provides that the competent authority of a state may agree to defer the recognition of profit, income, or gain in respect of property alienation by a resident of the other state in the course of a corporate organization or reorganization not recognized as a taxable transaction in the other state. This provision is identical to one in the OECD model and also appears in many of Canada's treaties with OECD member countries, such as the Netherlands, the United Kingdom and the United States.

INDEPENDENT PERSONAL SERVICES

Article 14 is largely patterned on the OECD model except one provision which provides that a resident of one state is deemed to have a fixed base in the other state throughout any 12-month period if the resident is present in that other state for more than 183 days in aggregate in that period. Income from independent personal services[19] is taxed by the state of which the person rendering the services is a resident, unless the person has a fixed base in the other state. Income attributable to the fixed base is taxable in that other state.

DEPENDENT PERSONAL SERVICES

Article 15, subject to Articles 16 (directors' fees), 18 (pensions and annuities) and 19 (government services), provides that salaries, wages and other remuneration from employment are taxable in the state in which the employment is exercised to the extent derived from that exercise. Such remuneration is exempt from tax in the source state if (a) the employee is present in the other state for a period or periods not exceeding 183 days in any 12-month period; and either (b) the remuneration is paid by an employer who is not a resident of the other state; or (c) the amount received does not exceed CDN$ 1,500.[20] These provisions are similar to their counterparts in the model conventions.

Under paragraph (3), income received by an individual from employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a contracting state shall be taxable only in that state. In contrast, both model conventions include employment exercised aboard a boat engaged in inland waterways transport, and the jurisdiction to tax is determined by the place in which the effective management of the enterprise is situated.

DIRECTORS' FEES AND REMUNERATION OF TOP LEVEL MANAGERIAL OFFICIALS

Article 16 is patterned on the U.N. model. It provides that directors' fees, and remuneration of a top-level managerial official of a company are taxable in the state of which the company is a resident.

ARTISTES AND ATHLETES

The model conventions have identical provisions on this subject. Article 17(1) states that artistes and athletes may be taxed in the country in which they perform their activities. Article 17(2) is an anti-avoidance provision to allow the source country to tax income from such activities when it is paid to another person (normally a corporation) even if this person has no PE or fixed base in the source country to carry out the performances. Article 17(3), which has no counterparts in the model conventions, provides that the anti-avoidance rule does not apply if the entertainer or athlete established that neither he or she nor any person related to him or her participates directly or indirectly in the profits of the person to whom the income accrues.

Where the activities are performed within the framework of an official cultural exchange programme between the two states, the income is not taxed in the source state. Such an exemption is not included in the model conventions.

PENSIONS, ANNUITIES AND ALIMONY PAYMENTS

Article 18 is patterned on Alternative B in Article 18 of the U.N. model. Pensions and annuities[21] are generally taxable in the recipient's state of residence. Periodic pension payments and annuities are, however, taxable also in the source state but the tax is limited to the lesser of (a) 15 percent of the amount taxable under the domestic law of that state, and (b) the rate determined by reference to the rate applicable to a resident of that state.

An exemption from tax in the source country is allowed in Article 18(4) for war pensions and allowances (including pensions and allowances paid to war veterans or paid as a consequence of damages or injuries suffered as a consequence of a war) to the extent that the payment would be exempt from tax in the state of source if the recipient were resident there.

Alimony and other similar payments are taxable in the state of residence of the recipient. In order to avoid double taxa-

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18. The term "principally" is defined in the Technical Explanation of the Canada–U.S. Treaty to mean more than 50 percent, which may be adopted for the purpose of the Treaty.
19. The term "professional services" is defined in Art. 14(2) to include independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.
20. The $ 1,500 exemption is considerably less than the $ 10,000 specified in the Canada–U.S. Treaty, presumably because labour costs and the standard of living are lower in Mexico.
21. The term "annuities" is defined in Art. 18(3) to mean "a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered), but does not include a payment that is not a periodic payment or any annuity the cost of which was deductible for the purposes of taxation in the contracting state in which it was acquired".

tion, that state should not tax such payment if the payer cannot deduct or credit the same for the purposes of taxation in the source country. No similar provisions are contained in either of the model conventions.

GOVERNMENT SERVICE

Article 19 is in principle the same as the provisions in the model conventions. Paragraph (1) provides that remuneration for services other than pensions is subject to tax in a state when paid by that state or its political subdivisions to a resident of the other state who is not a national of that latter state, or did not become a resident of that state solely for the purpose of rendering the services. Consequently, local personnel working at an embassy, consulate or other similar office in a contracting state are taxed according to the law of that state. Paragraph (2) provides that paragraph (1) does not apply to remuneration for services rendered in connection with a business carried on by a contracting state, political subdivision or local authority.

INCOME FROM ESTATES AND TRUSTS

Income from estates and trusts is dealt with in Article 21(2) as "other income", and taxable by the recipient's state of residence. The source state, if so permitted by its domestic law, may impose a withholding tax of up to 15 percent.

STUDENTS AND TRAINEES

Article 20 is identical to the OECD model and provides that if a student or business trainee, who is or has been a resident of a contracting state, receives payments solely for the purpose of his or her maintenance, education or training while staying in the other state, those payments are not taxed in that other state, provided that such payments arise from sources outside that state. Unlike the U.N. model, Article 20 does not require the visiting state to give the same tax exemptions, reliefs or reductions available to residents to the students and trainees in respect of grants, scholarships and remuneration from employment.

DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Article 26 provides that the Treaty shall not affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements. This is identical to the model conventions.

OTHER INCOME

Article 21 is a catchall provision restricting taxation of income not dealt with elsewhere in the Treaty to the recipient's state of residence. Paragraph (2) provides that some income may also be taxed in the state of source according to its domestic law. In the case of income from trusts and estates, the tax rate is limited to 15 percent. A similar provision is also contained in the U.N. model.

Unlike the model conventions, Article 21 has no provision dealing with income which is effectively connected with a PE or fixed base.

TAXATION OF CAPITAL

The Treaty departs from both model conventions and has no provisions dealing with taxation of capital.

ELIMINATION OF DOUBLE TAXATION

Article 22 provides for a standard credit method of eliminating double taxation. It is surprising that the Treaty contains no general tax sparing credit clause, although Canada has been fairly liberal in allowing developing countries tax sparing provisions in their treaties.

Article 22(l) merely allows the ordinary foreign tax credit to Canadian taxpayers for taxes paid in Mexico on business profits, income and capital gains. If the taxes are not actually paid to Mexico, no credit can be claimed in Canada, except in the case of dividends. Article 22(3) allows a limited tax sparing credit for dividends: a tax of 15 percent is deemed to have been paid on a dividend paid by a company which is a resident in Mexico. Under current Mexican tax law, no withholding tax is levied on dividends paid out of after-tax profits of a Mexican company to a non-resident shareholder.

As in Canada's other treaties, Article 22(l)(b)[22] is included to preserve the special Canadian tax treatment afforded dividends paid out of the exempt surplus of a foreign affiliate in Mexico. In the case of Mexico, double taxation is avoided by allowing credit for taxes paid in Canada on Canadian-source income. For dividends, the credit covers both the underlying corporate tax on the profits out of which the dividends are paid and the withholding tax.

SPECIAL PROVISIONS

Article 23 (non-discrimination), Article 24 (mutual agreement procedure) and Article 26 (exchange of information) are identical to their counterparts in the model conventions.

MISCELLANEOUS RULES AND ANTI-TREATY SHOPPING PROVISION

Neither of the model conventions deals with this subject. Article 27(l) is a standard Canadian treaty provision which has the effect of ensuring that the Treaty will never eliminate a benefit available under either domestic tax legislation or other agreements. It provides that the provisions of this Treaty "shall not be construed to restrict in any manner any exemption, allowance, credit or other deduction accorded (a) by the laws of the contracting state in the determination of the tax imposed by that state; or (b) by any other agreement entered into by a contracting state".

Article 27(2) states that nothing in the Treaty shall be construed as preventing a contracting state from imposing a tax on amounts included in the income of a resident of that state with respect to a partnership, trust or controlled foreign affiliate, in which the resident has an interest.

Article 27(3) contains a so-called "anti-treaty shopping"

22. It provides that: "subject to the existing provisions of the law of Canada regarding the determination of the exempt surplus of a foreign affiliate and to any subsequent modification of those provisions – which shall not affect the general principle hereof – for the purpose of computing Canadian tax, a company which is a resident of Canada shall be allowed to deduct in computing its taxable income any dividend received by it out of the exempt surplus of a foreign affiliate resident in Mexico".

rule. It provides that the Treaty "shall not apply to any company, trust or partnership that is a resident of a contracting state and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that state, if the amount of the tax imposed on the income or capital of the company, trust or partnership by that state is substantially lower than the amount that would be imposed by the state if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more individuals who were residents of that state". Similar provisions are included in Canada's treaty with the United States.

ENTRY INTO FORCE

Under Article 28, the Treaty will enter into force on the date on which the two states exchange instruments of ratification. It will apply, in respect of tax withheld at the source on amounts paid or credited to non-residents, on and after the first day of January of the calendar year in which it enters into force; and in respect of other taxes, for taxation years beginning on or after the first day of January in the calendar year in which the Treaty enters into force. The Treaty has been approved by the Mexican Congress and is in the process of being approved by the Canadian Parliament.

TERMINATION

Article 29 provides that the Treaty has been concluded for an indefinite period of time, but notice of termination may be given on or before 30 June of any calendar year after the year in which it enters into force.

CONCLUDING REMARKS

The signing of the Treaty certainly comes at an opportune time since it coincides with the beginning of trilateral free-trade negotiations among Canada, Mexico and the United States. The Treaty will also undoubtedly serve as a model treaty for Mexico in negotiating treaties with other OECD countries. It may take some time for Mexico to develop a system of treaty interpretation and administration that is familiar to Western investors, but this treaty certainly helps to bring the Mexican tax system closer to the international tax norm. It opens new opportunities for investment in Mexico, and provides greater certainty as to the Mexican tax liability and consequences.

Conference Diary

JANUARY 1992

International Aspects of U.S. Taxation: Cross Border Concepts and Planning Strategies. 77150 Lesigny, France, 13-15 January (English), and
U.S. and European Reorganizations, 77150 Lesigny, France, 16-18 January (English):
The American Tax Institute in Europe, 9, avenue Matignon, 75008 Paris, France. Tel.: (33 1) 42563370. Fax: (33 1) 4299 1751.

Steuerplanung und Steuerpraxis Europa–USA. St. Moritz (Switzerland) 13-17 January. (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postfach, CH-8022 (Switzerland). Tel.: (01) 2192399.

2nd Conference on the Tax Treatment of International Capital Markets Transactions, Zürich, 27-28 January (English):
International Tax Academy, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31-20-626 7726; Fax: +31-20-620 9397.

MARCH 1992

I.T.P.A. Guernsey Seminar, Guernsey, Channel Islands, 12-13 March (English):
Elizabeth Husband, International Tax Planning Association Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England. Tel.: Sevenoaks (0732) 62910. Fax: Sevenoaks (0732) 63762.

EC Corporate Tax Directives: challenges and opportunities for businesses operating in Europe (co-sponsored by KPMG), Brussels, 12-13 March (English):
International Tax Academy, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31-20-626 7726; Fax: +31-20-620 9397.

NEW ZEALAND: CORPORATE AND INTERNATIONAL TAX REFORMS IN 1991 BUDGET

Andrew M.C. Smith*

On 30 July 1991, the Minister of Finance, the Hon. Ruth Richardson, delivered her first Budget since the election of the National Government in October 1990. As expected the Budget continued the tax reform process started by the previous Labour Government with a number of changes to corporate and international tax. Additionally a discussion paper[1] was released outlining issues to be considered in the reform of the taxation of cross border income flows.

* Senior Lecturer in Accountancy, Victoria University of Wellington, New Zealand.

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I. COMPANY TAX CHANGES – THE VALABH COMMITTEE REPORT

In November 1990, the Consultative Committee on the Taxation of Income From Capital (the Valabh Committee) released its discussion paper on the taxation of distributions from companies, inviting submissions from interested parties. The Committee's final report was released as part of the Budget with a statement of the Government's intention as to how they would proceed with the Committee's recommendations.

A. *The definition of dividends for tax purposes*

The taxation scheme for distributions from companies was revised when dividend imputation was introduced in 1988. Since these changes were made a number of problems had arisen in practice which required legislative attention. A number of small amendments have been proposed and accepted by the Government which will clarify these existing provisions.

B. *Company share repurchases*

After lengthy debate and consultation a new Companies Bill is likely to be passed later this year replacing the old Companies Act of 1955.

Two proposals in the bill will have a major impact on what constitutes a "dividend" for income tax purposes. Firstly, the long-standing prohibition on a New Zealand company repurchasing its own shares would be removed. Secondly, the Companies Act would no longer contain references to par values of shares. It is therefore important that a taxing regime be defined for share repurchases when they become legal and the existing taxing regime for distributions upon a company winding-up be modified to reflect the abolition of share par values.

The changes proposed for companies legislation will allow companies to buy back their own shares under either an offer made to all shareholders to buy back a proportion of their shares or an offer to a selected number of shareholders. It is proposed that shares repurchased are cancelled; however, some submissions on the Companies Bill have called for treasury stock provisions.

The Committee identified two ways share repurchases could be taxed. One would be to treat the repurchase as a partial winding-up, the other to distinguish between on-market and off-market purchases, as is currently done in Australia. On-market repurchases would be treated as an ordinary sale of shares while in an off-market repurchase a dividend would be derived by the vendor shareholders to the extent that the price paid for the shares exceeds the total of the paid-up share capital and any share premium paid on issue of the shares.

1. The Valabh Committee, *The Taxation of Distributions from Companies – Final Report* (Wellington, July 1991). Two other documents forming part of the Budget statement are reviewed in this article. They are: *Taxing Income Across International Borders – A Policy Framework* (Wellington, 30 July 1991) and *Taxation Policy: Business Tax Policy 1991 – A Statement on Government Tax Policy* (Wellington, 30 July 1991).

The Committee felt that there were few grounds to distinguish share repurchases on the basis of on and off-market purchases. In both cases the effect on the company's retained earnings and shareholder wealth is the same. Therefore the tax consequences of both should be identical to avoid giving incentives for companies to characterize dividend distributions by way of share repurchases. However, it would be inequitable to tax a part of the consideration received for the sale of shares if a vendor is unaware that the issuing company is the purchaser, when if sold to any other party the whole consideration would be a capital receipt. Also by making such a concession for on-market purchases the Committee felt significant avoidance opportunities would arise given the absence of a comprehensive capital gains tax.

The Committee proposed for resident companies and resident vendor shareholders that the dividend component of a share repurchase will be taxed at the *repurchasing* company level with the entire consideration exempt to the vendor shareholder.[2] Fringe benefit tax ("FBT") will be levied upon the repurchasing company based upon the amount of the dividend component of the share repurchase.[3] The payment of FBT would be met by a debit to the company's dividend imputation credit account. In that regard share repurchases will be put on the same basis as the payment of a dividend, net of tax. This treatment would not apply where a vendor shareholder was exempt from resident withholding tax (i.e. tax-exempt). Instead the amount of the repurchase deemed a dividend would be paid tax-exempt.

The amount of the dividend deemed from a share repurchase is proposed to be determined under a revised Section 4A(1)(c) which also applies to return of capital to shareholders upon a company winding-up. Under an averaging formula the amount of the dividend would be, to the extent that the consideration for the shares exceeds the aggregate of the paid-up capital, share premium and net realized capital profits. The use of an averaging formula would prevent marshalling arrangements where capital sources (e.g. share premium, realized capital profits) are only distributed through the share repurchase.

Repurchases involving non-residents would be treated differently. The dividend portion of a share repurchase from a non-resident would be subject to non-resident withholding tax as is levied for ordinary dividend payments. The dividend portion of a share repurchase by a non-resident company from a New Zealand resident shareholder would also be treated as assessable income in the normal way. This too is likely to pose problems for New Zealand resident shareholders if they do not have the ability to require the repurchasing company to supply them with the relevant information to make such a determination.

It is proposed that the general anti-avoidance section (Section 99) be modified to deal with tax avoidance arrangements involving the repurchase of shares in substitution for the payment of dividends.

The Committee also proposed a treasury stock regime should the Companies Bill be amended to allow treasury stock to be held by issuing companies. With treasury stock the repurchase would be treated as a non-taxable transaction, provided certain conditions are met such as not more than five percent of any class of shares are held as treasury stock and that the stock be held for not more than one year.

The Government has deferred making final decisions on the Committee's recommendations until company law reform proposals are finalized and other changes to the tax status of dividends are made. The proposals involving a revised Section 99 will also be deferred until the Valabh Committee's current review of the general anti-avoidance provision is completed.

C. *Qualifying companies regime*

This proposal is designed to simplify the taxing provisions for small private companies of which there are many in New Zealand, primarily as a vehicle for small owner-operator businesses. Currently all companies are largely taxed on the same basis.[4]

The Committee felt that a distinction could be made between closely and widely-held companies.

Closely-held companies are virtually a substitute for partnerships and sole traderships, with a high degree of integration with their shareholders. However, shareholders of small companies have exposed themselves to a considerably more onerous taxing regime than if they had used a partnership or sole tradership.

The introduction of dividend imputation in 1988 has removed the major disadvantage of companies of the double taxation of profits. This has been of greater assistance to widely-held companies than closely-held ones, as prior to 1988 the latter avoided such double taxation by distributing profits in the form of directors' fees to shareholder/employees which were deductible to the company. However, changes in 1985 deeming distributions from capital sources taxable as dividends have affected closely-held companies more directly than widely-held ones. Shareholders in closely-held companies can now only receive capital distributions tax-free upon the winding-up of the company, in contrast to partnerships and sole traders who can receive non-taxable capital profits at any time. This has presented artificial incentives for closely-held companies to voluntarily wind up to distribute capital profits and for the shareholders to then incorporate a new company to continue operating the existing business.

The Committee stated:[5]

> a departure from the conventional approach of disregarding the source from which dividends are paid is warranted where there is in substance little distinction between the actions of a company and its shareholders. Such closely-held companies and their shareholders are in reality indistinguishable from

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2. This exemption will also apply to shareholders who would be assessable on the sale of shares, i.e. where the shareholder was a share dealer, or the shares were acquired for the purpose of resale, or disposed as part of a profit-making scheme or undertaking.
3. FBT is levied at the rate of 49 percent. It is based on the corporate and top marginal individual tax rate of 33 percent grossed up.
For example:

$$\frac{0.33}{1-0.33} = 49\%$$

Thus the consideration paid by the company for the shares repurchased would be equivalent to a net-of-tax sum and the company will pay the equivalent tax otherwise due by the shareholders. Note that the same taxing scheme is currently applied to non-cash deemed (constructive) dividends.
4. Some provisions apply only to small family companies to prevent contrived income splitting among family members, e.g. Sec. 191. Companies with stock exchange listings have some relaxation of the shareholding continuity requirements for loss offsets and carry-forwards and for carry-forwards of credit balances in the dividend imputation account.
5. The Consultative Committee on the Taxation of Income From Capital, *The Taxation of Distributions From Companies* (Wellington, 1990), at 15.

alternative forms of business organizations such as partnerships and sole traders. A closer alignment of the tax treatment would seem desirable.

This would attribute capital gains made by closely-held companies to their shareholders resulting in distribution of such gains tax-free in shareholders' hands.

The Committee has proposed that a "qualifying company" regime be introduced for the taxing of closely-held companies, more akin to the taxing regime applying to partnerships. In order to be a "qualifying company" a company must not have more than five shareholders[6] and if any shareholder was a company it too must be a "qualifying company". The company must be New Zealand resident. A limitation would be placed upon foreign-source income (other than dividends) of not more than NZ$ 10,000 per annum. Companies would achieve "qualifying company" status by all shareholders and directors electing that status, with effect from the beginning of the income year.

Qualifying companies would be able to pay two types of dividends to their shareholders – exempt dividends and dividends with full imputation credits attached. The decision to distribute what category of dividend would be left entirely to the company. However, there would be streaming rules to require qualifying companies to pay exempt and taxable dividends to all shareholders in the same proportion in a given income year. A qualifying company would be required to maintain a simplified form of imputation credit account. Qualifying companies would be able to pay capital profits to shareholders by way of exempt dividends. Where a shareholder is a trustee, the trustee must vest all current year dividends from qualifying companies in beneficiaries other than a non-qualifying company.

Salaries paid by a qualifying company to shareholder/employees would be deductible to the company irrespective of whether withholding taxes ("PAYE") applied or not. All in-kind benefits distributed to shareholder/employees either as constructive dividends or as remuneration would be subject to FBT.[7] Expenditure incurred by the company in providing in-kind benefits to shareholders who are not employees would be non-deductible. If interest was incurred by shareholders to purchase shares in a qualifying company which provided in-kind benefits, a special apportionment rule would apply.

Qualifying companies would not be able to form a group with non-qualifying companies for the purposes of the loss offset provisions. However, losses could be passed through to shareholders in certain situations, in a similar manner to losses incurred by partnerships. To pass through losses it is proposed that all companies in the group must have one class of share with identical rights in all respects. Losses would be attributed to shareholders according to the proportion of shares held in the course of an income year. The company's loss would be entirely removed in each year by an attribution process. The loss pass through option would be elected by the unanimous vote of all shareholders and directors. Any existing loss carry-forwards at the time the election was made would not be eligible for the pass through regime and be required to be carried forward by the company.

Transitional arrangements proposed include a concessionary tax of 7.5 percent (to be called qualifying company election tax) on existing retained earnings held by companies entering the regime during a specified period. Assets of a revenue nature owned by companies at the time of entry to the regime would be carried over at their book values. During a transitional period a company must cancel 25 percent of its losses if it enters the regime. After that all losses would be cancelled on entry.

The "qualifying company" is likely to be well received by shareholders in closely-held companies. Unfortunately at this stage the administrative details surrounding the proposals are far from clear and such shareholders would want assurance that the introduction of such a regime would be accompanied by simplified administrative and compliance procedures.

The Government has indicated it agrees with the proposals and that the regime will be operative for the income year beginning 1 April 1992. Companies will have until 1 October 1992 to elect to be a qualifying company for the 1992/93 income year. A bill has been introduced into Parliament which is expected to be passed later this year enacting the qualifying companies regime.

D. *Other matters*

In its discussion paper the Committee recommended that the excess retention tax ("ERT") be abolished. This tax applied to small private companies whose major activities involved the derivation of investment income. As inter-company dividends under New Zealand law pass as exempt income to recipient companies (until 1 April 1992), the tax was imposed on undistributed dividend income to prevent companies being used as a "trap" for dividend income avoiding the need for distribution and taxation of those dividends to individual shareholders.

Since release of the discussion paper the Government has already repealed the tax. The subsequent decision in the Budget to remove the inter-company dividend exemption (discussed below) has also meant the tax would be redundant by 1992 anyway.

The Valabh Committee was originally briefed to consider issues regarding extension of dividend imputation to non-residents as well as the tax status of cross border intercompany loans giving rise to constructive dividends. These issues will be left to the review of international taxation discussed later in this article.

II. COMPANY TAX CHANGES – BUDGET ANNOUNCEMENTS

In addition to the Valabh Committee report, the Budget also contained a number of other important changes for company taxation.

A. *Inter-company dividend assessability*

For many years the receipt of a dividend by a company has been deemed exempt income under Section 63. This exemption, while designed to mitigate double taxation of income within company groups, has formed the basis of a number of tax avoidance arrangements.

It has recently come to the attention of the Government that a number of large New Zealand companies had entered into tax avoidance arrangements using redeemable preference

6. Persons related to the first degree are to be treated as one person.
7. This would result in the benefit received by the shareholder being non-assessable and treated as being on a net-of-tax basis. FBT is levied at a rate of 49 percent which is the top income tax rate of 33 percent grossed up.

shares as a way of transferring losses between companies in a manner which is not otherwise permitted by the loss offset provisions in Sections 188 and 191. Estimates suggested that a significant amount of income tax has been lost through redeemable preference share arrangements this year. Therefore it was decided to remove the dividend exemption. The original objective of the exemption is less relevant since the introduction of dividend imputation in 1988.

From 1 April 1992, all dividends received by a company will become assessable and subject to resident withholding tax of 33 percent. The exemption will remain for dividends derived from non-resident companies (including those resident companies deemed non-resident under a double taxation agreement). A further exemption will remain on a transitional basis for certain redeemable preference share dividends until 1 April 1994. From 1 April 1992, non-cash intercompany dividends will become subject to FBT[8] but be exempt from tax to the recipient.[9]

For certain dividends payable on "fixed rate shares",[10] the dividend exemption was removed from Budget night – 30 July. This was done to prevent further tax avoidance through redeemable preference share arrangements. The "grandfather" clause retaining the exemption for certain preference shares was retained until 1 April 1994 because its removal "could cause undue disruption to the financial market".[11] It is a common view that this "grandfather" provision was made to prevent financial distress to certain large companies who are believed to have extensive investments in redeemable preference share investments. In order to be eligible for "grandfathering", the following conditions have to be satisfied:

(1) the dividends are payable by a company which has no exemption from New Zealand income tax;
(2) the shares are not subject to any change in terms under any roll-over provisions, etc.;
(3) the shares were acquired by the taxpayer prior to 30 July 1991 or under a binding contract prior to that date;
(4) the shares are redeemable without High Court approval;
(5) the shares carry a fixed dividend in terms of commercial interest rates;
(6) the shares are not specified preference shares issued under pre-1986 legislation.

An additional transitional provision applies to dividends paid between resident companies with 100 percent common ownership. For these companies the exemption will remain until 1 October 1992. This is designed to tie in with the new consolidation regime discussed later in this article.

The foreign company dividend exemption will also apply to dividends which are deductible to the payer in a foreign jurisdiction. These dividends will be subject to foreign dividend withholding payment ("FDWP") at a rate of 33 percent, which is a withholding tax imposed when foreign-sourced dividends are received by a New Zealand resident company, prior to such dividends being distributed to individual shareholders. Under current domestic law these dividends are assessable to company recipients but in some cases are exempt due to reliefs afforded under certain double taxation agreements.

The changes will have a significant effect in terms of the interest deductibility test under Section 106(1)(h). On a conceptual basis allowing a company an interest deduction for funds borrowed to purchase shares in another company can be inconsistent because a tax deduction is allowed for an expense incurred to earn exempt income. Under New Zealand law such a deduction is allowed if the borrower owns two thirds or more of the shares in the other company.[12] This provision has led to arrangements of interposing subsidiary companies to purchase shares in other companies where the two-thirds test will not be met. Such techniques have been normal in the redeemable preference share arrangements. The removal of the dividend exemption will raise the issue that the general interest deduction test in Section 106(1)(h)(i) and (ia) also applies where interest is incurred by a company to finance the purchase of shares in another company rather than the specific test in Section 106(1)(h)(ii).

B. *Company loss carry-forwards*

The Government has signalled its intention to significantly reduce the ability of companies to carry forward and offset losses, and has introduced legislation to achieve this objective.

Currently companies can offset losses (horizontal offset) between members of a group of companies if there is two-thirds common ownership between the companies concerned. Companies can also carry forward losses to be offset against future years profits provided there is 40 percent continuity of shareholding in the loss company from the beginning of the year in which the loss is incurred to the end of the year when it is offset.

A number of problems have been identified by the Government with these current provisions. The Government believes the existing rules favour companies over individuals. Companies can transfer losses if there is 40 percent continuity of shareholding so that effectively a 60 percent interest in the losses can be transferred while individuals cannot transfer losses at all. A number of loopholes have become apparent which allows companies to easily meet the 40 percent continuity test in a manner not contemplated by the legislature. These loopholes have involved the use of corporate trusts and purchasing of companies with current year losses shortly before the end of the profit company's fiscal year. The current test also allows shareholders who own at least 40 percent of a company to transfer shares between themselves and maintain the 40 percent continuity requirement. The ownership tracing requirements for loss carry-forwards are cumbersome for listed companies, particularly those listed on foreign stock exchanges and for subsidiaries of listed companies.

It has been decided to strengthen the provisions from 1 April 1992 based upon a 66 percent continuity of shareholding test. The test will be based upon the voting power of shareholders in respect of decision-making by the company. Voting power will be defined as the percentage of power to vote in relation to decision-making concerning the:
- distributions to be made by the company;
- constitution of the company;
- variation in the capital of the company;
- appointment or election of directors of the company.

If differing percentages are obtained under the above test, the interest would be determined using an average.

In certain circumstances where a company has options on issue, or if the percentage of assets or income a person is

8. Refer to explanation of FBT on non-cash dividends in earlier discussion on share repurchases.
9. Sec. 63(2B).
10. As defined in Sec. 63(2D).
11. *Taxation Policy: Business Tax Policy 1991, supra* note 1, at 78.
12. Sec. 106(1)(h)(ii).

entitled to exceeds their percentage of voting power, or if certain forms of debentures in the nature of shares are on issue, the interests of shareholders will be determined by reference to the market value of all interests in the company. Special provisions are made for listed companies partially owned by other listed companies, where the interest is less than 50 percent. This will reduce compliance costs for such companies.

These provisions will substantially take effect from 1 April 1992. A number of transitional arrangements will be put in place until that date.

A bill has been introduced into Parliament to effect these changes. A number of submissions from professional bodies such as the New Zealand Society of Accountants have been very critical of these proposals. In particular, the new voting test and market values test are likely to be difficult to administer in practice. Secondly, the new provisions are expected to make it difficult for financially distressed companies to raise additional capital without the benefits of their accumulated tax losses. Given the current recession this may contribute to company failures.

Recent media statements have suggested that the Government is now rethinking the company loss proposals. While some of the changes made to overcome several blatant loopholes are likely to remain, the 66 percent continuity requirement may be changed as well as some of the complex basis for tracing shareholding interests. Legislation may not be finalized until early 1993.

Policy statements issued on Budget night with respect to these changes reveal that the changes are primarily motivated by revenue considerations. Many of the other arguments put forward to justify these changes are weak and do not bear scrutiny. The New Zealand Parliament has for a long time legislated against trafficking in tax loss companies on grounds that tax losses "belong" to the shareholders of those companies at the time the losses were incurred. If this is the case Parliament should be more consistent and allow such shareholders to directly receive the benefit of those losses if they sell their shares in such companies with accumulated tax losses. Arguments that companies are favoured over individuals in respect of losses are not credible when dividend imputation regimes have been adopted based on integrating company and shareholder taxation in respect of profits but not in respect of losses. Also individuals cannot have their tax losses extinguished in the way that companies can on the basis of changes in shareholding.

The changes will not entirely stop company loss trafficking. As with most complex legislation loopholes may be found which defeat the new provisions, although the proposed Sections 187A and 191A giving statements of purpose for the loss carry-forward and offset provisions will make it easier for the Commissioner to apply the general anti-avoidance provision in such situations.[13] The rules still allow tax losses of loss companies to be transferred to profitable companies prior to the transfer of shares. This may be achieved by changes in the basis for inventory valuation or by arranging a transaction deductible to the purchasing company and taxable to the loss company just prior to the sale of the shares.

C. *Consolidation provisions*

Current New Zealand tax laws tax members of company groups individually and allow offsets of net income between group members in certain circumstances. Transfers of assets between members of a group can give rise to taxable transactions as if the transactions were made with unrelated parties. Changes announced with regard to the dividend exemption and further restrictions upon company loss offsets have meant that a more onerous taxing regime applies to company groups.

The Government has decided to partly offset these changes by introducing a company consolidation regime. The regime will allow corporate groups to be treated as one. Intragroup dividends, sales of assets and income flows will be disregarded for income tax purposes. The taxation status of company groups will much more closely reflect consolidation accounts prepared for financial reporting, with the emphasis on economic substance over legal form. Significant compliance costs savings will result as consolidated groups will only have to file one tax return and only have one active imputation credit account. The group will be assessed as a whole.

The consolidation regime will be elective. Companies will be able to consolidate for tax purposes where they have 100 percent common ownership using the new tests proposed for company loss carry-forwards. All group members must be resident in New Zealand for income tax purposes. Consolidation will not be permitted if it is a step in a tax avoidance arrangement. Groups must consist of either all qualifying or non-qualifying companies but not a mixture of both. The consolidation criteria must be met by every member of the group from the beginning to the end of an income year.

When a company group deconsolidates or a company leaves the group, there will be a deemed disposal and reacquisition of any assets transferred between group members.

The new provisions are proposed to come into effect from 1 April 1992. Companies will be able to make the election to consolidate until 1 October with effect backdated until 1 April. Some transitional measures are proposed with respect to the dividend exemption removal. Legislation to enact the regime has yet to be introduced.

It is expected that the consolidation regime will prove attractive for many company groups and will result in significant tax compliance savings. It will assist company groups to restructure their affairs without extra taxation complications.

D. *Dividend imputation credit anti-streaming provisions*

Under the dividend imputation regime introduced in 1988, there are comprehensive provisions to prevent the streaming of imputation credits away from shareholders who cannot use them, such as tax-exempt bodies and non-residents. It has come to the attention of the Government that loopholes existed in these provisions. Reforms have been enacted to strengthen the "stapled stock" anti-avoidance provisions to take into account arrangements involving the use of trusts. Debentures on which interest paid is deemed as a dividend under Sections 192 and 195 will be treated as shares for the purposes of the imputation anti-avoidance rules as well as the dividend stripping rules in Section 99(5). The anti-streaming rules will also apply to arrangements involving the use of bonus issues.

13. The Privy Council has already held in *Challenge Corporation* that the general anti-avoidance provision Sec. 99 can be used to prevent trafficking in tax loss companies. See also A.M.C. Smith, "New Zealand: The Implications of the Commissioner's Statement on Section 99", 45 *Bulletin for International Fiscal Documentation* (February 1991), at 60-66.

The shareholding continuity requirements for imputation accounts of 75 percent have been relaxed to 66 percent to bring them into line with the new loss carry-forward provisions.

E. *Tax recovery*

Under Section 276 of the Income Tax Act, the Commissioner can recover tax payable by a wound up company from any new company set up by the shareholders of the original company. It is designed to prevent companies from avoiding tax liabilities by asset stripping. Tax practitioners had identified that the provision was extremely wide and could have unintended consequences for other companies in a company group situation and for companies involved in the takeover of other companies. Revenue authorities have also found that the provision does not prevent asset stripping as intended. Section 276 will be revised allowing the Commissioner to recover tax owing from directors and shareholders of companies that have entered into arrangements or transactions to deplete the assets of the company so that it cannot meet any tax liabilities. The provision will now apply whether or not those parties also have other equity interests in other companies.

F. *Depreciation*

The Valabh Committee has considered depreciation issues in another paper reviewed in an earlier article.[14] In the Budget the Government has indicated that it "broadly endorses" most of the Committee's recommendations except for the proposal to allow a deduction for losses on the disposal of buildings. It is intended that most of the Committee's recommendations will be enacted and that the Commissioner of Inland Revenue "will commence an immediate and comprehensive review of rates of depreciation in light of the criteria suggested by the Valabh Committee".[15] The extension of depreciation allowances to intangible assets with limited life will also be considered.

Subsequent statements by cabinet ministers have suggested that the review of depreciation rates in most cases is likely to result in an increase in allowable rates. This is likely to assist business taxpayers as for many categories of assets the current tax depreciation rates are low by international standards.

The lack of support for deductibility of losses on the disposal of buildings is inconsistent and simply reflects revenue concerns. For many years buildings were not subject to clawback of depreciation allowances if a building was sold for more than its written-down book value for tax purposes. However, since 1988 such clawbacks are made and therefore a symmetrical treatment is warranted which allows for deductions of losses should a building be sold for less than its book value, as is the case with other types of assets. Given building conditions in New Zealand, particularly with respect to meeting earthquake safety codes, many buildings have a limited life and may be required to be demolished with the owners suffering a real economic loss.

III. INTERNATIONAL TAX REFORMS – BUDGET CHANGES

New Zealand for many years has imposed a non-resident withholding tax on interest payments made to non-residents. This has been at a rate of 15 percent although many double taxation agreements allow for a reduced rate of 10 percent. The tax may be a minimum if the loans are between associated parties.

It has become a common arrangement for foreign lenders to "gross-up" interest rates for the withholding tax and many domestic lenders have found it necessary to enter into arrangements to avoid the imposition of non-resident withholding tax on interest payments. Such avoidance has become extremely widespread by large corporate borrowers and the revenue collected from the withholding tax is relatively low.

It has been decided that from Budget night exemptions will be offered for certain borrowers from the need to deduct withholding tax. Instead a small levy of two percent of the interest paid will be charged for the right to make payments net of withholding tax. This levy will be applied under the Stamp and Cheque Duties Act 1971 and is not subject to relief under any double taxation agreements. If payments of interest are made between associated parties non-resident withholding tax will still be applied.

In order to obtain the exemption, a borrower must apply to the Commissioner for status as an "approved issuer". This will be approved within 20 working days (four weeks) unless the Commissioner believes that the borrower has been responsible for serious default or neglect in complying with his/its tax obligations. Approved issuers will be required to register with the IRD details of the securities which will be paid tax-free to non-residents. Non-payment of the levy will result in the non-tax status of the security being revoked and will revive the liability for non-resident withholding tax.

This provision simply recognizes the reality that non-resident withholding tax has been easily avoided for many years and that such taxes have little place in deregulated capital markets. However, interest payments will still be liable to a two percent levy and this may still give an incentive for borrowers to continue to use existing avoidance arrangements to avoid both the withholding tax and the two percent levy. Interestingly, the well known loopholes for avoiding the withholding tax were not removed in the Budget announcement. This may reflect the belief that a small two percent levy will be willingly paid by borrowers for the greater tax certainty it confers. The imposition of the levy means that there still will be an incentive for borrowers to deduct withholding tax where the lenders are able to obtain full credit for the withholding tax in their home countries. This will help contain any revenue loss from these changes.

IV. INTERNATIONAL TAX REFORMS – DISCUSSION PAPER

A discussion paper was released on Budget night outlining possible options for reform of the international taxing regime. This reflects the need for reform of the current international tax regime as it affects New Zealand residents' international incomes and also the need for reform of the taxing regime for non-residents investing in New Zealand.

A. *Foreign-source income derived by New Zealand residents*

The existing taxing regimes for New Zealand residents were introduced from 1987 and provide for comprehensive taxation of all foreign-source income under a branch equivalent

14. See A.M.C. Smith, "Continuing Tax Reform Programme in New Zealand", 45 *Bulletin for International Fiscal Documentation* (July/August 1991), at 385.
15. *Taxation Policy: Business Tax Policy 1991, supra* note 1, at 72.

regime for foreign companies controlled by New Zealand residents and a foreign investment fund ("FIF") regime for certain passive foreign investments owned by New Zealand residents. Since introduction the regimes have been found to have high compliance costs and other undesirable effects on certain taxpayers.

The current New Zealand branch equivalent regime is extremely comprehensive taxing both passive and active income derived by foreign companies closely controlled by New Zealand residents in all but seven major countries.[16] Such companies have their income attributed to their New Zealand shareholders using New Zealand income determination rules.

Already the regime has been retrospectively deferred for controlled foreign companies outside certain named tax haven jurisdictions pending this review. A number of possible reform options have been highlighted. These include:

(1) permitting a simplified income calculation in New Zealand for the controlled foreign company based on the income returned to foreign revenue authorities;
(2) restricting the application of the regime to companies resident in specified tax havens;
(3) restricting the application of the regime to "passive" income. This would be income which is really New Zealand-source income which has been diverted to another jurisdiction or a close substitute for New Zealand-source income. Earnings from "active" business operations would remain exempt. The United States, Canada and Australia have adopted a similar approach to foreign-sourced income.

The Government in its election manifesto had stated it would consider reform of the regime using options (2) and (3) above.

As yet it is not possible to predict which reforms the Government may adopt. It has stated in making reforms it wishes to balance competing objectives of encouraging New Zealand residents to invest where pre-tax returns are highest, to raise revenue and protect the tax base and minimize compliance/administration costs. Given the tight fiscal situation it is unlikely that any changes will be made that will result in significant revenue losses or give rise to any major tax avoidance opportunities.

The FIF regime applies to interests held by New Zealand residents in foreign investments funds, life insurance policies, unit trusts, superannuation funds and mutual funds, etc. New Zealand interest holders are taxed annually on any unrealized change in the market value of their investments plus any distributions received. This basis is used as a proxy for the income of the FIF. The Government is concerned that the objective of the regime is maintained; otherwise there would be incentives for New Zealand residents to make passive investments offshore or as a way of avoiding the branch equivalent regime for controlled foreign companies.

The regime has given rise to a number of problems. The regime is complex and difficult to follow for many New Zealand investors. Compliance costs are high. Difficulties have arisen using the market value income method where interests in a FIF are not normally traded in market transactions, e.g. life insurance and superannuation funds. The taxing regime does not allow capital gains derived by FIFs to remain non-taxable while capital gains similarly earned directly by investors are not taxed. The FIF regime does not look to the country where the income is earned and does not give credits for tax paid in foreign countries by the investment fund. There is an inherent assumption in the regime that all FIFs are either located in tax havens or are exempt from tax offshore.

The discussion paper lists a number of options for reform. These include:

(1) a revised definition of a FIF;
(2) an exemption for small FIF holdings. This option may give incentives for investors to deliberately spread their FIF holdings into small units and may result in significant revenue loss in aggregate;
(3) a variation in the recognition of income from FIFs including deferral of taxation of any gains until realization. The deferral effect could be compensated by a higher tax rate upon realization;
(4) introduction of a separate taxing regime for foreign super/annuation and life insurance funds. This would overcome the difficulty in obtaining market values for interests in such investment vehicles. One option suggested is for contributors to pay a withholding tax of 33 percent when contributions are made to such funds.

The suggested reforms are disappointing and only address some marginal problems with the whole FIF regime. In particular, the regime may treat migrants to New Zealand harshly where they cannot realize or change their investments easily; for example, with life insurance and superannuation funds.[17] The proposed withholding tax on life insurance/superannuation premiums could be particularly harsh, especially if the policy was already taxed in a foreign jurisdiction. It is likely to be subject to compliance and evasion problems.

Another form of tax which is also under review is the foreign dividend withholding payment regime discussed earlier. The withdrawal of the intercompany dividend exemption from 1 April 1992 suggests that the withholding tax is no longer warranted in most circumstances and therefore partial repeal is warranted. It is expected that the withholding tax will remain for certain foreign-sourced inter-company dividends that remain tax-exempt after 1 April 1992.

B. *New Zealand-source income derived by non-residents*

The taxing regime applying to non-residents investing in New Zealand has not been reviewed as part of the tax reform programme conducted over the past seven years. In many ways the current regime is outdated and is more appropriate for a closed, highly regulated economy which New Zealand had prior to 1985.

The Government has announced that the taxing regime applying to non-residents will be reviewed. As the regime currently applies there is considerable scope for non-residents to avoid New Zealand taxes in respect of New Zealand-source income through transfer pricing arrangements, thin capitalization schemes and other creative forms of financing such as cross border financial leases. Existing provisions to control these types of tax avoidance arrangements are believed to be weak.

The current regime is also discriminatory against non-resident investors. Non-residents cannot take advantage of imputation credits attached to dividends paid by New Zealand

16. These countries are Australia, France, Germany, Japan, the United Kingdom and the United States.

17. For a detailed discussion of the effects of the FIF regime on immigrants to New Zealand, see K. Holmes and K.R. Best, "Impatriate Taxation: New Zealand", *Taxation and Inbound Investment in Pacific Rim Countries* (Amsterdam: IBFD, 1991).

companies. Instead dividends are subject to a further withholding tax which in the case of countries with which New Zealand has not concluded a double taxation agreement ("DTA"), is at a rate of 30 percent. This results in a combined tax rate of 53.1 percent for distributed profits. Even with treaty countries the dividend withholding tax rate is normally 15 percent, resulting in a combined tax rate of 43 percent. Both are substantially higher than the corporate rate of 33 percent.

This problem is particularly acute with Australia. Despite both countries having entered into a free trade agreement, trans-Tasman tax harmonization has not been brought within the scope of the agreement. Both countries have comprehensive dividend imputation provisions but neither country recognizes dividend imputation credits granted in the other country. Thus trans-Tasman dividend flows are subject to double taxation. The New Zealand Government has now placed a high priority on reforming the trans-Tasman tax regime in consultation with the Australian Government. Discussions are to be started soon in the context of further review of the free trade agreement with Australia.

The options for reform of trans-Tasman taxation will mainly centre on recognition in one county of imputation credits attached to dividends from the other country. This may be done by way of a new DTA, a tax provision under the free trade agreement or by reciprocal provisions incorporated into domestic legislation. The existing New Zealand/Australia DTA of 1972 is now outdated and changes are necessary in respect of other matters. A potential difficulty exists with New Zealand's and Australia's obligations under non-discrimination clauses in DTAs entered into with third countries. If New Zealand and Australia extend recognition of dividend imputation credits between each other on a reciprocal basis, this may give rise to pressure from other trading partners such as Japan and the United States to grant similar concessions to their citizens.

Also as part of international tax reforms, the Government has announced a review of bilateral tax agreements. The review is additional to renegotiation of the DTA between Australia and New Zealand. The objective of the review is to ensure the existing DTAs are "in line with current taxation and economic policy and are contributing to New Zealand's economic growth".[18] This will be done within a framework of identifying problems with particular agreements and possible solutions. The "highest priority will be given to the DTAs with New Zealand's major trading and investment partners".

Many of New Zealand's DTAs follow the OECD model. DTAs tend to shift the allocation of taxes between countries rather than impose extra taxes, particularly in respect of dividend and income flows. As New Zealand is a net capital importer, the effect of most existing DTAs is to shift revenue from the New Zealand Government to foreign governments rather than increase the overall burden of taxes for foreign investors.

It is now known what factors are motivating the desire to review and renegotiate existing DTAs. Several existing DTAs include "tax sparing" clauses where New Zealand has agreed to recognize tax incentives given to New Zealand residents by foreign countries. Given the removal of most tax incentives in New Zealand it is inappropriate that New Zealand continue to recognize foreign ones.

Any future DTA negotiations will be based upon a careful assessment of the following factors:

(1) identification of the problems the DTA will overcome;
(2) the manner in which the DTA will correct these problems;
(3) the fiscal cost of the DTA;
(4) the potential risks to the New Zealand tax base of a DTA;
(5) the benefits to New Zealand as a whole from a DTA;
(6) alternative solutions to the problems the DTA is attempting to solve and the costs/benefits of those alternatives.

It is unfortunate that the desire to solve trans-Tasman taxation issues, particularly with respect to dividend imputation, does not appear as strong for other countries. This is likely to reflect revenue concerns particularly, given New Zealand is a capital importer. The Government is unlikely to agree to unilateral extension of imputation credits to non-residents or even removing the dividend withholding tax, as such moves are unlikely to be matched reciprocally by other DTA countries. Such unilateral relief would cost substantial revenue to New Zealand but New Zealand resident investors would not enjoy similar relief in respect of their foreign investments. It is known that some Government advisers favour extension of dividend imputation credits on a reciprocal bilateral basis but even this option will have revenue costs.

