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I. SELECTED PAPERS FROM THE FIRST PACIFIC REGION CONFERENCE SPONSORED BY THE U.S. BRANCH OF IFA IN MAUI, HAWAII ON 22-24 MAY 1991

The first Pacific Region Conference, sponsored by the U.S. branch of IFA, was held in Maui, Hawaii, 22-24 May 1991. The highly successful conference was attended by some 90 participants, including government officials from the United States, Japan, Hong Kong and Korea. Conference participants also included representatives of companies, law and accounting firms and academics. This issue contains a selection of the papers presented during the conference, covering each of the five topics:

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The Tenth Annual Summer Program in United States Law and Legal Institutions

13 July 1992 - 14 August 1992

The Tenth 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 U.S. legal system and to significant areas of U.S. law. The Program should give participants both a basic understanding of the U.S. 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.

The lectures of the Tenth Annual Summer Program in United States Law and Legal Institutions will be held each morning Monday - Friday, 13 July to 14 August 1992, on the campus of the internationally-renowned University of Wisconsin, Madison, Wisconsin, U.S.A. In addition to the regular morning sessions, there will be opportunities for the participants to learn about legal research and writing and the U.S. legal system outside the formal lectures. The participants also will be able to meet with practicing lawyers and members of the U.S. judiciary. Another unique and important attraction of the Program is that participants are able to work and socialize with practicing lawyers and legal scholars from around the world.

For more detailed information regarding the Program, write to:

Ms. Theresa Dougherty
University of Wisconsin Law School
Office of the Dean, Room 207
Madison, Wisconsin 53706, U.S.A.

CONTRIBUTIONS 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.

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DOING BUSINESS IN AND WITH MALAYSIA
INCLUDING ACQUISITIONS

Veerinderjeet Singh

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I. DESCRIPTION OF BASIC TAX STRUCTURE

Income tax in Malaysia is levied under the Income Tax Act, 1967 ("the Act"). The tax structure is the derived and remittance basis. A person resident in Malaysia is liable to income tax on income accruing in or derived from Malaysia and on foreign income remitted to Malaysia. This scope of charge does not apply to a resident person carrying on banking, insurance or air/sea transport operations. In such cases, the resident person carrying on such operations is liable to tax on worldwide income. A non-resident person is liable to income tax on income accruing in or derived from Malaysia but is not taxed on foreign income which is remitted into Malaysia.

The Act sets out the main classes of income upon which income tax is chargeable. These are as follows:
- gains or profits from a business;
- gains or profits from employment;
- dividends, interest or discounts;
- rents, royalties or premiums;
- pensions, annuities or other periodic payments not falling under any of the above;
- gains or profits not falling under any of the above.

Income tax is also chargeable on special classes of income under Section 4A of the Act. Certain types of income which might not be otherwise taxable are brought into the tax net:
- amounts received by a non-resident for services rendered in connection with the use of property or rights belonging to, or the installation or operation of any equipment purchased from that non-resident;
- amounts received by a non-resident in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme; or
- rent or other payments (excluding film rentals subject to film hire duty) to a non-resident under any agreement or arrangement for the use of any movable property.

Malaysia has a "preceding year" basis of assessment. The chargeable income of a person for a year of assessment is ascertained by reference to the income for the calendar year (for non-business income), and the financial or accounting year ending in the year immediately preceding that year of assessment (for business income).

A. *Corporate income tax*

1. Tax base

The scope of charge of a corporation/company is as mentioned above. A corporation is resident in Malaysia for a particular year if at any time during that year the management and control of its business or of any one of its businesses is exercised in Malaysia. "Management and control" generally refers to the place where the board of directors meet to make decisions.

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Generally, income less expenses from all sources is aggregated and subject to tax. The term "business" includes profession, vocation and trade and every manufacture, adventure or concern in the nature of trade. Business profits are computed on the basis of normal accounting principles as modified by certain tax adjustments.

Business expenses wholly and exclusively incurred in the production of income are deductible from gross income. Certain expenses are specifically disallowed, for example, income tax or similar taxes, depreciation or amortization, capital expenditure, entertainment expenses (with certain exceptions), leave passages, payments to non-residents on which withholding tax was not deducted, domestic or private expenditure, etc.

For non-business sources, the deductibility of expenses is also subject to the general rule, i.e. the expenses must be wholly and exclusively incurred in the production of income.

Business losses incurred in a particular year are deducted against income from all sources (i.e. aggregate income) in that year. If there is insufficient aggregate income, the unutilized losses are carried forward indefinitely to be utilized against income from all business sources in subsequent years. Non-business losses cannot be deducted from aggregate income or carried forward.

(a) *Depreciation*

As a general rule, no direct deduction is allowed for tax purposes in respect of capital expenditure or depreciation charged in the accounts. Instead, the Act provides for the deduction of capital expenditure incurred on assets purchased and used for purposes of a business by way of capital allowances (tax depreciation). Capital expenditure which falls under any of the following categories would qualify for capital allowances:

- plant and machinery
- industrial buildings (e.g. factory)
- agricultural expenditure
- forest expenditure
- mining expenditure

The capital allowances are deducted against adjusted income (i.e. gross income less expenses). However, for mining expenditure, the allowance is treated as an expense and deducted against gross income. Capital allowances are only granted if the taxpayer makes a claim. The rate of allowances differs depending on the type of qualifying expenditure. In the case of plant and machinery, the allowances are made up of an initial allowance of 20 percent (granted in the first year only) on qualifying expenditure and an annual allowance which is computed based on prescribed rates for various plant and machinery used in different industries. The annual allowance is calculated on a straight line basis based on the original cost of the asset. In the case of non-commercial motor vehicles, the qualifying expenditure is restricted to M$ 50,000. Where an asset was owned and utilized for less than two years, any capital allowances granted would be withdrawn.

Capital allowances are only allowed for business sources. If a person has more than one business source, capital allowances in relation to one source cannot be utilized to offset the adjusted income of another business source. In the event of an adjusted loss or a shortfall of adjusted income, the unabsorbed capital allowances claimed can be carried forward indefinitely to be utilized against the adjusted income of the same business source in subsequent years. However, if the business source ceases, the unabsorbed capital allowances will be permanently lost.

(b) *Tax holidays*

Resident corporations/companies which participate in activities or produce products promoted by the government are eligible for pioneer status, i.e. a tax holiday of five years on profits derived from the promoted activity/product. The promoted activities/products relate to the manufacturing, agricultural, hotel and tourism sectors. The tax holiday period may be extended from five to ten years if certain conditions are fulfilled. For companies that apply for pioneer status after 1 January 1991, pioneer profits are reduced by capital allowances. Any capital allowances which are not utilized during the pioneer period (tax holiday period) are not available for setoff in the post-pioneer period. Any adjusted loss of the pioneer period is also not available for setoff in the post-pioneer period. Companies which are granted pioneer status enjoy a complete exemption from tax on the profits generated by the pioneer business during the tax holiday period. Dividends paid out of the tax-exempt profits will also be exempt from tax in the hands of shareholders.

However, the 1992 Budget proposed that application for pioneer status made and approved on or after 1 November 1991 would not qualify for any extension of the pioneer period, i.e. the tax holiday will only be for five years. Further, only 70 percent of the statutory income (i.e. adjusted income less capital allowances) will be abated for each of the five years. Therefore, 30 percent of the statutory income would be subject to tax at the normal corporate tax rate. The amount abated will continue to be credited to a tax-exempt account from which tax-exempt dividends may be declared.

Besides the total relief from tax granted by way of pioneer status, there are other types of tax incentives which provide partial relief from tax either through exemptions or double deduction of expenditure. (It should be noted that some of the incentives are mutually exclusive.) These include the following:

(i) Investment tax allowance where a company involved in a promoted activity or producing a promoted product is granted an allowance not exceeding 100 per cent of the qualifying capital expenditure incurred within a period of five years. The period for an integrated agricultural activity may be extended for an additional five years. The amount of the allowance will be deducted from adjusted income and this amount will be credited to a tax-exempt account from which tax-exempt dividends can be declared to shareholders.

Under the 1992 Budget, application for investment tax allowance made and granted on or after 1 November 1991 would be eligible for an allowance not exceeding 60 percent of the qualifying expenditure. Further, the amount of allowance to be utilized will be restricted to a maximum of

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70 percent of the statutory income. The balance of 30 percent of the statutory income would be subject to tax at the normal corporate tax rate. Any unutilized allowance will be carried forward to subsequent years of assessment. The amount of allowance utilized will continue to be credited to a tax-exempt account.

(ii) Industrial adjustment allowance of up to 100 percent of qualifying expenditure incurred within a period of five years by a manufacturing company which undertakes an approved industrial adjustment programme (i.e. an activity undertaken by any sector in the manufacturing industry to restructure by way of reorganization, reconstruction or amalgamation with the view to strengthening industrial self-sufficiency, improving industrial technology, increasing productivity, enhancing the efficient use of natural resources and efficient management of manpower). The amount of adjusted income equal to the allowance is exempt from tax and may be distributed to shareholders as tax exempt dividends.

(iii) Abatement of adjusted income in respect of location of a factory in a promoted industrial area, small-scale companies, compliance with government policy on capital participation or employment in industry, purchase of component parts from small-scale companies and exports. The abatements are confined to manufacturing companies resident in Malaysia and the amount of adjusted income that is abated will be credited to a tax exempt account from which tax-exempt dividends can be distributed to shareholders.

All the abatements stated above other than that in respect of exports are to be abolished with effect from the year of assessment 1993 (as proposed in the 1992 Budget). The abatement for exports will be applied against statutory income and will be granted only to resident companies located in the Principal Customs Area (i.e. excluding the Free Trade Zones, Labuan and Langkawi) and which are 70 percent Malaysian owned.

(iv) Export allowance which is available to resident companies exporting agricultural produce and to trading companies exporting locally manufactured products. This allowance is deductible from gross income.

With effect from the year of assessment 1993 (as proposed in the 1992 Budget), export allowance will only be available to resident companies located in the Principal Customs Area and which are 70 percent Malaysian owned.