However, it must be clearly recognized that the current taxation regime is unacceptable particularly for investors from non-DTA countries. Investors from those countries would be well advised to consider reducing their exposure to New Zealand tax when investing in New Zealand possibly through the use of careful transfer pricing or thin capitalization arrangements.[19] The latter option may be more attractive given that inter-company dividends are now assessable in New Zealand and that dividends from New Zealand investments can be readily converted into interest through a local wholly-owned subsidiary of a foreign company.

V. CONCLUSION

The Budget announcements represent a three-pronged strategy of aggressive suppression of tax avoidance opportunities to protect the revenue base and reduce the deficit, reform of the existing international tax regime as it affects New Zealand residents and lastly reform of the taxing regime as it affects non-resident investors. It appears that with the openness of the New Zealand economy and the critical need for foreign investment, the Government has at least recognized that the New Zealand tax system is unattractive for foreign investors. Unfortunately, the Government has given a high priority to elimination of the fiscal deficit within three years in order to reduce interest and exchange rates and this objective will ultimately temper any reforms made. It is therefore likely that reforms of the international taxing regime will not be as comprehensive as they should be because of revenue considerations. It is essential that substantial changes be made to the tax law as it affects foreign investment both from Australia and elsewhere.

18. *Taxing Income Across International Borders: A Policy Framework, supra* note 1, at 35.
19. It must be noted that Sec. 22 can be applied by the Commissioner to counter tax avoidance through transfer pricing arrangements.

TAXATION AND INVESTMENT IN THE PHILIPPINES

Tax Division, SGV & Co., Philippines

a member firm of Arthur Andersen Worldwide Organization

I. DIRECT TAXES

A. *General*

The national government is the chief taxing authority in the Philippines. With respect to local taxes, the new Local Government Code, signed into law in October 1991, authorizes provinces, cities, municipalities and barrios the power to create their own sources of revenue and to levy taxes, fees and other charges.

B. *Corporation income tax*

Domestic corporations, including joint ventures and partnerships, whether or not registered,[1] are taxed on their annual net taxable income from worldwide sources at the rate of 35 percent. However, a joint venture or consortium formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal and other energy operations is not considered a corporation. Hence, the joint venture partners are taxed separately on their income from the project.

Foreign corporations are taxed only on their Philippine-source income. A non-resident corporation (i.e. one not engaged in a trade or business in the Philippines) is generally subject to a flat rate of tax on gross income, with no deductions allowed. Interest income on foreign loans earned by a non-resident foreign corporation is subject to a 20 percent tax. Non-resident foreign cinematographic film owners, lessors or distributors are taxed at the rate of 25 percent on gross income. Foreign international carriers pay a tax rate of 2.5 percent of their gross Philippine billings. Rentals, leases and charter fees payable to non-resident owners of vessels chartered by Philippine nationals are subject to a 4.5 percent final withholding tax. Reinsurance premiums from Philippine sources received by a non-resident foreign corporation are expressly exempted from income tax.

Rentals, charters and other fees payable to non-resident lessors of aircraft, machinery and other equipment are subject to a final withholding tax of not less than four percent but not more than ten percent, to be fixed and determined by the President upon the recommendation of the Secretary of Finance. However, a rate of 7.5 percent is imposed on these rentals, charters and fees until the President has prescribed the rate appropriate for each category of property.

A resident foreign corporation is taxed in the same manner and at the same rate as a domestic corporation. In addition, the after-tax profits remitted by a Philippine branch of a resident foreign corporation to its head office abroad are subject to a tax of 15 percent (unless the resident foreign corporation is registered with the Export Processing Zone Authority). However, profits remitted by a branch office engaged in petroleum operations in the Philippines are subject to only a 7.5 percent rate. Fixed or determinable annual periodic gains, profits and income are not considered branch profits unless they are effectively connected with the conduct of the branch's trade or business in the Philippines. The profit remittance tax rate may be further reduced by tax treaties.

Income from sources within the Philippines includes:
- interest derived from a borrower residing in the Philippines;
- dividends from domestic and, in certain cases, foreign corporations;
- compensation for services rendered in the Philippines;
- gains, profits and income from the sale of real property in the Philippines; and
- rent and royalties from property located in the Philippines, including rent and royalties for the use in the Philippines of patents, copyrights, secret processes and formulae, goodwill, trademarks, trade names, trade brands, franchises and similar properties.

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- I. Build-Operate-Transfer Scheme

1. Except general professional partnerships and joint ventures formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal and other energy operations pursuant to an operating or consortium agreement under a service contract with the government.

Royalties taxable in the Philippines include technical services provided to resident corporations. The Tax Code explicitly enumerates services which, even if rendered abroad, generate Philippine-source income. The Tax Code also provides that gains from the sale of shares of stock in a domestic corporation will be treated as Philippine-source income regardless of where the shares are sold.

Corporations follow a quarterly system of filing income tax returns. Every corporation must file in duplicate and on a cumulative basis a quarterly summary declaration of its gross income and deductions for the preceding quarter or quarters. Income tax is levied, collected and paid on the basis of this declaration. The tax so computed is decreased by the amount of tax previously paid or assessed during the preceding quarters. This tax must be paid no later than 60 days after the close of each of the first three quarters of the taxable year, whether a calendar year or a fiscal year.

On or before 15 April, or on or before the 15th day of the fourth month following the close of the fiscal year, corporations are required to file an adjustment return covering the total net taxable income of the preceding calendar or fiscal year. If the sum of the quarterly tax payments made is not equal to the total tax due on the entire net taxable income of the year, the corporation must either pay the excess tax still due or seek a refund of the excess amount paid. In the latter case, the refundable amount shown in the corporation's final and adjustment return may be credited to the estimated quarterly income tax liabilities for the taxable quarters of the succeeding taxable year.

Branches vs. subsidiaries
Before doing business in the Philippines, a foreign corporation must compare the advantages and disadvantages of setting up a branch or a subsidiary.

A branch is taxed only on its Philippine-source income. A subsidiary is taxable on its worldwide income, although the effects of international double taxation can be mitigated through the foreign tax credit.

After-tax profits remitted by a branch to its head office are taxed at a rate of 15 percent. However, net after-tax earnings remitted as dividends by a subsidiary to its parent are taxed at 35 percent, although this rate may be reduced to 15 percent in certain circumstances.

For purposes of computing a branch's net taxable income, the head office can allocate to the branch a ratable part of un-allocable expenses, interest payments, losses and other deductible items that are effectively connected with a trade or business conducted exclusively in the Philippines. The parent company cannot allocate part of its overhead expenses to its subsidiary although some form of expense sharing can be effected through a technical service agreement.

If the foreign operations in the Philippines are expected to be profitable and there are plans to reinvest the profits in the business, it is usually more advantageous to establish a subsidiary because dividends are taxable only as and when declared to a parent. In the case of a branch, the opportunity for capital accumulation without the incident tax burdens may not be as readily available as it would be in the case of subsidiaries.

Generally, the financial results of the branch's operations are combined with those of the head office in a consolidated income tax return, on the basis of which the head office computes its income tax liability to its home country.

Another advantage of a subsidiary arrangement is the subsidiary's separate juridical personality. A foreign parent company is insulated from contractual and other liabilities incurred by its Philippine subsidiary. The liabilities of a branch, on the other hand, are deemed to be those of the home office.

A branch must deposit with the Securities and Exchange Commission government securities worth ₱ 100,000 after the issuance of its licence, and additional securities worth two percent of its gross income in excess of ₱ 5 million after each fiscal year. No such requirement is imposed on a subsidiary. The absence of such a requirement is another advantage of a subsidiary operation over a branch, particularly if the Philippine operation becomes profitable.

C. *Individual income tax*

In taxable year 1982, a modified system of gross income taxation took effect for individual taxpayers. Under this system, individual income is classified as compensation income, business income or passive income.

Compensation income and business income are subject to graduated tax rates ranging from 1 to 35 percent.

In general, gross compensation income includes all income from employment. Payments made by a general professional partnership to a partner for services rendered do not fall in this category but are considered business income of each individual partner. Business income includes all gains, profits and income of whatever kind and in whatever form, derived from any source not included in the classification of compensation income and passive income. Passive income includes dividends, interest, royalties and prizes. Passive income is subject to final withholding tax at varying rates.

There is a pending bill which proposes to adopt a simplified net income taxation scheme for self-employed individuals engaged in business, and professionals engaged in the practice of their profession. Under this proposed bill, self-employed individuals and professionals will be taxed based on four income tax brackets with tax rates ranging from 4 to 30 percent. The 30 percent rate will be imposed on a net income of over ₱ 250,000. The proposal also seeks to limit the type of deductions that can be claimed by these taxpayers.

Individual citizens and resident aliens are taxed on their worldwide income; non-resident aliens are taxed only on Philippine-source income.

Individual taxpayers are entitled to personal exemptions: ₱ 6,000 for single individuals, ₱ 7,500 for heads of households, ₱ 12,000 for married persons and ₱ 3,000 for each dependent up to four children.[2] Individuals deriving purely compensation income are not entitled to any deduction from their gross earnings other than the allowable exemptions. However, individuals deriving business income may deduct necessary business expenses or losses; donations and contributions (up to six percent of taxable income); taxes (excluding income, estate and gift taxes) paid or accrued in connection with a trade or business; and capital losses to the extent of capital gains. In lieu of these itemized deductions, taxpayers may elect a standard deduction in an amount not exceeding ten percent of gross income.

2. There is a pending bill proposing to increase the personal and additional exemptions of individual taxpayers. The proposed amounts are: ₱ 9,000 for single individuals, ₱ 12,000 for head of a family and ₱ 18,000 for married individuals.

A married couple may elect to compute individual income tax separately based on their respective total taxable income. Husbands and wives electing to compute their income tax separately are entitled to a personal exemption of ₱ 6,000 each. The additional exemption for each dependent may be claimed by only one of the spouses and the total amount of additional exemptions that may be claimed by only one of the spouses, and the total amount of additional exemptions that may be claimed by both, may not exceed the maximum allowable additional exemptions.

Filipino citizens who have been living abroad and who intend to remain abroad are taxed at graduated rates based on their gross income from non-Philippine sources after the following have been deducted: (a) a personal exemption allowance equal to US$ 2,000 if single or if married but legally separated, or US$ 4,000 if married or head of the family; and (b) the income tax paid to the foreign country in which they reside.

Non-resident alien individuals engaged in a trade or business in the Philippines are taxed at the same rates as citizens and resident aliens on their Philippine-source income. Dividends, shares in the net profits of a partnership (taxed like a corporation), interest, royalties and prizes and other winnings, however, are subject to a final withholding tax of 30 percent. Non-resident aliens not engaged in business are subject to a flat rate of 30 percent on all types of Philippine-source income. A non-resident alien is deemed to be engaged in a trade or business in the Philippines if he stays in the Philippines for an aggregate period of more than 180 days during any calendar year. If he stays for 180 days or less, he is not considered engaged in a trade or business in the Philippines.

1. Foreign tax credit

A citizen or a domestic corporation can elect to take a credit or a deduction for any income, war profits or excess profit taxes paid or accrued during the taxable year to any foreign country. A resident alien is entitled to a foreign tax credit if the country of which he is a citizen or subject grants similar rights to Filipino citizens.

The taxpayer must indicate in his income tax return his desire to claim a foreign tax credit; otherwise he will be deemed to have elected the foreign tax deduction. However, the taxpayer must show that he is entitled to a foreign tax credit before being permitted a foreign tax deduction.

The amount of the foreign tax credit is subject to two limitations, based on the taxpayer's taxable income from foreign sources. The limitations may be expressed as follows:

$$\frac{\text{tax credit}}{\text{total Philippine tax liability}} \text{ may not exceed either } \frac{\text{net taxable income within the foreign country}}{\text{net taxable income from all sources}} \text{ or } \frac{\text{net taxable income from all non-Philippine sources}}{\text{net taxable income from all sources}}$$

2. Withholding of income tax

(a) Withholding tax on employees

The tax withheld from gross compensation income ranges from 1 to 35 percent depending on the taxpayer's status and number of dependents. Taxes withheld from an employee with more than one employer work out as creditable taxes which are applied to the employee's final income tax liability. However, withholding tax becomes a final tax for the following types of employees deriving compensation income from only one employer: single or married but legally separated, head of a family and married with only one spouse receiving compensation income from the same employer.

(b) Withholding tax on residents other than employees

A creditable withholding tax is imposed on income payments to certain professionals (10 or 5 percent in case of payments to juridical entities other than general professional partnerships), income payments to contractors (1 percent) and rentals (5 percent).

Income payments to partners in a general professional partnership are subject to a creditable withholding tax of 15 percent, except in respect of partners who are non-resident aliens, whether or not engaged in trade or business in the Philippines whose income payments are subject to a final withholding tax of 30 percent.

All sales, exchanges or transfers by individuals of real property classified as ordinary assets, and by corporations, of real property, whether classified as ordinary or capital assets, are subject to the following creditable withholding tax based on gross selling price to be withheld by the buyer:
- 2.5 percent if the vendor is habitually engaged in the real estate business certified as such by the Chamber of Real Estate Buildings Association, and is registered with the Housing and Urban Development Coordinating Council ("HUDCC");
- 5 percent if the vendor is not habitually engaged in the real estate business; and
- zero percent if the vendor is certified as engaged in low-cost housing projects by the HUDCC and the consideration for each transaction does not exceed ₱ 500,000.

Dividends received by a domestic or resident foreign corporation or by resident individuals from a domestic corporation liable for the payment of any internal revenue tax are no longer subject to tax. Royalties, prizes and other winnings received by resident individuals are subject to a final withholding tax of 20 percent.

Every bank or banking institution must deduct and withhold from the interest on peso savings and time deposits and on yields from deposit substitutes (except interest paid or credited to non-resident alien individuals and foreign corporations) a final tax equal to 20 percent of the interest or yield. Deposit substitutes are alternative forms of obtaining funds from the public (other than deposits) through the issuance, endorsement or acceptance of debt instruments for the purpose of relending or purchasing receivables and other obligations or financing the borrower's own needs or the needs of his agent or dealer. Such instruments include banker's acceptances, promissory notes, repurchase agreements, certificates of assignment or participation and similar instruments with recourse as may be authorized by the Central Bank of the Philippines for banks and non-bank financial intermediaries or by the Securities and Exchange Commission of the Philippines for commercial, industrial, and finance companies and for other non-financial companies.

(c) Withholding tax on non-residents

To ensure that the income tax payable by non-resident alien individuals and foreign corporations not engaged in a trade or business in the Philippines is collected, income tax is generally withheld at source by whoever has control over the payment of the income. The withholding tax rates applied to the actual tax computed in the tax return are fixed at 30 percent for individuals and 35 percent for corporations. Interest income on foreign loans extended by non-resident foreign corporations is subject to a 20 percent final withholding tax.

Dividends received by a non-resident foreign corporation from a domestic corporation subject to income tax are subject to a 15 percent withholding tax if the country of domicile of the foreign corporation permits as credits to the foreign taxes due from such corporation Philippine taxes deemed to have been paid in the Philippines equivalent to the rebate of 20 percent. Examples include dividends remitted to a country with whom the Philippines has a tax treaty with a "tax-sparing" provision. The same 15 percent rebate applies to Philippine dividends received by a foreign corporation domiciled in a foreign country whose tax law does not impose any tax on foreign-source dividends.

All remittances of interest, dividends, rents, royalties, premiums, compensation, remuneration for technical services or other fixed or determinable annual, periodic or casual gains and income, including capital gains, derived from sources within the Philippines, are subject to withholding tax on the gross amount thereof.

D. *Other taxes*

1. Overseas communications tax

A tax of 10 percent is imposed on the amount paid for communication transmitted from the Philippines. This is payable by the person paying for the services rendered.

2. Capital gains from the sale of shares

Individuals and corporations that derive net capital gains from the sale or exchange of shares of stock in any domestic corporation are taxed at 10 percent if the amount of gain is ₱ 100,000 or less and 20 percent if the amount is more than ₱ 100,000. However, individuals and corporations that sell shares of stock listed and traded through a local stock exchange are taxed at one fourth of 1 percent of the gross selling price of the shares of stock sold.

3. Capital gains from sale of real property

A final capital gains tax of 5 percent is imposed on the amount realized from the sale of real property by individuals. "Amount realized" refers to any money received, excluding interest on payments for instalment sales, plus the fair market value of the property other than money received by the seller.

4. Export tax

An export tax is levied on the export of logs. The export tax rate, as imposed by the Tariff and Customs Code, is 20 percent of the gross F.O.B. value at the time of shipment, based on the prevailing rate of exchange.

5. Local taxes

The new Local Government Code delineates the powers of the provinces, municipalities, cities and barrios and limits these powers to ensure uniformity in local taxation. The basic policy of the new Code is to enable the local government units to enjoy genuine and meaningful local autonomy in order to attain their fullest development as self-reliant communities. Thus, they are given the power to create and broaden their own sources of revenue.

6. Real property tax

The imposition of real property taxes will be governed by the new Local Government Code. Under the new Code, the rates cannot exceed 1 percent of the assessed value of the real property in the case of a city or municipality within the Metropolitan Manila area. The assessed value is the fair market value ("FMV") of the real property multiplied by the assessment level. The assessment level is the percentage applied to the FMV to determine the taxable value of the property. The assessment levels depend on the nature of the property and/or improvement: commercial, industrial, residential, agricultural.

For commercial, industrial or mineral land, the assessment level is generally 50 percent of the FMV; for agricultural land and timber and forest land, 40 percent; and for residential land, 30 percent. The assessments for all improvements are based on the current assessment levels. However, these levels cannot be lower than those prescribed for land or more than 80 percent of the FMV, except in the case of residential houses, where the levels range from 15 to 80 percent of the FMV.

The assessed value of land and buildings used exclusively for educational, cultural or scientific purposes and of the improvements thereon is 15 percent of the FMV. For land and improvements used for recreational purposes, the assessed value is also 15 percent of the market value. Included among the properties used for recreational purposes are properties owned by sports or athletic clubs not operated primarily for profit.

A uniform annual tax of 1 percent of the assessed value of real property is levied in addition to the regular (basic) real property tax.

7. Travel tax

Travel tax is levied on citizens of the Philippines, permanent resident aliens and non-immigrant aliens who have been in the Philippines for more than one year. The rates of travel taxes are expressed in U.S. dollars, and range from US$ 120 to US$ 200.

E. *Double taxation agreements*

Double tax treaties with the following countries have been ratified and are currently in force: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Indonesia, Italy, Japan, Korea, Malaysia, the Netherlands, New Zealand, Pakistan, Singapore, Sweden, Thailand, the United Kingdom and the United States.

II. INDIRECT TAXES

A. *Indirect tax structure*

There are currently four major indirect taxes in the Philippines: the excise tax, the value added tax, the percentage tax on other businesses and the documentary stamp tax.

B. *Excise tax*

There are two kinds of excise taxes: specific and ad valorem. The specific tax is based on weight, volume capacity or any other physical unit of measurement. The ad valorem tax is based on selling price or any other specified value of the article.

Excise taxes are applied to articles manufactured or produced in the Philippines for domestic sale, consumption or any other manner of disposition, as well as to imported articles. In the latter case, excise taxes are applied in addition to any customs duties. When articles locally-produced or manufactured are removed and actually exported without being returned to the Philippines, whether they are exported in their original state or as ingredients or parts of any manufactured articles or products, any excise tax paid for them may be credited or refunded upon submission of proof of actual exportation and upon receipt of the corresponding foreign exchange.

Articles subject to excise tax include distilled spirits, wines, fermented liquor, tobacco products and cigarettes, manufactured oils and other fuels, fireworks, cinematographic films, saccharine, automobiles, non-essential goods (e.g. jewellery, perfumes and toilet water, yachts and other vessels intended for pleasure or sports) and mineral products, including coal and indigenous petroleum. The excise tax on compounding liquors, matches and video tapes has been abolished.

C. *Value added tax ("VAT")*

The VAT system, which was introduced by Executive Order No. 273, took effect on 1 January 1988. In general, the VAT applies to all persons engaged in the business of selling goods and services in the Philippines. Enterprises with annual gross sales or receipts not exceeding ₱ 200,000 are not subject to VAT but they may elect to be covered by the VAT.[3]

1. VAT on the sale of goods

VAT at the rate of 10 percent is imposed on the sale of goods. The tax base is the gross selling price or value in money of the goods sold or exchanged, including the following:
- charges for packaging, delivery and insurance if separately billed; and
- excise taxes if the goods are subject to excise tax.

If the gross selling price in the invoice is unreasonably lower than market value, the latter is the VAT base. The selling price is considered unreasonably lower if it is more than 30 percent lower than the market value of the same goods of the same quantity sold in the immediate locality.

2. VAT on services

The VAT base for services is the gross receipt which includes not only cash but also constructive receipt of payments. The term "gross receipt" refers to the total amount of money or its equivalent representing the contract price, compensation or service fee. It includes the amount charged for materials supplied with the services and deposits or advance payments actually or constructively received during the taxable quarter for the services rendered or to be rendered for another person. It excludes the VAT.

3. VAT on importation

The 10 percent VAT is also imposed on the importation of goods for resale or for use. The VAT is based on the total value used by the Bureau of Customs in determining tariff and customs duties plus duties, excise taxes, if any, and other charges. Other charges refer to charges on imported goods prior to release from customs custody. These include postage, insurance, commissions and similar charges. If the duties are determined on the basis of volume or quantity, the base is the landed cost (duties, freight, insurance and other charges).

4. Manner of billing the VAT

A VAT taxpayer may bill the VAT to the buyer of his goods or services. The VAT need not be billed separately in the invoice. If the VAT is not billed separately, or is billed separately but erroneously, the total invoice amount must be multiplied by $^1/_{11}$ to arrive at the output tax.

5. Tax credits

Under the VAT system, the following items constitute creditable input taxes:

(a) *VAT paid on the purchase or importation of goods*
- for sale or conversion or incorporation into a finished article for subsequent sale or for use in the course of business;
- for use as materials in the sale of services;
- for use in a trade or business for which a depreciation allowance is allowed (capital goods).

(b) *Zero-rated and exempt transactions*
A zero-rated sale is a taxable transaction for VAT purposes. A sale of goods and/or services taxed at a zero rate does not result in any VAT liability but the input tax on such a sale is available as a tax credit to a VAT-registered person.

An exemption, however, means that the sale of the goods or services is not subject to VAT (output tax) but the seller is not allowed any tax credit on VAT previously paid (input tax). The person making an exempt sale of goods or services is not allowed to separately bill any output tax to his customers because the transaction is not subject to VAT.

The purchaser of goods or services which are exempt from VAT is not entitled to any input tax on such purchases.

A taxpayer with zero-rated sales of goods and services can opt for a tax credit to be applied against any internal revenue tax liability he has or for a refund of the input tax he paid corresponding to the zero-rated sales.

Zero-rated sales of goods consist of:
- Export sales made by a VAT-registered person. Such sales include foreign currency-denominated sales or sales to non-residents of goods manufactured in the Philippines for delivery to residents and paid for in foreign currency remitted to the Philippines.
- Sales to persons or entities whose exemptions are effectively zero-rated under special laws or international agreements.[4]

Zero-rated sales of services consist of:
- Processing, manufacturing and repacking services for persons doing business outside the Philippines where the finished goods are exported and the fee is paid for in foreign currency remitted to the Philippines.
- Services for persons that are effectively zero-rated under special laws or treaties.
- Services performed in the Philippines which are paid in foreign currency remitted to the Philippines.

Exempt transactions include:
- The sale of non-food agricultural, marine and forest products in their original state only if sold by the producer or the owner of the land where such products are produced. In the hands of a subsequent seller, the sale is subject to VAT.
- The sale or importation of agricultural and marine food products at all stages of production when the products are sold in their original state.
- Medical, dental, hospital and veterinary services.
- Fertilizers; pesticides and herbicides; chemicals for the formulation of pesticides; seeds, seedlings and finger-

3. These enterprises will be subject to a 2 percent tax base on their gross receipts.
4. This refers to exemptions granted under special laws and treaties which are extended to the grantee and supplier of goods. An example is sales to U.S. military bases, where the exemption of the grantee extends to the seller.

lings; fish, animal, and poultry feeds; some bean and fish meals.
- The sale of books, although sales of magazines, newspapers or bulletins are exempt only if they appear at regular intervals with fixed prices for subscriptions and sale and are not devoted principally to advertisements.
- Export sales by persons exempt from registering under VAT or by persons required to register under VAT but who fail to register.

D. *Percentage tax*

The following service establishments are subject to percentage tax:
- operators of hotels, motels and similar establishments;
- caterers;
- carriers and operators of garages;
- dealers in securities and lending investors;
- franchise holders;
- transmissions originating from the Philippines by telephone, telegraph, telemeter exchange, wireless and other communication equipment services on overseas dispatch, message or conversation;
- banks and non-bank financial intermediaries;
- finance companies;
- insurance companies;
- agents of foreign insurance companies;
- proprietors, lessors or operators of establishments subject to amusement tax;
- winnings from horse races or Jai-alai games.

In addition, a seller of goods or services whose gross annual sales or receipts do not exceed ₱ 200,000 is subject to a percentage tax of 2 percent of gross sales or receipts.

Taxpayers subject to percentage tax are not subject to VAT.

E. *Documentary stamp tax*

Documentary stamps must be affixed to certain instruments used in business transactions, i.e. bank checks, bonds, debentures, certificates of stock, deeds of sale, promissory notes, etc.

Documentary stamp taxes are also collected on bills of lading, acceptances, drafts and other bills of exchange, insurance policies, warehouse and hotel receipts, mortgages and deeds of trust, powers of attorney and other documents. Additional documentary stamp taxes are imposed on the registration of privately owned passenger automobiles, motorcycles, scooters and jeeps.

III. INVESTMENT

A. *General*

The new Foreign Investments Act of 1991 ("the Act") governs foreign investments with incentives. It is the basic law that outlines the conditions, activities and procedures where foreign enterprises may invest and do business in the Philippines. It establishes the restricted areas, and declares all other areas as open to unlimited foreign equity participation. In brief, the restricted areas are those reserved to Philippine nationals by the Philippine Constitution and special laws; those activities affecting public health and morals; those that are defence-related; small and medium-sized domestic market enterprises with a paid-in capital of less than US$ 500,000; export enterprises which use raw materials from natural resources with a paid-in capital of less than US$ 500,000; and those activities that are already served by existing enterprises.

B. *Qualifications of a registered enterprise*

In addition to providing basic guarantees to all investors, the Act provides a comprehensive scheme of benefits for certain enterprises in high-priority areas of economic activity.

All investors and enterprises, including export zone enterprises, are entitled to basic constitutional rights and guarantees, including freedom from expropriation without just compensation, the right to remit earnings on investments and the right to repatriate investments in the currency in which the investments were originally made. The remittance of foreign exchange to meet payments of interest and principal on foreign loans arising from technological assistance contracts is also assured.

The Act grants preferential tax and other benefits to registered enterprises in preferred areas. Preferred areas of investment are those sectors of the economy that are crucial to the nation's development. The Investments Priorities Plan ("IPP"), prepared annually by the Board of Investments ("BOI"), is a list of the preferred areas, classified according to preferred pioneer and preferred non-pioneer activities. Both import-substitution and export industries are listed as high priority in the IPP. Labour-intensive industries and industries that increase the value of agricultural, mining and timber products for export are also emphasized.

A preferred pioneer area is one which, in addition to being important to national economic development, involves the manufacture or production of commodities of raw materials that are not produced on a commercial scale in the Philippines, or one that uses a new design, formula or process for producing or transforming raw materials into finished products.

For each preferred area of activity that produces goods mainly for the domestic market, the BOI establishes a measured capacity, which is the difference between annual demand and annual production capacities of existing producers. When a sufficient number of firms have been registered to fill the industry's measured capacity, that industry is removed from the preferred list. If the measured capacity in any non-pioneer area is not filled by Filipinos within three years after the area has been listed in the IPP, the area is opened to full ownership by foreign nationals, subject to constitutional and statutory limitations.

The nationality requirements for registration for incentives with the BOI differ according to the classification of the area in which the enterprise's proposed project will lie, i.e. pioneer or non-pioneer. Basically, an applicant for registration under the IPP must be a citizen of the Philippines in the case of a natural person. In the case of a partnership or any other association, the applicant must be organized under Philippine law with at least 60 percent of its capital owned and controlled by Philippine citizens. In the case of a corporation or a cooperative, it must be organized under Philippine law with at least 60 percent of its capital stock outstanding and voting shares owned and held by Philippine nationals. Further, at least 60 percent of the board of directors must be Filipino citizens.

A 100 percent foreign-owned enterprise may also apply for registration under the IPP provided it engages in a pioneer project or exports at least 70 percent of its total production. These enterprises are required to attain the status of a Philippine national within 30 years or within a longer period as prescribed by the BOI. Registered enterprises, whether pioneer or non-pioneer, that export 100 percent of their total production, are not covered by this requirement without prejudice to minimal local sales authorized by the BOI to meet domestic shortages. In addition, the area in which the foreign corporation operates must not be one reserved by the Constitution or other laws to Filipinos.

C. *Fiscal incentives*

Enterprises registered with the BOI are entitled to a number of incentives.

1. Income tax holiday

Newly registered firms will be fully exempt from income taxes for six years from the date of commercial operation for pioneer firms, and four years for non-pioneer firms. This can be extended for an additional year in the following cases:

- the project uses indigenous raw materials;
- the project meets the prescribed ratio of capital equipment to number of workers set by the BOI;
- the net foreign exchange savings or earnings amount to at least US$ 500,000 annually during the first three years of operation.

Expanding firms will be entitled to an exemption from income taxes proportionate to their expansion for a period of three years from the date commercial operation commences. They are, however, not entitled to additional deductions for incremental labour expenses during the period within which this incentive is availed of.

2. Additional deduction for labour expenses

For the first five years from registration, a registered enterprise is allowed an additional deduction from taxable income of 50 percent of the wages corresponding to the incremental direct labour for the number of skilled and unskilled workers, if the project meets the prescribed ratio of capital equipment to number of workers set by the BOI.

3. Tax and duty-free importation of capital equipment

Importation of machinery, equipment and accompanying spare parts of new and expanding registered enterprises will be exempt to the extent of 100 percent of the customs duties and national internal revenue taxes. This incentive may be availed of within five years from the effective date of the Act, or until 12 August 1992.

4. Tax credit on domestic capital equipment

A tax credit equivalent to 100 percent of the national internal revenue taxes and customs duties that would have been waived on the machinery, equipment and spare parts, had these items been imported by the registered enterprise which purchases such capital equipment from a domestic manufacturer, is also available. This incentive may be availed of within five years from the effective date of the Act, or until 12 August 1992.

5. Contractor's tax

Registered enterprises are exempt from the contractor's tax, whether national or local.

6. Tax credit on domestic breeding stocks and genetic materials

Within ten years from the date of registration or commercial operation, such enterprises are entitled to a tax credit equivalent to 100 percent of the value of the national internal revenue taxes and customs duties that would have been waived on the breeding stocks and genetic materials had these items been imported by the registered enterprise which purchases the breeding stocks and genetic materials from a domestic producer.

7. Other

- Exemption from all taxes and duties on the importation of breeding stock and genetic materials within ten years from the date of registration or commercial operation of the enterprise.
- Tax credit for taxes and duties on raw materials used in the manufacture, processing or production of its export products and forming parts thereof.
- Access to the bonded manufacturing/trading warehouse system.
- Exemption from taxes and duties on imported supplies and spare parts for consigned equipment.
- Exemption from the wharfage dues and any export tax, duty, impost and fee.

D. *Non-fiscal incentives*

1. Simplification of customs procedures

Customs procedures for the importation of equipment, spare parts, raw materials and supplies and the export of processed products are simplified.

2. Unrestricted use of consignment equipment

There will be no restriction on the use of consigned equipment provided a re-export bond is posted, unless the equipment and spare parts are imported tax and duty free.

3. Employment of foreign nationals

The employment of foreign nationals in supervisory, technical or advisory positions for five years from registration, which may be extended for limited periods, is allowed. The president, general manager and treasurer or their equivalents of foreign-owned registered firms will not be subject to the foregoing limitations.

E. *Additional incentives*

In addition to the above incentives, the following will also be available to enterprises locating their operations in less developed areas:

- Less-developed-area enterprises will be automatically entitled to pioneer incentives regardless of nationality.
- 100 percent of the cost of the construction of necessary and major infrastructures and public facilities can be deducted from taxable income. If the total amount cannot be deducted in one year, deductions may be carried over to subsequent years until the total amount has been deducted.
- The rate of incentive for additional deduction for labour expenses will be doubled for enterprises located in less developed areas.

1. EPZA-registered firms

A foreign corporation may also register with the Export Processing Zone Authority ("EPZA") and locate its facility in any of the country's export zones. Four zones are currently in operation: Bataan, Mactan, Baguio and Cavite.

Firms registered with the EPZA are entitled to all of the incentives given to firms registered with the BOI. In addition, they will also be entitled to the following:
- special tax treatment of merchandise within the zone;
- exemption from local taxes (except real estate tax) and licences; and
- exemption from real estate taxes on production equipment and machinery not attached to real estate.

2. Phividec-registered firms

Foreigners may also choose to locate in the 3,000 hectare Phividec Industrial Estate in Misamis Oriental operated by the Philippine Veterans Investment Development Corporation ("PHIVIDEC").

Firms registered with the Phividec Industrial Authority are entitled to the following major incentives:
- exemption from customs duties and internal revenue taxes on imported capital equipment, raw materials and supplies used in the production and storage of goods for export;
- admission of fully owned foreign enterprises in selected industries;
- tax holiday for the first three years of operation;
- exemption from wharfage dues if the construction of a pier or wharf is funded by the importer; and
- employment of foreign nationals for technical and management levels.

3. Regional or area headquarters' incentives

Multinational companies establishing regional or area headquarters in the Philippines may be licensed to supervise their own affiliates, subsidiaries or branches in the Asia-Pacific region. These regional or area headquarters and their expatriate executives will be entitled to a number of incentives.

(a) *Expatriates*
- multiple entry visa valid for one year and renewable annually provided that the foreign expatriate receives a salary of at least US$ 12,000 per annum;
- withholding tax of 15 percent on gross income received from the regional or area headquarters;
- tax and duty-free importation of personal and household effects;
- travel tax exemptions.

(b) *Regional headquarters*
- exemption from income tax;
- exemption from contractor's tax;
- exemption from all kinds of local licences, fees and duties;
- tax and duty-free importation of training and conference materials;
- importation of motor vehicles for expatriate executives and their replacement every three years provided the taxes and duties are paid upon sale to non-qualified persons;
- exemption from the registration requirements of a foreign corporation doing business in the Philippines;
- upon application with the BOI, establishment by the regional headquarters of warehouses to supply spare parts or manufactured components and raw materials to the Asia-Pacific region and other foreign markets.

F. *Offshore banking units*

A foreign banking corporation may establish an offshore banking unit ("OBU") in the Philippines.[5] OBUs must maintain net office funds of at least US$ 1,000,000. Incentives granted to OBUs include the following:
- foreign currency transactions with non-residents of the Philippines and other OBUs are tax exempt;
- foreign currency transactions with foreign currency deposit units, local commercial banks and branches of foreign banks are also tax exempt;
- interest of foreign currency loans to residents is subject to a final withholding tax of 10 percent.

Incentives to foreign personnel of OBUs include the following:
- multiple-entry visa renewable annually;
- exemption from immigration fees and customs duties on personal effects, as provided in the Tariff and Customs Code;
- 15 percent withholding tax on gross income received from an OBU.

G. *Withdrawal of fiscal incentives*

In December 1986, the government withdrew all tax and duty incentives of government and private entities, subject to certain exceptions:[6]
- tax and duty incentives covered by the operation of the non-impairment of obligation provision of the Constitution;
- tax and duty incentives conferred by effective international agreements to which the Philippine government is a signatory;[7]
- tax and duty incentives enjoyed by enterprises registered with the BOI pursuant to Presidential Decree No. 1789, as amended; the Export Processing Zone Authority pursuant to Presidential Decree No. 66, as amended; and the Philippine Veterans Investment Development Corporation Industrial Authority pursuant to Presidential Decree No. 535, as amended;
- suspension of taxes and duties due from the distressed copper mining industry pursuant to Letter of Instruction No. 1416;
- tax and duty incentives conferred under the basic tax codes, i.e. the National Internal Revenue Code, as amended, and the Real Property Tax Code, as amended.

H. *Magna Carta for countryside and Barangay business enterprises*

To encourage the development of small-scale business enterprises in areas outside metropolitan Manila and other highly urbanized areas, Republic Act 6810 (otherwise known as the "Magna Carta for Countryside and Barangay Business Enterprises" or "Kalakalan 20") was approved by Congress on 14 December 1989.

Kalakalan 20 exempts small business enterprises and ventures from all taxes, including income tax, VAT, licence and building permit fees, and other business taxes, except real property and capital gains tax, import duties and other taxes on imported materials.

Business enterprises covered by Kalakalan 20 include the following:
- enterprises employing 20 people or less that are engaged

5. Presidential Decree 1034, issued in September 1976.
6. Executive Order No. 93.
7. For this purpose, an effective international agreement is any agreement which is operationally binding upon and in force between the Philippine government and the other parties concerned.

in productive undertakings that would benefit the economy in the area;[8]
- enterprises whose assets at the time of registration do not exceed ₱ 500,000;
- enterprises whose principal offices or business operations are situated in the countryside.

Besides providing tax relief, the bill hopes to eliminate bureaucratic restrictions by requiring the business enterprise to register in the municipality or town where it operates. The licence fee, to be paid to the city or municipal treasurer, costs ₱ 250. In their second year of operation, however, these enterprises pay fees ranging from ₱ 1,000 to ₱ 5,000, depending on their initial assets.

I. *Build-Operate-Transfer Scheme*

On 14 July 1989 the Senate and House of Representatives approved the "build-operate-transfer" ("BOT") scheme, under which a contractor will construct, finance, operate and maintain a given infrastructure facility. The contractor operates the facility, charging its users the appropriate tolls, fees, rentals and charges sufficient to recover its operating and maintenance expenses and its investment in the project, plus a reasonable rate of return. The facility will then be transferred to the government agency or local government unit concerned at the end of a fixed term not exceeding 50 years.

The contractor may obtain financing from foreign and/or domestic sources and/or engage the services of a foreign or Filipino contractor. However, the following conditions must be complied with:
- in the case of foreign contracts, Filipino labour must be employed or hired in different phases of construction where Filipino skills are available;
- the financing of a foreign or foreign-controlled contractor from Philippine government financing institutions should not exceed 20 percent of the total cost of the infrastructure facility or project;
- the financing from foreign sources should not require a guarantee by the government or by government-owned or controlled corporations.

The BOT scheme also includes a supply-and-operate situation. This is a contractual arrangement where, if the interest of the government so requires, the supplier of equipment and machinery for a given facility operates it, providing in the process technology transfer and training to Filipino nationals.

Priority projects available to private contractors will be identified yearly by the government and other concerned groups.

8. An example of such an undertaking is the processing of raw materials or a combination of raw materials and manufactured goods into marketable products. Excluded from the measure are enterprises engaged principally in professional services, retailing, wholesaling or trading of commodities, products or merchandise.

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J. Frans Spierdijk

INTRODUCTION

At the General Assembly in Stockholm on 31 August 1990, it was announced that IFA's General Council had appointed Mr. F. Fernandez Ordoñez, at that time Minister of Foreign Affairs of Spain and previously Minister of Finance, our President-elect. The intention was that Mr. Fernandez Ordoñez, who planned to retire from his high public function earlier this year, would be the candidate to be elected IFA President as of the close of the Barcelona Congress in 1991. However, the developments within the political arena of his home country unexpectedly turned out to be such that Mr. Fernandez Ordoñez was not in a position to retire from his post of Foreign Affairs Minister. Consequently, he had to inform us that he would not be available for the IFA Presidency. Of course we can only accept this situation with understanding. On behalf of our Association I wish Mr. Fernandez Ordoñez, whom we all hope to see in Barcelona, all sorts of success and satisfaction in the fulfilment of his important public responsibilities.

We are extremely fortunate that our President, Mr. Karl Beusch, after careful consideration and after consultation with the German Branch, is prepared to extend his Presidency by another period of two years. Under his leadership IFA may look forward with confidence to what lies ahead of us, in particular to the Congresses in Cancun (1992) and Florence (1993).

With sadness we learned that our Honorary President Prof. J. Baron van Houtte (Belgium) passed away on 23 May 1991 at the age of 84. He was IFA President from 1971 to 1973, succeeding Dr. Mitchell B. Carroll. He was a man of great authority in scientific and political circles, where he fulfilled many important functions. At the same time he was a very amiable person who commanded great respect. Those of us who have known him as IFA President will cherish the memory of him.

Our Honorary President, Mr. Alun G. Davies CBE, received a Doctorate honoris causa of the University of Wales at Bangor, North Wales. The honour was conferred on him by HRH the Prince of Wales. On behalf of IFA I have conveyed to him our sincere congratulations.

STOCKHOLM CONGRESS

The attendance of 1,300 participants and 650 accompanying persons proved to be about the ideal number to fit nicely into the Berns Congress Centre and the other locations where the Congress and the events surrounding it took place. The Organizing Committee must have felt great satisfaction with this choice of the Congress venue, located as it is in the very centre of Stockholm and within walking distance of many hotels. I am sure that this was one of the reasons why we had such a good attendance at all of the Working Sessions and Seminars. Not just the Congress venue but everything in the organization radiated with efficiency and an agreeable atmosphere. We owe great thanks for this to Prof. Sven-Olof Lodin, Mr. Peter Sundgren, Mrs. Kerstin Böström and to the many Swedish Branch members who assisted them. I would also like to make special mention of the excellent professional Congress Organizer (Congrex) the Swedish Branch had engaged. The beautiful weather during the last week of August was simply an extra bonus.

We were greatly honoured by the presence and an address of his Majesty King Carl XVI Gustaf at the Opening Ceremony. His Majesty stayed on at the reception afterwards to exchange views with a number of our members. The election of Prof. Dag Helmers as an Honorary Member of IFA during the General Assembly of 31 August 1990 is another event worth recording here. President Karl Beusch on that occasion outlined Prof. Helmers' many contributions to the development of Swedish and international tax law and of his significance for IFA in particular.

Main Subject I, "Taxation of cross-border leasing", was discussed at very well-attended Working Sessions. General Reporters Prof. G. Lindencrona and Mr. S. Tolstoy (Sweden) wrote a very interesting report on the basis of 31 National Reports. Discussion Leader at the Working Session was Prof. J.P. le Gall (France), whereas the Session was chaired by Mr. A. Stenshamn (Sweden). The Panellists were Mr. L. Levin (U.S.A.), Prof. Dr. A. Rädler (Germany), Prof. K. van Raad (Netherlands), Prof. A. Yoran (Israel), and Mr. Woo Taik Kim (Korea), while Mr. R. Gustafsson (Sweden) acted as Secretary of the Subject. The Resolutions Committee for Subject I was composed as follows: Mr. P. Cumyn (Canada), Chairman, and Mr. L. de Broe (Belgium), Mr. N. Prentice (U.K.), Mr. C. Sellerier (Mexico), Mr. P. Spori (Switzerland) and Prof. K.S. Tikka (Finland) as members.

Subject II, "International mutual assistance through exchange of information", was treated in a likewise interesting Report by General Reporter Avv. B. Gangemi who had received 21 National Reports. With Mr. J. Salsback (Sweden) in the chair, Discussion Leader Mr. R.M. Hammer (U.S.A.) managed to direct the discussion on the rather controversial subject along the lines set out by him in advance, together with his Panellists Mr. R. Baconnier (France), Mr. A. Elvinger (Luxembourg), Dr. H. Flick (Germany) and Mr. J. Francke (Sweden). Secretary of the Subject was Dr. B. Wiman (Sweden). Prof. A. Nooteboom (Netherlands) chaired the Resolutions Committee. Members were Dr. R. Asorey (Argentina), Dr. M. Desax (Switzerland), Mr. J.M. Déry (Canada) and Mrs. J. Pagan (U.K.). I refer to the Reports of Proceedings written by Dr. J.B. Bracewell-Milnes (U.K.) on Subject I and Subject II and to the Resolution on Subject I and the Précis on Subject II and the review of same by the Chairmen of the Resolutions Committees as published in the IFA Yearbook 1990 for more information.

I would like to express IFA's sincere gratitude to the General Reporters and the National Reporters of both Subjects and to all the other people referred to above for their time and efforts.

Of the five Seminars scheduled for the Congress, Seminar E on "International tax aspects of East-West joint ventures" was chosen as a last-minute decision and the timing proved to be right on target. It was important and interesting for IFA to meet with some representatives from former East Bloc countries in Europe and to exchange views. The Seminar was chaired by Prof. V. Uckmar (Italy) and his Panellists were Dr. A. Burzynski (Poland), Mr. T. Haataja (Finland), Dr. W. Kuiper (Netherlands), Mr. H.M. Liebman (Belgium), Dr. C. Repassy (Hungary) and Dr. S. Shibaev (U.S.S.R.). The other Seminars were: Seminar A on "The Nordic Multilateral Tax Treaty", with Prof. N. Mattsson (Sweden) as Chairman, and Messrs. P. Dyhr (Denmark), H.M.A.L. Hamaekers (Netherlands), H. Loechen (Norway), B. Rhodin (Sweden) and H. Skurnik (Finland) as members of the Panel. Seminar B treated "Income tax consequences of the transfer of residence by individuals". Prof. DDr. H.G. Ruppe (Austria) acted as Chairman, and the Panel comprised Mr. R. von Siebenthal (Switzerland), Mrs. J. Sneum (Denmark), Mr. J.A. Stacey (Canada) and Prof. F. Wassermeyer (Germany). Prof. L. Mutén (U.S.A.) chaired Seminar C on "Double taxation treaties between industrialized and developing countries – OECD and UN Models – a comparison". The Panel of this Seminar comprised Messrs. M. Collins (U.K.), J.F. Court (France), M.S. Feinberg (U.S.A.), A. Figueroa (Argentina) and O.P. Vaish (India). The Panel of Seminar D "Income tax reform in the Nordic countries" was chaired by Prof. E. Andersson (Finland), assisted by Prof. M. Aarbakke (Norway), J. Drejer (Denmark) and Prof. S.O. Lodin (Sweden) as Panellists.

The preparation of a Seminar and its presentation require a lot of work. We would like to thank all people involved for their invaluable contributions. They helped to make the scientific part of the Stockholm Congress a great success.

The social programme the Swedes had in store for us was magnificent. The excursions, the golf tournament, the Vasa Museum and the performance of Swedish music, Don Giovanni at the Opera Theatre, the Gala Dinner with three of Sweden's best dance bands are just a few examples of many more most enjoyable festivities.

Finally, I would like to mention that a meeting took place during the Stockholm Congress, upon the initiative of Mr. Peter Sundgren, between past and future IFA Congress Organizers, which proved to be very useful and it is intended to continue this exercise. Together with the data bank built up by the General Secretariat, meetings like these will prove to be of great help to organizers of future Congresses.

PERMANENT SCIENTIFIC COMMITTEE

In February 1991 the PSC had a long and fruitful meeting in Barcelona. The Spanish Branch, and Mr. M. Marin Arias in particular, proved to be excellent hosts in every respect. We were glad to welcome some of the new members of the Committee in our midst: Prof. L. Fischer (Germany) and Mr. T. Miyatake, permanent deputy of Prof. H. Kaneko (Japan). Unfortunately, due to the Gulf War, some of our members did not undertake the trip to Barcelona, including the new members Mr. A. Toffoli Tavolaro (Brazil) and Dr. A. Rafael (Israel).

Two sub-Committees (for the directives and the seminars) were set up on a tentative, one-year basis, comprising Dr. J.B. Bracewell-Milnes (U.K.), Prof. I. Claeys Bouuaert (Belgium), Mr. D.R. Tillinghast (U.S.A.) and Mr. O.P. Vaish (India). Additional persons will be selected according to the subjects concerned. The General Secretariat will act as central point of coordination. A third sub-Committee was formed to coordinate the 'Research' work, with Prof. H. Ault (U.S.A.) as its Chairman, Mr. H.M.A.L. Hamaekers (Chief Executive IBFD), Prof. Avv. A. Fantozzi (Chairman PSC) and myself as members. The research work already proved a success in the preparatory work of Messrs. P. Kirpenstein and D. van Hilten (Netherlands) on Seminar topics for the 1992 Cancun Congress and Dr. A. Manganelli (Italy) for the proposed Florence topics. We are grateful to the IBFD for this initiative, which will certainly be continued and expanded.

The Chairman of the PSC will annually write a letter to the National Branches to ask for proposed topics which could be treated during future IFA Congresses, either as main Subjects or as Seminars. Since there is a demand for more variety, we need more topics. I would like to make an appeal to all Branches to respond to this request.

For the Barcelona Congress, 26 National Reports were submitted for Subject I "The determination of the tax base for real property", and 30 for Subject II "Protection of confidential information in tax matters". Thanks to the hard work done by the General and National Reporters we have again two fine volumes of Cahiers for the Barcelona Congress. It was decided some time ago that it is worthwhile to have a Seminar now and then in one of the Congress languages only.

The Subjects and Seminars for the 1992 Cancun Congress were finalized. The titles of the Subjects are " Transfer pricing in the absence of comparable market prices" and "Tax consequences of international acquisitions and business combinations". The Seminars will treat: "Advance ruling, practice and legality"; "Tax consequences of operating through an independent agent"; "Branch tax"; "Tax treatment of international loans"; and "Mexican tax treaties". We are grateful to Prof. G. Maisto (Italy) and Mr. W.B. Taylor (U.S.A.) that they are willing to act as General Reporters and we wish them success.

The Subjects for the 1993 Florence Congress were definitely fixed. Subject I will treat "Interpretation of double taxation conventions" and Subject II, "Non-discrimination rules in international taxation". I am glad to report that Prof. Dr. K. Vogel (Germany), who resigned from the PSC, remains involved in IFA's scientific work, this time by accepting the post of General Reporter for Subject I in Florence. Prof. Avv. P. Adonnino (Italy) will be the General Reporter for Subject II.

Initial discussions took place on the 1994 Toronto Congress. Some interesting topics are on the table, and the PSC will do its utmost to offer a diversified scientific programme, which will satisfy all our Congress participants.

EXECUTIVE COMMITTEE

The Spanish Branch hosted the meeting of the Executive Committee on 6 May 1991 in Barcelona. Prof. Avv. P. Adonnino (Italy), a well-known 'face' in IFA circles, attended the meeting for the first time as fully-fledged member. As regards the composition of the Executive Committee, the following persons will be proposed for membership to the General Council for another period of two years: Mr. S.H. Goldberg (U.S.A.), Mr. I.W. Harris (Hong Kong) and Mr. P. Sundgren (Sweden). Three members are due for statutory resignation: Mr. A. Buelinckx (Belgium), Mr. G. Delorme (France) and Dr. A.R. López (Argentina). Mr. F. Fernandez Ordoñez offered his resignation from the Committee in connection with the withdrawal of his candidacy for IFA President, as reported in the introduction to this Report. Subject to approval by the General Council these members will be replaced by members from Belgium/ Luxembourg, France, Brazil and Spain.

The Guidelines for the organization of an IFA Congress are being redrafted by the General Secretariat. They will be submitted to the Executive Committee for official ratification at their October 1991 meeting. Thereafter they will be available, in looseleaf form, to all organizers of future IFA Congresses.

The status of the Blueprint Committee is under review by the Executive Committee. It will be on their agenda for the meeting in Barcelona in October of this year. Also on that agenda will be a proposal to amend the IFA Statutes, in particular Article 8, so as to provide for the establishment of Branches in certain territories which may not qualify as countries under the present wording of said Article.

BLUEPRINT COMMITTEE

The Committee met on 5 May 1991 in Barcelona with Dr. R. Lenz in the chair at meeting facilities kindly provided by the Spanish Branch. It discussed mainly the diversification of the scientific Congress programme and arrived at the following recommendations. Firstly, to maintain the two main Subjects and the Seminars as an integrated programme so as to have a good balance between topics of a scientific and of a more practical nature. Secondly, to organize on a trial basis during the Florence Congress in 1993 a non-interpreted Seminar in concurrence with one of the two main Subjects and thirdly, to instruct the Chairmen of the Seminars more in detail so as to arrive at lively discussions with maximum participation from the floor. Prof. Fantozzi, who participated in the discussion, said that the PSC would take this up and make recommendations to the Executive Committee in due course. The Blueprint Committee further endorsed an idea of Prof. Fantozzi – which needs to be worked out by the PSC in more detail – to change the organization of the Working Sessions of the main Subjects and its results. Under the new procedure the General Reporter would prepare a document outlining the main aspects of the Subject. In addition he would draft a Resolution proposal. The Committee recommended to introduce this procedure on a trial basis during the Florence Congress also. Meanwhile it was established that, based on the decision of the Executive Committee during the 1990 Stockholm Congress, a Résumé (Précis) rather than a Resolution would be the rule.

MEMBERSHIP FEES

The General Treasurer will propose to maintain the membership fees for 1992 at the level of the previous year:
- 105 Dfl. for individual members of National IFA Branches,
- 115 Dfl. for direct individual members, and
- 250 Dfl. for corporate members.

Thanks to the continuous efforts of the General Treasurer and the cooperation of the National Branches a marked improvement in the collection of membership fees has been achieved over the years.

NATIONAL BRANCHES AND MEMBERSHIP

Although no new IFA Branches were recognized during the Stockholm Congress, preliminary talks on the formation of a Branch were held with direct members in Egypt, Taiwan, Thailand and Costa Rica. I had the opportunity to attend regular Branch meetings in Switzerland, France and Germany. A trip to India was cancelled due to the Gulf War, and other circumstances beyond my control unfortunately prevented me from attending the Regional Conference in Hawaii, and from visiting Taiwan and the Branches in Hong Kong and Japan.

The General Secretariat receives more and more news about the activities in more and more Branches. The U.K. Branch, as we all know, is particularly active. One of their meetings this year was a new concept, i.e. a Junior Workshop where younger members of the Branch were specially invited to speak. The Newsletter issued by the U.S. Branch shows how much alive that Branch and its regional groups are. And then there are reports on numerous bilateral IFA meetings being held in various parts of the world. More widespread knowledge of these activities may appear to contain valuable elements and suggestions for other IFA Branches. Therefore the General Secretariat intends to send a Newsletter to the Secretaries of the National Branches on a three-monthly basis with the news it receives. In this connection I would repeat my request to inform the General Secretariat about forthcoming Branch meetings, bilateral meetings and the like on a regular basis.

REGIONAL CONFERENCE

From 22 May to 24 May 1991, a successful Regional IFA Conference was held on Maui, one of the Hawaii Islands. The "Pacific Region Conference" was initiated by the U.S. Branch and organized together with Branches from Australia, Canada, Hong Kong, Japan, the Republic of Korea, Malaysia, Mexico, New Zealand and Singapore. The Subjects discussed were: "Taxation of doing business in the country"; Cost sharing and transfer pricing"; "Enforcement"; "Inpatriate taxation" and "Tax accounting methods". The Conference was attended by some 90 participants and 40 accompanying persons, coming from 17 countries and including six government representatives. A report on the Conference appeared in the June 1991 issue of the Bulletin. The IBFD has published the contributions of the panellists in a comprehensive book, *Taxation and Inbound Investment in Pacific Rim Countries* (470 pages), containing a wealth of information on the countries concerned. This Conference was truly a regional one in that there was such active involvement of many Branches and people from Pacific Rim countries. The U.S. Branch deserves our sincere appreciation for their initiative and support of this Conference. Given the importance of the Pacific Region in our world economy, more IFA Regional Conferences there may perhaps be looked forward to.

MITCHELL B. CARROLL PRIZE 1990

Out of three candidates, Miss Outi Elisabeth Raitasuo (Finland), was elected the winner of the Prize for 1990. It was awarded to her during the official Opening Ceremony of the Stockholm Congress on Sunday night, 26 August 1990 by Prof. DDr. H.G. Ruppe, Chairman of the Jury, for her work "Tax sparing provisions in double taxation agreements between developed and developing countries". Honourable mention was given to the work of Dr. R.S. Collier (U.K.) dealing with the topic of tax avoidance, "The consequences for international fiscal law of unilateral anti-tax haven legislation".

I am glad to report that for 1991 three papers have been submitted for the Prize. Let me repeat my appeal to all readers of this report to do everything they can to promote the Mitchell B. Carroll Prize within their professional circles. As you know the Prize can be won by young tax experts under 35 years of age. The General Secretariat will be glad to provide you with more information.

THE 45TH CONGRESS IN BARCELONA

The third Congress in Spain – IFA went to Madrid in 1959 and in 1972 – promises to be a very attractive one. Barcelona is a most alluring and booming city with a hard-working and friendly population. It is the proud capital of Cataluna, bursting with activity in preparing itself for the Olympics in 1992 and of course for our IFA Congress in 1991! The Spanish Organizing Committee, in particular Mr. Manuel Marin Arias, seems to have everything under control and we are confident that the Congress, which will be held in a spacious and efficient Congress Centre, will run as smoothly as ever. Both the scientific programme and the social programme are tempting, the weather early October is usually good, the city of Barcelona and the province of Cataluna are extending us a special welcome, so there is every reason for IFA members to attend the 45th Congress in great numbers.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

We congratulate our Executive Committee member, Mr. John Avery Jones CBE (U.K.), who became the new Chairman of the Board of Trustees of the IBFD earlier this year, succeeding Prof. A. Nooteboom from the Netherlands. The beautiful and practical premises of the Bureau, which were officially opened by the Mayor of Amsterdam on 17 May 1991, will provide ample space for all of its expanded activities in the field of publishing, seminars, the International Tax Academy and related matters. As mentioned earlier in this Report, IFA will continue to have close cooperation with the Bureau in the field of study and research for the PSC.

CONTACT WITH INTERNATIONAL ORGANIZATIONS

I would like to thank our 'Ambassadors', Mr. R. Baconnier (France), Mr. J. Guttentag (U.S.A.), Mr. L.T. Halpern (U.K.), Mr. H.M.A.L. Hamaekers (Netherlands), Mr. R.M. Hammer (U.S.A.) and Mr. J.W.B. Westerburgen (Netherlands) for their reports as published in the IFA Yearbook. Mr. Joe Guttentag acted for a long time as our Liaison Officer with the OAS but had to give this up because of his moving to Japan; a special word of thanks to him for his devoted services for so many years. Hopefully we will be able to find a worthy successor for him in due course.

RESOLUTIONS XLV IFA CONGRESS, BARCELONA, 1991

SUBJECT I:
The Determination of the Tax Base for Real Property

Précis (Original version: French)

The determination of the tax base for real property was discussed as one of the two main Subjects at the 45th Congress of the International Fiscal Association held in Barcelona in 1991.

Volume LXXVIa of the *Cahiers de Droit Fiscal International* containing a General Report and 26 National Reports had previously been made available to the participants as background information and a Panel presentation opened the general discussion.

The Discussion Leader identified as topics of particular importance the following subjects and invited the intervening Congress participants to focus their attention in particular on them:
- Is there any merit in comparing tax bases for real property on an international scale in view of the plurality of concepts, methods and procedures applied?
- What difficulties and possibilities for the practitioner result from international divergencies in valuation methods?
- Is harmonization of valuation concepts, methods and procedures desirable – and is it feasible?
- What procedural rules should govern valuation of real property?

A. As regards the merit of comparing tax bases for real property on an international scale, a large consensus was reached that:
(a) There is significant merit in doing so in order to
  (i) acquire additional knowledge and better understanding of the concepts, methods and procedures available,
  (ii) take advantage of the experience of others in the field,
  (iii) initiate and encourage some 'convergence' in the field of real property taxation;
(b) the comparison made to date reveals that the most common and widely accepted starting point from which the tax base for real property is determined, is the concept of "fair market value" of the property;
(c) concepts other than "fair market value" must also be used where appropriate, either to attain a greater level of fairness or because fair market value of the property is not easily ascertainable; examples of such other concepts would be "historical cost" for income tax purposes and "current use value" in certain cases such as agricultural property. Several participants expressed the view that the international comparison of tax bases for real property should be undertaken with prudence since extraneous factors can have an important impact on the choice of the tax base, for example the social and economic policy of the government, the influence of pressure groups, etc.

In view of the difficulties of arriving at a fair valuation of real property it was suggested that taxes which do not rely on such valuation should be preferred.

B. As regards difficulties and possibilities arising for the practitioner from international divergencies in valuation methods, the discussion revealed that a number of problem areas do in fact exist, for example in connection with the deduction of a debt relating to a property for the purpose of evaluating that property or in connection with the elimination of double taxation when the nature of the tax levied in two countries on the same property subject to the same taxable event (e.g. death of the owner) is different (income versus estate tax).

The general decision was that such problems must be resolved by the tax authorities either by means of unilateral actions or pursuant to the provisions of bilateral tax treaties.

C. As regards the desirability and feasibility of harmonizing valuation concepts, methods and procedures, a large consensus was reached that while harmonization is desirable, it will be long and difficult to achieve, perhaps even impossible with respect to procedures.

Several Congress participants stressed the fact that harmonization does not mean uniformity and the general decision was that the pursuit of an harmonization objective should not bring about the adoption of concepts, methods or procedures against the legitimate interests of national public authorities or taxpayers.

A few participants presented general lines along which harmonization could be undertaken (for instance an evaluation by the taxpayer subject to a right of pre-emption by the authorities) but the majority failed to support any suggestion made.

D. On the question of what procedural rules should govern valuation of real property, Congress participants explored three separate points:
(a) Should rules on valuation of real property be established by (parliamentary) law exclusively or to what extent is it acceptable that they are determined
  (i) by administrative regulations or
  (ii) by written standards?

  The discussion confirmed the finding of the General Report that both systems (one system where valuation rules tend to be found in laws and the other system where valuation rules are often found in regulations or procedure manuals reflecting court decisions) are acceptable and work well without major disagreement.

  Recent recourse to constitutional "equal rights protection" clause[s] by aggrieved taxpayers in real property taxation cases tends to bring about a certain convergence of the two systems with a vew to ensuring equal and fair treatment to the taxpayers.
(b) Should valuation for tax purposes be reserved to public authorities or be performed by independent professionals?

  It was argued that the use of independent professionals (as done in the USA and Canada for instance) did not, in itself, contravene ethical rules and that some privatization of the valuation function may increase in the future in view of governmental budgetary constraints.
(c) How to resolve a valuation dispute between a taxpayer and the government?

A very large consensus was reached that a comprehensive system of administrative and judicial appeal that permits a quick, cheap and reliable challenge of the valuation made by the public authorities is indispensable.

Note of President

The determination of the tax base for real property was the first subject of the Barcelona Congress and was extensively researched by the reporters and the members of the panel. This research revealed a great diversity in the taxes involved, whether they are taxes of a general scope concerning income or capital, or specific taxes the scope of which is limited to real property.

A variety of taxation methods was also revealed, involving either a declaration by the taxpayers or valuations carried out by the administration; in the latter case, the fact that valuations are out of date is often the source of distortions in the implementation of tax.

It has generally been recognized that an objective tax base for real property taxes should be based on the notion of fair market value in most cases. The difficulty is that such market value can only be ascertained by the collection of information concerning the different local real estate markets, collection which would have to be constantly renewed in order to be kept up to date. In fact, administrations proceed only to revise their information at long intervals because of the costs involved and revaluations done by the application of arbitrary coefficients do not take into account the real evolution of the markets.

In general, it appears that taxes levied on real property are generally unfavourably regarded even though they are rarely at the source of difficulties of an international order. Thus the idea could be put forward that such taxes should basically be abolished since they do not correspond to the principles of modern taxation. However, such taxes continue to remain a privileged source of income, particularly for local authorities. It is therefore necessary to improve the determination of their bases by utilizing the services, where appropriate, of independent experts or to maintain their rate sufficiently low so that the inequities which they inevitably contain remain within acceptable limits.

Over and above harmonization which appears to be basically a pious hope because of the considerable difficulties to be surmounted, the attention of the tax authorities should be drawn upon the necessity to offer taxpayers, often ill-equipped to contest the arguments of the administration, appeal mechanisms apt to ensure a more equitable application of the law. Interesting examples have been given concerning particularly the American and Belgian legislations which reveal the deficiency of the guarantees actually offered even at the highest level.

Great progress can be accomplished, at the level of procedures, in order to ensure a more appropriate assessment of levies on real property.

SUBJECT II:
Protection of Confidential Information in Tax Matters

Resolution (Original version)

The 45th IFA CONGRESS:

RECALLING its précis of the 44th Congress in Stockholm.

TAKING NOTE of 31 National Reports and the General Report as published in the *Cahiers de Droit Fiscal International,* Volume LXXVIb, and

TAKING FURTHER NOTE of the discussions held during the Congress on 8th October, 1991.

Whereas
(1) the respect for private life has emerged through centuries as a fundamental right of the individual.
(2) the economic welfare of States, fair sharing of the tax burden, and equal competition between enterprises require that the State be able efficiently to obtain relevant tax information from third parties.
(3) the growing importance of international business relations, the corresponding danger of international tax evasion, the abolition of the borders within economic unions and the principles of comity require that relevant tax information be likewise exchanged between states bound by tax treaties.
(4) information is exchanged internationally subject to the rule of law and the principles of good administration.
(5) treaty protection should clearly be given to the private life of taxpayers.
(6) treaties recognize that trade secrets should enjoy protection in this respect.
(7) the best way to secure protection of taxpayers is to provide for prior notification of measures which might encroach on the taxpayer's rights and to enable him to seek a remedy against such measures.
(8) prior notification should not apply in instances where tax fraud is reasonably suspected.
(9) tax administrators hold confidential information of taxpayers in a fiduciary capacity.

Recommends:

I. DOMESTIC EXCHANGES OF INFORMATION

(1) The private life of the individual taxpayer should be adequately protected against tax information requests from third parties.

(2) Professional secrecy should be uniformly guaranteed and extend to all recognized advising professions, whether their members are nationals or foreigners.

(3) Except when notification jeopardizes the assessment of taxes, the taxpayer should receive prior notification of a request for information from third parties. The taxpayer and the third party to whom the request is made should have a prior right to object to the request before a judicial or administrative court.

(4) Tax administrations must be held liable for unauthorized use of confidential information in their possession.

(5) Prior notification should consist of:

(a) identification of the requesting party;
(b) the content of the request; and
(c) the content of information the requested party proposes to exchange.

II. EXCHANGE OF INFORMATION BETWEEN STATES

(1) International exchange of information must likewise be excluded when information concerns private life or trade secrets.

(2) Except when notification jeopardizes the assessment of taxes, the taxpayer should have prior notification of a tax information request by the requesting State, consisting of the same information as in I(5) above.

(3) The taxpayer in the requesting State and either such taxpayer or the third party who is the subject of the request in the requested State should have a right to object before a judicial or administrative court prior to the request being made or entertained.

Note by the chairman (J.F. Avery Jones) of the résumé committee on Subject II

In passing the resolution for Subject II, the following qualifications were noted in the discussion.

Recital (8). An amendment was proposed, but too late to be in order to be voted upon, to delete this recital, as being unnecessary in view of the opening words of resolutions I(3) and II(4) – except where notification jeopardises the assessment of taxes. The résumé committee did intend both to be included: the exception for suspicion of fraud is an obvious protection for the tax authority, but in addition it was intended that the possibility of notification jeopardising the assessment should constitute a separate exception. This might cover the possibility of a non-fraudulent taxpayer removing assets from the jurisdiction of the tax authority. Although the reference to jeopardising the assessment would normally cover suspected fraud, it is possible to think of cases where fraud was suspected but the tax authority was sufficiently secured so that the assessment would not be jeopardised. For this reason, it was thought best to state both exceptions.

Recital (9). It was appreciated by the committee that the reference to fiduciary capacity is meaningless in a civil law state, but the expression had been used in the panel discussion and it was thought best to retain it. It is intended to convey that the taxpayer's ownership of confidential information is not impaired by the information being in the possession of the tax authority. Resolution I(4) imposes a liability on the state for any unauthorised disclosure.

Resolution I(1) – third parties. An amendment dealing with the question whether spouses and close relatives were third parties, was raised but not voted upon, on the basis that this note would explain that it was intended that they should be regarded as third parties (so that information about the taxpayer's private life could not be obtained from them). The topic was limited to third party information powers, and nothing should be implied about the extent to which this information could be obtained from the taxpayer himself.

Resolutions I(1) and II(1) – private life. The precise definition of private life was not discussed in any detail. The committee intended that purely financial information about the taxpayer should not be included. There are also occasions where information about a taxpayer's private life will need to be exchanged, for example, in determining the state with which the taxpayer's personal relations were closer as part of determining centre of vital interests in dual residence cases. The resolution should therefore be read as indicating a general principle to which there may be exceptions.

AN ASSESSMENT OF THE VAT IN TAIWAN

Bingyuang Hsiung*

I. INTRODUCTION

The value added tax ("VAT") in Taiwan was implemented on 1 April 1986 as a reform to the original business tax. The aims of the reform were twofold: to increase the competitiveness of exports and to improve the efficiency of the business tax structure. In addition, the stated policy was that the reform would be revenue neutral.[1] Since its inception, the new VAT has won wide acclaim both domestically and internationally.[2]

This article presents findings of a preliminary assessment of the VAT in Taiwan. To provide background information, Part II outlines the origin, scope, structure and major changes to the VAT. Part III examines the impact of the VAT from various angles and explores the policy implications of the empirical findings. Suggestions for improvement are proposed in Part IV, and Part V concludes the article.

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II. THE VAT IN TAIWAN

Before the VAT was adopted, sales tax was comprised of the gross business receipt tax, the stamp tax and the commodity tax. Revenue from these taxes constituted 27.8 percent of the total tax revenue in 1984.[3] The VAT was first proposed by a tax reform committee in 1969, but not adopted until 17 years later. On 1 April 1986, the new business tax, the major component of which was the VAT, was instituted to replace the sales tax.[4]

A. *Scope of the VAT*

The business tax includes two categories: the non-VAT category and the VAT category. The non-VAT category and the applicable tax rates are as follows:

(1) for banks, insurance companies, trusts and investment companies and securities companies, the business tax is five percent of gross sales;
(2) for nightclubs and restaurants with entertainment performances, the business tax is 15 percent of sales. For bars, tea houses and coffee shops, the business tax is 25 percent of sales;
(3) for small business entities (i.e. those with monthly sales of less than NT$ 200 thousand (i.e. approximately US$ 7,400)) and other business entities approved by the Ministry of Finance, the business tax is one percent of sales as determined by the administration.[5] Small entities, however, may opt to enter the VAT category.

All other business entities fall within the scope of the VAT.

B. *Tax rate and taxes incurred*

The VAT rates range from five to ten percent with the effective rate determined by the Executive Yuan.[6] The VAT rate is currently five percent. The tax rate applies to the sale price of transactions. The tax payable is determined by deducting the taxes on purchases from the taxes on sales.

C. *Exemptions*

The VAT does not apply in two circumstances:

(1) to goods and services which are zero-rated with credit, i.e. those for export. The applicable tax rate is zero, but taxes paid in the previous stages of production are refunded;
(2) goods and services which are zero-rated with no credit; here taxes on particular transactions are waived, but taxes paid in previous stages of production are not refunded. Approximately 30 types of transaction are exempt, including:
  (a) sale of land;
  (b) agricultural and fishery products;
  (c) arms and communication equipment sold to the military;
  (d) services, medicines and food provided by hospitals and clinics;
  (e) newspapers, magazines, radio and TV programmes;
  (f) processing of rice and flour;
  (g) fixed assets not purchased on a regular basis.

* Associated Professor, Department of Economics, National Taiwan University, Taipei, Taiwan, Republic of China.

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1. See Lu (1985).
2. Delegates from a number of countries have visited Taiwan to study the system. Taiwan has also sent officials abroad to conduct classes for other countries contemplating the adoption of the VAT.
3. See Yen (1987).
4. The revised Business Tax Law contains some 60 articles.
5. This is mainly to take account of the fact that these small business entities usually lack the accounting ability to do the requisite bookkeeping for the VAT.
6. Lin (1986) used the input-output analysis to calculate the appropriate tax rate for the VAT. With revenues remaining unchanged, the estimate called for a VAT rate between 4.5 percent and 5.5 percent. See also Lin (1981), Lin (1985) and Her (1985).

D. *Major changes to the VAT*

There have been three major adjustments to the VAT since its inception. Those changes and their causes are briefly outlined in this section.

1. Exemptions of VAT on gold bullion

Gold is mainly used for decorative purposes and for savings and investment. Gold which is used for decorative purposes can be seen as a consumption good and thus imposition of VAT is appropriate. Such is not the case, however, where gold is used for savings and investment purposes. Since the Chinese have a special fondness for purchasing gold as a savings instrument, a VAT surcharge does not comport with the idea of taxing the value added during the production process. Consequently, although VAT was initially levied on all gold transactions, after a period of protest and debate the VAT on gold bullion was abolished, but the VAT on the consumption use of gold remains intact.[7]

2. From surcharge to tax included in price listing

When the VAT was introduced, the tax was charged in addition to the price listed, which generated widespread public complaint. On the one hand, the surcharge method caused confusion for retailers in listing the prices – numerous disputes arose between sellers and buyers. On the other, retailers often tried to persuade customers not to request the general invoice (i.e. proof of purchase) and, in return, the retailers would not charge customers the five percent VAT. Since the customers could purchase the goods five percent cheaper, they would generally comply with the retailer's request. As a result transactions were not recorded and tax revenue was lost. In response to these practices, the price listing was changed to a tax-included method.[8]

3. Bimonthly tax filing

When the new tax took effect, business entities were required to file for the business tax on a monthly basis. The substantial paperwork involved for both the taxpayer and the administration made the monthly filings practically unmanageable. Therefore, 21 months after the VAT was implemented, business entities were allowed to file for the business tax on a bimonthly basis.[9]

III. IMPACT OF THE VAT

The VAT is a new method of taxing business transactions in Taiwan and certain conditions must be fulfilled before the tax can be successfully implemented. For instance, business entities in general should have basic accounting abilities and the tax administration must be equipped with facilities and personnel capable of recording and cross-checking the tax filings.[10] This section examines the impact of the new system. In particular, the various economic indicators and how these indicators evolved before and after the VAT was adopted are examined.

A. *Macro-indicators*

As a reference at the aggregate level, Table 1 lists the annual growth rates for certain macro-indicators for the last ten years. The average growth rates before and after adoption of the VAT are also listed.

7. See Liu & Wu (1987).
8. An additional reason for making the change, which was not mentioned by the government, was that with a tax-included price listing, a future increase in the tax rate would be less likely to cause a public outcry. See Hsue (1987).
9. Bimonthly filing, however, is optional; business entities may choose to make monthly filings. See Hsue (1987).
10. Moreover, once implemented, the outcome obviously depends on numerous factors, including specific administrative procedures involved, reactions of the business community, timing of the implementation, etc.

TABLE I
GROWTH RATE OF BUSINESS TAX REVENUES AND SELECTIVE ECONOMIC INDICATORS

	Bus.T.Rev.		Population		Exports		G N P		Per.Cap.In.		Whole.Price	
1980	31.1%		1.9%		22.9%		7.4%		22.6%		21.5%	
1981	29.8%		1.9%		16.5%		6.3%		15.9%		7.6%	
1982	13.3%		1.8%		4.2%		4.8%		5.3%		–0.2%	
1983	4.4%	18.0%	1.5%	1.6%	16.3%	14.9%	5.4%	7.4%	8.9%	12.0%	–1.2%	3.2%
1984	13.9%		1.5%		19.8%		11.9%		11.1%		0.5%	
1985	6.5%		1.3%		1.5%		8.0%		4.2%		–2.5%	
1986	27.3%		1.0%		23.2%		8.0%		15.7%		–3.4%	
1987	59.5%		1.1%		13.4%		13.6%		11.4%		–3.3%	
1988	18.5%	27.8%	1.2%	1.1%	1.4%	5.2%	9.3%	10.1%	7.9%	9.5%	–1.6%	–1.7%
1989	5.5%		1.0%		0.9%		7.3%		9.3%		–0.3%	

Source: 1. Yearbook of Financial Statistics, Taiwan Province, Republic of China, 1990.
2. Yearbook of Tax Statistics, Republic of China, 1990.
3. Taiwan Statistical Data Book, 1990, Council for Economic Planning and Development, Republic of China.

Note: 1. The figures for Business Tax Revenues are for the fiscal year which is from 1 July to 30 June of the next year.
2. All other figures are for the calendar year.

Clearly, as compared to the expansion of the economy (as reflected by the growth rates of GNP and per capita income) revenue from the business tax fluctuated drastically over the same period. This is indicated by the increase in the business tax revenue the year the VAT was implemented, and by the difference of approximately ten percentage points in the two average growth rates for the two sub-periods with 1986 as the dividing line. Furthermore, the revenue increases in the business tax were not caused primarily by expansion of the economy since the growth rates show different patterns. Adoption of the VAT did not cause price fluctuations because prices actually went down at the wholesale level. In addition, the numbers indicate that the goal of revenue neutrality was missed by a wide margin. This presumably means that the revenue potential of the VAT was not fully appreciated by the tax experts in calculating the "revenue-neutral" rate for the VAT. As for exports, there does not seem to be a direct link between VAT and exports. Since exports are influenced by a number of factors, it is difficult to draw any conclusion based on information at the aggregate level.

B. *Revenue structure*

Table 2 shows the annual growth rates of the revenue from the business tax, business income tax, personal income tax and overall taxes for the period studied. It reflects the rather surprising impact of the VAT on the business income tax. In particular, the revenue from the business income tax increased significantly immediately after adoption of the VAT and the increase continued even after the revenue increase of the business tax slackened. This may be explained by the fact that the cross-checking procedure of the VAT brings more business transactions into records which are accessible to the tax administration and it therefore becomes more difficult for business entities to resort to "double bookkeeping" to avoid taxes. The drastic increase in revenue from the business income tax provides a material reinforcement for the strength of the VAT.[11]

While the stated goals of adopting the VAT were to fortify the competitiveness of exports and modernize the business tax structure, the link between the business tax and the business income tax did not appear to be fully appreciated by either the government or the experts. The link was never mentioned in discussions prior to the adoption of the VAT.[12]

The revenue increases in both the business tax and the business income tax directly led to a significant increase in total tax revenue. In contrast, revenue from the personal income tax also increased for the same period but not with similar magnitude. It may be argued, however, that the cross-checking procedure enables the government to keep better account of business transactions and thus yields higher levels of business profit. Since part of the higher levels of profit eventually find their way into higher levels of personal income, the VAT indirectly contributes to generating more revenue for the personal income tax.

TABLE 2
REVENUE GROWTH RATES
OF SELECTIVE TAXES

	Business Tax Revenue		Business Income Tax Revenue		Person Income Tax Revenue		Total Tax Revenue	
	Ann.Gr.	Ave.Gr.	Ann.Gr.	Ave.Gr.	Ann.Gr.	Ave.Gr.	Ann.Gr.	Ave.Gr.
1980	31.1%		20.3%		35.5%		18.5%	
1981	29.8%		20.2%		41.5%		20.5%	
1982	13.3%		6.0%		20.7%		7.3%	
1983	4.4%	18.0%	–13.2%	8.6%	12.1%	18.1%	1.3%	11.9%
1984	13.9%		16.7%		–5.3%		12.0%	
1985	6.5%		8.4%		14.9%		3.0%	
1986	27.3%		1.6%		7.6%		1.8%	
1987	59.5%		20.3%		10.3%		14.8%	
1988	18.5%	27.8%	36.2%	29.2%	33.4%	22.6%	20.9%	19.0%
1989	5.5%		31.2%		24.0%		21.4%	

Source: Yearbook of Tax Statistics, Republic of China, 1990.
Note: The figures are for the fiscal year.

C. *Regional differences*

The connection between the business tax and the business income tax is interesting and warrants further attention, particularly as to whether the connection exists in the four administrative areas. Table 3 shows the characteristics of these areas.[13]

TABLE 3
POPULATION AND AREA OF THE FOUR
ADMINISTRATIVE AREAS

	Taipei	Kaohsiung	Taiwan Prov.	Taiwan Area
Population	2703	1374	16030	20107
Area	271.7	153.6	35575	36000
Density	9945	8947	451	559

Source: Statistical Abstract of Interior of the Republic of China, 1990.
Note: 1. Areas are in square kilometres.
2. Population is in thousands.
3. Densities are persons per square kilometre.

11. Before the VAT was implemented, businesses would not under-report their expenses, but they might find ways to under-report revenue. With the VAT in place, it becomes more difficult for businesses to under-report revenue. This means that net income of the businesses in general will increase and consequently the revenues of business income tax will increase.
12. See Wang (1983), Lin (1986) and Chieu (1985).
13. Both Taipei and Kaohsiung are metropolitan areas, with Taipei located in the north of Taiwan and Kaohsiung in the south.

Table 4 lists the annual growth rates of the revenue from the two taxes in Taipei City, Kaohsiung City, Taiwan Province and the Taiwan Area. Table 5 shows the averages of the annual growth rates for the two sub-periods with 1986 as the dividing line.

The numbers in all the regions demonstrate similar patterns. The revenue of the business tax increased significantly in 1986, the year the VAT was adopted, and continued to increase afterwards but at a somewhat slower rate. Although the revenue of the business income tax in all regions also increased significantly in 1986, the sharp upturn in the two metropolitan areas came a year later. It is interesting to note that in 1986 the increase in revenue from the business tax in both Kaohsiung City and Taiwan Province were higher than that in Taipei City (with annual changes of 122.9 percent, 63.7 percent and 44.4 percent, respectively).

This seems a trifle puzzling, since a larger increase should have derived from a business centre such as Taipei. One possible explanation is that before adoption of the VAT, tax collection and auditing procedures in Taipei were stricter than in the other two regions. Therefore, the shift to the VAT system effectively accelerated the administrative capacity of the tax administrations in these two regions, and thus exerted a larger impact on business entities. The averages in Table 5 for the two sub-periods clearly indicate the impact of the VAT on both the business tax and the business income tax in all regions.

D. *Different businesses*

I will now examine how the VAT affects different businesses; ten out of the 37 businesses which are listed in the Business Tax Law are discussed. Table 6 lists in percentage points the number of business entities by their 1989 annual sales for the ten selected businesses. The criterion of selection is the range of size of the business entities in different businesses, as reflected by annual sales. As is clear from the table, six of the businesses have conspicuous numbers of business entities with annual sales in the 100 million to 1 billion NT range.[14] In contrast, four businesses have less than 0.1 percent of the business entities with annual sales of more than 100 million NT. The purposes of analyzing the impact of the VAT on these ten businesses are twofold: to ascertain how the VAT affects different businesses in general, and to determine whether the size of the business entities, as reflected by their annual sales, plays a role in determining how they respond to the VAT.

14. The exchange rate between the U.S. dollar and the new Taiwan dollar (NT) is approximately 1 to 27.

TABLE 4
REVENUE GROWTH RATES OF BUSINESS TAX AND BUSINESS INCOME TAX

	Taipei		Kaohsiung		Taiwan Prov.		Taiwan Area	
	Bus. T.Rev	Bus.Inc. T.Rev	Bus. T.Rev	Bus.Inc T.Rev.	Bus. T.Rev	Bus.Inc T.Rev	T.Rev	T.Rev.
1981	29.9%	21.7%	23.6%	–8.2%	31.1%	23.3%	29.8%	30.2%
1982	19.2%	9.8%	7.0%	–7.4%	8.2%	1.9%	13.4%	6.0%
1983	1.4%	–22.4%	2.1%	0.9%	8.5%	3.5%	4.4%	–13.2%
1984	11.4%	15.7%	12.5%	20.5%	16.9%	17.6%	13.9%	16.7%
1985	7.1%	0.3%	0.7%	6.3%	6.9%	22.1%	6.5%	8.4%
1986	27.5%	4.5%	31.9%	0.7%	26.1%	–2.2%	27.3%	1.6%
1987	44.4%	16.9%	122.9%	12.5%	63.7%	26.9%	59.5%	20.3%
1988	23.2%	47.4%	8.8%	32.6%	16.4%	22.3%	18.5%	36.2%
1989	5.2%	53.4%	11.9%	30.0%	4.2%	–4.2%	5.5%	31.2%

Source: Yearbook of Tax Statistics, Republic of China, 1990.
Note: The numbers are for fiscal years.

TABLE 5
AVERAGE ANNUAL GROWTH RATE OF BUSINESS TAX AND BUSINESS INCOME TAX FOR TWO SUB-PERIODS

	Taipei		Kaohsiung		Taiwan Prov.		Taiwan Area	
	Bus. T.	Bus.I.T.	Bus. T.	Bus.I.T.	Bus. T.	Bus.I.T.	Bus.T.	Bus.I.T.
1980 – 1986	16.1%	4.8%	13.0%	1.7%	16.3%	11.0%	15.9%	6.6%
1987 – 1990	24.3%	39.2%	47.9%	25.0%	28.1%	15.0%	27.8%	29.2%

Source: Yearbook of Tax Statistics, Republic of China, 1990.
Note: The numbers are for fiscal years.

Before presenting the revenue from the business tax for these businesses, a brief recount is in order regarding the factors affecting the taxes paid by the business entities. The sales of a business entity can be separated into four categories:
(1) taxable sales, on which the normal rate of five percent is applied;
(2) zero-rated sales, which refer to exports;
(3) tax-exempt sales, which are mainly sales of capital goods; and
(4) special tax rate sales, which are sales of financial sector entities.

Since the tax-exempt sales are all below ten percent of total sales in these ten businesses,[15] the sales which are zero-rated become a more important factor in determining the tax revenue from a particular business. If the sales of the business include a high percentage of exports (notably the intermediary business), then the refunding of taxes paid in the previous stages of production may make the net tax revenue from this business negative. Table 7 reflects this characteristic.

The numbers in the table represent the annual growth rates of the business tax revenue in these ten businesses. A few statements can be made about these numbers. First, while the annual growth rates for the ten businesses in general show significant increases after adoption of the VAT, the annual growth rates for individual businesses vary. In addition, all the businesses sooner or later experienced at least one drastic change in tax revenue. Second, for the four businesses which are characterized by smaller sales, the growth rates of the tax revenue show a relatively homogeneous pattern. The increase in the tax revenue from these four businesses all occurred in 1986, the year the VAT was adopted. Third, due mainly to the zero-rated tax applicable to exports, entities in the intermediary business actually paid negative taxes (i.e. received positive net refunds with a growth rate of −199 percent) in 1986. A direct policy implication of this is that for its unique nature in obtaining tax refunds, tax auditing of business entities in the intermediary business must be strengthened to avoid possible "false export-true refunding". In summary, the responses of various sized businesses to the VAT do not seem to differ significantly.

E. *Public vs. private business entities*

With the public business entities producing approximately 20 percent of the GNP,[16] it is interesting to examine whether the VAT exerts a different impact on these entities compared to its impact on private business entities. This inquiry has at least two implications. First, since public business entities are generally larger, the comparison will provide additional information on the significance of size in determining the impact of VAT. Second, given that public busi-

15. Yearbook of the Information Centre, Ministry of Finance, 1990.
16. Taiwan Statistical Data Book, Council for Economic Planning and Development, Republic of China, 1990.

TABLE 6
PERCENTAGE OF BUSINESS ENTITIES OF DIFFERENT SALES LEVELS IN TEN BUSINESSES

Annual Sales	Retail	Manufacturing	Construction	Transportation	Banks	Intermediary	Publishing	Repair	Processing	Service	Total
– 10M	84.4%	73.1%	85.5%	67.7%	22.1%	67.4%	91.9%	96.2%	90.6%	95.7%	82.1%
10 – 100M	14.0%	22.1%	13.0%	29.3%	43.8%	27.1%	7.8%	3.2%	8.7%	3.8	15.5%
100 – 1000M	1.5%	4.5%	1.4%	2.7%	32.1%	5.2%	*	*	*	*	2.3%
1000M	0.1%	0.4%	0.1%	0.3%	2.0%	0.3%	*	*	*	*	0.2%
Total	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %

Source: Yearbook of the Information Centre, Ministry of Finance, Republic of China, 1990.
Note: *, less than 0.1 percent.

TABLE 7
REVENUE GROWTH RATES OF BUSINESS TAX FOR TEN BUSINESSES

Year	Retail	Manufacturing	Construction	Transportation	Banks	Intermediary	Publishing	Repair	Processing	Service	Total
1984	18.09%	9.83%	6.59%	17.97%	9.04%	8.96%	17.39%	7.58%	30.83%	8.78%	12.4%
1985	−3.71%	2.75%	2.79%	8.06%	6.31%	−6.40%	5.56	7.04%	−0.64%	0.90%	2.1%
1986	−46.16%	257.46%	88.14%	183.25%	15.25%	−199.22%	260.53%	381.58%	209.62%	212.44%	83.1%
1987	5.2 %	34.37%	51.36%	16.63%	44.57%	47.05%	36.74%	42.08%	2.48%	45.80%	29.4%
1988	114.0 %	4.58%	15.16%	−1.26%	−0.11%	−80.86%	5.16%	10.58%	−15.15%	12.20%	11.8%
1989	48.14%	11.89%	44.64%	12.81%	63.80%	250.35%	12.01%	38.26%	13.57%	22.09%	41.1%

Source: Yearbook of the Information Centre, Ministry of Finance, Republic of China, 1985-1990.
Note: The numbers are for calendar years.

ness entities are different from private business entities in many respects (e.g. their regulated rates of returns, tighter accounting procedures, etc.), they might respond differently to the VAT.

As background information, Table 8 shows the composition of public business entities in terms of annual sales in recent years as compared to that of private business entities.

As might be expected, a larger percentage of public business entities have annual sales in the upper scale. In particular, except for the range of annual sales of up to NT$ 10 million, the percentage of public business entities in all other sale ranges exceeds that of private business entities. In addition, there is an obvious trend for public business entities to move into the range of higher annual sales. The next table lists the percentages of both public and private business entities as grouped by different taxable sales. The numbers indicate that business entities in both sectors have the larger percentages providing a disproportionate amount of taxable sales.

With Tables 8 and 9 as references, the next table lists the composition of taxes actually paid by both public and private business entities. A few observations can be made. First, adoption of the VAT did not grossly affect the tax revenue structure for either public or private business entities. In particular, approximately 90 percent of the business tax revenue from public business entities comes from entities with annual sales exceeding NT$ 100 million, and the corresponding percentage for private business entities is approximately 50 percent. Both numbers remained relatively stable before and after adoption of the VAT. Second, there is a trend for business entities with annual sales of more than NT$ 1 billion to increase their contribution to the business tax revenue percentage-wise. Third, a comparison of Tables 9 and 10 indicates that the correspondence between taxable sales and business taxes actually paid for the public business entities is somewhat different from that for private entities. The percentage points of taxable sales across the sales ranges for private business entities are, in general, close to the corresponding percentage points of business tax paid. In contrast, the numbers of the public business entities reveal a different story. For entities with annual sales between NT$ 100 million and NT$ 1 billion, the percentage of the business tax paid exceeds that of taxable sales by at least ten percentage points throughout the years. For the entities with annual sales above NT$ 1 billion, however, the percentage of taxable sales exceeds that of the business tax paid by at least 15 percentage points for the six-year period.

TABLE 8
PERCENTAGE OF PUBLIC AND PRIVATE BUSINESS ENTITIES OF DIFFERENT SALE LEVELS

	Public business entities						Private business entities					
	Num. of Sales/ Entities	– 10M	10 – 100M	100 – 1000M	1000M –	Total	Num. of Sales/ Entities	– 10M	10 – 100M	100 – 1000M	1000M –	Total
1984	1,569	28.6%	35.3%	31.5%	4.7%	100%	303021	82.4%	15.3%	2.2%	0.1%	100%
1985	1,605	27.5%	34.3%	33.4%	4.7%	100%	306993	82.4%	15.3%	2.2%	0.1%	100%
1986	1,945	28.6%	39.6%	26.9%	4.8%	100%	336067	79.7%	17.7%	2.6%	0.1%	100%
1987	1,880	23.9%	41.7%	29.6%	4.8%	100%	355431	77.3%	19.8%	2.8%	0.2%	100%
1988	1,885	23.7%	38.1%	33.1%	5.1%	100%	381223	76.8%	20.3%	2.8%	0.2%	100%
1989	1,890	22.4%	34.7%	37.1%	5.8%	100%	404956	75.8%	21.1%	2.9%	0.1%	100%

Source: Yearbook of the Information Centre, Ministry of Finance, Republic of China, 1985-1990.

TABLE 9
PERCENTAGE OF TAXABLE SALES REPORTED BY PUBLIC AND PRIVATE BUSINESS ENTITIES OF DIFFERENT SALES LEVELS

	Public business entities						Private business entities					
	Taxable Sales	– 10M	10 – 100M	100 – 1000M	1000M –	Total	Taxable Sales	– 10M	10 – 100M	100 – 1000M	1000M –	Total
1984	418,413	0.2%	5.9%	27.8%	66.1%	100%	2,439,937	18.4%	32.4%	31.5%	17.7%	100%
1985	457,794	0.2%	5.4%	28.1%	66.4%	100%	2,424,142	18.9%	33.0%	31.5%	16.6%	100%
1986	461,125	0.2%	4.6%	16.7%	78.5%	100%	3,459,973	16.0%	35.0%	32.1%	17.0%	100%
1987	484,091	0.2%	3.7%	14.7%	81.4%	100%	4,313,724	14.8%	35.6%	31.8%	17.8%	100%
1988	498,768	0.2%	3.6%	13.3%	83.0%	100%	4,889,818	14.2%	39.1%	30.1%	19.9%	100%
1989	531,426	0.2%	4.1%	8.9%	86.8%	100%	5,660,796	13.0%	34.1%	31.1%	21.8%	100%

Source: Yearbook of the Information Centre, Ministry of Finance, Republic of China, 1985-1990.
Note: 1. The numbers are for calendar years.
2. Taxable sales are in NT$ million.