(v) Double deduction for certain expenditure incurred for seeking opportunities for the export of manufactured products and agricultural produce.

(vi) Reinvestment allowance allowed to a resident manufacturing company which incurs qualifying capital expenditure for the purpose of an expansion, modernization or diversification activity. The allowance is deducted against adjusted income and the amount is credited to a tax exempt account from which tax exempt dividends may be distributed.

(vii) A tax exemption on the profits derived by a resident person from the carrying on of the business of transporting passengers or cargo by sea provided certain conditions are complied with.

(viii) A concessionary income tax rate of five percent on profits from offshore insurance and inward reinsurance.

(ix) Double deductions in respect of revenue expenditure incurred on approved research, export credit insurance premiums, insurance premiums on the import of goods, remuneration paid to handicapped employees, expenses incurred on approved training, cash contributions and payment for services of approved research companies or institutions, etc.

(x) Tax exemption for five years for approved research companies or institutions. The exempt profits may be distributed as tax exempt dividends to shareholders.

(xi) Profits from approved overseas investments are either fully or partially exempt upon remittance to Malaysia. The exempt profits may be distributed to shareholders as tax-exempt dividends. Certain pre-operational business expenditure in respect of such investments qualifies for deduction.

(xii) An approved operational headquarters company (100 percent foreign owned) which provides qualifying services to its offices or related companies outside Malaysia will be subject to a concessionary income tax rate of ten percent (for a period of five to ten years) on income derived from the provision of such services. Dividends received by the operational headquarters (incorporated in Malaysia) from related companies outside Malaysia are exempt from tax for a ten year period.

(xiii) Gains derived by an approved venture capital company from the disposal of shares in a venture company are exempt from income tax except where the disposal takes place after two years from the date of listing of those shares on the Kuala Lumpur Stock Exchange. The exempt gains are available for distribution as tax exempt dividends.

As proposed in the 1992 Budget, with effect from the year of assessment 1992, the exemption period for shares listed on the Kuala Lumpur Stock Exchange has been extended to three years. Further, losses arising from the disposal of shares in a venture company are now deductible and any unutilized permitted expenses can be carried forward to subsequent years of assessment.

(xiv) In Labuan, which was recently launched as an International Offshore Financial Centre, income from offshore trading activities carried on from Labuan is taxed at a concessionary rate of three percent of net profits as reflected in the audited accounts or a fixed amount of M$ 20,000 upon election. Income from offshore non-trading activities is exempt from tax. Expatriates employed in a managerial capacity by offshore companies in Labuan will be granted an exemption of 50 percent of employment income for five years commencing from year of assessment 1992. Trust companies providing legal, accounting or secretarial services are eligible for a 50 percent abatement of income for five years commencing from year of assessment 1992. Persons carrying on businesses involving the construction of qualifying assets (roads, drainage, telecommunication facilities, schools, hospitals, offices, ports or airport facilities, hotels, public utilities or amenities or any recreational facilities) in Labuan are eligible for 50 percent abatement of profits for five years.

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(c) *Capital gains*

There is no tax on capital gains other than the tax on gains arising from the sale of real property (which includes shares in real property companies) in Malaysia. Capital gains may be subject to income tax instead of real property gains tax where it can be established that the disposer is actually a dealer in such property or the transaction is an adventure in the nature of trade. Such gains may be taxed as business profits.

2. Tax rates and credits

Corporations are subject to a 35 percent income tax rate on the chargeable income and a three percent development tax on rental and business income. The development tax is to be phased out over the next few years.

There are no tax credits available other than credits on Malaysian-sourced dividends and double tax relief (discussed below).

3. Integration

Malaysia follows the imputation system in respect of corporate taxation, that is, tax paid by a corporation is imputed to the shareholders through the distribution of dividends. Therefore, the tax paid by the corporation is taken as advance tax paid by the shareholders (whether corporations or individuals) in respect of the dividends received. The imputation system applies only to income tax and does not cover development tax charged on a corporation. It is only applicable in the case of dividends paid, credited or distributed by a Malaysian resident corporation (i.e Malaysian-derived dividends). A corporation paying Malaysian dividends is required to deduct tax therefrom at the income tax rate applicable to the corporation. Therefore, only the net amount of dividends will be paid to the shareholders. A shareholder will be subject to tax on the gross amount of the dividends but a credit will be given against the tax chargeable. This credit will be the amount of the corporate income tax attached to the dividend received by the shareholder.

B. *Individual taxation*

1. Income tax

(a) *Residents*

The residence status of an individual is generally determined by the period of stay in Malaysia. In general, if an individual is in Malaysia in a calendar year for a period or periods amounting in total to 182 days or more, that individual will be tax resident. As such, the scope of charge to income tax will be on the derived and remittance basis described above. The income tax rate is on a graduated scale ranging from 4 to 35 percent. Taxable income (chargeable income) in excess of M$ 100,000 is chargeable at the rate of 35 percent. Chargeable income is arrived at after allowing personal reliefs (for the individual, wife, children, life insurance premiums and contributions to approved provident funds). In addition, a resident individual with business income and/or rental income in excess of M$ 5,000 will be subject to development tax at the rate of three percent.

Separate assessment is allowed on income derived by the wife from all sources.

(b) *Non-residents*

Non-resident individuals are assessed on income derived from Malaysia at the fixed income tax rate of 35 percent. Development tax at the rate of three percent would also be chargeable if business/rental income is derived from Malaysia. A non-resident is not eligible for personal reliefs.

2. Estate or inheritance tax

Estate tax (known as estate duty) is chargeable on the market value of all dutiable property which passes or is deemed to pass on the death of an individual. Where the deceased person was domiciled in Malaysia, all property whether movable or immovable, situated in Malaysia and all movable property situated outside Malaysia are subject to estate duty. Where the deceased person was not domiciled in Malaysia, estate duty is only payable on property situated in Malaysia.

The domicile of a person is the country in which the person has his permanent home and in which he has been habitually and physically present.

Gifts made within seven years before death are deemed as property passing on death. There is no further tax on inheritors of property of a deceased person (at the time of inheriting the property).

Where a person dies domiciled in Malaysia, estate duty is levied on the value of the estate in excess of M$ 2 million. For a person who dies domiciled outside Malaysia, estate duty is levied on the value of the estate in excess of M$ 400,000. The rate of estate duty in both cases ranges from five to ten percent. As announced in the 1992 Budget, estate duty is abolished with effect from 1 November 1991.

3. Gift tax

There is no gift tax in Malaysia.

C. *Partnership taxation*

Partnerships are required to submit tax returns for purposes of determining the share of taxable profits or allowable losses of individual partners. Such profits or losses will be assessed or allowed to the individual partners. Therefore, for income tax purposes, a partnership is not a taxable entity. However, for real property gains tax, a partnership may be liable to such a tax as a separate entity.

D. *Withholding taxes*

Malaysia has a fairly comprehensive withholding tax system on payments to non-residents. Withholding taxes are charged on the following types of payments:

(i) interest which is paid or credited to a non-resident and which is not attributable to a place of business of the non-resident in Malaysia. The rate of tax is 20 percent, which may be reduced by the provisions of a double taxation agreement

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("DTA") between Malaysia and the country of residence of the non-resident;

(ii) royalties paid or credited to a non-resident which are not attributable to a place of business of the non-resident in Malaysia. The 15 percent rate of tax may be reduced by the terms of a DTA;

(iii) contract payments paid to non-resident contractors. The rate of tax is 20 percent of the service portion of contract payments (of which 15 percent is in respect of the tax liability of the non-resident contractor and five percent in respect of the employees of the non-resident contractor);

(iv) special classes of income derived from Malaysia where the payer of such amounts to a non-resident would have to withhold tax at 15 percent of the gross amount of such payments. These special classes of income would include rental paid for movable property and technical or management service fees.

The withholding taxes are payable to the tax authorities within one month of paying or crediting the non-resident. Failure to comply with the withholding tax provisions would result in the withholding tax being a debt due by the payer to the government, disallowance of a deduction of such payment to the non-resident and imposition of penalties for the delay in paying the withholding tax.

It should be noted that interest paid to a non-resident by a bank in Malaysia or on approved loans exceeding M$ 250 million or on loans guaranteed by the Malaysian government is exempt from tax.

With regard to Malaysian resident individuals, interest received from licensed banks and financial institutions in Malaysia, unless specifically exempted, is assessable to a withholding tax of five percent on the gross amount.

E. *Branch profits taxes*

Branches of foreign corporations are treated in the same manner as locally incorporated corporations. The income tax rate is 35 percent on the chargeable income. Development tax of three percent is applicable on business and/or rental income. Since the foreign corporation is not tax resident in Malaysia, the scope of charge in Malaysia is confined to Malaysian-derived income.

The profits of a branch of a foreign partnership, or of a non-resident individual are assessable on the partners or the individual respectively. On the basis that they are not resident in Malaysia, the income tax rate is 35 percent.

F. *Mechanism for avoiding double taxation*

Under the Act, the Minister of Finance is empowered to enter into DTAs with any country for the avoidance of double taxation.

Where a DTA exists, bilateral tax relief is given to a Malaysian resident for foreign tax suffered on income remitted into Malaysia. This relief will be the lower of Malaysian tax chargeable on the foreign income or the foreign tax suffered. If no DTA exists, unilateral tax relief is given to a resident for the foreign tax suffered on income received in Malaysia but it is restricted to the lower of Malaysian tax chargeable on the foreign income or one-half of the foreign tax on the foreign income. Besides the foreign tax credit method, some DTAs eliminate double taxation by way of exemption (either total or partial) of certain types of income.

G. *Capital taxation*

1. Property taxation

Real property gains tax ("RPGT") is charged on gains arising from the disposal of real property situated in Malaysia. Real property includes land and buildings any interest, options or other rights in or over land as well as shares in real property companies. A real property company is a controlled company which owns or acquires real property (or shares in other real property companies) whose value is not less than 75 percent of the value of its total tangible assets.

Every method, scheme or arrangement by which the ownership of an asset is transferred from one person to another constitutes an acquisition and disposal for RPGT purposes.