This stark contrast deserves further investigation. A tentative explanation is that public business entities with annual sales between NT$ 100 million and 1 billion have a higher degree of value added in the production process (possibly due to smaller amounts of deductible expenses); therefore the taxes paid percentage-wise exceed the corresponding taxable sales. For public business entities with annual sales of over NT$ 1 billion, however, the degree of value added is relatively low. Consequently, these entities paid a smaller percentage of business tax than what their sales called for. Whether this implies an "optimal" operation size of public business entities is an interesting question, the answer to which is yet to be found. The next table compares public and private business entities from a different angle. It lists in percentages the number of business entities, taxable sales and the business tax paid over a six-year period.

While the composition of public versus private business entities remained stable over the period under investigation, the taxable sales of public business entities dropped four percentage points when the VAT was introduced and continued to decrease slightly afterwards. Accordingly, the amount of business tax paid by public business entities also exhibited a decreasing trend, though at a slower pace. A more important fact to be noted, however, is that although public business entities accounted for only an insignificant percentage (0.5 percent) of the total business entities, they generated over 8 percent of total taxable sales and over 20 percent of total taxes paid. Since the size of public business entities are in general larger (see Table 8), it is understandable that they would generate a disproportionate amount of taxable sales. The gap between taxable sales and taxes paid, however, cannot be entirely explained by the size differences.

A few possible and tentative explanations are as follows. First, it is possible that the products of public business entities generally have a higher degree of value added and this results in a disproportionate amount of taxes paid by these entities. Second, since wages and salaries cannot be deducted as costs, it is possible that public business entities employ a larger number of employees and therefore must assume the resulting larger burdens of taxes.[17] A third possible explanation relates to the reliability of the accounting records of business entities in the two sectors. Since public business entities have less incentive to resort to "double bookkeeping", as compared to their counterparts in the private sector, they tend to report the sales figures more accurately and therefore incur more taxes. Consequently, upon the introduction of the VAT, the taxable sales of private business entities experienced a greater increase. As a result, the relative importance of taxable sales generated by public business entities declined. The interesting contrast between public and private business entities obviously needs more attention. It is likely that all three factors mentioned above, in particular the latter two, contribute to the observed differences.

17. Business Tax Laws (1988), Art. 19.

TABLE 10
PERCENTAGE OF BUSINESS TAX PAID BY PUBLIC AND PRIVATE BUSINESS ENTITIES OF DIFFERENT SALES LEVELS

	Public business entities						Private business entities					
	Taxable Sales	– 10M	10 – 100M	100 – 1000M	1000M –	Total	Taxable Sales	– 10M	10 – 100M	100 – 1000M	1000M –	Total
1984	6,944	1.4%	9.7%	38.6%	50.1%	100%	12,307	18.2%	31.3%	33.7%	16.8%	100%
1985	7,449	0.1%	9.5%	40.1%	50.3%	100%	20,031	18.4%	34.3%	31.8%	15.5%	100%
1986	20,106	0.2%	4.9%	34.9%	60.0%	100%	63,390	17.8%	34.4%	28.7%	19.2%	100%
1987	26,725	3.0%	4.9%	34.3%	57.8%	100%	88,676	18.9%	32.0%	29.0%	20.1%	100%
1988	26,222	5.4%	3.5%	32.7%	58.4%	100%	96,472	18.6%	31.4%	28.4%	21.7%	100%
1989	30,761	7.9%	2.0%	25.0%	65.1%	100%	123,151	16.6%	28.0%	28.1%	27.4%	100%

Source: Yearbook of the Information Centre, Ministry of Finance, Republic of China, 1985-1990.
Note: 1. The numbers are for calendar years.
2. Taxable sales are in NT$ million.

TABLE 11
PERCENTAGE OF SELECTIVE INDICATORS FOR PUBLIC VERSUS PRIVATE BUSINESS ENTITIES

	Number of Bus.E.			Taxable Sales			Taxes Paid		
	Pub.	Pri.	Tot.	Pub.	Pri.	Tot.	Pub.	Pri.	Tot.
1984	0.5%	99.5%	100%	14.6%	85.4%	100%	25.3%	74.7%	100%
1985	0.5%	99.5%	100%	15.9%	84.1%	100%	26.4%	73.6%	100%
1986	0.6%	99.4%	100%	11.8%	88.2%	100%	24.1%	75.9%	100%
1987	0.5%	99.5%	100%	10.1%	89.9%	100%	23.2%	76.8%	100%
1988	0.5%	99.5%	100%	9.3%	90.7%	100%	21.4%	78.6%	100%
1989	0.5%	99.5%	100%	8.6%	91.4%	100%	20.0%	80.0%	100%

Source: Yearbook of the Information Centre, Ministry of Finance, Republic of China, 1985-1990.
Note: 1. The numbers are for calendar years.
2. Taxable sales are in NT$ million.

TABLE 12
GROWTH RATE OF SELECTIVE INDICATORS FOR PUBLIC VERSUS PRIVATE BUSINESS ENTITIES

	Business Entities			Taxable Sales			Taxes Paid		
	Pub.	Pri.	Tot.	Pub.	Pri.	Tot.	Pub.	Pri.	Tot.
1985	2.3%	1.3%	1.3%	9.4%	–0.6%	0.8%	6.5%	0.6%	2.1%
1986	21.2%	9.5%	9.5%	0.7%	42.7%	36.1%	169.9%	205.0%	195.8%
1987	–3.3%	5.8%	5.7%	5.0%	24.7%	22.4%	32.9%	39.9%	38.2%
1988	0.3%	7.3%	7.2%	3.0%	13.4%	12.3%	–1.9%	8.8%	6.3%
1989	0.3%	6.2%	6.2%	6.5%	15.8%	14.9%	17.3%	27.7%	25.4%

Source: Yearbook of the Information Centre, Ministry of Finance, Republic of China, 1985-1990.
Note: 1. The numbers are for calendar years.
2. Taxable sales are in NT$ million.

As a summary of the comparison of public and private business entities, Table 12 lists the growth rates of the number of business entities, taxable sales and business tax actually paid for public and private business entities separately and collectively. It seems that, after the VAT was introduced, business entities in the public sector did not experience significant changes in sales. The reported sales of private business entities, however, increased drastically. This can be explained by the fact that with the cross-checking procedure of the VAT it becomes more difficult for business entities to under-report sales and thus results in a tremendous increase in the sales reported by private business entities. This reinforces the proposition that the reliability of the accounting records of public business entities tends to be greater than that of private business entities. It again reflects the strength of the VAT in allowing the tax administration to control business activities more effectively.

F. *Appropriateness of the tax rates*

After adoption of the VAT, the business tax paid increased for both public and private business entities. It is interesting to note, however, that the numbers for public business entities offer a hint as to whether the tax rate (i.e. five percent) is appropriate. Since taxable sales for public business entities grew at much slower pace than the economic growth rate, the increase in the taxes paid cannot be explained by the expansion of the economy. It might have been caused by the larger (non-deductible) wages and salaries as explained above, but it is also possible that the tax rate was too high. Table 13 summarizes the possible combinations of taxable sales and business tax paid, and the corresponding explanations.

TABLE 13
COMBINATIONS OF CHANGES IN SALES AND BUSINESS TAX REVENUES

Sales after VAT	Rev. of Bus. T	Possible causes: Collection efficiency	Tax rate
decrease	decrease	decrease	too low
	no change	decrease	too high
	increase	decrease	too high
no change	decrease	no improvement	too low
	no change	no improvement	too high
	increase	no improvement	too high
increase	decrease	increase	too low
	no change	increase	appropriate
	increase	increase	too high

The fact that the tax revenue increased after adoption of the VAT does not prove in itself that the new system improved the efficiency of tax collection, since a higher tax rate would have had the same effect. The figures of reported sales, however, offer a better indicator of the VAT performance. If, upon introduction of the VAT, the sales increase significantly without other concurrent economic changes, then it can be directly inferred that the new system improves the tax administration's ability to keep account of business transactions. In addition, if the reported sales increase under the new system, then taxable income is likely to increase as well. Table 14 lists the growth rates of reported sales, revenue from the business tax, business income and revenue from business income tax. It is evident that the VAT brought about a significant increase in all categories. The numbers imply that while the VAT rate may be somewhat high, the system tremendously improves the efficiency of tax collection. The increases in both reported sales and business income provide the most important support for the success of the new VAT in Taiwan.

TABLE 14
GROWTH RATES OF SALES, BUSINESS TAX REVENUES, BUSINESS INCOME, BUSINESS INCOME TAX REVENUES

	Sales	Bus. Tax Rev.	Bus. Inc.	Bus. Inc. Rev.
1980	31.4%	13.1%	28.6%	20.3%
1981	24.8%	29.8%	–1.0%	20.2%
1982	6.6%	13.3%	2.7%	6.0%
1983	4.3%	4.4%	7.6%	–13.2%
1984	20.6%	13.9%	11.1%	16.7%
1985	5.7%	6.5%	–3.0%	8.4%
1986	5.8%	27.3%	15.0%	1.6%
1987	24.2%	59.5%	36.1%	20.3%
1988	13.4%	18.5%	20.6%	36.2%
1989	13.9%	5.5%	*	31.2%

Source: Yearbook of Financial Statistics, 1985-1990.
Note: 1. The numbers are for fiscal years.
2. *, not yet available.

G. *Effectiveness of the cross-checking procedure*

Table 15 lists the percentages of dummy business entities found and penalized for the cases randomly checked in selective months by the tax administration in Taipei City, Kaohsiung City, Taiwan Province and the Taiwan Area. The figures clearly reflect that as time passed, the strength of the VAT's cross-checking procedure was realized and it exerted a deterrent effect on the occurrence of dummy businesses.

TABLE 15
PERCENTAGE OF DUMMY BUSINESS ENTITIES FOUND BY CROSS-CHECKING FOR SELECTIVE MONTHS

Year	Mon	Taipei	Kaohsiung	Taiwan	Total
1986	Apr.	0.7%	0.7%	0.2%	0.41%
	Jun.	2.2%	1.4%	1.4%	1.7 %
	Oct.	0.4%	1.8%	0.5%	0.6 %
1987	Feb.	0.4%	0.6%	0.5%	0.5 %
	Jun.	0.8%	1.3%	0.3%	0.6 %
	Oct.	0.1%	*	0.8%	0.4 %
1988	Feb.	0.1%	*	0.1%	0.1 %
	Jun.	0.3%	*	0.1%	0.2 %
	Oct.	0.2%	*	*	0.1 %
1989	Feb.	*	*	*	*
	Jun.	*	*	0.1%	*
	Oct.	0.2%	0.1%	*	0.1 %

Source: Data offered by the Information Centre, Ministry of Finance.
Note: *, less than 0.1%.

IV. SUGGESTIONS FOR IMPROVEMENT

The adoption of the VAT significantly improved the tax collection of both business tax and the business income tax. Room for improvement, however, remains. In this section two proposals are advanced to improve the administration of the VAT. It is specifically proposed that certain expenses be excluded from deductible costs and that imports be taxed at customs upon entry.

A. *Non-deductible expenses*

Excluding certain expenses (e.g. expenses of less than NT$ 1,000) from deductible costs in calculating taxes will achieve several goals. First, it will simplify administrative procedure for both business entities and the tax administration. Second, since it will reduce the work load of the tax administration it will reduce the number of disputes between the tax administration and business entities (thus the quality of the tax collection process will be improved). Third, while the number of invoices for these expenses is large, the amounts on the invoices are generally small. Therefore the tax revenue involved is relatively minor compared to the administrative costs of handling the invoices.

Excluding certain expenses from deductible costs will understandably stimulate opposition from business entities, because it will increase their tax burden. Additionally, if the expenses cannot be deducted, the incentive for business entities to prepare a general invoice for transactions will disappear and this in turn will affect the completeness of records, and consequently the effectiveness of the cross-checking procedure. To avoid these potential detriments, a few measures can be undertaken. First, the method of "standard deductions" could be adopted to allow business entities to deduct a certain amount of their sales as expenses.[18] The standardized deductions could either be a certain percentage of sales or fixed amounts that vary with sales. Second, "standardized deductions" and "itemized deductions" could be made optional to business entities. This parallels existing procedures under the personal income tax law and offers more flexibility to business entities. The option may cause the tax revenue to decline slightly, but it would certainly cut current administrative costs. To avoid complexities, business entities would have to choose the standard or itemized deductions for a certain period of time. Third, the monthly lottery prizes now offered to holders of general invoices could be increased to maintain incentives for business entities to prepare the invoices. In summary, the aims of excluding certain expenses from deductible expenses are to reduce administrative costs and increase the efficiency of the tax collection process.

B. *Imports taxed at points of entry*

This issue was discussed extensively before the VAT was adopted, but reexamining it as the VAT is now implemented may shed new light on the issue. As is clear from the discussion in the previous section, there are two major achievements of the new VAT. First, the tax base of the business tax has been widened as reflected by the significant increases in reported sales, and as a result, the revenue of the business tax has increased. Second, the tax base of the business income tax has also been broadened because of the increase in reported sales. This, in turn, has resulted in a higher level of business income tax revenue. Both achievements can be traced to VAT's ability to provide the government with a firmer grasp on business activities. Therefore, the possible disadvantages of taxing imports upon entry must be weighed against the obvious advantages of better control of tax sources.

The most frequently raised argument against taxing imports upon entry is that it would increase the capital cost of the importers. Since it may take up to six months or longer for the importers to digest the imports, tax upon entry means that an additional five percent of the amount paid for imports must be set aside and frozen for this period. At least two arguments can be made against this. First, although taxing imports upon entry indeed increases the capital cost of the importers, all other business entities face the same problem in buying raw materials and the like. Therefore, there is really no reason why the importers should enjoy preferential treatment. Second, the five percent surcharge on imports cannot be argued to be an "additional" cost for the importers. Instead, it should be seen as part of the "normal" cost in making the import decision. As such, the argument against tax upon entry is rather weak; it is better viewed as reflecting the lobbying efforts of a particular interest group.

As stated above, the strength of the VAT lies in the cross-checking procedure which forces the previously unrecorded business activities to enter the tax-paying stream. Taxing imports upon entry is parallel to the withholding method of the personal income tax and its superiority to existing procedures is beyond doubt. While the details could be flexible (e.g. banks may offer loans or guarantees to the importers), a move toward tax upon entry is clearly required.

V. CONCLUSION

This article presents a preliminary assessment of the VAT in Taiwan. The strength of the tax is confirmed by the data. Specifically, the revenue of the business tax increased drastically, although this contradicts the official claim that the

18. Since the expenditures of the entities in the service business are mostly in form of expenses, the service business must be treated differently.

switch to the VAT was to be revenue neutral. However, consistent with the official goal, the efficiency of tax collection improved, as reflected by the continuous and significant increases in reported sales. While the increase in reported sales was perhaps as expected, the accompanying increase in reported business income was somewhat unanticipated. Although on hindsight the link between reported sales and business income is only natural, it did not appear that an improvement in the business income tax collection was among the policy objectives of adopting the VAT. In any case, the experience of Taiwan attests to the superiority of the VAT in taxing business activities.

An important policy implication regarding the link between the business tax and business income tax warrants mention. Since an increase in reported sales is likely to cause an increase in reported business income, an acceleration in the collection effort for the business tax will benefit not only the business tax itself but the business income tax as well. In contrast, adjustment of the VAT rate will possibly only increase the revenue of the business tax and not that of the business income tax. Furthermore, adjusting the tax rate requires legislative approval, while strengthening the tax collection procedures only requires administrative decrees. Therefore, the effort to modify VAT's collection procedures to improve efficiency should be continued. The predictable fruits of such efforts will be enjoyed by both the business tax and the business income tax revenue.

Finally, extensions of the present work are needed. For instance, an in-depth analysis of the relationships among reported sales, reported business tax, business tax paid, and business income tax paid from different businesses will offer guidance in improving tax collection. It is hoped that, as VAT gains in popularity on an international level, a better understanding of one country's experience will benefit the country as well as the international community.

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CONFERENCE ON THE TAX TREATMENT OF NON-PROFIT ORGANIZATIONS

This issue contains several of the papers presented during a multinational conference held in Taipei on 15 and 16 August 1991 on the tax treatment of non-profit organizations.

Non-profit organizations make up a somewhat invisible but usually significant component of many economies in industrialized and newly industrialized countries. In describing the ways in which non-profit organizations are taxed or not taxed, the papers provide insight into the policy options facing governments in designing the tax regimes applicable to non-profit organizations. Two of the key policy concerns which emerge are fairness, i.e. how tax-exempt non-profit organizations involved directly or indirectly in commercial activities are dealt with to avoid giving them a competitive advantage over regular commercial enterprises; and efficiency, i.e. how effective the fiscal incentives are in encouraging support for the activities of non-profit organizations, and whether the administrative costs associated with the increased complexity brought about by such incentives outweigh any favourable effect the incentives might have.

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INTERNATIONAL:

CONFERENCE ON THE TAX TREATMENT OF NON-PROFIT ORGANIZATIONS

INTRODUCTION

Charles R. Irish and Susan S. Katcher

POLICY OPTIONS

Non-profit organizations make up a somewhat invisible but usually significant component of many economies in industrialized and newly industrialized countries. The tax treatment of non-profit organizations thus raises important concerns about the fairness of the tax laws and the ways in which governments use taxes and tax incentives to achieve socially and economically desirable objectives.

The papers in this issue were prepared for a multinational conference held in Taipei on 15 and 16 August 1991, on the tax treatment of non-profit organizations. The conference was sponsored by the Ministry of Finance of the Republic of China and co-sponsored by the University of Wisconsin's East Asian Legal Studies Center.

In describing the ways in which non-profit organizations are taxed or not taxed in the Republic of China, Canada, Singapore, Japan, Korea, the United Kingdom, the Netherlands and the United States, the papers provide insight into the policy options facing governments in designing the tax regimes applicable to non-profit organizations.[1] This paper briefly describes these options and summarizes how the eight countries deal with them.

I. SHOULD NON-PROFIT ORGANIZATIONS BE GRANTED TAX FAVOURED TREATMENT?

Among the participating countries, the consensus is that some non-profit organizations, but not all, should be granted tax favours. Some countries, such as Korea and Singapore, take a fairly restrictive view on which non-profit organizations qualify for tax concessions. Other countries, most notably the United States, are relatively generous in defining the non-profit organizations entitled to tax-favoured status. Irrespective of the breadth of the definition of organizations entitled to receive tax-favoured treatment, the tax concessions are usually justified for one of the following reasons:

(1) Non-profit organizations carrying on socially desirable work should be encouraged and supported through tax concessions. Thus, non-profit organizations engaged in religious, charitable, educational, literary and scientific activities should qualify for tax-favoured treatment. In several of the countries surveyed, labour and political organizations and business associations are also included in the group of tax-favoured non-profit organizations.

Professor Irish is Volkman-Bascom Professor of Law, Director, East Asian Legal Studies Center, University of Wisconsin. Ms. Katcher received her J.D. from the University of Wisconsin, and is Assistant Director of the East Asian Studies Center.

(2) To stimulate savings, especially retirement savings, governments extend tax concessions to non-profit organizations which act as vehicles for the accumulation of pension savings. Many of the largest exempt organizations in the world have their exemptions because they serve this function. For example, TIAA-CREF, a teachers' retirement pension fund in the United States, has assets of US$ 70.9 billion and British Coal's Pension Fund is valued at £ 12 billion. Both are tax-exempt.

(3) Cooperative business and social associations often qualify for an income tax exemption under the theory that any net income of an association which is attributable to the members of the association should be treated as a reduction in the cost of doing business or carrying on social activities.

It is generally agreed that some sort of review process is necessary to ensure that only suitably qualified non-profit organizations receive tax favoured treatment. Among the countries surveyed, the most common review process is a requirement that non-profit organizations apply to the government for the available tax concessions. In a few instances, the application process is supplemented with periodic reviews of the receipts and disbursements of the non-profit organizations.

II. WHAT TAX CONCESSIONS SHOULD BE GRANTED TO NON-PROFIT ORGANIZATIONS?

All eight countries grant to qualifying non-profit organizations income tax exemptions that uniformly cover the non-profit organizations' exempt function income, such as tuition paid to a school and medical fees paid to a hospital. In addition, most of the governments extend the income tax exemption to passive investment income of the non-profit organizations. Among the eight countries, only Korea limits the exemption for non-profit organizations and taxes the income from passive investments.

1. The U.K. contribution will appear in an upcoming issue of the *Bulletin*.

Exemptions from other taxes also are commonplace. In Japan, for example, public interest corporations are exempt from the national registration and licence tax, the prefectural real property acquisition tax, the municipal fixed assets tax, and the newly introduced national land price tax. Similar broad-based exemptions are allowed in the Republic of China, Korea and Singapore. In the United States and Canada, where the income tax exemptions for non-profit organizations are fairly broadly available, exemptions from sales and property taxes are allowed, but on a more limited basis than the income tax exemptions. Thus, while religious organizations and schools in the United States may be exempt from real property and sales taxes as well as income taxes, non-profit business associations and social clubs commonly do not enjoy either property or sales tax exemptions.

III. WHAT RESTRICTIONS ARE IMPOSED ON DIRECT INVOLVEMENT IN COMMERCIAL ACTIVITIES?

It is widely recognized that allowing tax-exempt organizations to engage in regular commercial operations gives the exempt organizations a competitive advantage over taxable business enterprises. As a result, in most of the countries surveyed, the tax exemption extends only to exempt function income and (except for Korea) passive investment income. Profits from commercial operations unrelated to the exempt purposes of the non-profit organizations usually are taxed. In Canada, however, tax-exempt charities found to be carrying on unrelated business activities are subject to jeopardizing their official status as a registered tax-exempt organization and ultimately may completely lose their tax-exempt status and their position as a favoured recipient of charitable contributions. The Canadian judiciary has taken a liberal view of when businesses are related to the exempt purposes of the charities, with the consequence that Canadian charities apparently have considerable freedom to operate for-profit enterprises.

The Canadian experience illustrates that the distinction between related and unrelated business operations has great practical significance; the distinction, however, is difficult to make and varies from one country to another. In contrast to the Canadian judiciary's generous view of what constitutes a related business, for example, the Dutch Supreme Court has taken a highly restrictive view by declaring a volunteer blood bank operated by the Dutch Red Cross a commercial, competitive operation even though no commercial blood banks operate in the Netherlands. One suspects that the severity of the sanctions – loss of favoured status and ultimately complete taxation in Canada versus taxation of only the unrelated business income in the Netherlands – influenced the decision of whether the business was related or unrelated. In other words, with less draconian sanctions, the Canadian judiciary probably would be inclined to adopt a more stringent standard for when businesses are related to the exempt purposes of the charities.

IV. WHAT RESTRICTIONS ARE IMPOSED ON INDIRECT INVOLVEMENT IN COMMERCIAL ACTIVITIES?

With the exception of Korea, passive investment income of non-profit organizations is tax-exempt. This would appear to allow non-profit organizations to engage indirectly in commercial operations by putting the commercial operations into a wholly owned, for-profit subsidiary. Nonetheless, there is a general uneasiness when non-profit organizations have a close connection with regular profit seeking enterprises. The uneasiness is manifested in several different ways. In the United States and Singapore, non-profit organizations are limited in the extent to which they can own for-profit enterprises without jeopardizing their exempt status; in the United States, the financial arrangements between the non-profit organizations and the related business enterprises are closely regulated to limit abuses; and in several countries, non-profit organizations established by and potentially controlled by regular profit seeking enterprises are subject to stringent reviews of their activities.

V. WHAT RESTRICTIONS ARE IMPOSED ON INVOLVEMENT IN POLITICAL ACTIVITIES?

Probably the greatest differences in the tax treatment of non-profit organizations occur with respect to their political involvement. The United States seriously restricts the political participation in political campaigns and severely limiting their efforts to influence legislative and administrative decisions. At the other extreme are the Netherlands and the Republic of China, which impose no restrictions on the political activities of non-profit organizations.

VI. WHAT TAX CONCESSIONS ARE AVAILABLE FOR GIFTS TO NON-PROFIT ORGANIZATIONS?

Income tax deductions are usually allowed for gifts to designated non-profit organizations. The prevailing attitude is that such gifts should be encouraged through a fiscal incentive since the gifts will be used for socially desirable objectives. There are, however, a variety of different ways on what organizations should qualify to receive deductible gifts and what kind of property is deductible.

In Singapore, cash gifts are deductible if made to certain specific charitable organizations; gifts of property other than cash are deductible only in very limited circumstances. In the Netherlands and the Republic of China, gifts to charitable organizations are deductible, as are gifts to political organizations. In the United States, gifts of cash and many other kinds of property to charities are deductible for income tax purposes, but no deduction is allowed for contributions to political campaigns or organizations. The United States also has an extensive set of rules designed to curb the abusive opportunities which arise primarily because so many property interests are deductible.

Ceilings on the amount of deductible contributions are the norm, apparently under the theory that individual and corporate taxpayers should not be allowed to shelter all of their income from the tax collector, even by giving it away. Less common, but probably based more on sound policy, is the imposition of a threshold for deductible contributions. In Japan, for example, only contributions in excess of ¥ 10,000 per year are deductible, presumably under the theory that most people make contributions of ¥ 10,000 without regard for any fiscal incentives, so an incentive should be available only where it is likely to make a difference. The Canadian system of using a tax credit rather than a tax deduction also is notable because it ensures that the level of government subsidization for charitable contributions is not influenced by the individual donor's marginal tax rate.

VII. HOW ARE FOREIGN NON-PROFIT ORGANIZATIONS AND GIFTS TO FOREIGN NON-PROFIT ORGANIZATIONS TREATED?

Foreign non-profit organizations are treated in a variety of ways. The most benevolent is likely that of the United States, which allows foreign non-profit organizations to qualify for tax-exempt status in the United States on the same terms as U.S. non-profit organizations. The United Kingdom seems to adopt a similar approach in allowing the formation of an affiliated entity under U.K. law, which then can qualify for exempt status in the United Kingdom. Singapore and Japan take a somewhat different view and condition their tax concessions on the foreign non-profit organization's establishing that they will benefit local society.

Gifts to foreign charities typically tend to be not tax deductible, although specific tax treaty provisions can override this general treatment. For example, gifts to foreign charities are expressly deductible under the U.S.–Canada tax treaty. Thus, U.S. individuals and corporations can make deductible contributions to Canadian charities and vice versa, although the deductions generally may not exceed the portion of income derived from the other country.

CONCLUSION

Looking at the tax treatment of non-profit organizations brings into focus two of the key policy concerns influencing the structure of fiscal regimes: fairness – how tax-exempt non-profit organizations involved directly or indirectly in commercial operations are dealt with to avoid giving them a competitive advantage over regular profit-seeking businesses; and efficiency – how effective the fiscal incentives are in encouraging support for the activities of non-profit organizations, and whether the administrative costs associated with the increased complexity brought about by such incentives outweigh any favourable effect the incentives might have. Thus, while the tax treatment of non-profit organizations is an area frequently neglected, it actually merits increased attention.

UNITED STATES

Charles R. Irish

Volkman-Bascom Professor of Law, Director, East Asian Legal Studies Center, University of Wisconsin, Madison, Wisconsin

I. INTRODUCTION

A. *Overview*

Non-profit organizations form a central part of American society. The most visible group of non-profit organizations includes those engaged in religious, charitable, educational, scientific or artistic activities. A multitude of different religious groups exist as non-profit organizations. A large number of the entities concerned with preserving wilderness areas, wildlife and the quality of water and air also are non-profit organizations, as are the American Red Cross, the United Way and similar relief organizations. Many hospitals and other health care facilities[1] and some of the most prestigious universities in the United States, such as Harvard, Yale, Columbia, Stanford and the University of Chicago, are non-profit organizations.[2] The American Cancer Society and the American Heart Association are well-known non-profit organizations engaged in funding medical research activities. While many museums and centres for the performing arts are owned by the local, state or federal government, many others, such as the Getty Museum, the Cleveland Symphony Orchestra and the Joffrey Ballet, are independently operated, non-profit organizations.

There also are a great many other non-profit organizations that are not involved in religious, charitable, educational, scientific or artistic activities. Junior chambers of commerce typically are non-profit entities engaged in social welfare activities. Both public and private employee[3] labour unions are non-profit entities. The American Bar Association, the American Medical Association, the U.S. Chamber of Commerce and similar business oriented organizations generally are established as non-profit associations. Somewhat surprisingly to many people, country clubs, athletic clubs and other social clubs usually are established as non-profit organizations.

There are two important groups of entities that are somewhat similar to non-profit organizations. Public and private employee pension and profit-sharing trusts invest billions of dollars in U.S. and foreign capital markets and make retirement and profit-sharing disbursements to their employee beneficiaries. Because their activities are deemed to be of such great social and economic importance, however, they enjoy many of the tax preferences granted to the most favoured non-profit organizations.

Cooperative agricultural and business associations also are similar to non-profit organizations. Cooperatives represent a grouping of like-minded business people, such as farmers, who join together for a common business objective, such as marketing of agricultural produce. Although cooperatives are directly involved in commercial activities,[4] they are granted the same tax-exempt status as many non-profit organizations. Since the receipts of cooperatives come largely

1. Many hospitals and other health care facilities are owned by the local, state or federal government. In addition, the United States is somewhat unusual in that quite a number of health care facilities are private, for-profit enterprises. The Hospital Corporation of America, for example, is a for-profit corporation which operates hospitals throughout the United States.
2. Most universities in the United States are parts of the state and local governmental systems. The University of Wisconsin, the University of Washington, UCLA and the University of California – Berkeley, for example, are under the jurisdiction of the state governments where they are located.
3. The term "public employee" refers to an individual employed by a local, state or federal government. School teachers and fire fighters are public employees. A "private employee" is an individual working in the private sector – an employee of IBM or the Boeing Corporation is a private employee.
4. Cooperative associations are sometimes very large business entities. Twelve of America's 500 largest industrial corporations are cooperatives. *The Economist,* 20 July 1991, at 84. Some of the best known names in agriculture are cooperatives – Ocean Spray cranberries, Land O'Lakes butter, and Gold Kist chicken, for example – are all cooperatives.

from the members of the cooperatives, when cooperatives have a profit, it is returned to the cooperative members as a "patronage dividend" and not taxed. Instead, it is characterized as a reduction in the members' cost of doing business.

B. *Magnitude of non-profit activities*

Non-profit activities are very big business in the United States. The number of non-profit organizations (including pension funds and cooperatives) increased about 15 percent during the decade ending in 1987 to 1.3 million.[5] Revenues of non-profits (again including pension funds and cooperatives) are over $ 750 billion per year, or about 15 percent of the U.S. gross national product.[6]

Another indication of the importance of charitable, educational, religious, scientific and artistic organizations in U.S. society is the amount of tax revenues lost as a result of the deductibility of contributions to such organizations. For fiscal year 1992, it is estimated that federal tax revenues will be reduced by $ 16.9 billion.[7] This suggests total charitable contributions of in excess of $ 100 billion per year,[8] which does not include the very substantial amount of volunteer services performed for charitable organizations.[9]

II. TAX TREATMENT GENERALLY

A. *Income-based taxes*

1. Legal hierarchy

The United States has a federal system of government under which the powers and responsibilities of government are divided between the national government (commonly referred to in the United States as the "federal government") and the 50 governments of the individual states.[10] In the case of non-profit organizations, the laws of the individual states determine in broad terms the organization's operating structure; the federal income and excise tax laws impose restrictions on the range of permissible activities for non-profit organizations to qualify for tax-exempt status or other tax benefits; and the state income, sales and property tax laws describe when non-profit organizations can qualify for an exemption from those taxes.

In the United States, therefore, non-profit organizations typically are subject to a combination of state and federal laws. The state laws describe in broad terms how non-profit organizations are established and operated. The federal tax laws restate the state law conditions for establishment and operation and then impose additional requirements that must be met to qualify for tax-exempt status or as a designated beneficiary of charitable contributions. The state tax laws also establish fairly limited conditions under which non-profit organizations can qualify for income, sales and property tax exemptions.

2. Restrictions under state laws on the establishment and operation of non-profit organizations

Non-profit organizations in the United States are corporations and other artificial entities specially created under the laws of the individual states so that whatever profits they earn are not paid out to their creators or owners. Under state law, non-profit organizations are not restricted in their ability to engage in profit-making activities; instead, they generally are prohibited from paying out their profits as dividends or other profits distributions.

In theory, just about any activity can be carried out by non-profit organizations. In practice, however, non-profit entities are not attractive for regular commercial or investment activities because the profits of such activities may not be passed through to the owners or members of the organizations.

3. Federal tax treatment of non-profit organizations

(a) *The federal income tax exemption*

Most non-profit organizations are established and operated so that they qualify for exempt status under the federal income tax. Therefore, in practice, the federal requirements for obtaining tax-exempt status usually are the ones on which most attention is focused.

To qualify for tax-exempt status, the organizations generally must be prohibited through their articles of incorporation or other governing instrument from paying dividends or otherwise distributing profits to owners, members, officers or directors. Just as under state laws, the federal tax law qualification does not prevent non-profit organizations from generating profits. Unlike the state laws, however, the federal tax law also requires that non-profit organizations engage in specifically enumerated activities in order to qualify for tax-exempt status.

Presumably, the list of enumerated activities reflects the Congressional view that these activities are sufficiently worthwhile to warrant an exemption from the federal income tax. It is somewhat surprising, therefore, to find that the list is quite long. The major non-profit organizations qualifying for exempt status are as follows:

- Religious, charitable, scientific, literary, educational, or sports organizations and organizations involved in testing for public safety or working for the prevention of cruelty to children or animals;
- Organizations owned by the federal, state and local governments and operated for governmental purposes (such as a state owned corporation responsible for investing the state government's surplus funds);
- Corporations organized for the purpose of holding title to property, collecting income from the property, and paying the income over to another organization which is tax-exempt;[11]
- Civic leagues operated for the promotion of social welfare and local employees' associations operated for charitable, educational or recreational purposes;
- Labour, agricultural, or horticultural organizations;
- Business leagues, chambers of commerce, real estate boards, boards of trade and professional football leagues;

5. Cook, "Businessmen with halos", *Forbes*, 26 November 1990, at 100.
6. *Id.*
7. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1992-1996*, at 14-15 (1991).
8. Contributions by individuals, corporations and foundations totalled $ 123 billion in 1990, two-thirds of which went to religious organizations. "Sparing a dime", *The Economist*, 17 August 1991, at 24.
9. See "Donations last year topped $ 100 billion", *Insight*, 3 July 1989, at 47.
10. Washington, D.C. and the territories of the United States, such as Puerto Rico, also have local governments with special powers somewhat similar to the powers of the individual state governments.
11. In order to qualify for tax-exempt status, title-holding companies must be limited to being little more than passive holding companies. See Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (5th ed., 1987), at 367-369. Corporations and other entities which are engaged in active commercial operations are not tax-exempt even though all of their profits are paid to organizations exempt from tax. IRC Sec. 502.

- Social and athletic clubs and other organizations operated for pleasure or recreation;
- Fraternal benefit societies operating under a lodge system and providing for the payment of death, sickness, accident or other benefits to their members or dependents of the members;
- Voluntary employees' beneficiary associations providing for payment of life, sickness, accident or other benefits to the members of the associations or their dependents;
- Credit unions which are established without capital stock and operated for mutual purposes without profit; and
- Associations whose members are primarily former or present members of the U.S. armed forces.

Apart from entities seeking characterization as title-holding companies, organizations usually must be directly and actively involved in one or more of the tax-favoured activities in order to qualify for tax-exempt status. It is the actual activities of an organization which determine its tax-exempt status, not the destination of the organization's profits. As a result, it usually is not sufficient for an organization to commit its profits to exempt organizations since that commitment is not determinative of the organization's activities.[12]

Federal tax law requires that organizations be "exclusively" involved in one or more of the tax-favoured activities to qualify for tax-exempt status. The Internal Revenue Service ("IRS") and the courts, however, have interpreted the word "exclusively" to mean "primarily".[13] As a result, organizations can qualify for tax-exempt status so long as they are primarily engaged in the tax-favoured activities. They are permitted to have incidental activities unrelated to their exempt function without jeopardizing their tax-exempt status.

In most instances, non-profit organizations seeking tax-exempt status make a formal application to the IRS. In the application, the activities of the organization are listed, the relationships between the organization and its creators, members, officers and directors are described in some detail, and the receipts and expenditures are estimated. Attached to the application are the articles of incorporation or other governing instrument of the organization. After reviewing the application and seeking such additional information as is thought necessary, the IRS examining agent issues a ruling declaring the organization exempt or non-exempt from tax.[14]

(b) *Federal restrictions on direct involvement in profit-making activities*

The federal exemption from income taxes is not total. In general, the exemption extends only to profits earned in carrying on the exempt purposes of the organization or on passive investments. Thus, fees charged by a hospital for medical services it provides and tuition paid by students regularly enrolled at a university clearly are exempt from tax because they are earned by the hospital and university as they carry on their exempt activities. In addition, the income generated by a hospital from the operation of a cafeteria primarily for employees and medical staff is exempt from tax because the cafeteria's operation is closely related to the hospital's exempt purposes. Similarly, the fees paid to a university for special courses and conferences with substantial research or educational content are exempt from tax because offering the courses and conferences is a part of the university's exempt purposes.[15]

Investment income, such as dividends, interest, rents, royalties and gains from the sale of investments, also is usually exempt from tax, provided it is not received from controlled entities.[16] If, however, the investment income is derived from property acquired through debt financing, the income is treated as unrelated debt-financed income and is subject to tax. The specific type of abuse the government was concerned with is illustrated by the following example:

> A sells an incorporated business to B, a charitable foundation, which makes a small (or no) down payment and agrees to pay the balance of the purchase price only out of the profits to be derived from the property. B liquidates the corporation and then leases the business assets to C, a new corporation formed to operate the business. A (collectively, the stockholders of the original business) manages the business for C and frequently holds a substantial minority interest in C. C pays 80 percent of its business profits as "rent" to B, who then passes on 90 percent of the receipts to A until the original purchase price is paid in full. B has no obligation to pay A out of any funds other than the "rent" paid by C.[17]

Prior to 1969, this type of debt-financed transaction produced capital gains for the seller, which were taxed at relatively low rates as the purchase price was paid off, a rent deduction for the operator and no tax for the tax-exempt organization. Since 1969, the income received by B would be taxed as unrelated debt-financed income to the extent the purchase price was debt-financed. Thus, if 95 percent of the original purchase price were debt-financed, then 95 percent of the rent received by B would be subject to tax.

Profits generated from the regular and active conduct of commercial operations not related to an organization's exempt purposes also are subject to the "unrelated business income tax" and taxed in the same fashion as profits earned by regular, for-profit business enterprises.[18] If, for example, a tax-exempt scientific organization with an excellent reputation in the field of biological research exploits its reputation by regularly selling endorsements for various items of laboratory equipment to manufacturers, the income received from the endorsements is subject to the unrelated business income tax.[19] Similarly, a business league with a large membership which regularly mails brochures and other commercial advertising materials to its members for

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12. IRC Sec. 502 expressly provides that an organization operated for commercial purposes is not tax-exempt even though all of its profits are paid to other organizations which are exempt from tax. There is, however, at least one notable instance in which less than direct involvement qualifies for tax-exempt status – many private foundations just make grants and awards for charitable purposes; they are not directly involved in carrying out the charitable activities. Congress, with some reluctance, recognizes that these foundations should qualify for tax-exempt status, but because of past abusive practices by many foundations, their tax-exempt status is more closely monitored than other tax-exempt organizations.
13. Treasury Regulation § 1.501(c)(3)-1(c)(1), which relates to qualifying as a charitable organization, provides as follows:
> An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in [the tax law]. An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.
14. The IRS lists the organizations that are allowed to receive tax deductible charitable contributions in an annual publication entitled *Cumulative List of Exempt Organizations Qualified under IRC Section 170(c)*. The *Cumulative List* is updated with three quarterly supplements containing additions and name changes.
15. See Treas. Reg. § 1.513-1.
16. See *infra* for an explanation of the instances in which investment received from controlled enterprises is subject to tax. IRC Sec. 512(b).
17. U.S. H. Rep. No. 413, 91st Cong., 1st Sess., pt. 1, at 45 (1969).
18. See IRC Secs. 511-514.
19. Treas. Reg. §1.513-1(d)(4)(iv), Example (1).

fees paid by an advertising agency is liable for the unrelated business income tax on the fees it receives.[20]

The dividing line between related and unrelated business activities is not always clear. In 1990, the Aid Association for Lutherans received US$ 1 billion in insurance premiums and its president was paid US$ 431,590 in compensation,[21] but its income is tax-exempt since the Association is a fraternal benefit society which is supposed to provide death, sickness, accident and other benefits to its members or their dependents as part of its exempt purposes. Another recent example involves the National Collegiate Athletic Association ("NCAA") and the income it earns from the sale of advertising in game programmes for the NCAA's basketball championship tournament. The IRS has taken the position that the income is taxable because it comes from a business unrelated to the NCAA's exempt purposes. Recently, a federal court ruled against the IRS and said that the income was not taxable.[22] The court concluded that the advertising activity occurred with sufficient infrequency as to not constitute a business regularly carried on. Even though the advertising was a recurrent activity carried on each year, the tournament programmes were distributed over a period of less than three weeks each year. The IRS has said that it will continue to challenge the court's position under the theory that the time spent in soliciting for the advertisements and preparing the advertisements for publication should have been taken into account along with the time during which the programmes were actually distributed.[23]

(c) *Federal restrictions on ownership and control of business enterprises*

Under present law, it is possible for non-profit organizations to own and control for-profit business enterprises without jeopardizing their tax-exempt status. Dividends received by tax-exempt organizations are not subject to the unrelated business income tax even though the tax-exempt organization owns all or substantially all of the shares in the dividend-paying enterprise.

Non-profit organizations apparently make good use of this ability as many of them derive more income from unrelated business activities than from related activities.[24] Although a fairly widespread feeling exists that the unrelated business income tax provisions permit too much involvement in commercial business operations,[25] there are a number of ways in which abuses already are controlled. Some of the major anti-abuse measures are catalogued below.

Although dividends are not taxed when paid to a tax-exempt organization, interest, rents, royalties and annuities received by tax-exempt organizations from 80 percent controlled for-profit entities are subject to the unrelated business income tax.[26]

Since interest paid by for-profit business enterprises is generally a deductible business expense, tax-exempt organizations with substantial ownership of the business enterprises have sought to minimize the tax burden of the enterprises by withdrawing profits in the form of deductible interest rather than non-deductible dividends. If a for-profit enterprise has excessive debt, however, the interest expense deduction is partially or totally disallowed as to interest paid to the tax-exempt owner.[27]

In the case of private foundations,[28] stock ownership is generally limited to no more than 20 percent of the shares of a corporation.[29]

(d) *Federal restrictions on political activities*

The federal restrictions on political activities are aimed principally at non-profit charitable organizations and are largely in response to the perception that charities have been too heavily involved in political activities in the past. For many years, it was generally recognized that charitable organizations should not engage in political activities. If they did, they risked losing their tax-exempt status. Although it seemed clear that minimal involvement in political activities would not jeopardize a charity's tax-exempt status, there was a great deal of uncertainty as to what constituted "minimal" political activities. The combination of the uncertain standard regarding minimal political activities and the dire consequences of exceeding the standard meant that for many years the IRS usually did not enforce the prohibition against political activities with much rigor.[30]

The restrictions on political activities now have been clarified, as have the penalties for exceeding the restrictions. In general, the restrictions on political activities are of three major types:

(1) *Involvement in political campaigns*

One of the conditions for qualifying as a tax-exempt charity is that the organization must not participate in the election of any candidate for public office (either in support of the candidate or in opposition to the candidate).[31] Although this prohibition appears to be absolute, a slight and comparatively unimportant violation of the prohibition should not cause a loss of tax-exempt status for an otherwise qualified charitable organization.[32]

(2) *Prohibition against lobbying activities*

To qualify as a tax-exempt charity, no substantial part of the organization's activities must be directed to lobbying in favour of legislation.[33] In lieu of being subject to the rather

20. Id., Example (3).
21. Kelley, "Houses of the Holy", *Isthmus*, 6 September 1991, at 1, 8-9.
22. *National Collegiate Athletic Association v. Commissioner,* 914 F.2d 1417 (10th Cir. 1990).
23. *National Collegiate Athletic Association v. Commissioner,* Action on Decision, 3 July 1991.
24. "Making Tax-Exempts Pay: The Unrelated Business Income Tax and the Need for Reform," 4 *Administrative Law Journal* 527, at 528 n.3 (1991).
25. *Id.*
26. IRC Sec. 512(b)(13).
27. IRC Sec. 163(j). This provision is designed to prevent "earnings stripping" and applies also to excessive interest payments made to foreign parent corporations.
28. Private foundations are charitable organizations that derive substantially all of their support from a single source or from just a few sources. The Ford Foundation and the Rockefeller Foundation, for example, both obtained most of their resources from the Ford and Rockefeller families, so they are regarded as private foundations.
29. IRC Sec. 4943(c)(2). Activities between private foundations and the major contributors to the foundations and the directors and officers of the foundations also are very closely monitored. If the tax-exempt foundation confers an inappropriate benefit on the substantial contributors, directors or officers, the foundation and the managers of the foundation may face very stiff tax penalties.
30. The severity of the sanctions for engaging in political activities put the IRS in somewhat the same position as law enforcement officers charged with enforcing the criminal law with punishment vastly disproportionate to the offence. In such circumstances, the officers frequently will simply not enforce the law rather than impose the excessively severe sanctions.
31. IRC Sec. 501(c)(3).
32. Hopkins, *supra* note 11, at 281-282. The requirement apparently was added during a debate in the U.S. Senate by then Senator (and later President) Lyndon Johnson. It was intended to curb the activities of a private foundation in Texas, Johnson's home state, which Johnson believed had provided indirect financial support in opposition to his candidacy.
33. IRC Sec. 501(c)(3).

amorphous "no substantial part" test, organizations may elect to be subject to more concrete rules under which direct lobbying activities and attempts to influence public opinion are allowed so long as they do not exceed between 5 and 20 percent (depending on the size of the organization) of the organization's total expenditures.[34] Amounts in excess of the allowances are subject to a 25 percent excise tax,[35] and if the amounts are significantly in excess of the allowances on a regular basis, the exempt status may be revoked.[36]

(3) *Prohibition against grass roots lobbying*

The prohibition against devoting a substantial part of an organization's time and resources to attempting to influence legislation extends to efforts to influence public opinion. Such efforts are referred to as "grass roots" lobbying under the theory that the public represents the base to which legislators respond. As with direct lobbying activities, some grass roots activities are permitted; activities in excess of the allowances are subject to a 25 percent tax (if the organization elects the more certain standards set out in the lobbying and grass roots excise tax); and activities substantially in excess of the allowances on a regular basis can lead to revocation of the organization's tax-exempt status.

The Catholic Church and some fundamentalist Christian groups currently are taking very public, very active positions in opposition to abortions in the United States. A number of people have questioned whether such public pronouncements are consistent with the statutory restraints on political activities of tax-exempt charities. The combined political power of the Catholic Church and the fundamentalist organizations makes it difficult for the IRS to apply the tax law in the way in which it probably was intended.

4. State tax treatment of non-profit organizations

The major revenue sources for the individual states within the United States are income, sales and property taxes. There are considerable variations in the structure of these taxes, but it is fairly common for the state income taxes to provide an exemption that closely parallels the federal income tax exemption. Charitable, religious, educational, scientific and artistic organizations also frequently enjoy exemptions from state property and sales taxes.

III. SPECIAL INCENTIVES FOR GIFTS TO NON-PROFIT ORGANIZATIONS

A. *Income tax*

Individuals and corporations generally are allowed a federal income tax deduction for gifts of cash and other property to charitable organizations.[37] The deduction is equal to the amount of cash or the value of other property contributed to the charitable organizations. In the case of individuals, the amount of the deductible contributions is limited to 50 percent of the contributor's net income for gifts to public charities and 30 percent of the contributor's income for gifts to private foundations. For corporations, the ceiling on deductible contributions is ten percent of the contributor's net income.[38]

The deduction for individual taxpayers is an "itemized deduction", which means that it is allowed only for individuals who do not claim the standard deduction of approximately $ 5,500 for a married couple and $ 3,300 for a single person. In practice, the charitable contribution deduction is claimed on less than half of individual tax returns filed since the majority of individuals do claim the standard deduction. Further, because the individuals who use the standard deduction tend to have lower incomes and the great majority of individuals who do not use the standard deduction have relatively high incomes, the charitable contributions actually deducted are principally the contributions by higher income individuals. In other words, the income tax charitable contribution deduction tends to produce a tax benefit largely for higher income individuals; contributions made by low income individuals most often do not generate any tax benefit.[39]

A wide variety of property interests can qualify for the income tax charitable contribution deduction. Irrevocable gifts of real estate and other investment property are deductible even though the charitable organization's enjoyment of the property is deferred to some point in the future. Thus, a gift of a remainder interest in an individual's personal residence, with the remainder interest to take effect on the death of the individual, is deductible at the time the gift is irrevocably made, not when the individual dies.[40] The amount of the deduction is the present value of the remainder interest on the date the gift is irrevocably made. Similarly, a gift of a remainder interest in a portfolio of stocks and bonds, with the remainder interest to take effect on the death of the donor and the donor's spouse is deductible when the gift is made. With deferred gifts of stocks and bonds, however, the gifts must be in a specific form designed to insure that the charitable donee actually receives the benefit of the property for which the deduction is allowed.[41]

In recent years, as an indication of the growing interest in historic and environmental preservation, the charitable contribution deduction has been expanded to include gifts in which the donor irrevocably commits property to its historic or environmental use.[42] Under this rule, the owner of an historic building could give a local historic society a binding commitment to maintain the historic character of the building. The amount of the deductible contribution would be the decline in the value of the donor's property as a result of the restriction on the future use of the property. The

34. IRC Sec. 501(h).
35. IRC Sec. 4911(a)(1).
36. IRC Sec. 501(h)(1).
37. IRC Sec. 170. The charitable contribution deduction originated in the 1894 income tax statute and was incorporated into the 1917 version of the present income tax law. See Hopkins, *supra* note 11, at 40-41.
Although the deduction refers to contributions to charitable organizations, qualifying contributions also may be made to other organizations, such as organizations of war veterans, cemetery associations and fraternal benefit societies.
38. IRC Sec. 170(b)(1) and (2).
39. Contributions by lower income individuals tend to go to religious organizations and contributions by higher income individuals more often go to support education, the arts and scientific research; thus, the contributions to religious organizations frequently produce no tax benefit while the contributions to other organizations do yield tax savings.
For a brief time in the mid-1980s, the charitable contribution deduction was allowed on all individual income tax returns. This was the result of a special provision inserted in the Economic Recovery Tax Act of 1981 at the request of some congress people from the southern part of the United States who wanted to extend the benefit of the deduction to contributions to religious organizations by low income individuals.
40. IRC Sec. 170(f)(3).
41. Gifts of remainder interest in stocks and bonds must be in the form of pooled income funds, annuity trusts or unit trusts approved by the IRS. The pooled income funds, unit trusts and annuity trusts are structured so that opportunities for the donors to divert the trust receipts away from the charitable beneficiary are minimized. See IRC Sec. 664(d), which describes in some detail the specific requirements for qualified unit trusts and annuity trusts.
42. IRC Sec. 170(h).

owner of undeveloped land also could give a state or local environmental conservation group a binding commitment not to develop the land and claim a charitable contribution deduction for the decline in the value of the land as a result of the inability to develop the land.

The charitable contribution deduction is limited to gifts of cash and other property. Although many billions of dollars of services are contributed to charitable organizations each year, no deduction is allowed for the value of the services. Deductions are allowed, however, for unreimbursed expenses incurred in performing volunteer services for charitable organizations.[43]

B. *Estate and gift taxes*

Charitable contributions made by individuals also may be deductible for federal gift tax purposes.[44] Since the gift tax deduction is defined in broader terms than the income tax deduction, contributions by individuals that qualify for the income tax deduction invariably are deductible for gift tax purposes. The converse is not true, however, with the consequence that most tax planning involving charitable contributions is done by reference to the income tax deduction rather than the gift tax deduction.

Charitable gifts made at death usually are deductible for federal estate tax purposes. The estate tax deduction is similar to the gift tax deduction in that it is broader than the income tax deduction. Since the federal estate tax threshold now is set at $ 600,000, the estate tax charitable contribution deduction is of diminished importance. For wealthy individuals, however, the estate tax charitable contribution deduction remains a significant mechanism for reducing the federal death tax burden.

C. *Measures designed to curb abuses involving gifts to non-profit organizations*

The income tax charitable contribution deduction is especially notable because of the aggressive use made of the deduction. Taxpayers, individuals more so than corporations, have been ingenious in developing gift techniques that maximize the tax savings for the donors and too often leave the donee charitable organizations with questionable benefits and in some cases more liabilities than benefits. As a result, the U.S. tax law is replete with measures aimed at curbing abuses of the deduction. The principal anti-abuse rules are set out below.

1. Valuation of gifts other than cash

The deduction for contributions to charitable organizations is allowed for gifts of cash and other property. In the case of non-cash gifts, the amount of the deduction generally is based on the fair market value of the property. The tax law thus encourages taxpayers to overvalue gifts of property for charitable purposes and the evidence seems to indicate that overvaluation of gift property in fact is commonplace.

To curb abusive overvaluations of property, the government requires that contributions in excess of $ 500 be supported with information about the nature of the property given and how it was valued. For gifts in excess of $ 5,000, contributors usually are required to obtain an independent and fairly detailed appraisal of the gift property. In addition, in some instances where the abusive potential is especially great (such as with gifts of inventory property, discussed below), the deduction is computed by reference to the contributor's cost of the property rather than the value of the property.

2. Gifts of inventory property

Since the amount of the charitable contribution deduction generally is based on the value of the property rather than its cost, gifts of highly appreciated inventory property used to generate a greater net return for the donors than if the property had been sold at its market value. Thus, when the individual tax rates were 70 percent, a gift of property worth $ 100 but with a cost of $ 10 would produce a net return of $ 70 (the tax saving from a deductible gift of $ 100). A sale on the open market for $ 100, however, would produce a net return of only $ 37 ($ 100 in receipts minus the $ 63 in tax on $ 90 in gain). This opportunity resulted in many gifts of dubious value to charitable organizations. It also created irresistible pressure to overvalue the amount of the gift.

Congress believed that at a minimum there should be some costs associated with making charitable contributions; it thought that charitable gifts should result from benevolent motives, not commercial interests. Consequently, Congress amended the charitable contribution deduction to require that in the case of gifts of inventory property the amount of the deduction must be reduced by the amount of gain which would have been ordinary income if the property had been sold rather than given away.[45] The net result of the amendment was that gifts of inventory property generated deductions only equal to the cost of the property rather than the value of the property.

One serious side effect of the change was that gifts of works of art by the artists or their families to museums were greatly discouraged. Prior to the change, gifts of art work were fully deductible, so the artists had a significant reason to give at least some of their works to non-profit museums. After the change, the amount of the deduction was effectively reduced to zero because art work was inventory property and it had a zero cost in the hands of the artist or the artist's family.[46] To avoid the harsh effect of this rule, artists have to defer making gifts until their death, at which time the gifts of art work produce either an estate tax charitable contribution deduction or an income tax charitable contribution deduction for the family members who inherit the art work and then give it away.

There are two instances in which gifts of inventory property can generate a charitable contribution deduction in excess of the donor's cost. If a corporate donor makes a gift of food, medicine or similar items for use in caring for "the ill, the needy or infants", the amount of the deduction may be as much as twice the donor's cost (but not in excess of the value of the property).[47] Similarly, if a donor corporation makes a gift of new scientific equipment to an educational institution or a non-profit scientific research organization, the amount of the charitable contribution may be as much

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43. For example, the cost of a required uniform for a hospital volunteer and unreimbursed transportation expenses incurred in travelling to and from the hospital are deductible. Treas. Reg. §1.170A-1(g).
44. IRC Sec. 2522. The federal gift tax does not apply to gifts by corporations. Treas. Reg. § 25.0-1(b).
45. IRC Sec. 170(e)(1)(A).
46. Art works typically have a zero cost because the inputs in producing a painting or other work of art are themselves currently deductible expenses. The cost of paints and canvases, for example, are currently deductible by artists rather than being added to the cost of the painting.
47. IRC Sec. 170(e)(3). The actual amount of the deduction is a function of the donor's costs for the property given. If the property is highly appreciated (i.e. has a low cost), the donor's contribution deduction is equal to twice the cost. On the other hand, if the property is not highly appreciated, the donor's contribution deduction is equal to the property's cost plus half the appreciation.

as twice the donor's cost. With both exceptions, the U.S. government was especially mindful of the past abuses with gifts of inventory property and the potential for future abuses. As a result, the two exceptions are carefully hedged with a number of qualifications intended to insure that the donated property is used properly.

3. Gifts of deferred interests in tangible property

Individuals sometimes would make gifts of valuable art work or other tangible property, but defer the time the donee organization could take possession of the property until the death of the donor. This practice has been sharply limited by requiring that the charitable contribution deduction also be deferred until the donee organization takes possession of the gift property.[48]

Interestingly, deductions still are available for gifts of undivided interests in tangible property. Thus, if an individual makes a gift of an undivided one-half interest in a painting and reserves for herself the use and enjoyment of the painting for the other one-half, a deduction equal to 50 percent of the value of the painting is allowed.[49]

4. Gifts with benefits to the donors in exchange

In their enthusiasm to generate tax deductible contributions, charitable organizations sometimes have offered small gifts or other incentives in return for the contributions. The practice became so common and the value of the benefits to the donors so substantial that the IRS announced draconian measures to curb the practice. Essentially, what the IRS told the charitable organizations was that if they promoted their giving programmes with substantial rewards for the donors, the IRS would obtain a list of the donors and then audit the donors, with probable disallowances of some or all of their charitable contribution deductions.

Charitable organizations still offer inducements to make gifts, but the inducements now are much more likely to be of nominal value.

5. Gifts of remainder interests of personal property

In prior years, individuals could make deductible gifts of real property and their stock and bond portfolios, but defer the charitable organization's receipt of the gifts until the donor's death or some other term of years. The problem with this opportunity was that it created an irresistible temptation to make use of the property so that the donors received substantial benefits often at the expense of the charitable remainder beneficiaries. With stock and bond portfolios, for example, the donors would manipulate the holdings in the portfolios so that the current income was maximized, even though the remainder interest was eliminated or jeopardized.

To curb the abusive opportunities with deferred gifts, Congress requires that the gifts be in certain specific forms, all of which are designed to ensure that the benefits for which deductions are allowed are actually received by the donee organizations. Thus, gifts of deferred interests in stock and bond portfolios must be in the form of annuity trusts, unit trusts or pooled income funds which are structured in a fashion approved by the IRS. The approved structures all pay particular attention to protecting the deferred interests of the charitable beneficiaries.

48. IRC Sec. 170(a)(3).
49. IRC Sec. 170(f)(3)(B)(ii).
50. See Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* 101-102 (1989).
51. *Id.*, at 101.

IV. SPECIAL ISSUES

A. *Corporate tax integration*

The United States is one of the few industrialized countries with a "classical system" of corporate taxation. In the United States, corporate profits are doubly taxed. The profits are subject to the corporate income tax as they are received by the corporations. The profits are then fully taxed again when they are distributed to the individual shareholders and subject to the individual income tax.

Most industrialized countries and a great many other countries have decided that imposing a double tax on corporate profits is not good tax policy. The principal reasons usually given for not doubly taxing corporate profits are the following:
- Double taxation of corporate profits creates a tax-induced bias in favour of debt financing rather than equity financing since the interest expense is deductible but the dividend payments are not.
- Double taxation of corporate profits may discourage dividend distributions by the corporations as the shareholders seek to withdraw their profits in the form of increased gains on the sale of shares, which usually are subject to reduced tax rates, rather than the receipt of dividends which frequently are fully taxed at the individual level.
- Double taxation of corporate profits makes corporations less attractive than entities such as partnerships, cooperatives and joint ventures, which are treated as conduits with only one level of taxation.

To counter these undesirable side effects, a large number of countries have partly integrated their individual and corporate taxes so that there is an interdependence between the amount of corporate taxes due and the amount of individual taxes due. The most common forms of integration involve either a corporate level credit or deduction for dividends paid or a shareholder level credit for corporate taxes attributable to the dividends paid.

At various times in the last decade, Congress has considered proposals to integrate the individual and corporate taxes in the United States. As part of the consideration, the question was raised as to how corporate tax integration would interact with the tax-exempt status of non-profit organizations.[50] If corporate tax integration provisions are not extended to dividends received by tax-exempt organizations, it would diminish the relative advantage of tax exemption over regular taxable status. On the other hand, if the integration provisions are available for dividends received by tax-exempt organizations, it would enable business income earned by a taxable corporation to fully escape taxation to the extent it is distributed to tax-exempt shareholders.[51]

Since the United States has not introduced any form of corporate tax integration (and in fact has increased the instances in which corporate profits are doubly taxed), Congress has not made a policy decision as to how tax-exempt organizations should be treated under a corporate tax integration system.

B. *International issues*

There are two major international issues associated with non-profit organizations: (1) the tax treatment of foreign non-profit organizations with activities in the United States; and (2) the deductibility of charitable contributions made to support foreign charities or foreign charitable activities.

1. Tax treatment of foreign non-profit organizations with activities in the United States

Foreign organizations can qualify for tax-exempt status under the U.S. income tax law on the same basis as domestic organizations. In general, therefore, foreign organizations must be established under the foreign law equivalent of the non-profit organization laws in the United States and they must be primarily involved in activities enumerated as qualifying for tax-exempt status. In addition, the foreign organizations must formally apply for tax-exempt status using the same application forms as domestic organizations seeking tax-exempt status.[52]

The general federal tax law limits on the tax-exempt status also apply to foreign-based organizations. Thus, a foreign tax-exempt organization with U.S.-source income from an active commercial operation unrelated to the organization's exempt operations would be subject to the unrelated business income tax, just as domestic tax-exempt organizations are. Of course, just as with domestic tax-exempt organizations, the unrelated business income tax would not apply to income of foreign tax-exempt organizations from passive investments in the United States.

2. Deductibility of contributions to support foreign charities or foreign charitable activities

When a U.S. charity raises money specifically for use by a foreign charity or foreign charitable activities, the tax deductibility of the contributions depends on the control and oversight that the U.S. charity retains on the distribution of the funds. A deduction is not allowed for a contribution to a U.S. charity that simply raises funds for use by foreign charities. In relinquishing control of the use of the funds to the foreign charities, the U.S. charity is viewed as merely a conduit for the actual recipients, the foreign charities.

In contrast, a deduction is allowed when the role of the U.S. charity is significantly more than that of a conduit. When the U.S. charity reviews and approves specific projects of the foreign charities and determines that the foreign projects are in furtherance of its own charitable purposes, then it may raise funds for the projects and give grants to the foreign charities without impairing the deductibility of the contributions.

Direct gifts to foreign charities generally do not qualify for the U.S. income tax charitable contribution deduction. Under the U.S./Canada tax treaty, however, gifts to Canadian charities are deductible.[53] The amount of the deduction is limited to the donor's Canadian source income.

V. CONCLUSION

A. New initiatives

Changes in the tax treatment of non-profit organizations are being considered in at least three areas: (i) establishing a threshold for the charitable contributions deduction; (ii) requiring non-profit hospitals to provide substantial free services to the needy in order to qualify for tax-exempt status; and (iii) at the state level, imposing a user fee on non-profit organizations that are exempt from property taxes.

1. Establishing a threshold for the charitable contributions deduction

A perennial issue is whether to allow a charitable contribution deduction only for amounts in excess of a threshold, such as two percent of the donor's income. It is widely recognized that many of the charitable contributions in the United States are made as a result of a deep moral or spiritual obligation. Since these contributions would be made irrespective of their deductibility, the government revenues foregone as a result of allowing a deduction for these contributions is essentially wasted. To reduce the waste and thereby make the charitable contribution deduction more efficient, several tax reform proponents have suggested a threshold for the charitable contribution deduction.[54] The basic idea underpinning the threshold would be to allow a deduction only for extraordinary contributions, not the contributions that are routinely made because of a moral or spiritual obligation.

In part because of the opposition of the non-profit organizations who fear a decline in their contributions if a threshold is introduced, this change is not likely to be established in the near term.

2. Requiring non-profit hospitals to provide substantial free services to the needy in order to qualify for tax-exempt status

Non-profit hospitals make up only one percent of all tax-exempt organizations, but they account for 40 percent of tax-exempt revenues. Non-profit hospitals, however, are not automatically tax-exempt; instead they must be shown to serve a "public purpose" rather than just a "private purpose". In recent years, many have criticized the operations of hospitals on the ground that they extend medical services principally to those who are able to pay for the services; they provide only nominal services of dubious value to the poorest parts of society.

In part in response to the criticism of the tax-exempt status of hospitals, the IRS is doing a detailed examination of non-profit hospitals to see if they are abusing their tax-exempt status.[55] Congress also is considering modifications in the unrelated business income tax which would tax some of the profits of hospitals which presently are tax-exempt. The modifications in the unrelated business income tax, however, are unlikely to be introduced anytime in 1991.[56]

3. At the state level, imposing a user fee on non-profit organizations exempt from property taxes

The costs of public schools, police and fire protection, road repairs and garbage collection commonly are paid through real estate property taxes imposed by the individual states. Non-profit organizations, especially non-profit charitable organizations, quite often are granted partial or complete exemptions from the real property taxes in recognition of the socially desirable functions they perform.

For a variety of reasons, state and local governments now are finding it increasingly difficult to balance their budgets. As budgetary pressures grow, the state and local governments are likely to impose more and more "user charges" on the non-profit organizations exempt from property taxes to cover at least the costs of basic services of direct benefit to the non-profit organizations.

52. See Rev. Rul. 66-177, 1966-1 Cum. Bull. 132, and Rev. Proc. 59-31, 1959-2 Cum. Bull. 949.

53. The U.S. income tax treaty with Israel contains a provision similar to the Canadian treaty. The Israeli treaty has not been ratified, however.

54. See e.g., *U.S. Treasury Report on Tax Simplification and Reform* 81-83 (1984).

55. "Former Critic Hails IRS Scrutiny of Exempt Hospitals," *Tax Notes* (18 March 1991), at 1206.

56. "UBIT Reform Unlikely in 1991, Schulze Tells EO Conference", *Id.*

CANADA

Daniel Ish

Professor of Law, University of Saskatchewan, Saskatoon, Canada

I. INTRODUCTION

A. *Overview*

Canadian tax law distinguishes between charitable organizations and other non-profit organizations. While the treatment accorded each under the Income Tax Act[1] is similar in that neither pays income tax, the tax regime which pertains to each is drastically different.

Charities are involved in fund raising to support churches, synagogues, hospitals, schools, universities and community-benefit projects generally. The community-benefit organizations include libraries, museums, athletic associations and groups to protect the environment. Some charities carry out charitable activities directly while others act as secondary fund-raising bodies which support the charitable activities of primary charitable organizations.

B. *Magnitude non-profit activities*

The number of registered charities has risen considerably over the last 15 years. In 1990 there were 63,186 charities estimated to hold about $ 11 billion in property. The Auditor General of Canada estimates foregone revenue to the treasury of $ 220 million based on an imputed return on the capital. Also, because donations to registered charities are tax-deductible or tax-creditable to the donor, the annual cost to the federal government amounts to $ 600 million in foregone revenue, with approximately another $ 300 million in foregone revenue to the provinces. The total amount in charitable donations claimed for tax purposes in 1989 exceeded $ 3 billion; 30 percent of individual taxpayers, as well as corporations, made charitable donations.[2]

Non-profit organizations which are not registered charities are involved in a broad range of activities and include high profile political parties, sporting organizations such as golf and hockey clubs, professional groups and social clubs to name a few. Since there are no registration or filing requirements, it is not possible to determine precisely the number of non-profit organizations. An internal study by the Department of the Secretary of State estimated that in 1986 there were 60,000 incorporated non-profit organizations in Canada.[3]

C. *Registration requirement*

1. Charities

The primary mechanism which controls the non-taxability of charities and the deductibility of donations is the registration system. Upon application to Revenue Canada,[4] an organization which is a charity receives a registration number. Registered status is much coveted since it ensures non-taxability of the organization and since it is the sine qua non of deductibility of donations. The latter feature creates a tremendous incentive to taxpayers to donate; in effect, it amounts to a government subsidy of a charity's activities.

Once registered, a charity must comply with certain statutory requirements. Failure to comply does not result in taxability of income; rather, the result may be deregistration by Revenue Canada. Deregistration is the primary penalty the tax authorities utilize and it is the ultimate penalty; its mere threat is a powerful tool.[5]

The Income Tax Act divides registered charities into charitable organizations and charitable foundations; the latter is further subdivided into public foundations and private foundations. Thus, there are essentially three types of registered charities. Although there are significant differences in the detail of the provisions that apply to each, the features of the Act which apply to all three are relatively consistent.

A charitable organization generally is one that initiates charitable activities; it is one that *does things* as opposed to funding others. Typically, it is responsible for administering a charitable programme or series of programmes through its own paid or unpaid employees, agents or representatives. Over 90 percent of registered charities fall into this category.

A public foundation is generally formed to fund the charitable activities of other charities although it is permitted to carry on its own charitable activities. There is considerable overlap between charitable organizations and public foundations in terms of their capacity to conduct charitable activities.[6] The main reason for organizing both entities is often to distinguish short-term projects from long-term fund raising.

The primary purpose of a private foundation is "to serve as an endowment that earns income to distribute to fund other charitable activities"[7] although in practise it can carry out activities on its own account. Its distinguishing characteristic is the degree to which it is privately controlled or funded. In short, a private foundation is a registered charity which is controlled by a group of persons not dealing at arm's length, or which receives over half its funding from one person or from a group of related persons.[8] As will be seen later in this paper, the Act imposes greater restrictions on private foundations than it does on charitable organizations or public foundations.

A charitable organization need not be an incorporated body or a trust whereas by definition a charitable foundation, public or private, must be either a corporation or a trust.[9]

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1. Revised Statutes of Canada 1952, c. 148, as amended by Statutes of Canada 1970-71-72, c. 63, and as subsequently amended (hereinreferred to as "the Act"). Unless otherwise stated, paragraph and subsection references in this paper are to the Act.
2. Report of the Auditor-General of Canada to the House of Commons, March 1990, at para. 10.16.
3. *Id.*, at para. 10.125.
4. The Department of National Revenue, known as Revenue Canada, is Canada's national tax enforcement authority. The responsibility for implementing policy and for the preparation of legislation, however, lies with the Department of Finance.
5. During 1989/90 notices of proposed revocation were sent to 8,280 charities. Files of revoked charities are retained for five years. If during this time the organization wishes to be reinstated, its file and registration number are revived. Otherwise the full registration process is begun again. Of the approximately 63,000 registered charities, 4,300 registrations have at some time been revoked and subsequently reinstated, *supra* note 2, at para. 10-53-10-55.
6. Drache, *Canadian Taxation of Charities and Donations* (Deboo, 1990), c. 3. This looseleaf publication is the most commonly used resource material in this area.
7. See Bromley, "Private Foundations in Estate Planning", 1988 Conference Report, Canadian Tax Foundation, at 34.13.
8. Para. 149.1(1)(f), (g).
9. Para. 149.1(1)(a).

Registration is a matter of right so long as an organization conforms to certain requirements. Under the Act, a registered charity is required to be exclusively "charitable".[10] The meaning of charitable, however, is not defined by the Act, but is left to be determined under principles of common law.

In recent years there have been a number of court cases dealing with the meaning of "charitable"; they all tend to be interpretations of the English common law as set down in *Commissioners of Income Tax v. Pemsel.*[11] Pursuant to this case to be a charity an organization's objectives must fall into at least one of four categories:
(a) the relief of poverty;
(b) the advancement of religion;
(c) the advancement of education; or
(d) the advancement of other purposes beneficial to the community.

In addition to the requirement that an entity be for charitable purposes, the Act imposes a number of other requirements before registration can be obtained. First, a charity must either be "operated exclusively for charitable purposes",[12] in the case of a foundation, or "all resources must be devoted to charitable activities",[13] in the case of a charitable organization. The former phrasing referring to "charitable purposes", allows foundations latitude to fund activities of other charities. There are concessionary provisions in the Act which reduce the apparent strictness of this requirement. Subject to certain limitations, funds can be disbursed to other charities even by charitable organizations, limited political activity can be engaged in and certain related businesses can be carried on.[14]

A second statutory requirement is that no income of the charity can be paid or made available to any proprietor, member, shareholder, trustee or settlor.[15] Income in this context means net income of the charity after legitimate expenses are taken into account. Legitimate expenses include the payment of salaries or expenses to people falling within these categories.

Two more statutory requirements apply to charitable organizations and public foundations. In each more than 50 percent of the "directors, trustees, officers or like officials" must deal with each other at arm's length[16] and 50 percent of the source of funds must be contributed by persons dealing at arm's length.[17] Neither of these requirements applies to private foundations.

2. Non-profit organizations

While charities are subject to a relatively high degree of control through the registration regime, other non-profit organizations are surprisingly loosely controlled. These have no registration requirements; it is left to each organization and its advisors to determine whether it qualifies as a non-profit organization under the Act and is thus exempt from paying tax.

To qualify as a non-profit organization, an entity[18] must meet three tests.[19] First, it cannot be a charity or one that in the opinion of the Minister would be registerable as a charity. Second, it must be organized and operated exclusively for social welfare, civic improvement, pleasure and recreation or any other purpose, except profit. Third, no part of its income may be paid, payable, or made available for the personal benefit of any proprietor, member or shareholder; an exception is made for amateur athletic organizations.

There are no special incentives for donations to non-profit organizations that are not charities, which may partially explain Revenue Canada's somewhat relaxed supervision. However, there still exists opportunity for abuse. Unless an incorporated body is involved,[20] there is no requirement even to file a tax return, thus enabling potential tax evasion.

III. TAX TREATMENT GENERALLY

A. *Income-based taxes*

1. Charities: the disbursement quota

Once a charity has met the common law and statutory requirements of a legitimate charity and has been registered, it achieves total tax-exempt status. This status is premised on the desirability from a social policy perspective to encourage and subsidize charitable activities.[21] Aside from policing the basic requirements of charitable status, the Act imposes a quota for the disbursement of funds "to ensure that at least a minimum amount of a charity's annual income [is] actually used for charitable purposes".[22] The goal is that maximum benefit for charitable purposes should be achieved within a reasonable time.[23]

Generally, a charity must spend for charitable purposes at least 80 percent of an amount equal to the income for which receipts were issued in the immediately preceding taxation year.[24] The formula implicitly imposes a ceiling of 20 percent of income to be spent on operating expenditures, including fund raising activities. The 80 percent disbursement rule only applies to income for which a receipt has been issued. If a charity can receive non-receipted income, such as investment income or related business income, it increases its ability to build endowments for longer term stability and major projects because it need not disburse any percentage of these amounts.

In addition to amounts for which receipts have not been issued, certain other items of income are exempt from the formula. They are:
(a) a gift of capital received by way of bequest or inheritance;
(b) a gift received subject to a trust or direction to the effect that the property given, or property substituted there-

10. Para. 149.1(1)(a), (b).
11. [1891] A.C. 531; see also *I.R.C. v. City of Glasgow Police Athletic Association* [1953] 1 All E.R. 747.
12. Para. 149.1(1)(a).
13. Subpara. 149.1(1)(b)(i).
14. These will be dealt with in more detail later; see text at notes 24, 61 and 52, respectively.
15. Para. 149.1(1)(a); (b)(ii).
16. Subparas. 149.1(1)(b)(iii); (g)(i)(A).
17. Subparas. 149.1(1)(b)(iv); (g)(i)(B).
18. There is no particular form or entity that is required. A non-profit organization may be incorporated or unincorporated or it may be a trust.
19. Para. 149(1)(l).
20. Subsec. 150(1).
21. For a more elaborate discussion of the underlying policy rationale for the current Canadian tax treatment of charities and charitable donations, see Woodman, "The Tax Treatment of Charities and Charitable Donations Since the Carter Commission: Past Reforms and Present Problems", 26 *Osgoode Hall L.J.* (1988), at 537-539.
22. Drache, *supra* note 6, at 2-17.
23. Woodman, *supra* note 21, at 540 describes the maximum benefit issue in these terms: "The proposition here is that every dollar of tax concessions to charities and contributors to charities represents a cost to the Canadian taxpayer. Therefore the rules of taxation should ensure that "maximum benefit" is derived from them. Maximum benefit is, simply, pay-outs by charities on charity in a reasonable length of time."
24. Para. 149.1(1)(e); (2)(b).

fore, is to be held by the charity for a period of not less than ten years; and
(c) a gift received from another registered charity.[25]

These exceptions are designed to allow the establishment of endowment funds since without them 80 percent of the capital gifts would have to be distributed in the year following their receipt. The testamentary bequest exception is an extension of the ten-year direction rule; "it recognizes that if the testator failed to have the direction included when the will was drafted, it is impossible to remedy that oversight after he has died. The majority of testamentary capital bequests are presumed to be intended to form endowments, and the testamentary capital bequest exception was added to facilitate establishing them".[26]

There are other disbursement requirements imposed on foundations. Public foundations must disburse an additional amount equivalent to 4.5 percent of investments, less the amount of receipted donations and amounts received from other charities. Private foundations must also disburse 4.5 percent of investments and all gifts received from other charities.[27]

Failure to meet a disbursement quota renders a charity liable to deregistration. Notwithstanding this threat, there is considerable flexibility in the Act that may be of assistance. First, if a charity makes excess disbursements in one year, it can carry over the excess payment to meet the disbursement quota of other years. The excess can be carried back one year or forward five years to count toward disbursement quotas in those years.[28]

Under two different sections of the Act, the Minister is authorized to deem that disbursements have been made in situations where they have not been made in fact. One provision is designed to give relief when there is a deficiency in a charity's disbursement quota for the year.[29] Upon application, with appropriate supporting documentation, the Minister may deem a shortfall to have been paid for the purpose of the disbursement formula. "It would appear from the wording of the statute that once an application has been approved, the charity is deemed to have met its commitment for the year in question and does not, in the future, have to make up the shortfall."[30]

The other provision gives the Minister discretion to allow an accumulation of funds in the charity. Once approved, the amount accumulated and the income generated therein will be deemed to have been spent on charitable activity. The purpose of this provision is

> to allow a charity to build up a capital fund aimed at achieving a specific purpose, most often related to the construction of a building, though other objectives might also be acceptable. The approval for accumulation will be for a stated period of time and may be subject to specific terms and conditions.[31]

As indicated previously, the registration process is the primary hallmark of the regime of taxation of charities in Canada. So long as a charity maintains its registered status, tax advantages are obtained. As a result, deregistration – or the threat of deregistration – operates as the primary control mechanism. One ground the Minister can rely upon for deregistration is the failure of a charity to meet its annual disbursement quota.[32] Although there is no provision for taxing undisbursed funds when the disbursement quota is not met, a "penalty tax" applies when a charity is deregistered.[33] The tax is designed to ensure that all the assets of a deregistered organization are paid out for legitimate charitable purposes. The tax is imposed at a 100 percent rate on the value of all assets that are not legitimately disbursed within one year of deregistration; thus, "in a nutshell, the charity has one year to wind-down its operations. If it has assets left at the end of the year these will be effectively taxed away".[34]

2. Non-profit organizations

Non-profit organizations are exempt from paying tax. The key to tax-exempt status is that the organization must not have the pursuit of profit as an objective; the fact that a profit may be made does not in itself render the organization taxable. If the principal object and activity is a non-profit one, an ancillary profit-earning venture is allowable. Revenue Canada has established a number of tests to determine whether profit-making is a principal object and activity of an organization.[35] An organization is considered to be carrying on a trade or business if it is operating in a normal commercial manner; its goods and services are not restricted to the organization's members and their guests; it is operated on a profit-making rather than a cost recovery basis; or it is operating in direct competition with taxable entities carrying on the same trade or business. A Federal Court of Appeal decision[36] has held that if profit from a commercial activity is used to fund social and welfare objectives the organization is not operating for the purpose of profit. This case would seem not to follow the guidelines established by Revenue Canada. Where there is a conflict between Revenue Canada policy and the law as interpreted by the courts, the latter takes priority.

B. *Property and capital taxes*

Aside from the deregistration penalty tax, there are no federal capital taxes imposed on charities or non-profit organizations. Property taxes, on the other hand, which are imposed by municipalities in Canada, apply generally to charities and other non-profit corporations. There are cer-

25. *Id.*
26. Bromley, *supra* note 7, at 34:13.
27. Para. 149.1(1)(e). In the calculation a charity is allowed to exclude the assets it owns that are used directly in charitable activities or administration.

The effect that the 4.5 percent rule may have on the investment decisions of charities is described by Bromley, *supra* note 7, at 34:14, in the following terms:

> The theory is that 4.5 percent is a reasonable return for a charitable foundation to pay out each year. It is hoped that the foundation will earn, say, an 8 percent return on its investment assets, enabling it to add 3.5 percent to its capital base while distributing 4.5 percent to charitable causes. If, however, the foundation earns only a 2 percent return, it is required to dip into its capital base to meet its disbursement quota.
>
> The result is that a foundation has complete freedom to choose between income-producing or equity growth investments. If it invests only in treasury bills, its capital base can be enhanced by retaining some of the excess income. If it invests only in gold in the belief that the capital value will increase without the generation of revenue, then it must sell enough gold to generate 4.5 percent return. If gold appreciates significantly in the time period, the foundation will both have increased its value and be able to meet its disbursement quota without having generated any income.

28. Subsec. 149.1(20).
29. Subsec. 149.1(5).
30. Drache, *supra* note 6, at 2-19.
31. *Id.*, at 2-20.
32. Para. 149.1(2)(b); (3)(b); (4)(b).
33. Subsec. 188(1); (2).
34. Drache, *supra* note 6, at 6-13.
35. Interpretation Bulletin, IT-496.
36. *Alberta Institute on Mental Retardation v. The Queen* (1987), 87D.T.C. 5306. This case and its implications are discussed in the accompanying text at note 56 et seq.

tain exemptions from property taxes, such as for churches; these are based on the nature of the activity engaged in by the respective organizations.

III. SPECIAL INCENTIVES FOR GIFTS TO NON-PROFIT ORGANIZATIONS

A. *General*

Donations to registered charities are tax-deductible or tax-creditable for the donor. This attribute of the Canadian tax system creates a strong incentive to give to charities and enhances tremendously a charity's fund-raising abilities. The deductibility of donations is the main reason that charities seek to be registered since donors can deduct gifts only when they are evidenced by a receipt indicating the charity's registration number.

The deductibility provisions are somewhat detailed but the basic scheme can be easily explained. Donations by individuals, to a maximum of 20 percent of the donor's income, generate a federal tax credit of 17 percent of the first $ 250 donated and 29 percent of the balance.[37] The credit is against federal tax otherwise payable. Suppose, for example, a person donated $ 2,000 to a charity. The tax credit on the first $ 250 is $ 42.50 ($ 250 × .17) and on the next $ 1,750 is $ 507.50 ($ 1,750 × .29) for a total of $ 550.[38]

The value of the credit is increased by approximately 50 percent when the provincial tax rates are taken into account. Because provincial rates are set as a percentage of federal tax (approximately 50 percent), the total amount of the $ 550 credit in the above example increases to about $ 825.

The tax credit for charitable donations was introduced in 1988; prior to then individuals received a deduction from income for charitable donations. The deduction provision, as opposed to credits, still applies to corporations which can deduct up to 20 percent of income.[39]

There are two categories of gifts which are not subject to the 20 percent of annual income limitation. Donations to Her Majesty[40] (the federal or provincial governments) and "cultural gifts"[41] to certain institutions are creditable up to 100 percent of the donor's annual income.

There are no special incentives for donations to non-profit organizations that are not charities.

B. *Gifts of cultural property*

The 20 percent deduction rule, together with the capital gains provisions of the Act, create a disincentive for a donor to give capital property that has appreciated in value. The donation triggers a capital gain at fair market value which may result in a gift in excess of the amount allowed as a deduction to the donor. Without a relieving provision, the excess is taxable income in the donor's hands.

To remove this potential barrier, the Act contains provisions which enable donors to avoid any capital gains.[42] These provisions, which apply to all charities, are particularly important to donors who want to establish private foundations to hold their assets and businesses. The provisions allow the donor to

> elect as the proceeds of his disposition any amount not greater than the fair market value of the capital property and not less than its adjusted cost base to himself at that time. If the donor elects deemed proceeds of the adjusted cost base. . . he receives a charitable donation or credit of that amount without triggering any capital gains taxes.[43]

The precise value chosen by the donor must take into account the taxpayer's other income; it is necessary to do calculations in each case. The election of the disposition value, which applies both to tangible and intangible capital property, permits the donor to obtain the highest deduction consistent with the 20 percent rule while realizing the minimum possible capital gains.

A number of points in relation to the election are noteworthy. First, the property must be capital property. The characterization of property as capital is a subjective one, dependent on the use of the property in the hands of the donor. Second, the provisions do not protect the donor against taxation on the recapture of the value by which property has been depreciated. Third, because the provisions apply only if the fair market value is greater than its adjusted cost base, a capital loss cannot be triggered and claimed by the donor. Fourth, where there is no 20 percent deduction rule imposed, as is the case with gifts to Her Majesty and cultural gifts, the need for the elective provision virtually disappears. In these cases the donor need not be concerned about the appreciation of value of the property since the whole of the fair market value of the gift is deductible, without being limited to 20 percent of income, with a five-year carryover of excess contributions.[44]

C. *Methods to increase allowable deductions*

Most taxpayers do not seek to increase their deductible donations beyond the permissible 20 percent threshold; however, some do and thus the ability to invite greater donations with suitable tax incentives can be important to charities. The most common methods of legally increasing donations are outlined here.[45]

1. Maximizing househould deductions

Revenue Canada allows husbands, wives and minor children from a household to accumulate deductions in one name regardless of which name appears on the receipt. The advantage of one person claiming all charitable donations is that the $ 250 threshold at which the credit increases from 17 to 29 percent is reached more quickly. If donations are divided between husband and wife (or husband, wife and children), the total donation amount will receive less favourable tax treatment than if one person accumulates the donations for the tax credit.

2. Loans to a charity

If a donor loans capital to a charity interest-free, the entire amount of the interest can accrue to the charity without regard to the 20 percent limit. "The concept here is that the income on the loaned money will be used directly by the charity and thus will be excluded from the taxpayer's in-

37. Subsec. 118.1(3).
38. This example is one used by Drache, *supra* note 6, at 11-12.
39. Para. 110.1(1)(a).
40. Subsec. 118.1(1) in the case of an individual; para. 110.1(1)(b) in the case of a corporation.
41. Subsec. 118.1(1) in the case of an individual; para. 110.1(1)(c) in the case of a corporation.
42. Subsec. 118.1(6) in the case of an individual; subsec. 110.1(3) in the case of a corporation.
43. Bromley, supra note 7, at 34:4.
44. For a discussion of these provisions using a number of examples, see Goodman, "How Can Business Make Use of Charitable Donations?", 8 *Estates and Trusts Quarterly* (1987), at 270.
45. For greater detail about these mechanisms, see Drache, *supra* note 6, chapter 14.

come, allowing in effect, a 'gift' of 100 percent of the income."[46] The use of a loan may be of particular interest to a private donor who wants to protect capital in the event of a future need. By means of a loan, future economic contingencies can be met because there has been no alienation of beneficial interest in the property and demand for repayment can be made if necessary. "In the interim, [the donor] has achieved maximum tax efficiency because all income earned and equity growth on investments of the private foundation are exempt from tax".[47]

Two further points are important to note with regard to interest-free or low-interest loans. Unless the charity is an incorporated body, a recently introduced anti-avoidance provision[48] may attribute the income back to the donor. The provision does not apply to corporations but does apply to trusts or other unincorporated associations. Also, charitable foundations, as opposed to charitable organizations, have restrictions imposed on the use of borrowed money.[49]

3. Companies

If an individual or a family controls a private corporation, the corporation can be directed to make charitable donations and thereby receive a deduction of up to 20 percent of its income. The shareholders of the company can also make donations as individuals and receive a tax credit. Because corporate dividends are taxed in shareholders' hands by "grossing-up" dividends by 25 percent, there is opportunity for the same income to be used twice as a base for charitable donations.[50]

Taxpayers with business income, as opposed to salary or investment income, can usually justify charitable expenditures as advertising or business-promotion costs incurred for the purpose of earning income. If this characterization is obtained, the 20 percent limit does not apply. Case law recognizes that businesses have the option of treating gifts to charities as either promotion/advertising expenses or charitable donations.[51] It is not permissible, however, to receive a double deduction.

A common practise which Revenue Canada has tolerated is one where a corporation, usually a relatively large one, loans the services of one or more of its employees to a charity, usually during a fund raising campaign. The salaries paid continue to be deductions in determining the corporation's net income. Arguably these expenditures are true promotion/advertising expenses which are completely legitimate.

Another common practise in Canada is for large corporations and public institutions, such as universities, to cooperate in establishing employee salary check-off systems for donations to charities. Often the donations can be directed to a number of charities but sometimes a corporation will develop its own foundation to support a particular charitable organization.

V. SPECIAL ISSUES

A number of issues arise with respect to charities that involve potential abuse of the tax regime designed to encourage charitable activity. Underlying these special considerations is the primary control mechanism of deregistration, with its pervasive influence on the conduct of charities.

A. *Business activities*

The policy goals of tax measures aimed at charities dictate that commercial activities be discouraged, or at least strictly controlled. This issue is increasingly important in Canada as charities have become aggressive and creative in their search for funds and resources. With one exception, the Act does not prohibit charities from engaging in business activities; rather, it attempts to control business activities by requiring them to be related to the activities of the charity.[52] The exception applies to private foundations which are prohibited from carrying on any business activity.[53]

The Act does not elaborate upon what is meant by a related business other than by an inclusive provision which states:

> "related business" in relation to a charity includes a business that is unrelated to the objects of the charity if substantially all of the people employed by the charity in the carrying on of that business are not remunerated for such employment.[54]

Arthur Drache, in his work on taxation of charities, describes the purpose and function of these concessionary provisions:[55]

> This provision was inserted into the Act to allow charities to operate bingos, church suppers, bazaars, gift shops, cafeterias in hospitals and the like as well as to sell Christmas and other greeting cards to name just a few enterprises. In virtually every case, all the workers are volunteers though occasionally there will be a paid manager.
>
> Though many charities, notably hospitals and schools, are paid for services and pay their employees, they are "safe" because the business is in fact directly related to their objects. However, many charities also offer their facilities to the public in circumstances which raise doubts. For example, a university may rent out accommodation when its school year ends, offer computer services and so forth. Many believe that where this type of activity is being undertaken, it is prudent to set up a separate, taxable entity to carry on the commercial activity if the staff is being paid to provide the facilities to the public.

The sketchy nature of the legislation in this area has, not surprisingly, led to judicial interpretation. One case adopts an expansive view of allowable related business. In *Alberta Institute on Mental Retardation v. The Queen,*[56] the Federal Court of Appeal adopted a four-part test to determine whether a business carried on by a charity should be considered "related". The case arose as a result of the Minister refusing registration on the basis that the charity was carrying on an unrelated business where a fund-raising arrangement was entered into with a profit-making organization.

46. *Id.*, at 14-12.
47. Bromley, *supra* note 7, at 34:8. Bromley also notes that "[i]n my experience, people who are willing to give $ 500,000 are often prepared to loan $ 5 million or $ 15 million interest-free to their private foundations".
48. Subsec. 56(4.1).
49. Subsecs. 149.1(3), (4). See text at note 86.
50. Drache, *supra* note 6, offers an example of this at 14-15, comparing donations made directly by a sole proprietor with donations made with the assistance of a company. If a person earns $ 150,000 as a sole proprietor, the 20 percent limit dictates that a maximum of $ 30,000 can be donated and deducted in a year. However, if the $ 150,000 is earned by a corporation the total donation can be increased substantially. First, the company can donate and deduct $ 30,000. This leaves $ 120,000 in the company. At the small business rate this would attract tax at approximately 25 percent, leaving $ 90,000. If this were paid out to a shareholder as a dividend it would be "grossed-up" by 25 percent to $ 112,500. This amount would sustain an additional charitable donation of $ 22,500. Thus, the same $ 150,000 produces $ 52,500 inpotential charitable donations in the year where the money is earned through a company as compared to $ 30,000 where it is earned by an individual.
51. *Olympia Floor and Wall Tile (Que.) Ltd. v. M.N.R.*, [1970]C.T.C. 99 (Exch. Ct.); *Impenco Ltd. v. M.N.R.*, [1988] 1 C.T.C. 2339 (T.C.C.).
52. Para. 149.1(2)(a); (3)(a).
53. Para. 149.1(4)(a).
54. Para. 149.1(1)(j).
55. Drache, supra note 6, at 1-14.
56. *Supra* note 36.

All the profits were expended on the charitable objects of the organization. The four criteria looked at were:
(a) degree of relationship of the activity to the charity;
(b) profit motive;
(c) extent to which the business operation competes with tax-paying businesses; and
(d) length of time the operation has been carried on by the charity.

The court concluded that because all the funds raised had been devoted to charitable activities within the objects of the organization, the business was in fact related. The Auditor-General has concluded on the basis of this decision that:[57]

> almost any business or fund-raising activity would qualify as being "related" to the charitable objects of the organization so long as the funds were used for charitable activities. . . . We believe that although the legislation was intended to limit the business activities of registered charities it is unable to do so.