The rate of tax ranges from a maximum of 20 percent for assets disposed of within two years of acquisition to a minimum of five percent for assets disposed in the fifth year following acquisition. Assets sold after the fifth year are not subject to RPGT except for disposals by corporations, which continue to be subject to tax at five percent.

The charge to RPGT does not depend on the residence status of a person. Further, there are a number of situations where a transfer can be made at no gain/no loss; for example, a transfer among related corporations for purposes of achieving greater efficiency in operations or under a scheme of reconstruction or amalgamation of corporations where certain prescribed conditions are satisfied.

Assessment rates and land tax (quit rent) are payable by property owners according to the legislation of the local or municipal authorities on property located in their jurisdiction. These levies are meant for the maintenance and the provision of essential services to the areas. The rates/tax are levied as a percentage of the rateable value of the property.

2. Taxes on corporate capital

Registration fees are payable for the incorporation of a company as well as for the increase in the authorized share capital of a company. The amount of fees payable is on a sliding scale based on the amount of authorized share capital.

H. *Value added (or sales) taxation*

The government indicated in the 1989 Budget the possibility of introducing value added taxation in the near future to compensate for the loss in revenue due to the reduction in direct taxes and to overcome inherent weaknesses in the sales tax system. However, since then no further mention has been made of the value added tax.

Sales tax in Malaysia is a single stage ad valorem tax imposed on all goods manufactured in or imported into

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Malaysia. The rate of tax is five, ten or 15 percent depending on the type of goods. A number of products are exempt from sales tax. The sales tax must be paid to the Royal Customs & Excise Department within 28 days after the end of the taxable period (which is two calendar months). Besides sales tax, the other types of indirect taxes in Malaysia are import duties, export duties, excise duties and service tax.

With effect from 1 January 1992, the scope of service tax has been broadened to cover services rendered by professional and consultancy businesses, private hospitals, advertising firms, insurance companies and motor vehicle service and repair centres. The tax rate is five percent of the amount charged for the services provided.

I. *Taxation by political subdivisions*

Taxation in Malaysia is imposed at the federal level. The various states in Malaysia do not impose any form of tax on income. The states only impose some levies and rates (assessment rates) which are collected through the local or municipal authorities.

II. TAX PLANNING OPPORTUNITIES

A. *Form of business: branch vs. subsidiary*

1. Relative advantages and disadvantages

A foreign corporation may carry out operations in Malaysia through a branch or a local subsidiary. However, the Registrar of Companies encourages the incorporation of a subsidiary rather than the setting up of a branch. A branch may be registered where a foreign corporation has been granted government or quasi- government contracts.

From the tax point of view, a branch would not be regarded as being tax resident in Malaysia whereas a subsidiary can easily become tax resident in Malaysia if management and control is exercised in Malaysia. Once a subsidiary is resident, it is eligible for various tax incentives. The tax rate imposed on branch operations is the same as that imposed on a subsidiary. However, in terms of repatriation of profits, this is easily done in the case of a branch but for a subsidiary, the distribution of dividends may be restricted by the availability of tax credits under the imputation system. The tax credit and tax sparing relief given under some DTAs on dividends from Malaysia may make a subsidiary corporation more advantageous than a branch structure.

2. Allocation of deductions

There are no specific rules governing the allocation of deductions. The tax authorities apply arm's length principles in appropriate situations. The general principle for allowing a deduction is applied, i.e. expenses wholly and exclusively incurred in the production of income are deductible. As such, there is no advantage of a branch over a subsidiary or vice versa.

B. *Thin capitalization*

There are no thin capitalization rules under the Act and interest expense is deductible if it meets the requirements of the Act.

C. *Deductibility of charges for services rendered outside of Malaysia by affiliates*

1. Royalties

So long as royalties meet the requirements of the Act, they are deductible to the Malaysian payer. Since the payment would be to a non-resident, the withholding tax provisions must be complied with unless the royalties are exempt from tax under a DTA.

2. Services

A charge for services is deductible based on the general rule. However, where the services can be termed to be special classes of income, the withholding tax provisions must be complied with.

3. Stewardship

This charge is deductible based on general principles. The basis of allocation must be fair and reasonable. Again, the question of withholding tax must be addressed, i.e. management fees may fall within the scope of special classes of income in which case a 15 percent withholding tax applies. Although there are views expressed by consultants that payments made for management or administrative services should not come within the scope of special classes of income, the tax authorities are of the view that such payments are subject to withholding tax. The tax authorities have, however, indicated that payments made for ordinary day to day administration or management services of a routine nature, such as the share of overhead expenses incurred by the head office of a branch would be excluded from the ambit of the withholding tax provision. Needless to say, the charge for such services must be reasonable and commensurate with the services rendered.

D. *Opportunities for earning offshore income free of tax*

As mentioned earlier, the scope of charge to income tax is the derived and remittance basis. Therefore, if a Malaysian resident earns offshore income which is not attributable to business operations carried on in Malaysia, such income is not taxable unless remitted to Malaysia. For a non-resident, income remitted to Malaysia is free of Malaysian tax. There is therefore ample scope to earn offshore income without being subject to Malaysian tax.

E. *Capitalization of subsidiary*

The incorporation of a subsidiary to take over branch operations results in a new entity and the transfer of assets to the subsidiary must take place at arm's length values. This is similar to the transfer of business operations from one corporation to another. Branch losses and unutilized capital allowances cannot be carried forward on incorporation.

However, since the incorporation of a subsidiary to take over branch operations would result in a transfer between related entities (since the foreign corporation would be controlling

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the subsidiary), the fixed assets (e.g. plant and machinery) would be deemed to be transferred at the tax written down values and the subsidiary would continue to enjoy annual allowances on the original cost of the asset. Inventory can be transferred at a reasonable price (not necessarily market value) and the branch could reduce taxable profits arising on the sale or transfer of inventory.

F. *Joint ventures and partnerships*

An unincorporated joint venture is regarded as a partnership. As stated earlier, partnerships are treated as conduits and the income of a partnership is divided among its partners. Therefore, if a partnership incurs losses, the partners can set off the losses against their income/profits from other sources. This is advantageous compared to a corporation which is treated as a separate tax entity and where business losses would be carried forward to subsequent years.

G. *Acquisitions*

1. Asset acquisition

There are no special tax features on acquisition of assets by a foreign corporation. Any goodwill acquired in the purchase of a Malaysian business does not result in any tax advantage as the write-off of goodwill is not tax deductible. The acquisition of fixed assets used in the business results in tax depreciation at prescribed rates based on the purchase price. Acquisition of an office building does not result in any tax deduction. The acquisition of an industrial building (e.g. a factory) used in the business operations also results in tax depreciation at prescribed rates based on cost of the building (excluding cost of land). Interest paid on sums borrowed for the purchase of fixed assets used in the production of business income of the acquirer will be allowed as a deduction. Where trade debts are acquired, no deduction will be available on any such debts which are subsequently irrecoverable.

2. Stock/share acquisition

If a foreign corporation borrowed sums to purchase shares (stock) of a Malaysian corporation, the interest expense is deductible against the gross dividends received in the same year from the Malaysian corporation. Interest expense in excess of the dividends received is not available for deduction or carryforward.

H. *Selling tangible property*

The sale of a qualifying asset used in the production of business income will result in a balancing adjustment due to the comparison between the disposal price and the tax written-down value of the asset. If the disposal price exceeds the tax written down value, the difference (gain) is taxable. This gain will be restricted to the total amount of capital allowances granted. Where the tax written-down value exceeds the disposal price, the excess is allowed as a deduction (i.e. as a capital allowance). If a business is sold, the sale price should be allocated between the various assets. If not, the tax authorities may impute their values on the various assets to determine recapture of capital allowances.

If real property is sold, then real property gains tax may be applicable. If the sale is to a related corporation, such a tax may be avoided if certain conditions are met. The sale of inventory must be at market value. However, if the sale is made at or about the time the vendor ceases to carry on the business, the transfer value would be acceptable.

There is no tax on capital gains arising from the disposal of shares other than shares in a real property company. Shares in a real property company are not generally subject to real property gains tax if the owner was an individual and the sale took place in the sixth year after acquisition of those shares.

I. *Leasing tangible property*

There are special rules and regulations as regards the determination of taxable profits of a leasing business. Under the rules (Leasing Regulations 1986), certain types of lease agreements are deemed to be sale agreements.

In general, the lessor is regarded as the owner of leased assets and capital allowances are allowed to him. The lessee is allowed a deduction in respect of lease rentals except for lease rentals on non-commercial motor vehicles where the deduction is limited to M$ 50,000 per vehicle.

Where the lease rentals are paid to a non-resident lessor, then a withholding tax of 15 percent is applicable. This explains why cross border leasing is not very significant except in the case of specialized equipment.

J. *Performance of services*

A non-resident is considered to be trading in Malaysia if business activities such as selling or manufacturing are carried on in Malaysia. However, administrative or liaison activities could be carried on through a representative office without incurring tax liability provided the office is not involved in the negotiation of contracts, acceptance of orders or maintaining of inventory in Malaysia. Most of Malaysia's DTAs provide that having an office in Malaysia to purchase goods, collect information or advertise products will not constitute a permanent establishment.

K. *Treatment of agents*

An agent carrying on activities in Malaysia on behalf of a non- resident may lead to the non-resident being held to be trading in Malaysia and therefore subject to tax on attributable profits.

Where the agent or representative of the non-resident regularly concludes contracts in Malaysia on behalf of the non-resident, a trade will be deemed to be carried on within Malaysia. On the other hand, the mere soliciting of orders through an agent in Malaysia and their transmission to the principal for acceptance abroad do not, by themselves, constitute the exercise of a trade by a non-resident in Malaysia.

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A person can be appointed an agent of a non-resident person who is carrying on a trade in Malaysia. Such an agent would be chargeable to tax on behalf of that non-resident.

L. *Special industries*

1. Banking

A person resident in Malaysia and carrying on banking operations is subject to tax on a worldwide basis. A non-resident is taxed only on the income accruing in or derived from Malaysia. There are no special rules or regulations on the taxation of banks. General tax principles are applied in determining taxable income.