One of the senior officials in the Charities Division, Revenue Canada raises a number of issues with respect to the *Alberta Institute* decision in a recent article.[58] He states:

> It is difficult to evaluate the effect that this widely-publicized decision has had on the extent to which registered charities are becoming engaged in business activity, primarily as a means of raising funds. We know that charities are under increasing pressure to become self-sufficient, and that there is intensifying competition for the charity dollar. We also know that there are important tax policy implications to resolve in light of the *Alberta Institute* decision. Will charities inevitably prove to be unfair competition for tax-paying businesses if few or no restrictions are put upon the nature or extent of their business activities? Will charitable funds be put at undue risk in speculative ventures? Is it truly possible to say that any business activity that cannot, in and of itself, be considered a charitable activity, is without profit motive? And at what point will it be possible to say that the charitable motive or purpose behind a business activity no longer predominates?

Where it is found that a charity is carrying on an unrelated business, the consequence is not that the business income is taxed, as it is in some other jurisdictions.[59] The consequence is either that registration will be initially denied, as it was in the *Alberta Institute* case, or achieved registered status will be placed in jeopardy.[60]

B. *Political activities*

The issue of where charitable activity ends and political activity begins has been a major one. The elasticity of the concept of what is considered political as opposed to educational has blurred the distinction between the two. "It is arguable that all acts or failures to act are political, and that it is impossible to separate morals and politics."[61] Aside from partisan politics, many activities which support legitimate charitable objects are capable of being characterized as political. For instance, when a charity uses its resources to support a lobby for a change in the law to make it consistent with the charity's goals, this has been found to be political.[62]

Prior to 1986, *any* political activity of an organization might have led to a denial of registration or to deregistration. Because this was thought to be too restrictive, an important concession to reflect reality was allowed by an amendment to the Act. Now a charity can devote part of its resources to political activities provided that it devotes *substantially all* its resources to charitable purposes or activities, and
(a) the political activities are ancillary and incidental to its charitable purposes or activities; and,
(b) the political activities do not involve the support of or opposition of any political party or candidate.[63]

Political activities must be related to the organization's charitable objects; otherwise they are not permitted. Precisely how much of an organization's resources can be devoted to related political activity is not clear from the legislation, but an Information Circular[64] issued by Revenue Canada interpreting the meaning of "substantially all" suggests that 90 percent of resources must be devoted to charitable activities. Thus, in the opinion of Revenue Canada, no more than 10 percent of a charity's resources can be devoted to political actions.[65]

The 80 percent disbursement quota discussed above has impact here too. Since expenditures on political activity are by definition not charitable expenditures, they do not qualify for the purposes of meeting the 80 percent quota. Thus "those charities which rely on receipted donations will have a de facto limit on the amount they can spend because of the 80 percent rule".[66]

These two limitations result in the distinction between political activities and charitable activities still being of major importance to some charities. If an action can be characterized as educational as opposed to political advocacy, it is a legitimate charitable activity. The issue has been a continuing source of contention between Revenue Canada and charities, resulting in three recent decisions of the Federal Court.[67] These decisions elaborate upon what is meant by education as opposed to political advocacy. Three propositions emerge:[68]

> The first is that the advancement of education must involve training of the mind, or instruction, or an addition to the store of human knowledge. The second is that an organization that provides the public with selected pieces of information or

57. *Supra* note 2, at para. 10.91.
58. Juneau, "Some Major Issues Affecting Evaluation of the Charities Incentive", IX *Philanthropist* 3 (1990), at 9.
59. In the United States and in England and Wales there are provisions for taxing the unrelated trade or business income of charities. Canada's most pervasive review of its tax system, the Carter Commission, recommended that charities should pay tax at the corporation tax rate on business income. The reason given was to eliminate unfair competition with the private sector. The recommendation was never implemented. See Canada, Royal Commissionon Taxation Report (Ottawa: Queen's Printer, 1966), at 144.
60. See text at notes 32 and 34.
61. Woodman, supra note 21, at 562.
62. *Scarborough Community Legal Services v. The Queen* (1985), 85 D.T.C. 5102 (Fed. Ct. App.).
63. Subsec. 149.1 (6.1), (6.2).
64. Information Circular 87-1.
65. Woodman, *supra* note 21, at 566, criticizes the percentage test in determining the meaning of "substantial". She prefers the approach taken by the Court in Christian Echoes National Ministry Inc. v. United States (1972), 470 F. 2d 849 (U.S. Court of Appeals, 10th circuit). At page 855, the Court states: "The political activities of an organization must be balanced in the context of the objectives and circumstances of the organization to determine whether a *substantial* part of its activities was to influence or attempt to influence legislation. . . . A percentage test to determine whether the activities were substantial obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances."
66. Drache, *supra* note 6, at 1-17.
67. *Positive Action Against Pornography v. M.N.R.* (1988), 88 D.T.C. 6186; *Toronto Volgograd Committee v. M.N.R.* (1988), 88 D.T.C. 6192; *N.D.G. Neighbourhood Association v. Revenue Canada Taxation Department* (1988), 88 D.T.C. 6279.
68. Juneau, *supra* note 58, at 7. The reference to McGovern in this quotation is to the 1982 English case, McGovern v. Attorney-General, [1982] 2 WLR 222 (Ch. D.).

> opinion in order to convince the public to accept one side of a controversial issue will not be advancing education in its charitable sense. The third is that, as in McGovern, educational elements within a political purpose will not bring it within the sphere of charitable purposes.

These propositions appear to exclude any type of advocacy or lobbying activity for a particular point of view as being educational. To be educational the dissemination of all viewpoints is required. Presumably this requires organizations to give voice to points of view which may be contrary to their own interests. It must be remembered, however, that since 1985 related political activity is permissible so long as it is relatively minor in relation to the total activity of the charity.

One way around these problems is for a charity to carry on its political activities through a separately incorporated body. Also, one can anticipate a challenge to the political limitations contained in the Income Tax Act under the *Canadian Charter of Rights and Freedoms*[69] which, inter alia, contains protection of freedom of speech[70] and protection of equality before the law.[71] However, in the United States similar prohibitions in the Internal Revenue Code were held to be constitutional by the U.S. Supreme Court.[72]

C. *Canadian charities*

Canadian charities are permitted to be involved in charitable activities in foreign countries provided the activities are the charity's own activities. The charity must demonstrate that it controls the use of its funds in the foreign activity. Aside from having its own personnel carry out foreign activities, control can be obtained through a contract or agency agreement with a foreign charity, subject to periodic reporting on how the resources were utilized, or through joint venture agreements, with the Canadian charity being an active member with a voice in administrative policy decisions. Canadian charities are engaged in significant foreign activity. In 1986 registered charities spent in excess of $ 250 million outside Canada.[73]

There is an argument that charitable foundations can direct part of their resources to non-Canadian charities. A foundation must devote all its resources to "charitable purposes", as opposed to "charitable activities" in the case of a charitable organization. It has been argued that the phrase "charitable purposes" is[74]

> clearly broad enough to include distributing moneys to bona fide non-Canadian charities. Therefore, as long as the foundation meets its annual disbursement quota, by paying out each year to qualified donees not less than 80 percent of the previous year's receipted donations (excluding capital gifts) and 4½ percent of the value of its investments, it is free to distribute the whole or any part of its remaining funds, which is likely to represent a fairly considerable margin, to non-Canadian charities.

Canadian law allows taxpayers a deduction or credit for a gift to foreign charities in which the Government of Canada has made a donation.[75] At present there are only eight such organizations that qualify.[76] Obviously Revenue Canada has no ability to monitor or control these foreign charities to insure against improper use of funds.

There are a number of tax treaty provisions dealing with exempt organizations. For instance, Article XXI of the Canada–U.S. tax treaty allows Canadians to make deductible contributions to U.S. charities, and vice versa. It is arguable, although not altogether certain, that this provision can be used to allow transfer of funds from a Canadian charity to a U.S. charity.

The purchase of property in a foreign jurisdiction is one means by which a Canadian charity can transfer capital abroad. So long as title is retained by the Canadian organization the asset is under control of the charity. Revenue Canada has indicated that it will allow transfer of title in immovable capital property to a foreign local charity or government body.[77]

D. *Deregistration and other anti-abuse mechanisms*

It is apparent from the foregoing discussion that the registration process, with its counterpart deregistration, is the primary control mechanism with respect to charities. The grounds upon which the Minister can rely to deregister any charity are where the charity:

(a) applies to be deregistered;[78]
(b) ceases to comply with the statutory registration requirements;[79]
(c) fails to file information returns as required;[80]
(d) issues an improper receipt;[81]
(e) fails to maintain proper books and accounts as required by the Act;[82]
(f) fails to meet its annual disbursement quota;[83] or
(g) makes a gift to another registered charity the purpose of which is to delay the expenditure of amounts on charitable activities.[84]

There are additional grounds that do not apply to all charities. For example, charitable organizations and public foundations place their registration in jeopardy when they carry on an unrelated business, whereas private foundations place themselves at risk if they carry on any business at all.[85] Further, both types of foundations may be deregistered if

69. Canadian Charter of Rights and Freedoms, Part I of the Constitution Act, 1982; Schedule B of the Canada Act 1982 (U.K.), 1982, c. II.
70. *Id.*, Sec. 2.
71. *Id.*, Sec. 15.
72. *Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983).*
73. *Supra* note 2, at para. 10.102.
74. Goodman, *supra* note 44, at 278.
75. Para. 118.1(1)(g).
76. *Supra* note 2, at para. 10.99. The foreign charities to which ongoing donations are made are the following: International Peace Garden Inc., United States; International Peace Academy Inc., United States; Association for Canadian Studies in the United States, United States; The Aga Khan University Foundation, Switzerland; The Foundation for Canadian Studies, United Kingdom; The John Charnley Trust, United Kingdom; Association of Commonwealth Universities, United Kingdom; Water Pollution Control Federation, United States. One-time only gifts have been made to: International Institute of Strategic Studies, United Kingdom; French Library, Boston; Maureen F. Dobbin Memorial Fellowship, United States; Franklin College, United States; Lel Fondo Para la Reconstruction de Zonas Afectandas Por el Seismo, Mexico; China Fund for Handicapped, PRC The Auditor-General notes that in one case an annual gift of $ 1 for a number of years by the Department of National Health and Welfare to a foreign organization, at the request of a Canadian taxpayer, has made all Canadian tax payers eligible to claim a tax deduction or credit for gifts to the same organizations. The Auditor-General queries whether this was the intent of Parliament.
77. See letter dated 18 March 1981 of the Department of National Revenue, reproduced in Drache, *supra* note 6, at 2-41.78. Para. 168(1)(a).
79. Para. 168(1)(b).
80. Para. 168(1)(c).
81. Para. 168(1)(d).
82. Para. 168(1)(e).
83. Subsec.s 149.1(2), (3), (4).
84. Subsec. 149.1(4.1).
85. See text *supra* at note 51 et seq.

they acquire control of any corporation other than by way of gift or if they borrow money for long-term investments.[86]

There are three penalty taxes that may be imposed on charities. One is the "deregistration tax".[87] The second tax applies to foundations when they transfer 50 percent of their assets for the purpose of reducing their disbursement quota.[88] In such a case, a tax of 25 percent of the transferred assets is applied. The purpose of this penalty is to thwart avoidance of the disbursement quota based on 4.5 percent of assets.[89] The problem with this provision is that proof of motive is required; there are no reported cases dealing with this penalty. The receiving organization is jointly and severally liable for the tax where it has acted in concert with the donor foundation.[90]

The third penalty tax, which applies only to private foundations, is designed to discourage self-dealing between private foundations and non-arm's length parties. If a foundation is holding debt or equity with a company or an individual in a non-arm's length arrangement (defined as a "non-qualified investment"),[91] a penalty tax is imposed on the company or individual rather than on the foundation.[92] No penalty will accrue if the transactions are dealt with in an arm's length-like manner, for instance, if fair market interest is paid or if shares held are publicly traded.

Where the tax applies, it is onerous. An interest rate prescribed by Revenue Canada from time to time is imputed on the outstanding debt (and equity is deemed to be debt). The entire amount of the imputed interest is added to tax payable of the debtor where no amount of interest has been paid. Where some interest has been paid the shortfall, if any, between the amount actually paid and the prescribed rate is taxed in the hands of the debtor. This is a 100 percent tax on any shortfall because the amount is added to the tax payable of the debtor rather than to taxable income. If it were the latter, the actual tax cost would vary with the taxpayer's marginal rate whereas the imputed interest is an actual dollar cost to the taxpayer.

This provision can be both expensive and embarrassing.[93] Where the tax applies it does not bring any extra return to the private foundation or reduce its disbursement quota. The tax can be avoided by ensuring that an adequate return is paid on the non-qualified investment; the scheme of the Act condones this and this interpretation has been agreed to by the courts.[94] Also, the penalty does not apply where the outside taxpayer makes an interest-free loan to the foundation, rather than borrowing money from the foundation. Since the penalty tax does not apply to public foundations, a solution to the problem lies with the use of a "philanthropic fund" within a public charitable foundation, as follows:[95]

> A solution to this problem lies in the use of what Americans call a philanthropic fund, which forms part of a public charitable foundation, but operates much like a private foundation. That is, instead of establishing his own private foundation, a donor will approach a public foundation, such as the United Jewish Welfare Fund of Toronto, and make a gift to it of shares of his company, which are to form the permanent capital of a fund which will bear the donor's name and will be separately administered. While the donor will not legally be able to direct the public foundation concerning the investment of the fund or the distribution of its income, the public foundation will be required to consult with a committee nominated by him regarding these matters. For all practical purposes, the fund will function much like a private foundation, with the additional feature that professional assistance from the staff of the public foundation will always be available.
>
> Since we are dealing with a public foundation, the rule requiring minimum annual interest or dividend payments does not apply. Therefore, if in any year [the company] fails to pay the required minimum interest or dividends on its securities which are held by the philanthropic fund, this will not result in the imposition of penalties under the Income Tax Act. This is a decided advantage for the cautious donor.

VI. CONCLUSION: FUTURE DEVELOPMENTS

The latest amendments to the charities provisions of the Income Tax Act occurred in 1985.[96] There is no indication that there will be substantial amendments to the regime in the near future. Even those who have been quite critical of the current law and the latest amendments are not calling for change. One writer suggests that "it would seem appropriate that, for the time being, the charities area be left alone in order to see how the legislation works in practise".[97]

Although fundamental change is likely not forthcoming, there is an ongoing internal comprehensive review in process primarily dealing with administrative and enforcement matters. Many of these problems were highlighted by the Auditor-General in his report; he concluded that many of the procedures utilized do not provide effective checks on abuse.[98]

The Auditor-General discovered that 31 percent of the 63,000 charities failed to file their returns on time yet no late filing penalty was imposed by Revenue Canada. Thus, "the Department's administrative practises make it possible for a charity to file the required annual return only every second year".[99] His report also concluded that there is an inadequate compliance programme to determine the facility of tax credits or deductions claimed by taxpayers.[100]

The Auditor-General found somewhat anomalous that, apart from penalties for not filing and fraud, the only sanction available for contravention of the Act is deregistration and suggested that the legislation be amended to give power to levy a monetary penalty or to tax unrelated business profits. The response by the department responsible for initiating legislation does not indicate a willingness to support the Auditor-General's suggestion. It states:[101]

> While the Department is willing to consider the feasibility of providing penalties other than revocation, it should be noted that any system of monetary penalties may result in the diversion of funds intended by donors to be dedicated to charitable purposes into the Federal treasury, while having little effect on reducing non-compliance that is primarily inadvertent. In this context, the current legislative system of revocation of charitable status, with its resulting redistribution of a revoked charity's assets to other charitable purposes, may be the most appropriate.

The Auditor-General also expressed concern regarding the

86. Paras. 149.1(3), (4).
87. See *supra* notes 32-34 and accompanying text.
88. Subsec. 188(3).
89. See text *supra* at note 26.
90. Subsec. 188(4).
91. Para. 149.1(1)(e.1) contains a lengthy definition of "non-qualified investments".
92. Sec. 189.
93. See Goodman, *supra note 44, at 277.*
94. *Antoine Guertin Lte. v. The Queen* (1981), 81 D.T.C. 5268 (Fed. Ct. Trial Div.).
95. *Supra* note 44, at 277.
96. S.C. 1986, c. 6.
97. Woodman, *supra* note 21, at 567.
98. *Supra* note 2.
99. *Supra* note 2, at para. 10.39.
100. *Id.*
101. *Id.*, at para. 10.83, the response of the Department of Finance.

limits in the legislation on business activities. After a criticism of the courts' rulings on what is related business, the Auditor-General notes that "although the legislation was intended to limit the business activities of registered charities it is unable to do so".[102] Again, the departmental response does not suggest that any legislative remedy is forthcoming. It states:[103]

> The Department is aware that the tax treatment of business activities carried on by charities may require some legislative clarification. Any action must be carefully considered, in order not to discourage charities from pursuing the legitimate fund-raising activities that may be necessary to ensure their financial stability within the community.

In short, the future does not appear to hold any major changes in Canada's tax regime that governs charities. There may, however, be greater vigilance in enforcing the current provisions, although Revenue Canada continually pleads lack of sufficient resources to ensure more pervasive compliance.

102. *Id.*, at para. 10.95.
103. *Id.*, at para. 10.103.

THE NETHERLANDS

Hubert Hamaekers

Executive Director, International Bureau of Fiscal Documentation, Amsterdam

I. INTRODUCTION

A. *Overview*

The most common form of non-profit organization in the Netherlands is the "stichting" (foundation), a legal entity which administers capital for a certain purpose. In the past the purposes of a foundation were limited to religious, charitable, academic or cultural matters. However, since World War II foundations have been increasingly used as vehicles for cooperative efforts rather than for the formation and utilization of capital for the above purposes. Foundations have also been used for government and business purposes, such as research, administration and management of investments, pension funds and sales cooperation.

A second type of non-profit organization is the "vereniging" (association), which may be a legal entity if certain formalities are complied with. In general an association is used for sports activities, hobbies and cultural activities of its members.

The primary difference between a foundation and an association is that the foundation cannot have members (associates). The tax treatment of both types of organization is basically the same. Foundations are by far the most important type of non-profit organization and therefore this paper focuses on this type of organization.[1]

Legal structure of a foundation

Part 2 of the Dutch Civil Code deals with legal entities, and Section 6 of Part 2 sets forth the substantive and procedural requirements to set up a foundation. One or more individuals or legal entities may set up a foundation, or it may be set up by will. A foundation must be established by notarial deed which contains the statutes of the foundation. The capital allotted to the foundation must be utilized to achieve its statutory purpose(s).

The law does not prohibit a foundation from carrying on profit-making or commercial activities, but the statutes of the foundation may state that the foundation may not make a profit. The main legal restriction on foundations is that they may not make payments to founders, members of the managing board or others (with the exception of salaries paid to members of the managing board and payments of a charitable nature to "others"). "Payments" in this context means non-obligatory payments or payments without an equivalent consideration. This prohibition aims at preventing the use of foundations for private financial purposes. The penalty for non-compliance is dissolution of the foundation upon the request of an interested party or by a court on its own initiative.

The governing body of a foundation is the managerial board, and a supervisory body may be set up to supervise the board. The managerial board must register the foundation (regardless of whether it is commercially active) in the foundations register, a public register maintained by the regional Chamber of Commerce. As stated above, a foundation may not have members.

B. *Magnitude of non-profit organizations*[2]

According to the foundations register, 78,000 foundations were registered in 1988. The activities range from cultural to industrial, the most important of which are as follows:

Charitable, social, religious, educational, medical and scientific activities

Charitable, social and cultural entities	18,800
Employees' organizations and research institutions	6,400
Educational institutions	4,700
Medical and veterinary institutions	2,500
Religious institutions	1,900
Other	1,500

1. It should be noted that the concept of a trust, comparable to the Anglo-American trust, is not provided for under Dutch law, and only a few double taxation treaties make reference to a trust. However, in the future a trust may be recognized as a Dutch legal entity because the Dutch government signed the Convention on the Law applicable to Trusts and their recognition on 1 July 1985. Published in the Dutch Official Treaty Gazette 1985, No. 141.
2. The figures in this paragraph are derived from the 1989 report of the Netherlands Association for Tax Law on Foundations. See Report No. 180, Netherlands Association for Tax Law on Foundations (Deventer: Kluwer).

Financial services	
Administration and management of investments	3,800
Pension funds	3,300
Immovable property dealing	1,700
Holding organizations	1,600
Savings institutions	700
Housing associations	400
Trade and industry	2,000
Inactive or not coded	10,100

According to the Central Institute for Statistics, 13,200 foundations were engaged in business in 1988.

II. TAX TREATMENT GENERALLY[3]

A. *Income-based taxes*

Non-profit organizations are almost always legal entities and thus are not liable to individual income tax, which is only levied on individuals. However, such organizations may be subject to corporate income tax.

Corporate Income Tax Law ("CIT") Section 2, paragraph 1d and Section 4 deal with the taxation of organizations such as foundations. Section 2 paragraph 1d provides that such organizations are subject to CIT *if, and to the extent that, they carry on business activities.* Unlike companies which are subject to CIT on all of their income and capital, a foundation may be subject to CIT only on income derived from activities which have a business nature. Non-business income, such as passive investment income, legacies and donations, are not subject to CIT.

Business income is defined in case law, i.e. a business enterprise is an enduring cooperation of capital and labour in trade or industry (including independent professional activities) with the purpose of making a profit. A profit-making purpose in the case of a foundation may be presumed from the pricing policy applied to its products and/or services, and the financial results over a number of years.

The seminal case in this respect involved a foundation belonging to the Dutch Red Cross which operated a volunteer blood bank and laboratory.[4] It also engaged in scientific research and supplied blood to hospitals. The foundation charged individuals and institutions for its products and services, and during six consecutive years the Red Cross had a surplus. The Dutch tax inspectorate assessed the foundation to CIT on the grounds that, in respect of the production and supply of blood, the foundation was an enterprise, and further that it potentially competed with other enterprises in the Netherlands (even though no commercial blood banks operate in the Netherlands). The foundation argued that it was not a taxable entity because it did not aim to make profits, despite its surpluses for several years. The Supreme Court held that all activities relating to the blood were business activities and consequently taxable under CIT Section 2, paragraph 1d.

Activities of foundations intended to reduce the costs of its founding entrepreneurs may also qualify as business activities.[5]

CIT Section 4 provides that an organization is liable to CIT if it is engaged in activities which are also carried on by regular commercial enterprises, that is, if the foundation "competes" with business entities. This "competition" criterion has two functions:
- it achieves a certain degree of tax neutrality among taxpayers and foundations active in the same economic sector; and
- it eases the burden of the tax administration because the profit-making purpose of foundations may be difficult to prove. Evidence of competition is generally much easier to demonstrate.

In practice Section 4 comes into operation when a foundation maintains that its activities do not qualify as business activities because the profit-making purpose is formally and/or materially absent. However, an activity is taxable even if it only potentially competes with the activities of taxpayers (e.g. if the taxpayers concerned are not active in the area of the country where the foundation carries on its activities).[6]

One condition for the application of Section 4 is that the activities concerned must be profitable for a number of years. An incidental surplus is insufficient to attract CIT. A complication for foundations in this context is that non-paid volunteer work is valued at the open market price to establish whether a profit is made. Thus, costs not actually incurred cannot be deducted.[7]

CIT Section 5c provides an exemption for legal entities which carry on enumerated activities of a charitable or public interest nature; for example, activities which benefit the ailing, the elderly or the poor. Section 4 of the CIT regulations requires that if the entity makes a surplus, that surplus can only be used for the benefit of other exempt organizations under Section 5c or for the public interest.[8]

CIT Section 6 authorizes the government to grant an exemption to entities which carry on activities not listed in Section 5c, but which nonetheless serve the public interest.[9] A condition to qualify for the exemption is the absence of the profit-making purpose (or at least that the profit-making purpose is subordinate to the primary purpose of the organization). The organization's profits may not exceed 13,000 Dfl. in the current year and 65,000 Dfl. in total in the previous four years.

A proposed regime for pensions and annuities and organizations involved in such activities will affect the tax status of foundations which manage pension and annuity funds.[10] Many foundations have been set up to insure the pension rights of managing directors who are also majority shareholders of companies. Pension funds are currently covered by an explicit exemption (CIT Section 5b). Annuity foundations are generally set up by individuals to reduce their liability to individual income tax. Although annuity foundations are not covered by the Section 5b exemption, they will

3. For a general outline of the Dutch corporate income tax system, see *European Tax Handbook 1991* (Amsterdam: IBFD), Chapter Netherlands.
4. Decision of the Supreme Court of 15 November 1989, published in *Vakstudie-Nieuws* 1989, at 3,568.
5. Decision of the Supreme Court of 6 March 1985, published in *BNB* 1985, at 213.
6. *Id.*
7. This issue was also decided in the Red Cross case, discussed in the text *supra* at note 4.
8. This requirement does not apply to entities established under public law.
9. See for details, Exemptions Decree of 20 August 1971, as most recently amended on 18 December 1990, published in *BNB* 1971, at 168 and *Vakstudie Nieuws* of 10 January 1991, at 123.
10. Another proposal which has not yet been submitted to Parliament will abolish the privileged tax treatment of pension and annuity premiums (i.e. deductibility) if they are paid to entities in which the taxpayer himself has an interest.

generally not be subject to CIT because such organizations are not deemed to carry on a business. Under the new regime, however, such pension and annuity organizations will be deemed to conduct a business as defined in Section 4.

B. *Property and capital taxes*

With the exception of the municipal immovable property tax which is due by all persons who own or rent real estate, no specific tax is levied on the property, capital or (net) wealth of legal entities in the Netherlands. Capital duty is levied only on the formation or increase in the capital of companies. Net wealth tax is levied only on individuals.

III. SPECIAL INCENTIVES FOR GIFTS TO NON-PROFIT ORGANIZATIONS

A. *Income tax*

Section 47 of the Individual Income Tax Law ("IIT") provides that gifts made to resident religious, charitable, cultural or scientific institutions and to institutions which serve the public interest are deductible within certain limits. In any case, the deduction for gifts cannot exceed ten percent of taxable income. A similar provision is included in CIT Section 16, and here the deduction cannot exceed six percent of taxable profits.

Religious, charitable, cultural or scientific institutions qualify for the deduction regardless of whether they serve a public interest. Public interest must be distinguished from private interest. A public interest may be a limited interest, e.g. financing and managing a retirement home exclusively for members of a certain religion. A retirement home for members of one's family, however, is a private interest.

According to case law an institution serves the public interest if its purpose concerns activities which directly affect the public interest. An institution which serves private interests but incidentally affects the public interest does not qualify as a public interest organization.[11] A political party is a public interest institution.[12]

A recent amendment to IIT Section 47, paragraph 5 and CIT Section 16, paragraph 3 adds "humanitarian" institutions to the qualifying types of institutions. This amendment only has theoretical significance because such institutions are likely to qualify as public interest institutions. More important is the extension of the deduction to gifts made to specific non-resident institutions to be enumerated in the future by the Underminister of Finance.[13]

Gifts made by enterprises (whether or not incorporated) are deductible as expenses if the gift serves a business purpose, e.g. a gift to a charitable institution which is of promotional importance to the enterprise. A gift may be deductible as a business expense if the enterprise cannot reasonably refuse to make a donation when approached by the institution concerned. Gifts which are considered business expenses are fully deductible without the limitations of IIT Section 47 and CIT Section 16.

B. *Estate and gift tax*

A recipient of a gift is liable to inheritance and gift tax ("IGT"). The rates applicable to legal entities range from 41 percent to 68 percent depending on the amount of the gift. A reduced flat rate of 11 percent applies to gifts received by religious, charitable, cultural, scientific or public interest institutions.[14] This rate also applies to inheritances and legacies received by such institutions. Inheritances and gifts received by such institutions under 13,590 Dfl. and 6,795 Dfl., respectively, are tax-exempt.

If a foundation is established by will and notarial deed, the foundation inherits the capital of the foundation upon the death of the testator, and the above rules apply. In principle, gifts, inheritances and legacies received by foundations are not subject to CIT.

IV. SPECIAL ISSUES

A. *Tax treatment of non-profit organizations directly involved in commercial activities*

As mentioned above, foundations are subject to CIT if and to the extent that they carry on business activities. If there is any doubt as to whether an activity is a business activity, the competition criterion of CIT Section 4 will result in taxation if the foundation is profitable over a certain number of years, or if the activity competes with the business activities of taxpayers. Doubts as to the business nature of an activity may arise, for example, if the foundation is not allowed to make profits according to its statutes but it still derives positive results from its activities.[15]

As stated above the competition criterion is applied in a broad manner: competition in fact is unnecessary, potential competition is sufficient to subject the foundation to taxation. Application of the competition criterion is therefore of considerable assistance to the tax administration in combating the use of foundations to avoid CIT.

The General Tax Act ("GTA") provides various general measures to combat abuse. Any taxpayer who does not receive a tax return from the tax inspector within six months after the end of the accounting period in which he becomes liable to CIT must formally request a tax return. Taxpayers deliberately failing to comply with this obligation may be subject to a penalty of a maximum of four years imprisonment and/or a maximum fine of 100,000 Dfl. or if the taxable amount is higher, 100 percent of the tax due.[16] Foundations which have not yet been assessed must report each year whether they have become liable to CIT.[17]

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11. See Supreme Court decision of 12 October 1960, published in *BNB* 1960, at 296.
12. See decision of District Court of Amsterdam of 23 January 1980, published in *BNB* 1981, at 123.
13. The conditions for the deductibility of gifts to non-resident institutions are found in the Resolution of the Underminister of Finance of 24 October 1991 (No. DB 91/4571), published in *Vakstudie-Nieuws* 1991, at 3098. For example, gifts to European political parties and foreign organizations for the benefit of environmental protection qualify for deduction. A list of such institutions will be published in the future.
14. IGT Sec. 24(4). The amendment to IIT Sec. 47 and CIT Sec. 16 includes "humanitarian" institutions to the list of institutions which qualify for the 11 percent rate.
15. The Supreme Court has reiterated that such a provision in the statutes is irrelevant for purposes of determining whether a foundation aims to derive a profit when in fact profits are made over a number of years. See Supreme Court decisions of 29 June 1955, published in *BNB* 1955/299; 15 November 1989, published in *Vakstudie-Nieuws* 1989, at 3,568; and 6 December 1989, published in *Vakstudie-Nieuws* 1990, at 127.
16. General Taxes Act, Sec. 6 and Criminal Code, Sec. 23.
17. Since the competition criterion is applied so broadly, it is advisable to contact the tax inspector in cases of doubt to obtain a ruling on the tax liability and, if liable to tax, on the extent of the liability. The tax inspector can trace foundations not liable to CIT in the foundations register. Foundations which are not yet listed as corporate taxpayers will receive periodic enquiry forms from the tax inspector.

Every person must provide information which may be relevant to the tax inspector regardless of whether the person is liable to tax. This obligation also applies to information on the liability of other persons, i.e. business activities may appear from the books of related entities or clients of a foundation. The GTA also requires that corporate entities keep records which enable the tax inspector to ascertain whether the organization is liable to tax.

B. *Tax treatment of non-profit organizations with ownership interests in business enterprises*

1. Direct ownership and control

A common structure in the Netherlands is for a foundation to be the parent of a BV. The business activities are carried out through the BV, and the foundation acts as a mere holding company; it may perform non-business, non-competitive activities without becoming liable to CIT.

The holding function of a foundation is not regarded as a business (or competitive) activity. Dividends and interest received from the BV are not taxable. Royalties received in consideration of rights transferred to the BV when the BV is established are also tax free (the continuation of activities which give rise to royalty payments after setting up the BV, however, may subject the foundation to CIT). If the managerial board of the foundation is actively engaged in managing the business of the BV, the foundation is liable to CIT on the income derived from that activity, i.e. it is a business activity.

2. Holding companies that distribute all of their profits to non-profit organizations

Dividends received by a holding company from resident and non-resident subsidiaries are exempt under certain conditions (i.e. the participation exemption of CIT Section 13). Dividends paid by a holding company to a foundation which is the shareholder of the holding company, and therefore the ultimate beneficiary, are generally not subject to tax in the following cases:

- if the foundation is liable to CIT and the dividends are part of the business income of the foundation, the participation exemption applies;
- if the foundation is not liable to CIT or the dividends are not connected to the business income of the foundation there is no basis for taxing such dividends.

The tax levied at source on dividends (dividend tax of 25 percent) is not withheld if the participation exemption applies. In the case of dividends received by (resident) legal persons not subject to CIT, the dividend tax withheld will be refunded upon request. The same may apply if the dividends are not included in the business income of the foundation.

C. *Corporate tax integration*

The classical system of separate corporate and individual taxation of company profits is applied in the Netherlands.

D. *Non-profit organizations involved in political activities*

There are no specific rules on the tax treatment or curbing of abusive practices in the case of non-profit organizations engaged in political activities.

The general rules are as follows:
Foundations engaged in political activities are not liable to CIT if they do not perform other activities of a business nature or if they do not compete with the activities of taxpayers.

Gifts (which are not business expenses) to such organizations are deductible for CIT purposes because they are regarded as institutions which serve the public interest. The reduced IGT rate of 11 percent applies to gifts, inheritances and legacies made to such organizations.

E. *Anti-abuses measures*

There are no specific measures other than those described above.

F. *International issues*

Resident foundations which are not subject to CIT are, in principle, not entitled to the benefits of tax treaties. The criteria for taxing resident foundations as described above do not apply to non-resident foundations and other non-profit organizations; the general provisions on non-residents apply to these organizations. Non-resident individuals and corporate entities, including non-profit organizations, are taxable if they are engaged in business activities in the Netherlands through a permanent establishment or representative. They are also subject to tax on certain non-business revenue, such as income from immovable property situated in the Netherlands. Dividends, interest and royalties not connected to a permanent establishment which are paid to non-residents are not taxable.[18] The basis for taxing non-resident non-profit organizations is therefore broader than for resident foundations because the non-business income of resident foundations is generally not taxable. It is unclear whether non-resident non-profit organizations may successfully apply for tax-exempt status under the Decree of 20 August 1971 (see above).

G. *Other special issues*

A special form of (ab)use of foundations in the Netherlands concerns "closely held" pension and annuity foundations. Such foundations have been set up to reduce IIT and net wealth tax while the founders retain the power to use the amounts transferred to the foundation for private purposes. Case law provides a special method for combating abuse of such foundations. According to case law, a fiscal transparency regime operates where an individual who is entitled to the future pension or annuity payment can exercise power over the foundation as if the foundation's capital were his own. The foundation remains valid for civil law purposes but the IIT and net wealth tax consequences intended by the founder are denied.

The fiscal transparency regime is of less importance in recent years as a result of stringent regulations formulated by the Underminister of Finance on the management and investment of pension and annuity foundations. At least two thirds of the board of the foundation must comprise persons not related in any manner to the interested person, and at least 90 percent of the funds must be invested in a manner not related to that person.[19] The regulations also provide

18. However, dividends are subject to the dividend tax of 25 percent (usually reduced under tax treaties to 15 percent for portfolio dividends).
19. Regulations published in *BNB* 1987, at 252 and *BNB* 1989, at 70.

that when such foundations are dissolved the surplus must be paid to institutions which serve a public interest.[20]

A proposal relating to the treatment of pensions and annuities and to institutions which are active in this sector will also affect this type of pension and annuity foundation. Premiums paid to such closely-held foundations will no longer be deductible.

IV. CONCLUSION

A. *General*

The Dutch tax system does not have a clear structure for non-profit organizations. Certain organizations qualify immediately for exempt status; other organizations may qualify upon request. A third category of organization is untaxed if it does not aim to make a profit and does not compete with taxpayers. If liable to CIT the organization is only taxed on its business income, not on other income, such as that derived from portfolio investments.

A major problem is that the main vehicle for charitable and public interest activities has also become a means to carry out private and commercial activities. Although the competition criterion helps to curb abuse in many instances, certain kinds of revenue nonetheless escape taxation if a foundation, instead of a BV, is used for commercial activities.

However, charitable and public-interest institutions may be subject to taxation on non-commercial activities which potentially may be carried on by taxpayers as well (e.g. the Red Cross bloodbank case).

The situation of non-resident non-profit organizations and foreign entities which are not recognized as legal entities in the Netherlands (e.g. trusts) should be dealt with in the corporate income tax law. In particular, the anomaly of the heavier tax burden of non-resident non-profit organizations compared to resident organizations must be removed.

B. *New initiatives*

The tax treatment of foundations has been the subject of discussion by the Netherlands Association for Tax Law.[21] The Commission distinguishes between foundations which aim at charitable and other public interest activities and foundations which are active for private and/or commercial purposes. The Commission points to the undue advantage for the latter category even when business income is taxed. That category should be taxed on all of its activities and capital. The present system should be maintained for charitable and public interest foundations.

In the case of charitable and public interest foundations, unpaid labour performed by volunteers will be valued at the open market price which may result in a profit. If a profit arises the competition criterion becomes active, which may lead to CIT liability. The Commission questions this result and recommends excluding such advantages from the calculation of profit in such cases. Finally, the Commission recommends that statutory criteria apply to the fiscal transparency regime.

20. The Supreme Court, however, has held that such a condition is not permissible. See Supreme Court decision of 19 December 1990, published in *Vakstudie-Nieuws* 1991, at 350.
21. See *supra* note 2.

Conference Diary

JANUARY 1992

Introduction to Belgian Business and Tax Law. Brussels, Belgium, Saturday 25 January, 1, 8, 15, 22 and 29 February and 7 and 14 March (English):
VLEKHO-Brussel, Koningsstraat 336, B-1210 Brussels, Belgium, telephone 2/221.12.11, fax 2/219.78.79.

2nd Conference on the Tax Treatment of International Capital Markets Transactions, Zürich, 27-28 January (English):
International Tax Academy, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31-20-626 7726; Fax: +31-20-620 9397.

European Holding Companies in a Changing Tax Environment. Brussels, Belgium, 30/31 January (English):
VLEKHO-Brussel, Koningsstraat 336, B-1210 Brussels, Belgium, telephone 2/221.12.11, fax 2/219.78.79.

MARCH 1992

Accounting & Taxation for Life Insurance Offices, 4 and 5 March (English):
IBC Financial Focus Ltd., 57/61 Mortimer Street, London W1N 7TD, telephone: 71-6374383, fax: 71-3234298.

I.T.P.A. Guernsey Seminar. Guernsey, Channel Islands, 12-13 March (English):
Elizabeth Husband, International Tax Planning Association Membership and Conference Liaison Office, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England. Tel.: Sevenoaks (0732) 62910. Fax: Sevenoaks (0732) 63762.

EC Corporate Tax Directives: challenges and opportunities for businesses operating in Europe (co-sponsored by KPMG), Brussels, 12-13 March (English):
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JAPAN

Professor Fumitoshi Tamakuni

Professor of Law, Meiji Gakuin University, Tokyo, Japan

I. INTRODUCTION

A. *Overview*

There are two types of private organization for the public interest in Japan: a "juridical person" for the public interest (i.e. an incorporated non-profit association or a non-profit foundation) and a charitable trust. The main purposes of these organizations are the promotion of science or education, improvement of culture or social welfare, advancement of international relations, preservation of the environment and other activities in the public interest.

Civil Code 34 provides that "public interest corporations" are "incorporated non-profit associations or foundations relating to worship, religion, charity, science, arts and crafts or otherwise relating to the public interest". Although the precise meaning of "relating to the public interest" is not clear, the law does not define the phrase, nor does it clarify the requirements to obtain the status as a public interest corporation; this is generally left to the discretion of the competent authorities (who are not necessarily the tax authorities).

The business activities of non-profit foundations may be categorized as three types: the aid or subsidy type, the business type and the scholarship type.[1] Many aid or subsidy type foundations have been founded in the past 20 years. They are generally large and engage in substantial activities, such as research in art and science, especially natural science; support for school education, particularly in remote regions; welfare and protection, e.g. child welfare, welfare for the aged and protection of the physically or mentally handicapped; and the granting of scholarships, including aid for foreign students.

The Trust Law was enacted in 1922 and the charitable trust system was established at that time, but no charitable trust was authorized in Japan until 1977. There are several reasons why the charitable trust system did not become established in Japanese society. First, the government introduced a foreign system without forethought, and enacted it without careful examination. In the process of legislation, only a commercial type trust was contemplated. Second, the authorities were indifferent to the concept of a charitable trust. An authorization system was adopted for charitable trusts, but no application procedure was developed. Third, any tax incentives for improving charitable trusts, except the tax-exempt treatment of income from trust funds, has not been introduced into the Japanese tax system.[2]

About 20 years ago, a number of public interest issues were raised and considered by the Parliament, e.g. abuse of the system, confused corporate management, problems associated with corporate liquidations, etc. Charitable trusts were put forward as one of the means to solve these problems. Following the regularization of the authorization procedure, the first two charitable trusts were authorized by the Ministry of Construction and the Ministry of Foreign Affairs in 1977. Since then, the number of established charitable trusts has increased significantly.

B. *Magnitude of non-profit activities*

The number of incorporated non-profit associations or non-profit foundations reached over 20,000 in 1983 and is still growing. According to research of the Trust Association, the number of charitable trusts reached 254 in March 1989.

II. TAX TREATMENT GENERALLY

A. *Income-based taxes*

In Japan, the Income Tax Law ("ITL") and the Corporation Tax Law ("CTL") form the basis of the income tax system.

Interest income, including profits on redemption of discount bonds and debentures, dividends, distributions of gains, and other kinds of asset-based income are subject to withholding tax at a rate of 10 to 20 percent unless the tax is paid abroad by the recipient.

The ITL fully exempts "public corporations" from income tax (i.e. assessment tax and from withholding tax on interest, dividends, etc.), and partially exempts certain public interest corporations. Organizations designated as public corporations are those which are established for national purposes or corporations formed under special statutes; for example, local governments (municipal corporations), public funds (e.g. the Amami Islands Promotion and Development Fund), finance corporations (e.g. the People's Finance Corporation), public corporations (e.g. the Japan Broadcasting Association), banks founded under national policy (e.g. the Japan Development Bank), the National Theatre, the Japan Scholarship Society, the Land Development Division, etc.[3]

The ITL also grants a tax exemption for income derived from investments made by charitable trusts. Public corporations and charitable trusts which are subject to these provisions must file a return with the tax authorities through the payer of the interest on bonds and debentures, etc.

Schedule I of the CTL fully exempts public corporations from corporation tax because of their public character.

The CTL specifies a "public interest corporation", i.e. a private corporation established for public interest purposes as defined by law, as another category of non-profit organization. A public interest corporation is similar to an exempt organization in the United States. The CTL uses the term "public interest corporation" in the same sense as in Civil Code 34 (see above), but again no definition of public interest corporation is provided. The CTL merely states that public interest corporations are "the corporations and foundations designated in Schedule II". Thus, recognition of a corporation as a public interest corporation depends on whether the corporation is found in Schedule II of the CTL.

1. The annual total budgets of 30 percent of the business type foundations are less than 100 million yen, and the budgets of 50 percent of the foundations are less than 500 million yen. Nearly 20 percent of scholarship type foundations have less than a 100 million yen fund, and 40 percent have a 100 to 500 million yen fund. Annual total budgets of 70 percent of the scholarship type foundations are less than 100 million yen (those of 40 percent are less than 30 million yen). Generally speaking, the scale of the budgets of public interest corporations in Japan is not very large.
2. See Minoru Tanaka, "Public Interest Corporations and Charitable Trusts" (Keiso-shobo, 1980), at 18-22.
3. Foreign public corporations which engage in public interest activities are also exempt from Japanese income tax so long as the home country exempts comparable Japanese corporations from such taxation.

Schedule II enumerates many such corporations. For example:
- certain mutual aid associations and their federations;
- school corporations;
- certain kinds of trade associations;
- health insurance associations;
- corporations for social welfare;
- religious corporations;
- Chambers of Commerce and Industry;
- tax accountants' associations and lawyers' associations;
- incorporated labour unions;
- the Japan Red Cross;
- exporters and importers associations;
- Japan Bicycle Race Promoters Associations;
- incorporated associations and foundations established by Civil Code 34.

The ITL combines public corporations and public interest corporations as listed in Schedules I and II, respectively, of the CTL in one table. As a result, many public interest corporations are exempt from withholding tax (e.g. on interest income and dividends), and partially exempt from corporation tax. Income derived from non-profit business activities is not taxed, but income derived from certain profit-making activities (as set out in a Cabinet Order) is subject to corporation tax at a reduced rate.

Profit-making activities include the following:
- sales of real estate and loans for the purchase of real estate;
- manufacturing industries;
- communication services;
- specified businesses, i.e. express, contracting, printing, publishing, photo, hall, hotel, restaurant, agency, wholesale, credit guarantee, etc.;
- teaching of arts and crafts, except at specialized schools or other kinds of schools as defined in the School Education Law;
- warehousing; and
- the transferring or offering of incorporeal property rights.[4]

Public interest corporations must maintain books of account clearly showing the income from their profit-making activities. In computing the taxable income from profit-making activities, contributions of up to 30 percent of ordinary income by a profit-making branch to another branch of that corporation or to any other corporation are deductible. In the case of a social welfare corporation or a qualified private educational institution, the limits for deductible contributions are 50 percent of ordinary income or 2,000,000 yen, whichever is larger (see below).

The tax rate imposed on an ordinary corporation or an unincorporated association which carries on profit-making activities is 37.5 percent. If its capital at the end of each accounting period is 100,000,000 yen or less, or if it has no capital, or if it is a cooperative association, corporation tax is imposed at a rate of 28 percent on income of 8,000,000 yen or less. However, income earned by public interest corporations from profit-making activities is taxed at a rate of 27 percent irrespective of the amount of their capital or income. Taxes on undistributed profits or liquidation income are not levied on public interest corporations.[5]

B. *Property taxes*

1. Capital gains tax

No capital gains are deemed to arise if a person contributes property or cultural assets to the national or local government, nor do they arise if a person contributes property to public interest corporations and the contribution is recognized by the tax authorities as promoting education or science, improving culture or social welfare, or otherwise remarkably contributing to the advancement of the public interest.

2. Inheritance tax

Property which is acquired by a person engaged in work for religious, charitable, scientific, educational or social welfare purposes and which is certain to be placed in public use, is exempt from inheritance tax. No inheritance tax is levied when an heir contributes inherited assets to the national or local government or to a public interest corporation listed in a Cabinet Order as promoting education or science, improving culture or social welfare, or otherwise remarkably contributing to the advancement of the public interest. Exceptionally, contributions which unreasonably decrease the inheritance tax burden will remain subject to inheritance tax.

3. Registration and licence tax

A registration and licence tax (national tax) is levied when property rights are entered in official books (e.g. registration of real estate, etc.). Public corporations designated as such in Schedule II of the Registration and Licence Tax Law (the same as the CTL public corporation) and the national government are exempt from this tax. Public interest corporations listed in Schedule III of the Registration and Licence Tax Law are exempt from this tax when they register certain property, i.e. school buildings and land used for educational purposes, buildings or land of religious corporations used exclusively for religious purposes, etc.[6]

4. Real property acquisition tax

Real property acquisition tax is a tax levied by prefectures on a person's acquiring land or buildings (including rebuilding). The national government, urban and rural prefectures and municipalities, and certain parts of the Imperial estate are not subject to the real property acquisition tax. No tax is levied when public interest corporations acquire real property for basic non-profit purposes.

5. Fixed assets tax

A fixed assets tax is levied by the municipality on registered real estate. The taxpayer is the registered owner of land and buildings, etc. The fixed assets tax is not levied on real estate used for public business purposes by the national government, urban and rural prefectures or municipalities, or certain parts of the Imperial estate, or on real estate owned by public interest corporations which is used for public purposes.

4. However, in certain cases these activities will not be considered profit-making. For example, if more than half of the people working for the business are disabled persons (as provided by the Disabled Persons Welfare Law), or receive a livelihood protection allowance by the Livelihood Protection Law, or are over 65 years of age, or are women without spouses or widows who are supporting children (within the meaning of the Mothers, Children and Widows Welfare Law), and the business contributes to the livelihood protection for these individuals, then the business will not be considered a profit-making activity listed in the Cabinet Order.
5. However, the tax on ordinary income is levied on income accruing after the liquidation proceedings commence.
6. Note, however, that the public interest corporations listed under the Registration and Licence Tax Law do not include all of the public interest corporations listed in Schedule II of the CTL.

6. Land price tax

The land price tax was introduced in May 1991. This national tax is levied on the owner of land and is based on the cost of the land. The tax is not levied on government-owned land, on land owned by public corporations, nor is this tax levied on land owned by public interest corporations which is used for non-profit purposes.

C. *Other taxes*

1. Consumption tax

The consumption tax is levied on the business proprietor. Taxable transactions are domestic transactions in which consideration is paid for the transfer or lease of assets, the provision of services for business purposes, and import transactions. The consumption tax requires consumers to ultimately bear tax on the sales of goods and provision of services carried out in Japan. However, the transfer or lease of assets and provision of services by the national government, local government and other public corporations (listed in Schedule I of the Consumption Tax Law) are exempt from this tax. Examples include the transfer of stamps, registration fees, etc. In addition, certain types of transfers or leases of assets and provision of services by public interest corporations listed in Schedule I are exempt from consumption tax. Educational, medical and welfare services are non-taxable transactions according to governmental policy. However, the number of non-taxable transactions is very limited due to the philosophy underlying the consumption tax that it should spread the tax burden over a wide range of taxpayers.

2. Local taxes

The main local taxes related to non-profit organizations are prefectural and municipal inhabitant taxes, the prefectural enterprise tax on corporations, the prefectural real estate acquisition tax (discussed above) and the municipal fixed assets tax (discussed above).

The Local Tax Law provides that the national government, local governments or other public corporations, and specified public interest corporations (if they do not operate a for-profit business) are exempt from corporate inhabitant taxes. Public interest corporations established by Civil Code 34 are only exempt from inhabitant tax if their main purpose is the establishment of a museum or the pursuit of studies.

The national and local governments, and other public corporations are entirely exempt from the enterprise tax on corporations. Public interest corporations are exempt from this tax, unless they derive income from their profit-seeking activities.

III. SPECIAL INCENTIVES FOR GIFTS TO NON-PROFIT ORGANIZATIONS

Income tax

1. Individuals

If an individual taxpayer makes "approved contributions", that portion of the contribution that exceeds 10,000 yen may be deducted from the taxpayer's total taxable income. However, contributions may not exceed 25 percent of the taxpayer's total taxable income.

"Approved contributions" include the following:
- contributions to the national or local government;
- contributions to public interest corporations for educational, scientific, social welfare or other public interest purposes, which are specifically designated by the Minister of Finance; and
- contributions to schools or corporations for purposes designated in the Cabinet Order on income tax.

Contributions made by an individual taxpayer to approved charitable trusts which contribute to educational, scientific, social welfare or other public interest purposes are also treated as "approved contributions".

2. Corporations

The CTL allows deduction of charitable contributions made by corporations. Contributions to the national and local government and other designated contributions for public purposes are fully deductible. Contributions to public interest corporations established by Civil Code 34 or to other public interest corporations, which are designated by the Minister of Finance as being collected and appropriated for urgent disbursements for educational or technological development, for the promotion of cultural or social welfare and other designated purposes, are also fully deductible.

Contributions to certain public corporations or public interest corporations established by a special law and listed in the Cabinet Order on corporation tax as contributing to educational, scientific, social welfare or other public interest purposes, and contributions related to their main purposes are deductible up to 30 percent of ordinary income. For a social welfare corporation or qualified private educational institution, a deduction of 50 percent of ordinary income or 2,000,000 yen, whichever is larger, is allowed. Other contributions, including contributions to political or religious organizations or societies, are deductible up to the amount of 1.25 percent of income plus 0.125 percent of the paid-in capital. If a corporation does not have any capital, contributions are deductible up to 2.5 percent of income.

Payments of asset-based income to which a profit-seeking branch of a corporation is beneficially entitled, but which were made to another branch of the corporation are deemed to be a contribution to the profit-making business.

The money paid for setting up the trust corpus of specified charitable trusts (i.e. charitable trusts which remarkably contribute to the promotion of education or science, improvement of culture or social welfare or improvement of other public interests) by a domestic corporation is also treated as a charitable contribution.

IV. SPECIAL ISSUES

A. *Tax treatment of non-profit organizations directly involved in commercial activities*

Public corporations (listed in Schedule I of the CTL) are fully exempt from corporation tax. Public interest corporations (as listed in Schedule II of the CTL) are partially exempt from corporation tax, i.e. they are subject to corporation tax at a reduced rate of 27 percent on income derived from profit-making activities. The reduced rate applies regardless of whether a profit-making activity carried on by a public interest corporation is closely connected to its non-profit purpose and the ultimate purpose of the profit-making activity is the public interest, or whether a public interest corporation engages in a business wholly unrelated to its public interest purpose.

When public interest corporations deposit their income from profit-making activities in a bank or when they invest that income in bonds or securities, if the deposit or investment is made within the scope of the corporation's ordinary profit-making activities, the interest or income is subject to corporation tax as income from a supplementary profit-making business. If public interest corporations invest their surplus and maintain separate accounts, the income from these investments is deemed to be a contribution to non-profit activities and therefore deductible. If separate accounts are not kept, the interest or income is simply treated as income from profit-making activities.

Once the competent authorities designate a corporation as a public interest corporation, it is entitled to the tax benefits even if its actual activities do not conform to its original public interest purpose.[7] Designation as a public interest corporation is entirely within the province of the competent authorities, and lacking such a designation, a corporation cannot be treated as a public interest corporation for tax purposes. Thus, the designation by the competent authorities is the first and last opportunity to remove any non-qualifying organizations.

In principle, the business activities of public interest corporations are subject to the control of the competent authorities. For example, the competent authorities may issue a supervisory order, or investigate the business and financial situation of a public interest corporation at any time by virtue of their office. The competent authorities may require a corporation to prepare a business report, a financial statement or summary of a business plan. On the basis of such documents, the competent authorities may issue a direction or a suggestion. However, the basic policy as to when an investigation should be initiated and the proper response of the competent authorities is unclear, and the particulars of directions or suggestions vary considerably.

B. *Tax treatment of non-profit organizations with ownership interests in business enterprises*

Japanese law does not prohibit public interest corporations from substantially controlling affiliated profit-making companies. However, if a public interest corporation engages in unlimited commercial activities, it will be competing with profit-making enterprises. To prevent this, the competent authorities may examine and control the activities of public interest corporations. For example, in 1980, the Ministry of Labour issued a memorandum requiring the directors of the Labour Standards Bureau and Governors (i.e. the competent authorities) to direct or order public interest corporations not to establish companies which substantially seek profits under the umbrella of the public interest corporation. Whether or not a company seeks profits under the umbrella of a public interest corporation depends on whether the corporation made a substantial investment in the company and continued to finance it unreasonably, whether the executives hold additional positions in the company, whether the names are similar, whether both offices are located in the same building, etc.[8]

Affiliated profit-making companies or feeder organizations are treated as ordinary corporations insofar as they have profit-making purposes, and corporation tax is imposed at the normal rate (37.5 percent). When affiliated profit-making companies or feeder organizations contribute their profits to public interest corporations, the contribution is treated as a charitable contribution.

7. See the Office of General Affairs, "The present condition and the point at issue on private organizations for the public interest" (Government Press, 1985), at 27.
8. *Id.*, at 40-41.
9. Supreme Court Reporter on Civil Cases, Vol. 4, No. 6 (1970), at 625.

C. *Corporate tax integration*

After World War II, the Japanese tax system introduced a "dividend-received credit for individuals" as a method of integrating the corporate and individual income taxes. The ratio of net worth to total debt of Japanese corporations decreased substantially in the 1960s, one reason being a tax system that was favourable for debtors. In 1961, a "split rate" corporation tax was introduced, which applied a lower tax rate to undistributed earnings (at first 28 percent) than to distributed earnings, and a reduced dividend credit for individuals (from 20 to 15 percent). Thus, the Japanese tax system utilized a combination of the "dividend-received credit" and the "split rate corporation tax". However, the split rate system failed to prevent the decreasing ratio of net worth to total debt, and the integration system at both the individual income tax level and the corporation tax level was complex. As a result the split rate system was abolished in the 1988 tax reform, and the same tax rate now applies to both distributed and undistributed profits (effective from 1990).

D. *Non-profit organizations involved in political activities*

Political organizations (incorporated associations or foundations) have been treated as public interest organizations established under Civil Code 34. They are only taxed on income from profit-making activities, and the tax rate and the limit of deductible contributions are the same as those applicable to public interest corporations.

Generally speaking, property acquired by a political organization which is to be used for political purposes is exempt from inheritance tax. However, if a gift or bequest has been made to an unincorporated political organization, or a gift or bequest made to a political organization designated as a public interest corporation is considered likely to result in an improper reduction of the inheritance or gift tax burden of the donor or his relatives, etc., inheritance or gift tax will be imposed on the political organization.

Donations to political organizations by corporations are treated as general contributions. The amount of the donation is deductible for the donor up to the amount of 1.25 percent of income, plus 0.125 percent of the paid-in capital. When a political organization uses the income from profit-making activities for political activities, the payment is treated as a general contribution.

If an individual makes approved contributions to a political organization (i.e. a contribution to political parties or political funds organizations related to political activities set forth in the Political Funds Regulation Law), so much of the contribution as exceeds 10,000 yen in a year may be deducted from total income, but the allowable amount for contributions may not exceed 25 percent of total taxable income.

A company may also make political donations.[9]

E. *Anti-abuse measures*

If an individual taxpayer makes a gift to a non-profit organization, he may be exempted from income tax, gift tax and inheritance tax. However, the prerequisites for exemption are limited; for example, only "approved contributions" qualify as deductible charitable contributions, the tax-exempt property for inheritance tax is restricted to property which is "certain to be placed in public use" and the tax authorities have authority to determine whether a contribution fulfils the prerequisites. Additionally, if an individual makes a bequest, device or gift, and tax which would otherwise be levied on a legator's or donor's relatives (or other persons connected with them) is unreasonably reduced, the corporation is subject to inheritance tax or gift tax.

V. CONCLUSION

A. *General*

In Japan, the establishment of a public interest corporation is designated by the competent authorities. As the standard for authorization is not clear, the final decision is left to the discretion of the competent authorities. In fact, many "non-profit" but "non-public interest" colorations are included in public interest corporations established by Civil Code 34.[10]

If a corporation is authorized as a "public interest corporation" listed in the Schedules, it is treated as a public interest corporation under the ITL and the CTL regardless of its real activities. This does not mean that all corporations authorized as public interest corporations under Civil Code 34 should be tax-exempt or treated as public interest corporations for purposes of all taxes. Japanese tax law enumerates all profit-making businesses, and if public interest corporations engage in those activities they are liable to corporation tax regardless of their principal public interest purpose. However, in practice, if a non-profit organization which is designated a public interest corporation does not contribute to the public interest and engages in a profit-making business, the reduced corporation tax rate applies to its income.

Approved contributions to non-profit organizations may be deducted from an individual taxpayer's taxable income up to 25 percent of his income. Other contributions by individuals are not deductible. If an individual taxpayer contributes property to a non-profit organization, capital gains are deemed to arise except in respect of contributions to the national or local government, or designated contributions to public interest corporations.

Contributions to the national and local government, or designated charitable contributions by a corporation are fully deductible. Other designated charitable contributions are deductible up to 30 or 50 percent of ordinary income. General corporate contributions to other public interest corporations or political organizations are deductible for the donor up to the amount of 1.25 percent of income plus 0.125 percent of the paid-in capital. Charitable contributions by corporations receive more advantageous tax treatment than contributions by individuals, but even the favoured treatment of charitable contribution deductions by corporations is poor as compared to the advantages available in the United States.

B. *New initiatives*

Under the existing system, if the competent authorities qualify an organization as a public interest corporation, the organization is automatically granted income or corporation tax privileges. Thus, the competent authorities – who are not always tax authorities – establish the qualifications for tax-exempt status. This is recognized as a serious defect in the system, and the Society for the Study of the Tax System on Public Interest Corporations (hereinafter "the Society) has advanced a number of proposals as follows:

- Competent authorities should qualify a public interest corporation as a legal entity, but approval for tax-exempt status should be granted by the tax authorities.
- The tax authorities should use objective criteria when deciding whether to grant tax-exempt status.
- Public interest corporations should be divided into two categories, i.e. corporations which qualify for tax-exemption and corporations which do not qualify. The former should be exempt from corporation tax, income tax and local tax.
- The tax authorities should ascertain whether corporations qualified for tax-exempt status actually fulfil the conditions. If a corporation engages in activities outside the scope of acceptable conditions, the tax authorities should have authority to disqualify the corporation.

Public interest corporations are taxed on any income derived from profit-making activities even if the income will be used for a public interest purpose. On the other hand, the tax advantages available to public interest corporations may result in unfair competition with ordinary profit-seeking corporations. Thus, the basis for tax-exempt treatment should be clarified, and a system established to avoid unfair competition. The Society has also advanced proposals on this point:

- The profit-making activities of qualified public interest corporations should be divided into related business activities and unrelated business activities, and only the income from unrelated business activities should be taxed.
- If tax-exempt public interest corporations use income derived from unrelated business activities for the public interest, or include the income in their fund, this should be deducted from income.

Abuse remains a problem. Under the existing system, if the activities of a public interest corporation deviate from its original public interest purpose, the corporation will not forfeit its privileged treatment, nor will it be subject to any penalties. The Society has advanced proposals to deal with the problem of corporations which suspend their activities and those which are established to take advantage of tax loopholes:

- If tax-exempt public interest corporations do not apply a fixed proportion of its income for a public purpose, or do not include that income in their fund every year, the income should be subject to tax.
- Direct or indirect transactions (related to the grant of money or services) which individuals (and their families) who contribute to such corporations should subject to taxation.

As mentioned above, the tax incentives for gifts or contributions to non-profit organizations in Japan are inadequate for the healthy development of activities in the public interest. Such activities must be stimulated to play an important role in international society. The Society advanced the following proposals concerning the tax treatment of charitable contributions:

- A general charitable contribution system for all tax-exempt public interest corporations should be established.
- A fixed deduction should be allowed for cash contributions, and contributions of land, art work or other property should be deductible at a fixed rate (3/5 of the cash base) of income based on the market value of the property.
- Charitable contributions should be deductible up to a fixed amount of gross income.

These proposals have been advanced on the basis of the existing system in Japan, and they contain many worthy points.

10. See Osaka Chamber of Commerce and Industry, *Community Foundation Survey Mission Report 1990,* at 38.

SINGAPORE

Teoh Lian Ee

Mrs. Teoh Lian Ee ((LL.B. (Hons), LL.M. (Singapore) is the tax partner in Drew & Napier. Prior to joining Drew & Napier in 1988, she was with the Inland Revenue Department (Law Division) as an Assistant Commissioner of Income Tax for 13 and a half years.

I. INTRODUCTION

A. *Overview*

Non-profit organizations in Singapore include:
- social welfare organizations;
- cooperative societies;
- trade unions;
- certain government and quasi-government bodies;
- trade associations;
- religious organizations;
- certain social, recreational and sports clubs;
- certain educational institutions;
- training centres set up by various industries; and
- racial and communal organizations, such as clan associations.

1. Social welfare organizations
These include non-profit organizations which provide services and accommodation for the aged, such as the Little Sisters of the Poor Home for the Aged; organizations which provide services for the poor and destitute such as the Catholic Welfare Services; organizations which provide medical and health services such as the Buddhist free clinics, certain aftercare and drug rehabilitation centres, orphanages, and homes for delinquents such as Boys' Town and Girls' Town.

2. Cooperative societies
These assist members in financing their children's education, the purchase of homes, etc.

3. Trade unions
Trade unions are formed to regulate relations between employees and employers, to promote good industrial relations, improve working conditions, enhance the economic and social status of employees, raise the productivity of employees for their own benefit, the benefit of the employer and the benefit of the economy.[1]

4. Certain government and quasi-government bodies
These include organizations such as the National Theatre Trust, the Consumer Association of Singapore and the Board of Legal Education. The National Theatre Trust is involved in the promotion of the performing arts in Singapore. The Consumer Association of Singapore provides a service to the public by redressing grievances regarding unscrupulous traders. The Board of Legal Education is responsible for training and qualifying new lawyers.

5. Trade associations
The purpose of trade associations is to safeguard the business of their members. Examples of trade associations are the International Chamber of Commerce and the Singapore Rubber Association.

6. Social and recreational clubs
These are clubs organized to provide social, recreational or sports facilities for their members.

7. Certain educational institutions
These include the National University of Singapore and government and government-aided schools. Private schools are excluded.

8. Training centres
These are training centres set up by various industries to facilitate education and training in the respective industries; examples are the Electronics Industries Training Centre, the Singapore Insurance Institute and the Singapore Institute of Management.

9. Clan associations
Clan associations are usually formed on the basis of a common surname, for example, the Khoo Clan Association, or a common Chinese dialect, for example, the Hainanese Clan Association. The general objectives of a clan association are to preserve the traditions and culture of the clan, to maintain contacts between the clan members and to promote mutual interests of the clan members.

B. *Legal structure of non-profit organizations*

By and large, the usual legal form taken by non-profit organizations is that of a society registered under the Societies Act. As of June 1991, there were 4,153 societies registered under the Societies Act. Such societies are subject to the control of the Registrar of Societies.

Certain other types of non-profit organizations, for example, cooperative societies, trade unions or mutual aid societies, are registered under their own specific statutes (for example, Cooperative Societies Act). Certain government, quasi-government or public organizations are incorporated by virtue of an Act of Parliament.

Another popular legal form is a company limited by guarantee under the Companies Act. Under Section 29 of the Companies Act, a non-profit company formed for a purpose which is of national or public interest may apply for a licence to dispense with the use of the word "Limited" after its name, thus avoiding the commercial connotations associated with the word "Limited" in the minds of the public. Examples of such companies are the Society for the Prevention of Cruelty to Animals, the Red Cross Society and the National Kidney Foundation.

II. TAX TREATMENT GENERALLY

A. *Income-based taxes*

Singapore has a territorial basis of income taxation. Income-based taxes are imposed by the Income Tax Act ("ITA")[2] on income which has a source in Singapore, i.e. income accruing in or derived from Singapore, as well as income sourced outside Singapore but received in Singapore. Income tax is imposed on a preceding year basis. The following categories of income are subject to tax:
- gains or profits from any trade, business, profession or vocation, for whatever period of time such trade, busi-

1. Adapted from the definition of "trade union" set out in Sec. 2 of the Trade Unions Act.
2. All section references are to the ITA unless otherwise specified.

ness, profession or vocation may have been carried on or exercised;
- gains or profits from any employment;
- dividends, interest or discounts;
- any pension, charge or annuity;
- rents, royalties, premiums and any other profits arising from property;
- any gains or profits of an income nature not falling within any of the preceding paragraphs, such as casual earnings and profits from isolated revenue transactions.

The ITA does not have a special regime of taxation for non-profit organizations except where the non-profit organization has the status of a "club" or "trade association" or falls within any of the exemptions provided in the ITA. Where the exceptions do not apply, non-profit organizations are subject to income tax like any other tax-paying entity. The rate of tax applicable to a non-profit organization will depend on its legal form. If it is structured as a company or a trust, it will be subject to a flat rate of 31 percent; if it is structured as an unincorporated association such as a society, it will be taxed at graduated rates ranging from 6 to 55 percent but subject to a maximum effective tax rate of 32 percent.

B. *Special income tax regime for clubs and trade associations*

If a club or trade association qualifies as a charity it will be exempt from tax under Section 13(1)(g). Otherwise, it is taxed in accordance with Section 11 regardless of whether or not it is profit motivated.[3]

In the case of a club, if the association or club receives more than 50 percent of its income from members on revenue account, it is not deemed to be carrying on a business. Receipts from members include entrance fees, subscriptions, bar and food outlet sales and payments for provision of recreational and sports facilities. The surplus of receipts over expenses is not taxable income of the club if the 50 percent requirement is met.

In practice, the Comptroller of Income Tax has ruled that where a club or similar institution falls within the provisions of Section 11(1), the entire income of the club is exempted. Thus, investment income such as dividends, rents, interest and other types of receipts from non-members are exempt if the 50 percent requirement is met.

The special tax regime under Section 11(1) applies only to members' clubs. "Members" are defined in Section 11(3) as "those persons who are entitled to vote at a general meeting of the body at which effective control is exercised over its affairs". Thus proprietary clubs are excluded from Section 11, i.e. they are regarded as carrying on a business and are assessable to tax on their gains and profits in the normal manner. Where a club is taxable, its income is taxed at graduated rates, subject to an effective tax rate of 32 percent.

As stated above, a trade association is usually an association formed with the main object of safeguarding or promoting the profession or business of its members. Under Section 11(2), trade associations are deemed to carry on a business or trade only if more than 50 percent of their receipts, in the form of entrance fees and subscriptions, are from members who claim, or are entitled to claim these as deductions under Section 14, i.e. as business expenses incurred wholly and exclusively in the production of their income.

The types of income a trade association usually receives are business income (such as income derived from conducting training courses), interest, rents, entrance fees and subscriptions. The taxable amount is determined in the normal way, by allowing all revenue expenses incurred in the production of such income, capital allowances and losses carried forward (if any).

All clubs, associations and similar institutions, mutual or otherwise, whether specifically exempt or partially or wholly taxable, are required to file annual income tax returns with supporting accounts.

C. *Tax-exempt status under the ITA*

The ITA grants an exemption from income tax to certain types of non-profit organizations. If a non-profit organization qualifies under any of the exemptions, its income will be exempt from tax.

Under Section 13(1)(e), certain public authorities, boards or funds constituted by statute in Singapore, certain clubs, corporations and institutions in Singapore and certain authorities not incorporated in Singapore, which are listed in the First Schedule of the ITA, are all exempt from tax.

Section 13(1)(f)(i) exempts the income of a bona fide friendly society approved by the Comptroller. The exemption is not automatic – the society must apply for exemption. A friendly society is not defined in the Act, but as a matter of practice, the term includes funeral societies, benevolent associations and mutual benefit organizations. Mutual benefit organizations must be registered under the Mutual Benefit Organization Act. A mutual benefit organization is defined to mean any organization which uses the voluntary subscriptions of its members for the relief or maintenance of any member or his relatives during sickness, old age or widowhood, or the payment of money on the birth of a member's child or on the death of a member or his relatives. In practice, the activities of mutual benefit organizations are mainly confined to the provision of death benefits for members.

Section 13(1)(f)(ii) exempts income derived by any cooperative society registered under the Cooperative Societies Act ("CSA"). Under the CSA, any society which promotes the economic interests of its members, or which promotes the economic interests of the public generally, or any sector of the public, may be registered as a cooperative society.

However, under CSA Section 71, a cooperative society is generally required to pay a levy equal to five percent of the first $ 500,000 of its surplus and 20 percent of its surplus

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3. The relevant portion of Sec. 11 provides as follows:
(1) Where a body of persons, whether corporate or unincorporate, carries on a club or similar institution and receives from its members not less than half of its gross receipts on revenue account (including entrance fees and subscriptions), it shall not be deemed to carry on a business; but where less than half of such gross receipts are received from members, the whole of the income from transactions both with members and others (including entrance fees and subscriptions) shall be deemed to be receipts from a business, and the body of persons shall be chargeable in respect of the profits therefrom.
(2) Where a body of persons, whether corporate or unincorporate, carries on a trade association in such circumstances that more than half its receipts by way of entrance fees and subscriptions are from persons who claim or would be entitled to claim that such sums were allowable deductions for the purposes of section 14, such body of persons shall be deemed to carry on a business, and the whole of its income from transactions both with members and others (including entrance fees and subscriptions) shall be deemed to be receipts from business and the body of persons shall be chargeable in respect of the profits therefrom.

exceeding $ 500,000 to the Central Cooperative Fund (which was set up to further cooperative education, training, research, audit and for the general development of the cooperative movement in Singapore). In respect of the 20 percent levy for any surplus exceeding $ 500,000, the cooperative society can opt to pay this levy to the Labour Foundation (which was set up to fund union projects and activities).

Section 13(1)(g) exempts charitable institutions and charitable bodies of persons or trusts. The ITA does not, however, define a charity. In practice, only charities registered under the Charities Act are regarded by the Inland Revenue Department ("IRD") as falling within this section. A charity is defined in Section 2 of the Charities Act as "any institution, corporate or not, which is established for charitable purposes and is subjected to the control of the High Court in exercise of the Court's jurisdiction in respect to charities". "Charitable purposes" is in turn defined in Section 2 to mean "purposes which are exclusively charitable according to the law of Singapore".

There are two main sources of law on what amounts to charitable purposes in Singapore: the preamble to the English statute known as the Statute of Elizabeth I,[4] and case law.

According to the preamble to the Statute of Elizabeth I, charitable purposes include the following:

> The relief of aged, impotent and poor people; the maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, the repair of bridges, ports, havens, causeways, churches, sea banks and highways; the education and preferment of orphans; the relief, stock, or maintenance for houses of correction; the marriage of poor maids; the supportation aid and help of young tradesman, handicraftsmen and persons decayed; the relief or redemption of prisoners or captives; the aid or ease of any poor inhabitants concerning payment of fifteens, setting out of soldiers and other taxes.

In terms of case law, the leading House of Lords case of *Commissioners of Income Tax v. Pemsel* held:[5]

> 'Charity' in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any one of the preceding heads. The trusts last referred to are not less charitable in the eyes of the law because, incidentally, they benefit the rich as well as the poor as indeed, every charity that deserves the name must do either directly and indirectly.

The status of a "charity" is not automatic. Application must be made to the Commissioner of Charities, by means of a standard form. Although a charity enjoys tax-exempt status, it is still required to file annual returns and to keep proper accounts. As at 30 June 1991, there were 817 charities registered under the Charities Act. More than half of the registered charities are involved in the advancement of religion.

In respect of trade unions, only the non-trade or non-business income of a trade union registered under the Trade Unions Act is exempt from tax.

D. *Property and capital taxes*

There is no tax on capital gains in Singapore.

Property tax is levied at 16 percent of the annual value of all houses, land, buildings and tenements. "Annual value" is the gross rental value of the property, i.e. the gross amount at which the property can reasonably be expected to be let from year to year, with the landlord paying the expenses of repair, insurance, maintenance and taxes. Property tax is payable by the owner of the property.

Section 6(5) of the Property Tax Act, however, provides for an exemption of property tax in respect of buildings which are used for certain public, social welfare or charitable purposes such as public religious worship, public schools which are in receipt of grants-in-aid from the Government, charitable purposes and purposes conducive to social development in Singapore.

Non-profit organizations which own premises qualifying for exemption may apply to the Minister for Finance to be exempt from property tax. Such an exemption may be subject to conditions imposed by the Minister of Finance.

E. *Other taxes*

1. Stamp duty

Stamp duty is payable on certain documents in Singapore. There is no general exemption from stamp duty for non-profit organizations under the Stamp Duties Act. There is, however, an exemption in respect of any instrument executed by, on behalf of or in favour of the Government, and any instrument executed by or on behalf of any society registered under the CSA or executed by an officer or member of any such society and relating solely to the business of the society.

2. Entertainment duty

In Singapore, entertainment duty is levied upon every payment for admission to any entertainment which includes "any exhibition, performance, amusement, game or sport to which persons are admitted for payment" of the Entertainment Duty Act. Section 12 of this Act grants an exemption for certain entertainment organized by and/or for the benefit of certain non-profit purposes and/or organizations.

III. SPECIAL INCENTIVES FOR GIFTS TO NON-PROFIT ORGANIZATIONS

A. *Income tax*

Gifts to non-profit organizations approved as "institutions of a public character" are tax deductible to the donors of such gifts. These gifts would not be deductible under the general test for deductibility of expenses under the ITA (found in Section 14) which provides that the expense must have been incurred wholly and exclusively in the production of income.

In order for a donor to deduct gifts made to non-profit organizations, the gift must fall within one of the following three categories:

- approved gifts whether in cash or in kind made to the National Museum;
- cash donations to institutions of a public character;
- and approved gifts of computers (including software and peripherals) to a prescribed educational or research institution in Singapore.

The attainment of charity status operates only to exempt the income of the charity; it does not automatically mean the donor of a gift can deduct the amount of the donation from

4. The Statute of Elizabeth I was incorporated into the law of Singapore by the Second Charter of Justice 1826 (as judicially interpreted).
5. [1891] AC 531.

income. In order for the donor to do so, the charity must apply for the status of an institution of a public character. As this status is separate from that of the status of a charity, it is possible for an organization without charity status to obtain the status of an institution of a public character. Application for the status of an institution of a public character involves writing to the Ministry of Finance.

To qualify as an institution of a public character, an organization must be a non-profit organization and must fall within one of the categories listed in the ITA. These include:
- a hospital;
- a public or benevolent institution;
- a public authority or society engaged in research or other work connected with the care, prevention or cure of human diseases;
- a university or a public fund for the establishment, maintenance, enlargement or improvement of a university;
- an educational institution or a public fund for the establishment, maintenance, enlargement or improvement of such an educational institution;
- a charitable institution, or a body of persons or trust established for charitable purposes only;
- a non-profit organization engaged in or connected with the promotion of culture, the arts or sports.

B. *Estate tax*

Under Section 8(c) of the Estate Duty Act, inter vivos gifts made for public or charitable purposes 12 months or more before the death of the donor do not form part of the deceased's taxable estate, and are therefore exempt from estate duty. In the case of a gift for purposes other than charitable purposes, estate duty is payable on the gift if it was made less than five years before the death of the donor. If the gift was not perfected, i.e. the donee did not immediately assume enjoyment of the gift to the entire exclusion of any benefit to the donor, then estate duty would still be payable on that gift even if the gift was made more than five years or 12 months, as the case may be, before the death of the donor.

In the case of bequests made to institutions listed in the Fourteenth Schedule of the Estate Duty Act, no estate duty is payable on the value of the bequest regardless of when the bequest was made. The institutions listed in the Fourteenth Schedule are: the National University of Singapore, the Singapore Society of Accountants, the Board of Legal Education and the Law Society of Singapore.

IV. SPECIAL ISSUES

A. *Tax treatment of non-profit organizations directly involved in commercial activities*

1. General

Non-profit organizations are generally allowed to engage directly in commercial activities if such commercial activities are ancillary to their main objective, whether it be charitable, recreational, welfare, etc. As most of these non-profit organizations must be registered with the relevant government authorities (such as the Registrar of Societies), anti-abuse measures are by and large exercised by the relevant registration body. For example, a charity must be registered as such by the Commissioner of Charities, who has wide powers under the Charities Act, including powers to investigate and check abuses by charity trustees.

In addition, many of the statutes under which non-profit organizations have to be registered to qualify for exemption (e.g. Charities Act, Trade Unions Act, Cooperative Societies Act, etc.) have provisions enabling the registering body to enquire into the affairs of the non-profit organization, to check their books and records and to carry out, in some cases, ad hoc audits.

Anti-abuse measures are also provided under the ITA in respect of non-profit organizations which qualify for tax exemption. For example, the 80 percent rule requires that a charity apply in any year of assessment not less than 80 percent of its income to charitable objects within Singapore (see above).

2. Taxable income

Where a non-profit organization carries on commercial activities, it will be taxed on the profits it makes from such activities in accordance with the rules set down in the ITA. There are no special tax rules in respect of commercial profits made by non-profit organizations except in the case of clubs and trade associations (discussed below).

Business profits are computed on the basis of financial accounts submitted by the non-profit organization. Where a non-profit organization is set up as a company, it is required to have its accounts audited under the provisions of the Companies Act. Under Section 67 of the ITA, every person who carries on a trade or business is required to maintain proper books of account and other records to enable the income to be readily ascertained by the Comptroller of Income Tax.

The profit or loss as shown in the organization's accounts is the starting point. Adjustments are then made for non-taxable items (such as capital gains and tax-exempt income) and for non-deductible expenses and the differences between book and tax depreciation to arrive at taxable income.

3. Deductible expenses

The general rule is that all expenses which are wholly and exclusively incurred in the production of taxable income and which are not capital in nature are deductible. Allowable deductions include rent of business premises, salary costs, interest on borrowed funds used in the business, bad debts written off and specific doubtful debts, and contributions to approved provident and pension funds.

4. Capital allowances

Depreciation charged in the accounts is not deductible. Instead, the ITA provides for capital allowances on qualifying fixed assets:

(a) *Industrial building allowances*
Industrial building allowances are granted on buildings used for the purposes of a qualifying trade. In general, industrial buildings include buildings used for the manufacture of goods, the storage of goods on their arrival in Singapore and buildings used for research and development purposes of a manufacturing trade. Showrooms and offices do not qualify for industrial building allowances. An initial allowance of 25 percent of the cost of the building is given. Annual allowances of three percent of the cost are given until the total cost has been allowed (normally 25 years).

(b) *Plant and machinery allowances*
Generally, the cost of plant and machinery may be allowed over a three-year period. Computers and other prescribed automation equipment may be written off in one year.

(c) *Approved know-how or patent rights*
Capital expenditure incurred by a non-profit organization carrying on a manufacturing business in acquiring approved know-how and patent rights may be written off over a five-year period at 20 percent per annum.

(d) *Unabsorbed capital allowances*
Where the capital allowances cannot be fully utilized in any year because of insufficient income, the unabsorbed allowances may be carried forward and deducted from income in subsequent years. The ability to carry forward unabsorbed capital allowances is, however, subject to two conditions:
- the trade or business in respect of which the unabsorbed capital allowances were incurred must continue to be carried on; and
- in the case of a company, there must not be a change of more than 50 percent of the shareholding of the company.

5. Losses

Net operating losses can be deducted against the income of the company. Unutilized losses can also be carried forward indefinitely provided that any shareholding changes are not more than 50 percent. This means that at least 50 percent of the shareholders of the company on the first day of the year of assessment in which such carried forward losses are to be utilized is the same as that on the last day of the year in which the losses arose. The Minister has discretion to allow deduction of carryforward losses even if there has been a substantial change in shareholders. In practice, this discretion is exercised rather restrictively and usually only in cases of nationalization and privatization. There is no provision for group relief.

6. Charities

The exemption given to charities under Section 13(1)(g) is allowed so long as the charity applies not less than 80 percent of its net income towards charities or charitable objects within Singapore. This 80 percent rule is intended to prevent charitable institutions from abusing their tax-exempt status. Note that the charity must apply not less than 80 percent of its income by the end of the year of assessment and the income must be spent on charitable objects within Singapore.[6] To illustrate, if Charity A's adjusted net income for calendar year 1990 was $ 100,000, then at least $ 80,000 (80 percent of $ 100,000) should be applied for charitable purposes within Singapore no later than 31 December 1991 in order for the charity to qualify for exemption.

If by the end of any year of assessment a charity fails to apply at least 80 percent of its income of the preceding year to charity or charitable objects within Singapore, it will have to pay tax on the difference between the income of the charity and the amount actually applied to charitable purposes, unless the Revenue Department grants a further time extension for the charity to meet the 80 percent requirement.

The proviso to Section 13(1)(g) allows the carrying on of a trade or business by a charity on an exempt income basis provided that the income derived from such trade or business is applied solely for charitable purposes and either:
(i) the trade or business is exercised in the course of the actual carrying out of the primary purpose of the charity, or
(ii) the trade or business is mainly carried on by persons for whose benefit the charity was established.

In practice, most charities would have little difficulty in satisfying these conditions. For example, associations for the aid of the handicapped may carry on simple cottage crafts such as basket weaving and the making of greeting cards which are done by handicapped persons.

There is, however, no local case law on the interpretation of the above conditions, i.e. that the trade is exercised in the course of the actual carrying out of the "primary purpose" of the charity, or that the trade is mainly carried on by persons for whose benefit the charity is established. Some guidance may, however, be obtained from two English cases dealing with these conditions.

In respect of whether an activity is exercised in the course of the actual carrying out of a primary purpose of the charity, some assistance may be gleaned from the English case of *Trustees of the Dean Leigh Temperance Canteen v. Commissioners of Inland Revenue.*[7] That case involved a temperance organization which had set up a canteen at the Hereford market to promote the consumption of non-alcoholic drinks and which also provided light refreshments. The canteen was operated by trustees nominated by the temperance organization. The trust deed which appointed them also provided that any receipts of the canteen business should be applied to the running and maintenance of the canteen, to the provision of similar canteens in Hereford or elsewhere, or towards any other objects which tended to promote temperance. On these facts the court held that the promotion of temperance was the sole object of the trust and that this object was carried out by the operation of the canteen.

In respect of the requirement that the work in connection with the trade or business should be carried on by persons for whose benefit the charity was established, some assistance can be gleaned from the case of *Convent of the Blessed Sacrament, Brighton v. Commissioner of Inland Revenue.*[8] In that case, the objects of the Convent included the Christian education of young girls and the care of the sick. The nuns in the Convent took vows of poverty. They were entirely dependent on the Convent for their daily needs. Apart from training in religious matters, the nuns were also trained to teach in the Convent's school, which was a fee-paying establishment. On these facts, Finlay J, held that the work in connection with the business was carried on by the nuns who were the beneficiaries of the charity.

7. First Schedule organizations

There is no prohibition in Section 13(1)(e) against First Schedule organizations carrying on commercial activities. However, because their exempt status depends on whether they are listed in the First Schedule of the ITA, there is an implied controlling mechanism by which abuse of their exempt status can be prevented.

Section 13(1)(e) does, however, exclude from exemption any dividends received by a First Schedule organization from a company if, at the time the dividends are declared, the organization holds more than 50 percent of the issued share capital (unless otherwise approved by the Minister). Such dividends are taxed at the corporate rate of 31 percent (Section 42(4)). This means that First Schedule organizations are restricted in terms of investing in more than 50 percent of the share capital of companies unless these investments are approved by the Minister or unless the First Schedule organizations concerned are prepared to pay tax on the dividends received.

6. Expenditure on charitable objects outside Singapore does not qualify for exemption.
7. (1958) 38 TC 315.
8. 18 TC 76.

The proceeds from the sale of the shares in these companies would, however, appear to be exempt as they do not fall within the exclusion.

8. Friendly societies and cooperative societies

As Section 13(1)(f) is unqualified, it appears that even if such societies carry on commercial activities, any income so derived would be exempt. However, the following riders should be noted.

Friendly societies, which comprise mainly mutual benefit organizations must be bona fide, and in addition must be approved by the Comptroller of Income Tax. Therefore, there is again an implied mechanism for controlling abuse. Further, mutual benefit organizations must be registered under the Mutual Benefit Organizations Act and must file annual returns of their receipts and expenditure.

Cooperative societies must be registered under the CSA in order to qualify for exemption. To qualify for registration, the cooperative society must have objects which relate to the promotion of the economic interests of its members in accordance with cooperative principles. In addition, every registered society must have a prescribed organizational and management structure, must have its by-laws approved and must comply with other prescriptions in the Act. In particular, Section 69 of the Act restricts the investment or deposit of the cooperative society's funds except in the following ways:
- in the Post Office Savings Bank;
- in such investments and securities as are for the time being authorized for the investment of trust funds; with any bank registered under the Banking Act;
- in the shares of any other society approved for this purpose by the Registrar;
- in the purchase or leasing of land or buildings or in the construction of buildings necessary for the conduct of its business and the welfare of the cooperative movement, with the previous sanction of the Registrar; or
- in such other manner as may be approved in writing by the Registrar, either generally or in any particular case.

These requirements provide a safeguard against the abuse by cooperative societies of their exempt status and of the funds entrusted to them and contributed by their members.

9. Trade unions

A trade union registered under the Trade Unions Act is exempt from tax only on its income arising from non-business sources.

B. *Tax treatment of non-profit organizations with ownership interests in business enterprises*

A non-profit organization can carry on business directly or it can incorporate a company to carry on commercial activities. Alternatively, it can incorporate a holding company which in turn owns and controls operating subsidiaries. Where the non-profit organization is structured as a company, it can hold the shares of the operating or holding company directly in its own name. Where the non-profit organization is structured as an unincorporated association, it will have to hold the shares through nominees, usually the individuals who act as trustees of the society. Each of the companies owned directly or indirectly by the non-profit organization will be taxed according to the ordinary income tax rules and at the normal corporate rate of 31 percent.

C. *Corporate tax integration*

In Singapore the profits of a company are not taxed twice. Instead, Singapore utilizes the imputation system under which only the shareholder is taxed. Under this system, the company pays the tax first, i.e. corporate tax on its profits. If the profits are never used to distribute dividends, no further issue arises. If dividends are distributed, the company will declare a gross dividend equal to the actual net dividend it pays out plus the tax on that dividend (which it has already paid by way of corporate tax on the profits out of which the dividend is declared). The company is able to pay out only the actual net dividend because it is statutorily empowered to withhold tax at the rate of 31 percent from any declared dividend. The shareholder, although receiving only the actual net dividend, declares dividend income equal to the gross dividend and is taxed on the gross dividend at his marginal tax rate. (In the case of an individual, the rate is between 3.5 and 33 percent; in the case of a company, a flat rate of 31 percent.) If the tax withheld by the company on the gross dividend is greater than the tax that is payable by the shareholder on the same gross dividend, the difference is refunded to the shareholder. If the tax withheld by the company is equal to that payable by the shareholder, no further tax is payable by the shareholder. If the tax withheld is less than the tax payable by the shareholder on the gross dividend, the shareholder will have to pay the difference to the IRD.

Where the shareholder is a non-profit organization which is a charity or is otherwise tax exempt under the ITA, any dividend it receives will be exempt from tax. Effectively, this means that the income of the subsidiaries owned by the non-profit organization will also be exempt, since the charity or exempt body upon receiving the dividend income would receive a tax refund in respect of the corporate tax already paid by the subsidiaries (or holding company as the case may be). This is better explained by the following illustration.

> Assume Charity A has a subsidiary B which is a trading company. In the basis year (i.e. from 1 January to 31 December) of 1990, B made a profit of $ 110. After deducting expenses of $ 10, it was taxed in the year of assessment 1991 at 31 percent of $ 100, i.e. $ 31. B then declares a dividend of $ 100, withholds $ 31 and pays A $ 69. A receives actual dividend income of $ 69 and declares dividend income to tax of $ 100. As A is a charity and enjoys tax-exempt status, it is then refunded $ 31 which is the difference between the tax paid for it by B and the tax A is liable to pay on the gross dividend. Effectively, therefore, for the $ 100 profit which B makes, A will receive all $ 100; i.e. no tax is paid.

D. *Tax treatment of non-profit organizations involved in political activities*

In order to carry on political activities, the non-profit organization would either have to join an existing political party or form a political party. To form a political party, a society would have to be registered with the Registrar of Societies in the same way that any other society is registered. However, its tax position is not affected by whether it carries on political activities or not, but depends on whether it falls within the general scheme of the ITA or the special provisions discussed above.

There are no specific tax measures to curb abusive practices in relation to political activities, other than the general measures discussed in the earlier sections of this paper.

E. *Anti-abuse measures*

Gifts to qualifying non-profit organizations (i.e. institutions of a public character) must generally be cash gifts, thus reducing the scope for abuse. The only tax-deductible gifts in kind are those given to the National Museum and computers given to certain institutes for education or research. In respect of gifts in kind to the National Museum, the gift must be approved by the Minister. Additionally, the amount of the deduction depends on the value determined by the Minister, thus preventing any artificial inflation of the value of the gift.

Gifts of computers (including computer software and peripherals) must also be approved by the Minister. Only gifts of computers to prescribed educational or research institutions in Singapore will qualify for deduction.

In addition to the specific controls mentioned above, the ITA contains wide-ranging anti-avoidance provisions (Section 33) which enable the Comptroller to disregard or vary the arrangement and make such adjustments as he considers appropriate where he is of the view that the purpose and effect of any arrangement is directly or indirectly to avoid tax.

F. *International issues*

1. Non-profit organizations under Singapore's double taxation agreements

Presently, Singapore has concluded 26 double taxation agreements ("DTA") Generally under such DTAs, if the non-profit organization falls within the definition of a "Singapore enterprise", it will not usually be taxable in the other contracting state on its business income unless it has a permanent establishment there.

Under Singapore's DTAs, generally, the definition of "Singapore enterprise" does not refer specifically to non-profit organizations. The definition does, however, usually refer to commercial enterprises undertaken by Singapore residents. "Singapore resident" is, in turn, usually defined as "persons" resident in Singapore and "persons" defined to include any body of persons, whether corporate or not.

A non-profit organization (whether corporate or not) that carries on business activities would likely fall within the definition of "Singapore enterprise" and therefore qualify for the treatment accorded to Singapore enterprises under Singapore's DTAs. If the non-profit organization does have a permanent establishment in the other contracting state, it will generally be subject to tax in that other state on the profits attributable to the permanent establishment, even if the non-profit organization is tax exempt in Singapore (unless it also qualifies for tax exemption under the domestic tax laws of the other state).

2. Charitable objects within Singapore

With regard to charities, the ITA stipulates that 80 percent of the charity's income spent be used on charitable objects within Singapore. The condition that the money must be spent in Singapore took effect from the year of assessment 1983. Prior to 1983, charities with affiliates outside Singapore could channel money to these overseas affiliates without any adverse tax consequences. The 1983 amendment ensures that 80 percent of the exempt income must be spent within Singapore.

V. CONCLUSION

Non-profit organizations in Singapore are by and large fairly well-run and administered. This could be due to the fact that non-profit organizations must be registered under the laws of Singapore as a society under the Societies Act or, in the case of a specialized society, under a more specific statute relevant to that society (such as a cooperative society, a trade union or a mutual benefit society).

Under the laws of Singapore, it is unlawful for an association of ten or more persons to organize themselves to carry on any activity in Singapore unless they register as a society under the Societies Act. Any person who manages or assists in the management of an unlawful society is guilty of an offence and is liable on conviction to imprisonment for a term not exceeding five years. Any person who is a member of an unregistered society is also committing an offence which carries with it a fine of up to $ 3,000 or imprisonment not exceeding three years, or both. A registered society cannot establish a branch unless it has the approval of the Registrar of Societies.