Branches of foreign banks operating in Malaysia are required to withhold tax from interest payments made on borrowings from non-residents which are required for the purpose of maintaining the net working fund position of the branch in Malaysia.

2. Insurance

Income from an insurance business of a tax resident is generally subject to tax on a worldwide basis. There are special rules in the Act for determining the taxable profits of resident and non-resident insurance companies. The profits from carrying on inward reinsurance or offshore insurance are subject to a concessionary income tax rate of five percent.

3. Communications/real estate

There are no special provisions in the Act relating to the communications and real estate industries.

4. Transportation

A person resident in Malaysia and carrying on the business of transporting passengers or goods by sea is subject to tax on a worldwide basis. However, such a person may be exempt from tax from such a business if certain conditions are met.

A non-resident person carrying on a sea transport business in international traffic is assessable to Malaysian tax on profits derived from the carriage of passengers, mail, livestock or goods embarked or loaded in Malaysia (other than on transshipment). The taxable income of a non-resident shipping operator is determined based on either (i) the five percent method (applied to shipping charges from the embarkation of passengers or the gross freight loaded from Malaysia) or (ii) the acceptable certificate method, i.e. the Malaysian taxable income will be calculated based on world income and other details shown on the acceptable certificate obtained by the non-resident from the tax authorities in its country of residence. The normal corporate tax rate is applied to the income ascertained under either method.

The same rules stated above apply in determining the liability of non-resident airline corporations.

5. Natural resources

Corporations carrying on petroleum operations in Malaysia are taxed under the Petroleum (Income Tax) Act 1967. Petroleum income tax is chargeable at the rate of 45 percent. The non-petroleum income of a petroleum corporation is taxed in accordance with the general income tax rules.

In the case of activities involving mining of tin and other minerals, these are taxable based on the normal principles in the Act. However, as stated earlier, relief for the capital expenditure incurred in connection with mining activities will be allowed by way of a mining allowance deducted against gross income. There are also provisions in the Act to allow a deduction for prospecting expenditure against aggregate income of a person.

M. *Dual resident companies*

Generally, the DTAs make provisions to avoid dual residence. However, it may still be possible for a company to have dual residence. But in the context of the Malaysian tax system, there is no great advantage of using dual resident companies as Malaysia imposes tax only on Malaysian-derived income and foreign income remitted to Malaysia.

N. *Treaty network*

1. List of treaties

The DTAs that Malaysia has entered into generally follow the OECD model with certain modifications. Currently, Malaysia has DTAs with 31 countries: Australia, Austria, Bangladesh, Belgium, Canada, China, Denmark, Finland, France, Germany (Dem. Rep.), Germany (Fed. Rep.), Hungary, India, Italy, Japan, Korea (South), Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Romania, Singapore, Sri Lanka, Sweden, Switzerland, Thailand, United Kingdom, U.S.S.R. and Yugoslavia.

Malaysia has also entered into a limited treaty with the United States which provides for reciprocal tax exemption on income of shipping and air transport enterprises of the two countries. Most of the treaties provide for lower rates of withholding tax as well as for the availability of tax sparing relief.

2. Tax sparing

As most capital-exporting countries generally impose tax on a worldwide basis, a common feature of Malaysian tax treaties is the tax sparing provision which operates to preserve the benefit of the Malaysian tax incentives to the foreign investor from the capital-exporting country. When profits are taxed in the home country, a credit is given on the basis of the Malaysian tax that would have been charged if income had not been exempt from Malaysian tax. Tax sparing is usually for pioneer profits, investment tax allowance and interest or royalties which have either been exempt or taxed at a reduced rate.

3. Treaty shopping rules

There are currently no rules or provisions on treaty shopping in Malaysia's tax treaties.

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DOING BUSINESS IN AND WITH NEW ZEALAND

Anthony J. Lines and Graham G. Tubb

I. RESIDENCE

Residents of New Zealand are liable to New Zealand tax on all income, including income from outside New Zealand. Credit is allowed for any overseas tax paid, but this is limited to the New Zealand tax payable on that income.

An individual is resident in New Zealand where the individual's permanent place of abode is in New Zealand, or where the individual has been personally present in New Zealand for more than 183 days in any 12-month period. An individual will cease to be resident only where he has been absent from New Zealand for more than 325 days in any 12-month period, and he has at no time during the period had a permanent place of abode in New Zealand.

A company is resident in New Zealand if the company:
- is incorporated in New Zealand; or
- is controlled by its directors in New Zealand; or
- has its centre of management in New Zealand; or
- has its head office in New Zealand.

Resident withholding tax

Legislation was passed to introduce resident withholding tax ("RWT") on interest and dividends with effect from 1 October 1989. The rate of tax on interest is 24 percent and, on dividends, 33 percent.

RWT must be deducted from interest payments where the payer either holds a certificate of exemption (which will include banks and other lending institutions and persons with over NZ$ 2 million gross income) or makes the payment of interest wholly or partly in the course of carrying on a business. Holders of exemption certificates do not have the tax withheld from interest payments made to them.

It is the responsibility of the payer to deduct the tax and, therefore, the payer carries the burden of ascertaining whether the payee has a valid exemption certificate.

RWT is also deducted from dividends. Certificates of exemption may be granted by the Inland Revenue Department ("IRD") in a manner similar to that in respect of interest. The tax will not be deducted from dividends to the extent that imputation credits are attached to the dividends.

It should be stressed that RWT is not a "new" tax. It is a system (complementing the PAYE system for wages and salaries) of collecting income tax which is payable anyway but on the basis that the tax is paid as the income is earned.

II. NON-RESIDENTS

A non-resident is taxed on all income "derived from" New Zealand. Generally this means a non-resident is taxed on:
(a) income from a New Zealand or overseas employer for personal services performed whilst in New Zealand;
(b) income derived from any business wholly or partly performed in New Zealand;
(c) income derived from contracts made, or wholly or partly performed, in New Zealand;
(d) royalties and other like payments:
  (i) that are paid by a New Zealand resident and not paid in respect of a business carried on by him outside New Zealand through a fixed establishment outside New Zealand; or

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(ii) that are paid by a non-resident and are deductible by him in calculating his assessable income for New Zealand tax purposes;

(e) other income from New Zealand sources.

A non-resident other than a public entertainer who performs personal (including professional) services in New Zealand for an overseas employer is exempt from New Zealand tax if:

(a) the length of the visit is not more than 92 days whether or not the period of the visit falls into one or more income years; and

(b) the period in New Zealand in any one income year is 92 days or less, whether in one visit or several visits in the same income year; and

(c) the income is chargeable to tax in the country where the non-resident normally resides (a certificate from the relevant taxing authorities of that country must be produced).

Most of New Zealand's double tax agreements ("DTAs") extend the time period from 92 days to 183 days.

The Income Tax Act ("the Act") imposes withholding taxes on certain classes of income (non-resident withholding income) derived from New Zealand by non-residents, namely dividends, royalties and interest. Under the Act the rate of non-resident withholding tax is 30 percent on dividends and 15 percent on all other classes. Lower rates usually apply to residents of countries with which New Zealand has DTAs. The tax is imposed on the gross amount remitted, and a deduction is not allowed for any expenses incurred by the recipient in gaining or producing that income. Withholding tax is normally the final New Zealand tax liability on income subject to the tax. The principal exceptions to this are in relation to interest paid between associated persons and "non-cultural" royalties, where a DTA does not apply to the recipient.

From 1 August 1991 New Zealand debt issuers may elect to pay a two percent levy on interest rather than deduct non-resident withholding tax where foreign holders are not associated parties and the issue has been approved by the Inland Revenue Department.

It should be emphasized that New Zealand's DTAs alter the incidence of income tax which appears at first sight to be payable in terms of the New Zealand Income Tax Act. For example, a non-resident trader is ordinarily liable for New Zealand income tax in respect of income derived from New Zealand if a person situated in New Zealand is instrumental in procuring the purchase of goods from that non-resident trader with such goods being imported into New Zealand. Under most DTAs there is a mutual exemption for a non-resident trader in these circumstances, so that he is only liable for tax in his own country.

III. TAX RATES

As in most countries the rates of taxation in New Zealand are subject to fluctuation from time to time. The following commentary refers to the rates applicable at the time of publication but anyone interested should check the current rates at the time that such information becomes pertinent.

A. *Company taxation*

New Zealand companies pay tax at the flat rate of 33 cents on the dollar. New Zealand resident companies do not pay tax on dividends received from other New Zealand companies but will do so in most instances from 1 April 1992. Companies which are not resident in New Zealand are liable to New Zealand tax on income deemed to be derived from New Zealand. They are taxed in the same way as New Zealand companies except for the following particulars:

- the flat rate of tax is 38 cents on the dollar;
- apportionment of income will be allowed where it is derived partly in New Zealand, and partly elsewhere;
- income received from New Zealand dividends, interest and royalties is liable to non-resident withholding tax.

With effect from 1 April 1988 the Government introduced a full dividend imputation system. This system is similar in operation to the imputation system operating in Australia. Briefly, companies which pay tax can pass credit for that tax paid through to the shareholders when dividends are paid to shareholders. The net effect is, in most cases, that the corporate income will effectively only be taxed once at the individual shareholder's marginal tax rate.

Dividends paid to New Zealand resident companies are exempt from tax until 1 April 1992, although some classes of shares and certain floating rate debentures carry exempt dividends until 1 April 1994. Companies with 100 percent common ownership will be able to consolidate thereby ignoring dividend flows between members of the group for tax purposes. Imputation credits allocated to corporate shareholders can in turn be passed down to their individual shareholders when dividends are paid to the individual shareholders.

The legislation contains extensive rules to ensure that imputation tax credits are allocated fairly to shareholders and cannot be "streamed" to particular shareholders who can use them. Credits allocated to a shareholder in a tax loss position cannot be refunded, but the tax credit can be grossed up and carried forward by that shareholder as a tax loss.

To prevent trafficking in the shares of companies carrying a significant volume of unallocated credits, there is a 75 percent (66 percent from 1 April 1992) continuity of shareholding requirement. If this is breached then the credits arising prior to the change of shareholding are lost.

Credits attached to dividends received by a trust must be allocated proportionately to all beneficiaries, and it is not therefore possible to allocate credits to beneficiaries most likely to be able to use them. A similar rule applies in relation to partners in a partnership.

Unit trusts are taxed as if they are companies so that dividends derived from New Zealand companies and received by a unit trust are tax free until 1 April 1992. Distributions made to unit holders will be taxable but subject to the allocation of imputation credits.

From 1 October 1988 bonus issues can either be made as taxable bonus issues or non-taxable bonus issues. If the former, then the bonus issue is taxable as a dividend, but imputation credits can be allocated to the shareholder. If the bonus issue

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is non-taxable, then no immediate tax liability will arise. However, on a return of capital to shareholders in a winding up, the amount capitalized will be treated as dividends in the shareholders' hands. This can be contrasted with a return of capital of taxable bonus shares, which will be treated as a capital receipt in a winding up.

The imputation system only applies to New Zealand residents. Therefore imputation credits are not available to non-resident shareholders. The credits cannot even be used to offset non-resident withholding tax liability or tax on other New Zealand source income. Non-resident companies are not entitled to allocate imputation credits to shareholders under the New Zealand system.

New Zealand companies which receive dividends from non-resident companies are required to pay to the IRD a "withholding payment" equal to the company tax rate of 33 percent. In theory this is a payment on account of the potential New Zealand tax liability of a shareholder on the future distribution of that dividend. When the dividend is distributed down to the New Zealand individual shareholder, that shareholder will receive a credit for the withholding payment made to the IRD. Credit is given to the company recipient for any foreign withholding tax deducted at source. An individual shareholder who receives a dividend and a credit from the withholding payment account is able to claim a refund for any unused withholding credit allocated to the dividend.

When a foreign shareholder receives a dividend from a New Zealand company the non-resident withholding tax payable on that dividend is reduced by the amount of any withholding credit allocated to the dividend. Where the withholding credit is less than the non-resident withholding tax payable, the payer company is required to deduct the balance. If the withholding credit exceeds the non-resident withholding tax the foreign shareholder is able to claim a refund for the excess.

New Zealand has no "thin capitalization" rules, that is, a company carrying on business in New Zealand may have a nominal capital only with its working capital actually provided by way of loan. Particularly in the case of a New Zealand subsidiary of a foreign company, financing working capital by way of loan rather than equity is generally more tax efficient. The Minister of Revenue has announced, however, that thin capitalization rules may be introduced in the near future.

Before investing in New Zealand considerable thought should be given to the structuring of the New Zealand operation. A multitude of tax considerations needs to be taken into account in determining whether to use a branch or a subsidiary (or in some circumstances a trading trust) and in the most tax efficient method of providing capital. Professional advice should be sought in every case.

From 1 April 1992 closely-held private companies with no more than five shareholders can elect to be "qualifying companies". These entities are treated essentially in the same way as partnerships such that losses can be accessed by shareholders for offset against their own income and capital profits distributed tax-free without winding up.

B. *Personal taxation*

Individuals (including members of partnerships) are taxable on the following basis: on so much of the income as does not exceed NZ$ 30,875: 24 cents on the dollar; on so much as exceeds NZ$ 30,875: 33 cents on the dollar. Tax payable by employees drawing wages or salary on a regular basis is deducted at source by the employer, that is, the employee only receives net after-tax income.

C. *Taxation of other entities*

Partnerships are not assessed as separate entities but instead each member of a partnership is taxable in respect of his share of the partnership income at whatever rates apply to that partner. Similarly, joint ventures are not treated as separate entities so that each participant is taxed in respect of his share of joint venture income. Unlike joint ventures, however, partnerships must file tax returns.

Charitable bodies are generally exempt from tax.

Superannuation funds historically were given a concessional tax treatment, with pension funds generally being exempt from tax. However, that exemption was withdrawn with effect from 1 April 1988. Superannuation funds now generally pay tax at a flat rate of 33 percent. Government-approved funds are taxed as if they are "qualifying" trusts whereas non-approved funds are taxed as if they are unit trusts (i.e. in the same manner as companies). In many respects the net tax effect is the same. Employer contributions to employee superannuation schemes are subject to a withholding tax of 33 percent, but pensions and lump sum payments are tax free.

Trusts are taxed as separate entities for most purposes, with the principal qualification that income received by trustees and paid to or applied for the benefit of beneficiaries within certain time limits is treated as income earned by the beneficiaries rather than the trustees.

"Qualifying trusts" are given a more favourable tax treatment than "non-qualifying trusts", the latter being trusts created by New Zealand residents which have no New Zealand resident trustees or have not paid New Zealand tax on all their income (see below).

An unincorporated association is taxable as if it were an individual, that is, the members are not taxable in respect of the association's income, but instead the association is taxable at the personal income tax rates.

IV. INTERNATIONAL TAX MEASURES

The New Zealand tax legislation contains measures designed to minimize opportunities for international tax avoidance. These comprise four separate regimes.

A. *Controlled foreign company regime*

A non-resident company which is controlled by five or fewer New Zealand residents will be classified as a controlled foreign company ("CFC"). Control means ownership of 50 per-

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cent or more of the share capital; however the definition of control interest is defined very widely to prevent taxpayers from manipulating their control interest. Factors looked at in determining control include:

- percentage of paid up capital;
- percentage of nominal capital;
- percentage of voting rights or rights to decide on distributions, the company's constitution, variations in capital or appointment of directors;
- percentage of entitlement to receive income of the company;
- percentage of net assets which the New Zealand resident would be entitled to receive on a winding up.

There is an extensive anti-avoidance provision designed to prevent the use of indirect control interests through associated persons and otherwise.

A New Zealand shareholder in a CFC who holds more than a ten percent income interest in the CFC will be taxed on a proportionate share of the CFC's income. The CFC is effectively treated as if it was a branch of a New Zealand entity. For this reason the international regime is also called "the branch-equivalent regime".

Losses incurred by a CFC cannot be set off against income of the New Zealand resident shareholder. However, the losses can be carried forward and may be set off against future income of the CFC or future income of another CFC resident in the same territory as the first CFC, in which the same shareholder has an income interest.

The branch-equivalent regime does not apply to CFCs resident only in "grey list" countries unless they utilize a specified significant tax preference. There are seven countries listed as grey list countries: Australia, Canada, France, Japan, West Germany, the United Kingdom and the United States.

B. *Foreign investment fund regime*

The purpose of this regime is to tax residents on a current basis where they have interests in, but do not control, foreign entities in which they are able to accumulate income in low or nil tax jurisdictions. Such interests include policies with foreign life insurance offices and superannuation funds. The regime only applies to entities which primarily invest in portfolio investments, financial arrangements and land held for the purpose of earning rental income, and other similar passive investments. However, the second requirement to cause the regime to operate is that the entity's income must be subject to significantly less income tax than that which would have been payable had the same income been subject in full to New Zealand income tax as income derived by an individual resident in New Zealand.

The New Zealand resident holder of an interest in a foreign investment fund will be taxed on the unrealized capital gain arising in respect of his interest in the fund. In view of the fact that New Zealand does not yet impose taxation on realized capital gains, this treatment is particularly harsh.

C. *Foreign dividend withholding payment regime*

When New Zealand companies receive dividends from foreign companies the New Zealand companies are obliged to deduct withholding tax at the rate of 33 percent, which is effectively a deduction in advance for the tax payable on the dividends when distributed to the ultimate shareholders of the New Zealand company (this is discussed more fully above).

D. *Settlor trust regime*

In the past trusts with non-New Zealand resident trustees but New Zealand resident beneficiaries were regarded as non-residents for New Zealand tax purposes, with the result that no New Zealand tax was payable in relation to income earned by such trusts outside New Zealand. To overcome the use of "offshore" trusts established by New Zealand residents for the purposes of tax avoidance, a "settlor" regime has been introduced which provides in essence that a trust will be deemed to be a New Zealand resident if it is settled by a New Zealand resident notwithstanding that the trustees are non-resident.

The regime designates three classes of trust:

(1) a "foreign trust", being a trust settled by a non-New Zealand resident;
(2) a "qualifying trust", being a trust settled by a New Zealand resident and which has New Zealand resident trustees, and which has paid New Zealand tax on all its income;
(3) a "non-qualifying trust", being a trust which is neither a qualifying trust nor a foreign trust, i.e. a trust with a New Zealand resident settlor but non-resident trustees.

It is the third category of trust which has been used for international tax avoidance and which is accordingly the focus of the settlor regime.

The term "settlor" is defined extremely broadly and extends to any person even if not named as the settlor in the trust deed, who disposes of property to the trust or provides services to the trust for less than fully adequate consideration.

Clearly the ramifications of this regime are extensive. In particular it is essential that no New Zealand resident should settle *any* property or services on a trust settled by a non-resident, as that settlement by the New Zealand resident will taint the trust and cause it to become a New Zealand resident.

The non-qualifying trust regime also provides that a New Zealand settlor will be liable as agent for non-resident trustees in respect of tax on the trust's income. Any distribution made to New Zealand beneficiaries from such trust will also be taxable in the beneficiaries' hands at the rate of 45 percent. This is a penal provision designed to discourage the use of non-qualifying trusts in relation to New Zealand beneficiaries.

An individual intending to take up residence in New Zealand who has an existing trust should seek specific advice to determine the best method of dealing with the trust in the light of this regime.

Interestingly, the corollary of this new regime is that a trust settled by a non-resident which has New Zealand resident trustees will effectively be classified as a non-resident for New Zealand tax purposes so that it is only assessable on New Zealand sourced income.

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V. FILING OF RETURNS AND PROVISIONAL TAX

The New Zealand financial year ends on 31 March. Most taxpayers are required to furnish the Commissioner of Inland Revenue with a return each year in the prescribed form, setting forth a complete statement of all assessable and non-assessable income derived during the preceding year. It is the duty of every taxpayer to keep full records of all income and expenditure. In any dispute over liability for tax, the onus of proof is on the taxpayer.