The Registrar of Societies has wide-ranging powers over societies in Singapore, including the power to require any society to furnish him with information he may require concerning the society. Further, a society may not change its name, place of business or amend its bylaws without the prior written approval of the Registrar. A society cannot use any flag, symbol, emblem, badge or other insignia without the consent of the Registrar. The Registrar has the power to investigate any misuse of money or property by any officer or member of any society, either on the complaint of a member of the society or on his own initiative. The Registrar also has powers of entry, search and seizure where he has reason to believe that any society is being used for purposes prejudicial to public peace, welfare or good order in Singapore or incompatible with the rules and objects of the society. The Registrar also has powers to summon before him any person who he has reason to believe is able to provide relevant information.

As far as tax initiatives are concerned, it does not appear that there are any moves to introduce new tax initiatives for non-profit organizations. At present, non-profit organizations that wish to avail themselves of tax benefits will register as charities under the Charities Act so that they may enjoy the tax exemption accorded under the ITA.

TAIWAN

Joanne Ling

Joanne Ling is a section chief at the Taxation and Tariff Commission, Ministry of Finance, Republic of China. For the past seven years, Ms. Ling has been active in research on tax policy issues in the ROC, especially in the income tax area. She received the Harvard Certificate in Taxation from the ITP in 1990.

I. INTRODUCTION

A. *Overview*

Every society must necessarily choose the forms of institution through which it will seek to achieve social and economic goals. Traditionally two types of institution – private enterprise and government – have been used to meet these goals. In recent years, however, increased attention has been directed to a third sector: private non-profit organizations, hybrid organizations combining characteristics of a private enterprise with those of government.

Non-profit organizations are typically seen as alternatives to government in the sense that objectives other than profit maximization are assumed to be sought, with financing of the activities achieved substantially through voluntary, non-tax mechanisms, such as private donations or commercial sales and user fees.

The term "non-profit organization" is not defined in the Republic of China ("ROC") legislation, although a wide variety of non-profit organizations and entities are established under specific laws. These organizations include:
- educational, scientific or cultural organizations, such as private schools, industrial technology institutions, associations for academic research, foundations for scientific research;
- social service and welfare organizations, such as nursery schools, children's homes, institutions for the aged and the handicapped;
- health care organizations, such as hospitals, nursing or convalescent homes and mental health care;
- organizations for religious purposes, such as temples, churches, shrines and missions;
- funds which are non-commercial but which exist in a commercial context, such as employee pension and superannuation funds;
- associations for collective recreation or self-improvement, e.g. sports clubs, philosophical societies;
- associations for public affairs, such as foundations for environmental or consumer protection;
- civic, social and fraternal organizations, such as trade associations, professional associations, industry associations, international associations, economic business organizations, clan associations and alumni associations.

B. *Magnitude of non-profit activities*

The non-profit sector of the ROC economy is growing, and is expected to increase its share of the country's total economic activities. Organizations classified as non-profit organizations engage in hundreds of distinct activities, most of which qualify as tax-deductible "charities" serving a "public purpose". More organizations are being established at the rate of a thousand per year.

Statistical data relating to non-profit organizations, such as the total number of non-profit organizations, their contribution to national income, the total amount of labour in this sector of the economy, the total assets and annual revenues of non-profit organizations, is unavailable. Thus it is not easy to evaluate the magnitude of non-profit activities in the ROC. However, an idea of the magnitude of non-profit organizations can be drawn from the following statistics:

(1) The temples, churches, and shrines have leaped in number, from 9,477 in 1980 to 15,838 in 1989 – an increase of over 67 percent.
(2) The total number of private schools increased from 1,248 in 1980 to 2,330 in 1989 – an increase of 87 percent.
(3) Civic, social and welfare organizations increased in number, from 8,327 in 1980 to 12,336 in 1989, a 48 percent increase.
(4) Organizations and inmate assistance services have grown from 87 in 1980 to 147 in 1989, a 69 percent increase.

Non-profit organizations are growing more rapidly than for-profit organizations, which increased by 42 percent – although from a larger base – from about 631,337 in 1980 to 899,047 in 1989, the most recent years for which data are available.

II. TAX TREATMENT GENERALLY

A. *Income-based taxes*

Individual income tax is charged on individuals at rates from 6 to 40 percent of their taxable income which has a source in the ROC. Corporate income tax is charged on corporations, companies, partnerships and proprietorships at rates ranging from 15 percent to 25 percent on their worldwide taxable income.

An organization's activities in the charitable sector are not subject to corporate income tax on profits. Educational, cultural, public welfare, charitable organizations and institutions such as private schools, hospitals, nursing homes, asylums, etc, whose purposes are clearly defined and which meet the requirements set by the Executive Yuan, are exempt from corporate income tax. The exemption applies to all forms of income as well as to the income from subsidiaries.[1] Banks may pay interest on deposit to a non-profit organization without withholding of tax.

Non-profit organizations that meet the requirements for tax exemption must file a final tax return in accordance with the regulations,[2] and failure to comply will lead to taxation. However, religious organizations, trade guilds, employees welfare societies, fellow provincial or townspeople associations and student bodies that do not operate a business and that have no business or operational income apart from membership fees, donations, interest on foundation fund deposits or rental income from realty are not required to file a return.

Consumer cooperatives which by law do not conduct business with outsiders, such as consumers' cooperatives of the staff and students of a school, are also exempt from corporate income tax. However, regional cooperatives which provide members with consumer goods and engage in credit, production, transportation and marketing and public utilities must pay taxes with respect to income. The profit

1. Income Tax Law ("ITL"), Sec. 4, Item 13.
2. ITL Sec. 71.

from supplying consumer goods to members should be excluded from taxable income according to its proportion to the entire business income.

A non-profit organization must keep adequate records of its income and expenses to prove that its actual management complies with its status as a non-profit organization. There must be no abnormal financial relationships between donors and directors or trustees of a non-profit organization.

B. *Property taxes*

Exemption from taxation of real property – on land and buildings – is common in many countries. In the ROC, non-profit organizations are exempt from land tax, house tax and vehicle licence tax.

1. Land tax

Private land which is used for the following purposes is exempt from land tax:

(a) Land used by a foundation or for registered private schools established by such a non-profit organization, and land used for student practical training, farming, forestry, fishing, stock farming, pasturage industry and mining, and dormitories thereof which comply with regulations set by educational administrative agencies, and which is registered as non-profit property, is fully exempt.[3]

(b) Land used for private libraries, historic or science museums, and fine art galleries established with the approval of educational administrative agencies, and academic research institutions established in compliance with the Regulations for Private School Educational Institutes, are entitled to full exemption, if they are registered as non-profit organizations and established or operated by a non-profit organization, and the land is owned by the non-profit organization.[4]

(c) A 50 percent reduction in land tax is available in respect of land used for non-profit private parks and gymnasiums, wholly open to the general public and established with the approval of the competent authority. A 70 percent reduction is available if such a park or gymnasium is registered as a non-profit organization.[5]

(d) Land used for private hospitals or social charities and other enterprises for enhancement of the public interest which are non-profit and do not limit their services to people of the same trade, locality, clan or schoolmates, or other specific classes of people, is fully exempt. For a public interest enterprise approved by the competent authorities or a duly registered non-profit organization, land which is owned by the non-profit organization is eligible for exemption.[6]

(e) Land used for private cemeteries approved for establishment by the competent authorities as non-profit organizations is totally exempt from land tax, subject to the limitation that the land is zoned as public cemetery land.[7]

(f) Land used for religious organizations beneficial to social morale and education, duly registered as non-profit organizations or as temples; churches used for public sermons and approved by the Ministry of Interior for establishment as institutions conducting research in religious doctrines; land used for temples and other memorial halls or shrines: all these are fully exempt.[8]

2. House tax

School buildings and the office buildings of a private school, academic research institutions, buildings used to carry out the activities of a private charitable institution which is registered as a non-profit foundation, has achieved a creditable reputation, and has been approved by the competent authorities, are exempt from house tax.[9]

Shrines used exclusively for ancestral worship or churches and temples used by religious groups for religious services are exempt from house tax.[10] Offices owned by a non-profit service organization whose establishment is authorized by the government are also exempt from house tax.[11]

3. Vehicle licence tax

The ROC exempts non-profit organizations from the vehicle licence tax on their vehicles.

C. *Other taxes*

1. Value added tax ("VAT")

VAT is levied on the supply of goods and services within the territory of the ROC, as well as on imported goods.[12] The following goods and services fall in the category of non-credit exemptions under the VAT:

(a) medical services, medicine, lodging and meals supplied by hospitals, clinics and sanatoria;
(b) educational and nursing services provided by children's nurseries, homes for the aged or centres for the handicapped;
(c) educational services provided by schools, kindergartens, and other educational or cultural institutions, and cultural services provided pursuant to government commission;
(d) goods or services provided by student-run shops in professional schools which do not sell to outsiders;
(e) goods or services provided by legally established cooperatives to their members, and services provided pursuant to government commission;
(f) goods sold at auction, charity sales or shows by legally organized charitable or relief institutions, where the proceeds, after deduction of necessary expenses, are exclusively used by the institutions;
(g) goods or services sold exclusively to members by legally established and managed employee fringe benefit organizations of government agencies, government-operated enterprises or social associations.[13]

2. Stamp tax

Stamp tax is imposed on the receipt of monetary payments, deeds for the sale of movable property, contract agreements and deeds or contracts for sale, gratuitous transfers, partition or exchange of real estate or pledge of a lien on real estate to be submitted to government agencies for registration.[14] Receipts issued by corporate entities organized for

3. Land used for private tutoring or correspondence schools is excluded from this exemption. Regulations for Land Tax Exemption, Sec. 8, Item 1.
4. *Id.*, Item 2.
5. *Id.*, Item 3.
6. Private hospitals must also comply with these regulations.
7. *Id.*, Item 6.
8. *Id.*, Item 9.
9. House Tax Act, Sec. 15, Items 1 and 2.
10. *Id.*, Item 3.
11. *Id.*, Item 5.
12. Business Tax Law, Sec. 1.
13. *Id.*, Sec. 8, Items 3, 4, 5, 10, 11, 12 and 13.
14. Stamp Tax Law, Sec. 5.

educational, cultural, public welfare or benevolent purposes are exempt from stamp tax.[15]

3. Amusement tax

The amusement tax is imposed on the price of tickets sold or the fees collected by amusement businesses which provide sites, equipment or activities for entertainment.[16] Those who meet the following requirements are exempt from the amusement tax: all kinds of amusement provided by educational, cultural, public welfare, charitable institutions or organizations in conformity with the criteria for public welfare corporations or a foundation created under the general provisions of the civil law or duly registered with competent authorities in accordance with other laws or regulations, where the total proceeds are exclusively used by the institution or organization.[17]

III. SPECIAL INCENTIVES FOR GIFTS TO NON-PROFIT ORGANIZATIONS

A. *Income tax*

Cash donations to certain non-profit organizations are generally deductible for individual and corporate income tax purposes.[18] Tax deductibility provides a financial incentive to donate, but the extent of the incentive depends on the marginal tax rate to which the donor is subjected, and on any minimum or maximum limits on the amount of tax-deductible donations.

The basic concept of the charitable contribution deduction is that corporate taxpayers, and individual taxpayers who itemize deductions can deduct, subject to varying limitations, an amount equivalent to the value of a contribution made to a qualified donee. A "charitable contribution" for income tax purposes is a gift to or for the use of one or more qualified donees.

Several tax incentives are granted in respect of donations made to non-profit organizations. The deductibility of charitable contributions for a tax year is limited to a certain percentage of gross income. Deductibility of contributions to educational, cultural, public welfare and charitable organizations is limited to a maximum of 20 percent of the donor's gross income.[19] Deductible charitable contributions by corporations in any tax year may not exceed ten percent of corporate income.[20]

For individuals, the deductibility of donations to political parties is limited to 20 percent of the donor's gross income, but the maximum deductible amount may not exceed NT$ 200,000.[21] If the percentage limit is exceeded, the excess may not be carried forward and deducted in subsequent years. The deductible limitation of corporate contributions to political parties may not exceed ten percent of the contribution base, and the maximum deductible amount may not exceed NT$ 3,000,000.[22]

2. Land value increment tax

Land value increment tax is collected on the total incremental value at the time of the transfer of title to land which had previously been set at a certain value.[23] The rate of land value increment tax ranges from 40 percent to 60 percent.[24] Land value increment will not be charged to income tax. Land donated to establish social welfare enterprises or private schools in accordance with the law is fully exempt from land value increment tax.[25]

3. Estate and gift tax

Estate and gift tax is imposed by the Estate and Gift Tax Act. An individual donor who makes a gift of ordinary income or property to any charity is exempt from gift tax.[26] Property contributed to public educational, cultural, social welfare and charitable organizations by a legator, legatees or heirs is not included in the total value of the estate.[27]

IV. SPECIAL ISSUES

A. *Tax treatment of non-profit organizations directly involved in commercial activities*

1. Corporate income tax

The tax law does not specify whether or not non-profit organizations are allowed to engage directly in commercial activities; if a non-profit organization has been determined to be engaged in activities with a substantial public interest, it will receive the tax exemption privileges but only in respect of those activities.

A business that is related to the purposes of the non-profit organization and meets other requirements set by the Executive Yuan is generally tax-exempt. A non-profit organization may not engage in any activities outside the purpose for which it was established and approved. If it does, its exempt non-profit status will be revoked.

At least 80 percent of all net earnings must be put back into financing the services that the non-profit organization was formed to provide, i.e. not less than 80 percent of the income must be spent on its established purpose.

B. *Tax treatment of non-profit organizations with ownership interests in business enterprises*

1. Direct ownership and control

A non-profit organization may use its funds and income either to deposit in financial institutions, purchase bonds, certificates of deposit and bankers' acceptances, or to invest in first-class listed stocks and private bonds that are publicly issued in the open market. However, a foundation may use up to 80 percent of the donations which are granted by a second-class listed for-profit corporation to reinvest in that corporation. No percentage limit is imposed on investment if the foundation uses the donations to invest in first-class listed stock.

The number of donors and their spouses and relatives within the third degree (for example, father and son are relatives within first degree, grandfather and grandson are relatives within second degree, etc.) who hold positions as directors

15. *Id.*, Sec. 6, Item 14.
16. Amusement Tax Law, Sec. 2.
17. *Id.*, Sec. 4, Item 1.
18. Donations may also be made in the form of goods and services. However, there is no provision for the deductibility of donations of services.
19. ITL Sec. 17, para. 3, Item 2.
20. Income Tax Law, Sec. 36.
21. Election and Recall Law, Sec. 45-4.
22. *Id.*
23. Land Tax Law, Sec. 28.
24. *Id.*, Sec. 33.
25. *Id.*, Sec. 28-1, Item 1.
26. Estate and Gift Tax Act, Sec. 20, Item 3.
27. *Id.*, Sec. 16, Item 3.

or supervisors of the non-profit organization cannot exceed one third of the total directors and supervisors of the organization.

All countries appear to impose a "non-distribution" constraint, i.e. a prohibition on paying profit or surplus to owners, trustees or others associated with management of the organization. The ROC prohibits non-profit organizations from "distributing any surplus or profit to anyone associated with the organization".

If the organization is dissolved or if achievement of its purposes becomes impossible, the use of assets must be attributed to the local civic groups or specific organizations designated by the competent authorities. Violation of these requirements will result in revocation of tax-exempt status.

2. Feeder organizations

An organization operated for the primary purpose of carrying on a trade or business for profit is not exempt from income tax on the basis that all of its profits are payable to one or more organizations exempt from taxation.

C. *Corporate tax integration*

Dividends received by a non-profit organization are exempt from corporate income tax if the non-profit organization qualifies for tax-exempt status.

D. *Non-profit organizations involved in political activities*

Non-profit organizations are not prohibited from participating in political activities to influence legislation or elections in the ROC. The deductible limitation of contributions to political parties by individuals or corporations is the same as for charitable contributions in general, i.e. they may not exceed 20 percent and 10 percent of the contribution base, and the maximum amount of deduction cannot exceed NT$ 200,000 and NT$ 3,000,000, respectively.

E. *Anti-abuse measures*

As mentioned above, deductible charitable contributions by individuals and corporations in any tax year are subject to percentage limitations. The deductible limitations of contributions to political parties by individuals and corporations are subject to both percentage and amount limitations.

Many charities qualify as tax-exempt. Although the tax administration is empowered to audit the affairs and records of tax-exempt organizations, the effectiveness of the audit procedure is constrained by the limited personnel available. A for-profit organization could ease its tax burden by borrowing funds through non-profit organizations which are related to the for-profit organization.

F. *International issues*

Cross border contributions and cross border activities by charities are still quite minimal in the ROC, but with internationalization, these activities are expected to increase; as yet there are no specific measures to deal with these issues.

V. CONCLUSION

Non-profit organizations are granted special privileges in the ROC, presumably because they are thought to provide substantial public benefits. However, their existence is not free from controversy.

A. *Areas of concern*

More attention – and in some quarters, criticism – is being directed to the tax exemptions and deductions for charitable donations. The focus is largely on organizations exempt under the income tax law although the charitable contribution deduction is being subjected to an even greater barrage of criticism.

The dissatisfaction stems largely from the government's need at all levels for additional revenue. Tax exemptions shrink the tax base, forcing remaining taxpayers to bear a higher tax burden as the demand for tax revenue rises. This is most vividly demonstrated in metropolitan centres, where acres of valuable land owned by government, churches and the like escape property taxation, forcing such taxation at higher rates on adjoining parcels.

In addition to the drain on government revenue, the tax exemption is frequently attacked as creating a "loophole".

Another concern centres on the non-profit organization that is in fact a "for-profit organization in disguise". Non-profit organizations in the ROC are not well administered. Although specific law mandate registration with the competent authorities (e.g. associations for academic research must register with the Ministry of Education, religious organizations must register with the Ministry of Interior, etc.), non-profit organizations are not required to register with the tax authorities for purposes of tax exemption. The legality of some organizations is dubious in that they act like profit-maximizing firms. Such organizations exist only because of inadequate enforcement of the constraint against distribution of profits. These organizations have been misclassified; they are treated by the tax authorities as if they were providing trust or other collective services, but they actually pursue the private interests of their managers and directors. From a tax point of view, there is concern that abuses will occur and that tax evasion may be facilitated by bogus charities, particularly considering the limited capacity to supervise and monitor the activities of charities.

Commercial activities of non-profit organizations are exempt from tax on the basis that they are substantially or closely related to their tax-exempt purpose. Because a "related business" is not defined in the income tax code, a difficulty arises in distinguishing between activities that are partly commercial and those that are closely related to a tax-exempt purpose.

Recently, there has been growing attention as to whether non-profit organizations should be restricted in their participation in commercial activities – where they sell outputs, often competing with private firms – and what should be done if a non-profit organization engages in activities that are beyond the scope of its non-profit charter of authorization.

If a non-profit organization also engages in other activities, i.e. "unrelated business activities", those activities should be taxed as if the organization were simply an ordinary private enterprise. Because of the expense involved in monitoring accounts, non-profit organizations engaged in multiple activities – some tax-exempt, others not – can evade tax and become stiff competitors of private firms. Not surprisingly, the number of for-profit firms complaining of "unfair" competition is on the rise.

B. *New initiatives*

Not all non-profit corporations are exempt from income tax. Rather, only those organizations that meet the requirements set by the Executive Yuan are exempt. Presumably, any non-profit organization whose purposes do not fall within this list is subject to income tax as is a business corporation. The list of purposes that qualify for exemption, however, is extensive, and has been broadly interpreted. As a result, there are few significant classes of non-profit organizations that do not benefit from the exemption.

For an organization to secure recognition as a "charitable entity", it is not necessary for the organization to file an application with the tax authorities for tax exemption. The tax authorities recognize non-profit status only when the non-profit organization files an income tax return and claims tax-exempt status.

Even though a non-profit organization achieves a general exemption from the income tax, it remains potentially taxable on any unrelated business income. The unrelated business income tax only applies to active business income which arises from activities which are unrelated to the organization's tax-exempt purposes. However, an organization may satisfy the requirements of the rules pertaining to charitable organizations, although it operates a trade or business as a substantial part of its activities, where the operation of the trade of business furthers the organization's tax-exempt purposes and where the organization is not organized or operated for the primary purpose of carrying on a trade or business.

A non-profit organization's unrelated business activities have given rise to charges that tax-exempt organizations unfairly compete with for-profit enterprises. Many types of tax-exempt organizations are engaging in commercial activities in competition with the nation's small businesses and this phenomenon is increasing.

A variety of initiatives proposed by the Taxation and Tariff Commission, Ministry of Finance to the "problem of unfair competition" include:

(1) a more specific tax definition of the term "non-profit organization";
(2) all non-profit organizations should register with the tax authorities and should be subject to supervision by a specialist tax office. Non-profit organizations which claim the exemption should be required to file an application for tax exemption;
(3) repeal of some of the statutory exceptions to the filing requirements of non-profit organizations;
(4) a more specific tax definition of the term "unrelated trade or business";
(5) appropriate revisions to income tax laws and regulations governing non-profit organizations to reflect the existence of the commercial non-profit sector, and to remedy the unfair competition. A non-profit organization engaged in other activities ("unrelated business activities") should be taxed as if the organization was an ordinary private firm;
(6) a comprehensive statistical database should be developed to provide data about non-profit organizations – their size, outputs, contributions to the national income, composition, etc.

The non-profit sector of the economy is large, massive in the social service area, and growing. The law of tax-exempt organizations is dynamic. It is anticipated that examining the activities of tax-exempt organizations will help prevent the ever-present danger of abuse of any form of institution. All laws and regulations, including those applying to the non-profit economy, are inevitably imperfectly enforced. Organizations performing no socially useful purpose, seeking only to take private advantage of imperfectly enforced rules, can enter the non-profit sector and, in the process, damage public confidence in the sector. As a result, it is not only in the interest of society, but also in the interest of the vast majority of non-profit organizations whose activities are socially valuable, to restrict the fund-raising and service activities of all non-profit organizations in order to maintain and enhance the reputation of the sector as a whole.

KOREA

Tai Ro Lee

Professor of Law, Seoul National University since 1964; member of the Tax Policy Committee of the Ministry of Finance; member of the National Budget Study Committee of the Economic Planning Board; and formerly president of the Korean branch of IFA.

I. INTRODUCTION

A. *Overview*

Virtually all non-profit organizations in Korea, except religious organizations, are incorporated. The general statutory basis for incorporation is Article 32 of the Civil Code, which provides that "associations or the endowments for science, religion, arts, social association and other non-profit activities may be incorporated with the approval of the government authorities concerned".

Other types of non-profit organizations may be created under special laws, such as a labour union formed under the Labour Union Act, a private school under the Private School Act, etc. Still other types are usually created by legislative mandate; they are created under specific laws enacted for the very purpose of establishing such corporations. The Bank of Korea was established under the Bank of Korea Act, the Korea Housing Corporation under the Korea Housing Corporation Act, etc. Such organizations are created to serve certain governmental objectives and are publicly funded.

The activities of non-profit organizations are omnifarious but the major fields are education, science, social welfare, hospital facilities, religious worship and culture.

B. *Magnitude of non-profit activities*

While figures are not available concerning the total number of non-profit organizations, the number of non-profit organizations engaging in profit-seeking activities and therefore liable to pay tax was 1,502 in 1987, 1,561 in 1988, 1,727 in 1989 and 1,930 in 1990. These numbers exclude non-profit public enterprises.

These figures clearly indicate that non-profit organizations engaging in profit-seeking activities are steadily increasing, and it may be further inferred that the number of non-profit organizations as a whole is on the rise. The aggregate taxable income of the non-profit organizations that filed tax returns for 1990 amounted to 88.6 billion won, for which 31.2 billion won was paid in corporation tax.[1]

II. TAX TREATMENT OF NON-PROFIT ORGANIZATIONS

A. *Income-based taxes*

1. Individual income tax

The (Individual) Income Tax Act (the "Act") has no special provisions for non-profit activities of an individual. Therefore, if a person engages in income-producing activities, he is subject to income tax and can only claim a deduction for donations to specific organizations or for certain specific purposes. The fact that the taxpayer has directly used all or part of his income for the "public interest" does not entitle him to deduct or exclude that amount from the taxable base. Perhaps the absence of any special provision in the Act is based, in part, on the premise that a person seeking no profit does not earn income, although conceptually seeking no profit is consistent with obtaining income. The absence is more a reflection of the present situation that most, if not all, major non-profit organizations are incorporated.

2. Corporation tax

(a) *In general*

The Corporation Tax Act ("CTA") confines the taxable income of a non-profit organization to income derived from specific sources and from a "profit-seeking business" as specified in the CTA.[2]

Passive income, such as interest and dividends, is now taxed. Prior to 1989, interest and dividend income were excluded from gross income on the ground that such income is not the result of an active profit-seeking effort but most likely the fruit of the investment of available funds.

Capital gains from the sale of shares in business organizations also became taxable from the beginning of 1989.[3] The capital gain from the sale of a fixed asset is included within the scope of taxable income. However, the gain from the disposition of immovable property directly used to serve the primary purpose for which the non-profit organization was established is excluded from taxable income.[4]

Income arising from activities in the nature of a profit-seeking business is normally categorized as business income. The law enumerates the types of those businesses.

At present non-taxable income areas are considerably narrow, leaving relatively few categories of income as non-taxable. These include, for example, appraisal income, membership fees, royalties from copyrights or other intangible property, money received to redress damages, etc.[5] Probably the royalty is the most significant item. Also, while the range of "profit-seeking activities" is quite broad, there are certain areas that are not included in the enumeration. A typical example would be education; a non-profit educational institution may obtain income unburdened by corporation tax, but the omission is of little value because in reality a non-profit educational institution that enjoys income would be difficult or impossible to find.

(b) *Separate accounting*

Since a non-profit corporation is subject to corporation tax only on specified sources of income, it must maintain separate books for the profit-seeking activities and the non-profit activities (i.e. activities to accomplish the primary purpose of the organization). To eliminate administrative difficulties associated with making such allocations, assets and liabilities that are related to both categories are deemed to be solely related to profit-seeking activities.[6] Consequently, even when assets from which interest or dividends are derived are not connected with the business activity, any income generated is still treated as belonging to the profit-seeking activities for the purposes of separate accounting.

1. The exchange rate was 725 won to US$ 1 as of 2 July 1991.
2. CTA Art. 1.
3. CTA Art. 1, Item 5.
4. CTA Art. 1, Item 6, CTA Decree, Art. 2, para. 2.
5. CTA Basic Rules, 1-1-8.1.
6. CTA Decree Art. 2, para. 4.

This is because it is only necessary to determine the amount of taxable income and not the sources from which any particular taxable income is derived.

(c) *Transfer of assets from profit-seeking activities to primary purpose activities*

When assets or money of the profit-seeking activities are transferred or paid to the account of the non-profit activities, the transfer is either a "return of capital" or a "donation". If the amount of assets (or money) transferred exceeds the aggregate of the current and reserved income of the profit-seeking activities, the excess amount is considered a return of capital and the remaining amount a donation.[7] The return of capital being a capital transaction, it has no bearing on the determination of taxable income of the corporation. However, the donation, if treated as a deductible item, reduces the taxable income of the profit-seeking activities. Thus it is important to understand under what conditions and to what extent a donation is treated as deductible under existing law.

B. *Property taxes*

1. Capital gains tax

It is one of the peculiar features of the corporation tax that capital gains are taxed twice, first as corporate income and then as a capital gain. The capital gains tax may not be deducted in the computation of corporate income.

An accredited private school may sell property that constitutes a basic asset without incurring capital gains tax liability, provided the proceeds from the sale are to be used for educational purposes within three years (an additional three-year extension is possible).[8] It may also sell property used for profit-seeking activities that was acquired prior to 31 December 1985 tax-free, provided the proceeds from the sale are to be used to acquire another property for the profit-seeking activities within one year from the sale.[9] If the new property is disposed of within three years, the tax that was exempted will be recaptured by the tax authorities, unless the proceeds from the second sale are used for educational purposes.[10]

Similarly, social welfare corporations established under the Social Welfare Activities Act, and religious corporations, are relieved from capital gains tax liability when they sell property used for non-profit corporate purposes in order to use the proceeds for such purposes.[11] The proceeds should be used within three years (again, a three-year extension is possible); otherwise the exempt tax will be subject to recapture.[12]

2. Other property taxes

Taxes that are related to the acquisition, registration and holding of immovable property (and quasi-immovable property which requires registration for transactions that affect ownership)[13] are within the jurisdiction of the local political bodies such as the province, county, city, borough, etc. Specifically, these taxes are acquisition tax; registration tax; property tax; global land tax; city planning tax; and communal facilities tax. There are, of course, other local taxes that are not related to property rights. These taxes are of minor significance and are not dealt with in this paper except for the inhabitant tax which will be briefly mentioned in connection with the taxation of income.

(a) *Acquisition tax*

The acquisition tax is imposed at a flat rate of two percent of the price of the property on a person who acquires immovable property. However, the acquisition by a non-profit organization engaged in memorial services (e.g. a shrine), religion, philanthropy, science, technology or other public interest activity is relieved of the tax if the property is acquired for "direct" use for a non-profit primary purpose.[14]

(b) *Registration tax*

Registration tax is imposed when a person applies to have property rights, formation of a corporation, a firm or brand name, establishment of a corporate branch or place of business, etc. registered in the public record. Such registrations are either mandatory or essential to effectuation of the registrant's rights.

By and large, non-profit organizations that are exempt from acquisition tax are also exempt from registration tax. The principal exceptions to the registration tax are property used for religious worship located in Greater Seoul, Taegu and Pusan, and property acquired by a medical corporation for medical facilities located in cities, including Seoul and centrally-located cities, and in the situs of provincial governments.[15]

While donated property in general is taxed at a reduced rate of 1.5 percent, property donated to a non-profit organization is taxed at a still lower rate of 0.8 percent even when it is non-exempt.[16]

(c) *Property tax*

Property tax is imposed on buildings and other structures (hereinafter simply referred to as "structures").[17] Normally, business property is taxed at a flat rate of 0.3 percent annually, while residential buildings are taxed at a graduated rate which ranges from 0.3 to seven percent and "luxury property" is taxed at a flat rate of five percent.[18]

Basically, property that is exempt from acquisition tax is also exempt from property tax. However, property that is

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7. CTA Reg. Art. 1, para. 3.
8. Tax Preference Regulation Act ("TPRA"), Art. 67-3, para. 1.
9. *Id.*
10. TPRA, Art. 67-3, para. 2.
11. With respect to religious "corporations", a caveat is necessary in connection with the above exemption. The TPRA, which provides for the above exemption, expands the concept of "corporations" to include "an association, a fund and other collective body without a juridical personality". This apparently expands the definition of a corporation as found in the Basic Act for National Taxes, which grants juridical person status only to an unincorporated entity which has obtained a permit from the appropriate government authorities or which possesses the property as a basic fund used for the public interest. Although the provision in the Basic Law prevails over a conflicting provision in another Act, there appears to be no challenge to this broad definition of "corporation". As a result, under existing law, religious property owned collectively by the followers of the religion may be transferred free of capital gains tax.
12. TPRA Art. 67-14.
13. The reference to quasi-immovable property will be omitted hereinafter because it is not directly relevant to the subject of the paper.
14. Local Taxes Act ("LTA"), Art. 107.
15. LTA, Art. 127, para. 1, Item 1; LTA Decree, Art. 94, para. 2.
16. LTA Art. 131, para. 1, Item 2.
17. Property tax is also imposed on certain movable property such as aircraft, ships and heavy movable machinery, which require registration when the ownership or other rights pertaining to them are transferred or created. However, property tax on this property has little bearing on the present subject. The tax on land ownership is not included in the property tax, but constitutes a separate tax called "global land tax", which is discussed in the text below.
18. LTA Art. 188.

used by others for a fee or charge is taxed even when it is owned by public interest entities.[19]

(d) *Global land tax*

Global land tax is a tax on land held by the taxpayer.[20] There are three kinds of tax base for purposes of the global land tax, one of which will apply to a particular parcel of land: the global aggregate base, the separate aggregate base and the separate unit base.[21] In other words, all land is categorized into one of these three classes depending on which tax base should be used.

(1) *Global aggregate base*

All land within the country owned by the same owner is aggregated for the purpose of global taxation at progressive rates, except land on which certain structures stand. Even when a certain structure is built on a lot, the portion of the land in excess of the prescribed limit is included in the aggregation. This is to treat the excess portion of the land the same as a vacant lot.

"Certain structures" exclude structures on factory premises, structures within the boundary of a golf course, residential buildings, structures (other than those listed above) which have a value less than ten percent of the value of the attached land and illegally built structures.[22] The "prescribed limit" is the size of the floor area multiplied by a certain number set by law.[23] For instance, an office building in a commercial area within the boundary of a city planning zone has the multiplier of three.[24] If a building has a floor area size of 1,000 square metres, then that portion of the lot in excess of 3,000 square metres is included in computing the global aggregate tax base.

Excluded from the global aggregate tax base is the value of the land which is tax-exempt (if partly exempt, then it is proportionately excluded) or which is used for a factory, farming, livestock breeding, forest ground, golf course, resort, certain luxury facilities, other purposes similar to the above, and any special purposes that are considered by presidential decree to justify separate taxation.[25]

(2) *Separate aggregate base*

The value of the land within the "prescribed limit" of the space as explained above under the global aggregate base comprises the separate aggregate tax base.[26]

(3) *Separate unit base*

The land that is excluded from global aggregate taxation includes factory premises, farming land, animal breeding grounds, conservation forests, forests owned by a group of people with common ancestry, land used for a golf course, resorts and other specified luxury purposes, and other similar land. Presidential decree may designate a certain type of land as excludable when it is deemed necessary to facilitate the supply of land.[27]

The rate structures for both the global aggregate base and the separate aggregate base are progressive. The rates for the global aggregate base range from 0.2 percent for a value of 20 million won or less to five percent for that amount exceeding 5 billion won, encompassing nine brackets.[28] The rates for the separate aggregate base range from 0.3 percent for 100 million won or less, to two percent for amounts in excess of 50 billion won, also encompassing nine brackets.[29] The rates for the separate unit base vary depending on the kind of land but are all flat rates, which make it unnecessary to aggregate the value of land held by a particular taxpayer.[30] The purpose of the flat-rate taxation is twofold: first, to tax at a low rate without the burden of progression, and second, to tax at a high rate without the benefit of low bracket rates in the progressive rate schedule. Farm land, livestock breeding grounds and forests are taxed at a flat rate of 0.1 percent; while the rate for golf courses, resorts and other luxury structures is set at five percent.

Generally speaking, land that is exempt from acquisition tax is also exempt from aggregate land tax. The aggregate land tax, being progressive, can be fairly burdensome, particularly since appraisals, heretofore very conservative, are expected to approach market value in the near future. Thus, the exemption of the aggregate land tax is a considerable tax concession to a non-profit organization that requires a relatively large landholding.

C. *Other taxes*

The city planning tax[31] and the communal facilities tax[32], both of which are based on the value of either a structure or of land, are exempt in the manner that the property tax or the aggregate land tax is exempt for non-profit organizations.

III. SPECIAL INCENTIVES FOR GIFTS TO NON-PROFIT ORGANIZATIONS

A. *Income tax*

Voluntary giving serves numerous social goals and thus corporations are allowed to deduct donations from their gross revenue. Obviously, however, a donation can be abused to unjustifiably reduce the tax burden. To prevent such abuse the CTA has stringent rules on the deductibility of donations. To be deductible a donation must be for social welfare, culture, arts, education, religion, charity or other purposes designated by decree.[33] The "designated donations" are as follows:[34]

- donations to a social welfare foundation established pursuant to the Social Welfare Activities Act, to be used for project costs, facilities, costs or operating expenses for welfare or charitable purposes;
- donations to schools established pursuant to the Education Act (except national or public schools) and technical colleges established pursuant to the Technical College Act, to be used for facilities costs, education expenses or research costs;

19. LTA Art. 184.
20. It was part of the property tax until 1989, in which year the property tax on land became a separate tax with the change taking effect from the beginning of 1990. The change, which was a drastic measure, was brought about by the concern over escalating land prices and the perceived need to discourage excessive or speculative land holding.
21. LTA Art. 234-15, para. 2.
22. LTA Art. 234-15, para. 2.
23. LTA Decree, Art. 194-14, para. 1.
24. LTA Decree, Art. 194-14, para. 2.
25. LTA Art. 234-15, para. 2.
26. LTA Art. 234-15, para. 3.
27. LTA Art. 234-15, para. 4.
28. LTA Art. 234-16, para. 1.
29. LTA Art. 234-16, para. 3.
30. LTA Art. 234-16, para. 3.
31. LTA Art. 235 esq.
32. LTA Art. 239 esq.
33. CTA Art. 18, para. 1.
34. CTA Decree, Art. 42.

- donations or scholarships to individuals recommended by the head of a school established pursuant to the Education Act, or a technical college established pursuant to the Technical College Law, to be used for educational or research expenses;
- donations or scholarships to academic research associations, scholarships funds or technical promotion associations (including vocational training corporations established pursuant to the Vocational Training Basic Act) which have been approved by the government, to be used for educational or research expenses;
- donations to cultural and artistic organizations which have been approved by the government, to be used for project or operation costs;
- donations to organizations established to promote missionary activities which have registered with the government authorities concerned, to be used for operation costs;
- donations to individuals recommended by local governments or the Korean Athletic Association, or to that Association, to be used for training and competition expenses for improving skills in athletic games which are included in international games or competitions;
- donations to the Korean Committee of the International Industrial Skills Olympics, to be used for the expenses of sending participants to international industrial skills competitions;
- donations to the Korea Freedom League or to the Korea Veterans Association;
- donations and membership dues to the Korean Red Cross;
- donations to organizations established pursuant to the Act on Establishment of Organizations for Persons Having Offered Meritorious Services to the Nation;
- donations to boy or girl scouts organizations established pursuant to the Law on Development of Scout Activities;
- donations to non-profit corporations for the welfare of the elderly established pursuant to the Senior Persons Welfare Law;
- donations to the Korea Youth League established pursuant to the Korea Youth League Act;
- other similar donations as described in the Enforcement Decree;
- paying income from the profit-seeking activities of a non-profit corporation for its primary corporate purposes specified in the articles of incorporation.

Not all designated donations are deductible in their entirety. As a rule there is a ceiling on the amount of the deduction, i.e. the sum of seven percent of current income reduced by the loss carry-over and the "paragraph 3" donations (see below), and two percent of the average capital of the accounting year (not exceeding 5 billion won).[35] A non-profit corporation and a "non-profit public interest corporation", however, are entitled to use 20 percent and 60 percent, respectively.[36]

Paragraph 3 donations are donations to the central or local government, donations for national defence and donations for victims of natural disasters. These donations are not subject to the ceiling so long as the amount of such donations does not exceed current income minus the loss carry-over that would create a situation in which the corporation suffers a technical (tax) loss for the year. The Tax Preference Regulation Act contains provisions similar to paragraph 3 donations in respect of certain other types of donations.[37] The character of the recipient and the donative objectives vary under these provisions. Some provisions are transitory, such as the one to help the upcoming World Trade Fair to be held in Taejon, Korea; others are of a more permanent nature, such as the provisions for political contributions and gifts to private schools.

B. *Gift and inheritance tax*

1. In general

Property donated for a cause in the public interest is not subject to gift tax. If the donated property is part of the estate of a deceased individual, it is also excluded from the taxable base of the inheritance tax. For a donation to be excluded from taxable property under the Inheritance Tax Act ("ITA"), the property should either be given by the owner prior to death on the condition that the transfer take effect upon death,[38] or by the heirs after the owner's death but before the deadline for filing the inheritance tax return.[39] A gift that takes effect prior to the death of the donor is subject to the gift tax. If the donee is a person that qualifies for application of the exclusion for purposes of the inheritance tax, then donation prior to death will also qualify for exclusion from the base of the gift tax.[40] When any gain derived from the donated property inures to the heirs or the statutory kin of the deceased, however, the exclusion is denied.[41]

2. Definition of "public interest activities"

ITA Article 8-2, paragraph 1 provides that "assets donated for religious, charitable, academic and other public interest activities are not to be included in the taxable property of the inheritance tax". The ITA Decree enumerates 15 types of public interest activities, as follows:
- activities that significantly contribute to religious conversion and worship;
- activities of a social welfare corporation established under the Social Welfare Activities Act;
- activities of "a rehabilitation and protection association" established under the Rehabilitation and Protection Act;
- educational activities performed pursuant to the Education Act;
- activities of a public interest corporation established under the Act for Establishment and Operation of Public Interest Corporations;
- activities of a corporation established under the Korean Institute of Science and Technology Act or other special enactments which perform such functions as are enumerated in Article 2 of the Enforcement Decree for Establishment and Operation of Public Interest Corporations;[42]
- non-profit activities that significantly contribute to public sanitation;
- operation of a park or other public area open to the public;
- non-profit activities that significantly contribute to art and culture;
- activities of a medical corporation established under the Medical Practice Act;

35. CTA Art. 18, para. 1.
36. CTA Art. 18, para. 2.
37. TPRA Art. 49.
38. ITA Art. 8-2, para 1.
39. ITA Art. 8-2, para 6.
40. ITA Art. 34-7.
41. ITA Art. 8-2, para. 1 Proviso.
42. These functions are basically to conduct, and give financial aid to, academic or charitable activities, to offer scholarships to the needy students, and to support those engaged in academic or scientific endeavour.

- activities of a medical insurance association established under the Medical Insurance Association Act;
- activities of a medical insurance management group for public employees or private school employees established under the Public Employees and Private School Employees Medical Insurance Act;
- activities of the Korean Youth League established under the Act to Promote the Korean Youth League;
- activities of a "Saemaul" (New Village) Movement organization under the Saemaul Movement Promotion Act;
- activities of the Korea Legal Aid Association and a legal aid corporation registered under the Legal Aid Act.

IV. SPECIAL ISSUES

A. *Corporate tax integration*

Dividends received by a non-profit corporation are taxed in the same manner as any other type of income from a profit-seeking activity. There is no exclusion, deduction or credit allowed for dividends received. Only financial investment firms are entitled to exclude from gross income the dividends received from corporations listed on the Korea Stock Exchange. An individual shareholder whose holding is "small" is taxed on dividends received from listed corporations at the flat-rate withholding tax of 20 percent plus a local inhabitant tax of 7.5 percent of the above 20 percent (adding up to a total rate of 21.5 percent).[43] Dividends received by an individual from unlisted corporations are subject to the progressive individual tax rate schedule, but are given a tax credit in the amount of 17/99 of the dividends received.[44] Even when an individual holds shares in a listed corporation, if he falls within the category of a "large" shareholder, he is taxed in the same manner as an individual shareholder of an unlisted corporation.

The reason that no special consideration is given to inter-company dividends received, except in the case of financial investment firms, is partly to discourage a business corporation from using its available funds or borrowed funds to invest in other firms or to set up subsidiaries, thereby spawning related companies. No special favour is intended for non-profit corporations either, perhaps for somewhat different reasons. The policymakers probably did not want non-profit organizations to become a sanctuary for dividend income, which would likely turn them into holding companies totally free from both income taxation and inheritance taxation. Nor did they want them to be tax-free investment firms, from which interested parties could draw income in the form of salaries, grants, etc.

B. *Non-profit organizations involved in political activities*

A political party and its supporting organizations established under the Act Concerning Political Funds are not subject to gift tax for political donations. On the other hand, the donor may deduct the donated amount up to the point that the deduction does not cause a net loss for the tax year. To be entitled to the deduction, however, the donation must comply with the provisions of the above Act, which limits the amount of donation for each donor.[45]

C. *Anti-abuse measures*

The failure to use donated assets in accordance with the qualifying purposes may entitle the tax authorities to impose gift tax on a donee organization.[46] Not only must the donated assets be used for such purposes, but they should be put to use for those purposes within two years, unless approval for a longer period is obtained from the authorities.[47] When the donated assets are used for profit-seeking activities rather than for the public interest, the profit must be expended for the public interest purpose to the extent of 60 percent of the amount of the profit reduced by the corporate or income tax, the resident tax and any losses carried forward.[48] This expenditure must take place within one year from the end of the accounting year to which the profit is attributable. Furthermore, whether or not profits are realized, the expenditure must be made in an amount computed by multiplying the appraised value of the entire assets (excluding those directly used for public interest purposes) by 50 percent of the rate determined by the Ministry of Finance, which reflects the interest rate of a one-year term savings deposit in the bank.[49] There are other lesser requirements that must be satisfied to maintain the exclusion.

The ITA takes into account the possibility that a non-profit organization might in effect become a mere custodian of donated property for the donor or other persons related to or associated with the donor (such persons, including the donor, are identified as "specially related persons").[50] Thus, in order for a donation to qualify for exclusion from the taxable base, the donee organization's managerial structure must satisfy certain statutory requirements, which are intended to preclude the donor or specially related persons from controlling or influencing the management of the non-profit organization to which the donation is made. As a rule, the specially related persons should not be members of the board of directors or in a position to elect such members or to participate in making decisions on important matters of the organization. An exception is made in the case of a social welfare corporation established under the Social Welfare Activities Act or a medical corporation established under the Medical Practice Act. In this situation up to one third of the members of the board may be comprised of specially related persons. In the case of a medical corporation, a further exception is provided so that a donor who is a licensed medical doctor is not included in the category of "specially related persons".

When a requirement that has been previously satisfied is breached by reason of resignation, death or change in relationship, a grace period of two months is allowed to rectify the situation.[51]

When the shares in a domestic corporation are donated, that portion in excess of 20 percent of the total outstanding shares of the corporation cannot be excluded from the tax base. This rule also applies when the shares are purchased with donated funds in excess of the limit.[52] This limitation is designed to prevent the donee organization from becoming a dominant shareholder in a business corporation, through which the donor or the donor's successors are able to perpetuate corporate control.

43. Income Tax Act, Art. 15, para. 3, Item 3 and Art. 144, para. 1, Item 2, "Ga".
44. ITA, Art. 71, para. 1.
45. TPRA, Art. 50.
46. ITA Art. 8-2, para. 4.
47. ITA Decree, Art. 3-2, para. 7.
48. *Id.*, item 2.
49. *Id.*, item 4.
50. ITA Decree, Art. 3-2, para. 1.
51. ITA Decree, Art. 3-2, para. 11.
52. ITA Art. 8-2, para. 1, Proviso.

V. CONCLUSION

The draft proposal for tax reform during the period of the Seventh Five-Year Economic Plan (1992-1996) suggests that measures may be further strengthened to prevent tax avoidance through the device of a public interest corporation.

Clearly, the legislative trend for the tax treatment of non-profit organizations is toward tightening the measures dealing with any abuses of non-profit organizations to avoid wealth transfer taxes. The income tax rate for non-profit corporations has already been raised to bring it up to the normal rate applicable to business corporations in general. Despite the fact that the 1990 tax reform in this area significantly reduced the opportunities for such abuses, further efforts are being made to identify any remaining loopholes and to discourage anyone from establishing, giving donations to, or gaining control of a non-profit organization with the intent to use it as a means to avoid taxes or to maintain perpetual control of a business entity. Not much attention seems to be given to cross border activities of non-profit organizations because their impact on the tax scene is almost negligible.

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