Tax is payable on an instalment basis and is provisional until a final calculation is made at the end of each tax year. The only exceptions to this are for employees and individuals deriving income of less than $ 2,500 per annum. Provisional tax is based in most cases on 105 percent of the income of the previous year or if a return has not been filed, 110 percent of the income of the year before that, and is payable in three instalments. Those persons earning in excess of $ 100,000 per annum are required to estimate their income for the current year and pay provisional tax accordingly or run the risk of being assessed with penalty tax.

The requirement to pay provisional tax does not apply to overseas companies with no fixed based in New Zealand, who are not deemed to be New Zealand residents, nor to non-resident individuals who receive only non-resident withholding income in respect of which withholding tax has already been deducted.

VI. TRANSFER PRICING

Section 22 of the Act allows the Commissioner of Inland Revenue, in relation to a business carried on in New Zealand but controlled by a non-resident, to issue an arbitrary assessment where the business appears to produce insufficient income or an excessive loss. This is designed to overcome transfer pricing, where affiliated companies in various countries structure inter-parties transactions so that the profit principally arises in a country with a low tax rate. The transfer pricing legislation was enacted in the 1930's and is unsophisticated. The Minister of Revenue has announced that it will be extensively overhauled in the near future to place New Zealand on a par with its main treaty partners.

VII. TAX LOSSES

Losses incurred for New Zealand tax purposes by both resident and non-resident taxpayers may be carried forward and offset against the income of any future year. In the case of companies, this can only be done if there is at least 40 percent (66 percent from 1 April 1992) continuity of shareholding from the commencement of the period in which the loss was incurred continuously to the end of the income year in which the loss offset is being claimed. Public companies on the official list of the Stock Exchange of New Zealand are exempted from this requirement within certain limits. Tax losses cannot be carried back. Companies within the same group (i.e. where there is two-thirds commonality of shareholding) may transfer losses amongst each other in certain circumstances, so that the losses can be offset against profits made by another company in the group.

VIII. ROYALTIES

Royalties are in all cases treated as taxable income in New Zealand, and most importantly, the term "royalty" is defined in very broad terms in the Act, to include not only what are normally regarded as royalty payments but also payments for the supply of know-how. The definition includes any payment as consideration for the following:

- the use of or right to use any copyright, patent, trademark, design, model, plan, secret formula, process or other similar property or right;
- the supply of scientific, technical, industrial or commercial knowledge or information;
- the supply of any assistance which enables the application or enjoyment of any of the above.

It is immaterial whether the payment is periodical and how the payment is described and computed; nor is it material that the payment is an instalment of the purchase price of any real or personal property.

If a royalty payment is given in consideration for one of the items listed above, and for some other matter, then the payment may be apportioned into its several components. It should be noted that the definition of royalty can apply to know-how payments of a reimbursing nature (being payments to reimburse for expenditure incurred by the payee).

The broad definition of royalty fits in with international practice, New Zealand's DTAs and the policies of the OECD.

A distinction should be made between payments for know-how and payments for services. The distinction is that the former is an asset, and as such, it is something which is already in existence and is not brought into being in pursuance of a particular contract. Thus, if a contract is one for the supply for the use of the buyer of what might broadly be termed a "product" which is already in existence or substantially so, it is a contract for the supply of know-how and payments under the contract would be royalties. On the other hand, if the contractor is required to supply special skills and knowledge in order to bring the "product" into existence for the buyer, payment under the contract would be considered to be for services.

The importance of this distinction is that if the provider of the services in New Zealand does not have a permanent establishment in New Zealand then pursuant to New Zealand's DTAs, the services will not be taxed in New Zealand, whereas royalties payable to a non-resident are subject to non-resident withholding tax (see above).

IX. DEDUCTIONS

The same basic method of calculating tax applies to all taxpayers. After excluding all exempt income, taxable income is assessed on the net amount resulting after all allowable deductions have been made. This would include the following:

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- revenue expenditure incurred in producing assessable income or necessarily incurred in carrying on a business;
- depreciation on plant and other capital assets;
- special incentive deductions or other deductions specifically provided for under the Act.

Expenditure deductions are subject to accrual rules which prevent benefits arising from prepayment schemes and require apportionment.

The New Zealand Commissioner of Inland Revenue allows a standard deduction for expenses in relation to royalties, as follows: 25 percent for trade marks, 35 percent for patents, 50 percent for know-how and 40 percent for a combination of these.

X. FOREIGN TAX CREDITS

The Act provides relief from double taxation, as discussed above. Reference should also be made to the appropriate DTA. Generally, the country which is the source of the income has the primary right to tax, and the country of residence, the obligation to grant a credit. Where non-residents derive profit from trading activities in New Zealand, they will often be exempted from taxation in respect of this income unless they operate through a fixed establishment in New Zealand.

XI. TAXES OTHER THAN INCOME TAX

A. *Goods and services tax*

The Goods and Services Tax Act 1985 ("GST") imposes a comprehensive value added tax of 12.5 percent on the supply of all goods and services in New Zealand. There are very few exemptions, the most notable one being financial services. The New Zealand legislation model has recently been followed in Canada and Fiji.

Whilst it is intended that the tax be borne as a final tax by consumers, it is charged on all transactions, including those between registered businesses. Those registered businesses are entitled to deduct GST charged to them on costs and overheads from their GST liability arising from supplies of goods and services made by them. The actual obligation to collect and pay GST is on the supplier, and it is the supplier's responsibility to contractually pass on that cost to the recipient.

Exports from New Zealand are not subject to goods and services tax. Imports into New Zealand are subject to the tax.

B. *Land tax*

Companies and individual taxpayers are presently liable to pay land tax but it is abolished from 1 April 1992. This is a tax separate from income tax which is assessed on the total "land value" (that is, excluding the value of buildings and other improvements) of land owned on the 31st day of March in each year. Until 1 April 1990 an exemption existed for the first NZ$ 175,000 of land value. This exemption abated dollar for dollar on a pro rata basis, so that when total land owned by a taxpayer was valued at NZ$ 350,000 he would pay tax on the full NZ$ 350,000. From 1 April 1990 this exemption was reduced to NZ$ 10,000 but if land value exceeds that sum then no exemption is given at all.

The rate of tax is one percent for the year ending 31 March 1991. The rate reduces to 0.5 percent for the year ended 31 March 1992 and then ceases. For the year ending 31 March 1991 land tax was payable in two equal instalments on 7 May and 7 October 1990 calculated by reference to the value of land owned on 31 March 1990. In the following year land tax was payable in full on 7 May 1991.

Various types of land, including land used solely or principally for farming or agricultural activities and residential land of less than 4,500 square metres in area, are exempt from land tax.

Land tax is payable by both resident and non-resident owners. A 50 percent surcharge imposed on non-residents was abolished with effect from 1 April 1990. Land tax is deductible as an expense where it is incurred in carrying on a business.

C. *Local body rates*

Owners of real property are assessed for rates by local authorities. The rates are usually determined on the basis of the value of the land and its town planning zoning classification or on the total capital value of the site, including all improvements. The rates levied on commercial and industrial properties generally exceed those levied on residential properties.

D. *Capital gains and wealth taxes*

There is no capital gains tax in New Zealand, nor is there a wealth tax. However, in certain circumstances, gains that would be considered to be of a capital nature according to ordinary concepts can be classified as income. Profits from certain land sale transactions, pursuant to Section 67 of the Act, fall into this category. However, such provisions are not common, and usually only apply to gains which are of a quasi-income nature.

E. *Stamp duty*

This is a type of tax imposed upon the transfer of non-residential real estate, and upon non-residential leases. The duty charged is either calculated on the basis of the value of the property transferred, or on the rental payable in the case of leases. On the transfer of real estate, the rate of duty is one percent of the first NZ$ 50,000 of the value, 1.5 percent of the second NZ$ 50,000 of the value, and two percent of the value in excess of NZ$ 100,000. In the case of leases, the duty is 0.4 percent of the maximum annual rental payable during the term of the lease.

F. *Gift duty*

Gift duty is imposed on gifts made by New Zealand domiciled individuals on a sliding scale of between five percent up to a maximum of 25 percent. There is an exemption for the first NZ$27,000 of gifts made by any individual in any one year.

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For non-New Zealand domiciliaries, gift duty is only payable in respect of gifts of property situated in New Zealand.

G. *Estate duty*

Estate duty is imposed on the estate of a deceased individual who is domiciled in New Zealand at the rate of 40 percent. There is a complete exemption in respect of the first NZ$ 450,000.00 worth of assets in the estate. There is also an exemption in respect of family chattels and the matrimonial home of a deceased passing to a surviving spouse. For non-domiciliaries estate duty is only imposed on assets situated in New Zealand, whereas for domiciliaries, estate duty is imposed on worldwide assets although a credit is provided for duty paid on overseas assets.

XII. CONCLUSION

Obviously, this summary of New Zealand taxation law is relatively brief. New Zealand taxation law is complex, and is subject to regular and substantial amendment by the Government on an annual basis. It is therefore essential that specific and detailed advice be obtained from a New Zealand tax advisor prior to the implementation of any investment strategies.

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KOREA

COST SHARING AND TRANSFER PRICING

Sai Ree Yun and Yoong Neung Kee

I. INTRODUCTION

In January 1990, Korea's Office of National Tax Administration ("ONTA") issued its first detailed regulations regarding taxation of transactions conducted between companies in Korea and their related overseas companies. The regulations are designed to implement the transfer pricing rules which require that companies apply an arm's length price in their transactions with related parties; otherwise, the tax authorities may calculate taxable income to reflect an arm's length price. For the effective administration of the transfer pricing rules, the regulations impose new reporting requirements on companies subject to the regulations, effective for taxable years beginning on or after 1 January 1989.

In recent years, the Korean tax authorities have become increasingly concerned about cross border transfer pricing between related companies. In the past, many domestic and foreign-invested companies were granted tax incentives for investment, such as five year tax holidays, and transfer pricing was not a substantial issue. As the Korean economy matures, however, such tax incentives are fading out. In addition, the increasing number of multinational companies having a local base in Korea, particularly in the international trading sector recently opened to foreign investment, has alerted the tax authorities to the possibility of income shifting to low tax jurisdictions through intercompany pricing.[1] The recent trends in the OECD countries of adopting new transfer pricing legislation or applying the rules more aggressively also might have prompted the Korean government to establish rules in this area.

Related party transactions in Korea are generally governed by Article 20 of the Corporate Tax Law ("CTL"), which allows the Korean tax authorities to adjust a taxpayer's income if the taxpayer is deemed to have unreasonably reduced its tax liability through related party transactions. Also, in general, Korea's tax treaties provide for the arm's length principle in related party transactions, but there have been no detailed guidelines for the operation of this principle.

In 1988, the Korean government amended the Corporate Tax Law Enforcement Decree ("CTL-ED") to adopt the arm's length principle for cross border related party transactions.[2] Subsequently, the CTL Enforcement Regulations were amended to incorporate brief explanations of the methods of determining an arm's length price, such as the comparable uncontrolled price method, the resale price method and the cost plus method.[3] Finally, in 1990 ONTA issued the Operational Regulations Regarding Taxation of Transfer Pricing ("ONTA Regulations")[4] which provide detailed rules for the operation of the transfer pricing rules established by the above statutes and, as their immediate function, serve as guidelines to corporations for the preparation of their 1989 corporate tax returns.

II. OVERVIEW

A. *General principles applicable to transfer pricing*

1. Transactions subject to the rules

Transactions which are subject to the Korean transfer pricing rules are the sale and purchase of inventory assets, the provision of services and other transactions.[5] Inventory assets include merchandise, finished products, semi-finished products, work in

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1. According to a recent report, the ONTA selected 368 out of more than 2,700 Korean corporations having foreign subsidiaries, and 1,305 out of about 7,700 foreign-invested enterprises or foreign corporations' branches in Korea as entities to be affected by the new transfer pricing regulations. See *Business Korea* (March 1990), at 57.
2. See CTL-ED, Art. 46(4) (methods of determining an arm's length price) and CTL-ED, Art. 122(1)(9) (arm's length transactions deemed to have been conducted between a foreign corporation and its place of business in Korea). See also CTL-ED, Art. 46(5) (corporation's obligation to provide data and evidentiary documents upon the request of a tax official for the determination of an arm's length price).
3. See CTL Enforcement Regulations ("CTL-ER"), effective 26 March 1989, Art. 22(2). See also CTL-ER, Arts. 22(3) (documents to be produced), 45(3) (forms to be attached to a tax return) and 59(12) (arm's length price applied to transactions conducted through a domestic place of business of a foreign corporation).
4. Office of National Tax Administration Regulations No. 1062, dated 24 January 1990 ("ONTA Regulations"). Together with the ONTA Regulations, the ONTA issued the Notice regarding Designation of Financial Statements or Supplementary Schedules of Financial Statements of Foreign Related Persons (ONTA Notice No. 90-4, dated 24 January 1990) ("ONTA Notice") and the Administrative Regulations regarding the Transfer Pricing Rules (ONTA Regulations No. 1061, dated 24 January 1990).
5. ONTA Regulations, Art. 4.

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process, raw materials and stored products.[6] "Other transactions" include the lease of assets, the transfer, sale or use (i.e. licensing) of tangible assets other than inventory assets, the sale and purchase of intangible assets, loans and any other transactions affecting the profit or loss (i.e. taxable income) of an enterprise.[7] The rules, however, do not apply to capital transactions – such as an increase or decrease in capital – which do not affect the taxable income of a corporation. Also, the rules do not apply to a loan guarantee by a foreign parent company, which is a common method of financing a Korean subsidiary under the present foreign exchange practices.

2. Foreign related persons subject to transfer pricing rules – level of common control

(a) *General*

Under Korean law, transfer pricing adjustments in related party transactions are governed by the general rule of related party transactions under Article 20 of the CTL and Article 46 of the CTL-ED. The scope of "related parties" under these provisions is broad enough to include any major shareholders or those who have management control of a company.[8] Thus, no specific level of control is set by law for a related party subject to transfer pricing adjustments.

The transfer pricing rules apply to cross border transactions conducted between a domestic juridical person and a foreign juridical person which is "related to" the domestic juridical person (as defined below). For purposes of the rules, a domestic place of business of a foreign corporation (such as a branch) will be treated like a domestic corporation.

The ONTA Regulations, on the other hand, impose reporting requirements when a domestic corporation or branch of a foreign corporation conducts transactions with foreign related persons. For the application of such reporting requirements, a 50 percent ownership test is generally used. For this purpose, a foreign related person ("FRP") is defined as a foreign corporation whose relationship with a Korean taxpayer as of the date of a transaction falls into one of the following categories:

(1) the foreign corporation owns, directly or indirectly, 50 percent or more of the total number of the outstanding shares or the total amount of the paid-in capital of the Korean corporation;

(2) the Korean corporation owns, directly or indirectly, 50 percent or more of the total number of the outstanding shares or the total amount of the paid-in capital of the foreign corporation;

(3) with respect to a foreign corporation having a domestic place of business (such as a branch) in Korea, another foreign corporation which directly or indirectly owns 50 percent or more of the total number of the outstanding shares or the total amount of the paid-in capital of the first foreign corporation; or

(4) the taxpayer is in a distributorship relationship with a foreign corporation.[9]

It should be noted that the rules apply only to those transactions conducted by a taxpayer which is *juridical person*, a term that has the same meaning as in the CTL. Since the CTL uses the term "juridical person" to indicate taxable entities under the CTL but does not define a juridical person, reference must be made to the Commercial Code to determine the scope of this term. The Commercial Code provides for four types of juridical persons:

- joint stock companies (an equivalent to corporations under U.S. corporate law);
- limited stock companies (companies close to statutory close corporations in many states of the United States);
- incorporated partnerships; and
- incorporated limited partnerships.

In addition, associations or foundations established with the permission of the relevant authorities as well as non-profit foundations with property are treated as juridical persons for tax purposes.[10]

Individuals, unincorporated partnerships or other associations not taxable as juridical persons under the CTL will not be subject to the rules. Trusts and estates also are not treated as juridical persons and thus are not subject to the rules. For the ease of reference, a juridical person will be referred to as a corporation.

Since the rules regarding reporting and other documentation requirements are important for practical reasons, specific cases of FRPs for purposes of the reporting requirements will be discussed in more detail below.

(b) *Specific applications*

(1) *Branch and head office*

The transfer pricing rules apply to transactions between a Korean branch of a foreign corporation and its affiliated companies, which include the parent company and subsidiaries of the branch's head office. According to the FRP definition, a foreign corporation with a Korean branch is not an FRP of the Korean branch. A foreign corporation's income attributable to a Korean branch, however, is subject to Korean tax as domestic source income. In computing the foreign corporation's domestic source income, transactions between the foreign corporation and the Korean branch should be based on the same arm's length principles as adopted in the transfer pricing rules. As a practical matter, therefore, a foreign corporation and its Korean branch would be requested to report transactions between themselves in the same format as that used for the annual reporting of transactions with an FRP (Form No. 59) for the purpose of calculating the head office's domestic source income.

(2) *Sister companies*

A Korean subsidiary's sister companies meeting the 50 percent test will constitute FRPs. The ONTA appears to take the position that the term "indirect control" in the test includes

6. CTL-ED, Art. 85(43).
7. ONTA Regulations, Art. 4.
8. See CTL-ED. Art. 46(1).
9. CTL-ER, Art. 45(3)(34)(D) (added by the Ministry of Finance Enforcement Regulations No. 1818, dated 4 April 1990).
10. National Tax Basic Law ("NTBL"), Art. 13(1).

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relationships "under common control", i.e. the relationship of sister companies.

(3) *Non-voting shares*

In applying the 50 percent ownership test, the rules do not clarify whether only voting shares are counted or whether non-voting shares are counted as well. Since a non-voting share is also a share, absent a specific provision indicating otherwise, the word "shares" in the definition of FRP appears to include non-voting shares. However, the tax authorities might find an FRP, if either way of counting shares produces a result that satisfies the 50 percent test.

(4) *Treasury shares*

The term "outstanding shares" in the test includes shares which are subscribed and not yet paid in at the time of the relevant cross border transactions, but it excludes treasury shares.

(5) *Combination of ownership*

Indirect ownership under the rules means a second tier or third tier ownership satisfying the 50 percent test. Indirectly owned shares and directly owned shares will be combined for application of the 50 percent test. For instance, if Corporation A owns 10 percent of Corporation C and 50 percent of Corporation B, which in turn owns 40 percent of C, then A will be deemed to own 50 percent of C.

(6) *Transactions through an unrelated party*

The rules and the reporting requirements also apply to a transaction between a taxpayer and the FRP but conducted through an unrelated third party, if the recipient of goods or services and the amount of consideration has been determined in advance. This provision appears to fit the Korean trade system under which export/import transactions are generally conducted through licensed trading companies. However, because many foreign-invested companies or branches now have trade licences, it will not have as much significance as in the past.

B. *General standards and methodology*

The transfer pricing rules adopt the arm's length principle under which the taxpayer and its FRP will be deemed to have conducted their transactions at an arm's length price (or "independent enterprise price" in Korean terminology). The rules list the following methods of computing an arm's length price:
(1) the comparable uncontrolled price method,
(2) the resale price method,
(3) the cost plus method and
(4) other reasonable methods.

The first three methods are basically market approaches predicated on the existence of a market for the transaction involved, and the fourth method includes a functional analysis which looks, *inter alia*, at each party's contribution to the income produced.[11]

III. METHODOLOGY

A. *Sales of tangible property (inventory)*

1. General

For pricing sales of tangible property, such as finished products, semi-finished products, work in process and raw materials, the rules prescribe the four internationally accepted methods.

The pricing methods are based on the arm's length principle, i.e. the price that would have been charged in transactions involving assets or services identical to or similar to the assets or services transacted between the taxpayer and its FRP if such transactions had been conducted in a normal market and between independent (not related) parties under identical or similar circumstances to the related party transaction.[12]

If a taxpayer is viewed as having reduced its tax liabilities by receiving from an FRP consideration less than an arm's length price or by paying to the FRP consideration exceeding an arm's length price, the tax authorities will recompute the taxpayer's income for the taxable year. The taxpayer's liquidation income upon dissolution (excluding dissolution by merger) also would be computed based on an arm's length price.

In general, the arm's length price of inventory assets is more readily ascertainable based on a market analysis than that of other goods or services. In determining the arm's length price for the sale and purchase of inventory assets, the four pricing methods will be applied in the order listed above.[13] Thus, for example, the resale price method will be applied only if it is too difficult to determine relevant price under the comparable uncontrolled price method.[14]

2. Comparable uncontrolled price method ("CUP")

Under this method, an arm's length price is determined by reference to comparable transactions between a buyer and a seller who are independent parties. Comparable transactions are transactions involving the same types of inventory assets of similar volume under similar terms and conditions. Thus, the following requirements should be met for a transaction to be comparable to the related party transaction in question:

(a) The transaction should be between independent unrelated parties. This includes transactions between the corporation in question or an FRP and an unrelated party as well as transactions between two unrelated parties neither of which is related to the corporation in question or the FRP.

(b) The goods to be compared should be as nearly as possible physically identical to the goods at issue.

11. These four methods appear to follow the precedents in the U.S. Treasury's Section 482 Regulations and the methods and principles outlined in the 1979 OECD report, "Transfer Pricing and Multinational Enterprises" ("OECD Report").
12. ONTA Regulations, Art. 3.
13. CTL-ED, Art. 46(4).
14. This preference for the market-oriented approach is also shown in the U.S. Treasury's Section 482 Regulations and the 1979 OECD Report.

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(c) The circumstances under which the independent unrelated parties deal with each other should be similar to the circumstances in which the corporation in question trades with its FRP in terms of the level in the distribution chain (e.g. wholesale or resale), trade volume and other transaction conditions.

If differences exist between the transaction at issue and a comparable transaction in terms of the level in the distribution chain, trade conditions, volume and other factors, and if such differences can be quantified, the price will be adjusted to reflect the differences.[15]

The CUP method is generally preferred to other methods because of its directness of using evidence of open market prices and the proximity to the definition of an arm's length price. In practice, however, it is often difficult to determine the price under the CUP method due to lack of evidence of open market prices. In such a case, recourse will be made to the resale price method or the cost plus method.

3. Resale price method

According to this method, an arm's length price is determined by deducting a normal profit margin from the resale price at which a buyer of inventory assets resells these assets to an unrelated party.[16] Generally, the resale price method applies where assets purchased from a related seller are resold to an unrelated party.

A normal profit margin (the resale price multiplied by a normal profit rate) is computed from comparable transactions in which a buyer in a related party transaction, or an unrelated party engaging in the same or similar business activities, buys the same or similar inventory assets at an arm's length price from an unrelated party and resells the assets to an unrelated party.[17]

The normal profit margin is calculated by adding up the sales price of the inventory traded during a specific period of time. Therefore, an issue is how to determine the proper length of time that will be the basis for determining the scope of the transactions for calculating a normal profit margin. In general, the period of time may be a quarter, half or full year, whose first or final date falls closest to the date on which the relevant transaction takes place.

Modifications are made to the profit rate from the comparable transactions based on a functional analysis, i.e. reflecting differences in functions and risks undertaken by the reseller in the related party transaction and those in the comparable transactions. For example, if the reseller performs the role of a trade broker, the normal profit margin could be related to a brokerage fee. For this purpose, one may refer to the ONTA guidelines on standard rates of brokerage service fees in international trading. If the reseller is a distributor performing activities such as storage, marketing, distribution and servicing of the goods, then a substantial profit margin would be expected.

The Korean tax authorities have used a standard profit margin table (or standard net income rate table) by business category, which is updated every year, for cases where the taxpayer could not produce sufficient books and records to compute taxable income. For example, a foreign-invested trading company is currently assigned 7.0 – 13.6 percent profit margin rate, depending on the amount of its gross sales revenue. Since the standard profit margins are primarily based on Korean market conditions and operating costs of Korean corporations, however, it might not be reasonable to apply them to foreign corporations. In practice, the resale price method is useful in transactions in which the arm's length resale price of the assets is easily identifiable whereas the arm's length purchase price of the assets is not.

4. Cost plus method

Under the cost plus method, an arm's length price is determined by adding a normal profit margin to the cost of acquiring (by purchase, construction or manufacture) the inventory assets which are sold to a related party. The normal profit margin is computed by multiplying the costs incurred to purchase, construct or manufacture the inventory assets by the normal profit rate. The normal profit rate means, in the case where the seller (or an unrelated party engaging in the same or similar business as the seller) acquired inventory assets the same as or similar to the inventory assets through purchase, construction or manufacturing and sold them to an unrelated party at an arm's length price, the ratio of the total sales profit to the total acquisition costs.

In computing an appropriate profit margin under the cost plus method, differences in factors, such as functions performed by the purchaser or cost-sharing arrangements (if any), between the actual transaction and the comparable transaction should be reflected and adjusted. This method is generally useful where the purchaser adds substantial value to the goods, for example, by manufacturing, before reselling them. This method is also useful in cases in which the arm's length purchase price is easily identifiable whereas the arm's length resale price is not.

5. Other reasonable methods

If it is impossible or unreasonable to use the above methods because of the lack of comparable transactions or other reasons, other reasonable methods of allocating income from a cross border related party transaction may be used.

One of the "other reasonable methods" is a variation or combination of the CUP method, resale price or cost plus method. For example, a corporation may use a product purchased from an unrelated party and another product manufactured by itself to produce a final product and sell the final product to its FRP. In such a case, the arm's length price of the final product may be determined by combining the CUP method and the cost plus method.

Another method is the so-called "profit split" method under which income is allocated to the related parties on the basis of their proportional contribution to the income. The factors to be considered are: (i) the expenses incurred by, and the

15. CTL-ER, Art. 22(2).
16. 1979 OECD Report, at 33.
17. ONTA Regulations, Art. 8(2).

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price of the fixed assets used for, the purchase, manufacture or sale of the inventory assets in a related party transaction, (ii) the functions performed at each stage of the transaction, and (iii) other factors indicative of the measures of contribution to production of the income.

B. *Licence of intangible property*

Intangible assets under the CTL include copyrights on academic and artistic works (including movies), patents, trademarks, designs, models, drawings, secret formulae or processes, films or tapes for radio and television broadcasting and other similar assets or rights, and information on industrial, commercial or scientific knowledge, experience or skill.[18] For the licence of intangible property, an arm's length price will be determined according to methods similar to those described above with respect to the sale and purchase of inventory assets. The rules also recognize the long-term profitability of intangible property to the taxpayer, which is similar to the "super royalty" concept under the U.S. rules (see below).

In general, royalty payments are fully deductible to the payer licensee. The withholding tax rate for royalty payments under the CTL is 26.875 percent (including the surtax) of the gross royalty amount. Under many of Korea's tax treaties, the withholding tax rate is reduced to 10-15 percent. For example, under the U.S./Korea tax treaty, the withholding tax rate (including the surtax) is 16.125 percent. Many licensing agreements are subject to government clearance, including the examination of the agreements under Korean antitrust law, but no further disclosure is required for application of the reduced withholding rate under a treaty.

In determining an arm's length price for royalty payments, the following factors, among others, will be considered:

(i) the propriety of the royalties paid or received, by analyzing and comparing the technology to licence or to be licenced under the technology licence or inducement agreements and documents relating to the approval of such technology licence or inducement with the actual technology licensed;

(ii) the propriety of the method for determining the fees paid for transactions involving intellectual property, by obtaining documents regarding how such fees are determined;

(iii) the fairness of the compensation, by examining the changes due to the importation of the intangible property (e.g. the degree of increase trend in the sales volume, the trend in increase of long-term profitability, the degree of contribution to improvement in productivity);

(iv) whether the intangible property for which compensation is paid is incorporated into the raw materials or products purchased (i.e. whether the compensation is paid twice);

(v) whether the imported technology is actually performed or used, by obtaining documents regarding the performance or use of such technology; and

(vi) the excessiveness or inadequacy of the compensation, by collecting information regarding the price at which a competing, independent company wishes to purchase identical intangible property or information regarding the compensation paid or received when the transferred intangible property is retransferred to a third party.[19]

In most cases, it would be difficult to find a comparable licence. In such cases, one alternative would be to compare the profitability of the taxpayer on a long-term basis with the trend in the same or similar industry. This is similar to the "super royalty" approach provided in Section 482 of the U.S. Internal Revenue Code. Under the U.S. super royalty provision, income from the transfer of intangible property must be "commensurate with the income attributable to the intangible". This approach would look at the profitability of the licensee *subsequent to* the licensing, marking an exception to the arm's length principle which concerns a comparable transaction *at the time of* the transaction. It is doubtful, however, whether the ONTA would zealously apply the super royalty approach, which was devised as a way to block income shifting from a U.S. parent to its overseas subsidiaries, to cases in which Korean subsidiaries are the recipient of technologies. In practice, such an approach would rarely be applicable in an inward technology transfer, because in most cases any income shifting would be made by a foreign licensor to a Korean licensee.

If related companies enter into cost sharing arrangements and pay research and development ("R&D") expenses pursuant to such arrangements, such arrangements should be executed in advance in writing. Contracting parties must bear the expenses and liabilities on an arm's length basis. The R&D activities for which the cost sharing is undertaken must be carried out in accordance with the contract provisions. The participating companies must acquire the ownership or rights to use the developed intangible property.

The amounts shared by the participating companies must be directly related to the intangible property produced as a result of the R&D activities. A foreign R&D company may allocate to a Korean participating company only the direct and indirect costs for the R&D activities after deducting research expenses separately arising upon the request of another specific related company; and income such as royalties for providing the developed intangible property to parties other than the participating companies.

Under Korean law, in general, cost sharing payments by the participating company probably have to be capitalised for amortization over the statutory amortization period (currently five years).[20]

C. *Use of tangible property (lease)*

As a general rule, payments for the lease of tangible property should be based on the CUP method, but if there are no com-

18. CTL, Art. 55(1)(ix).
19. See 1990 Documentary Analysis Guidelines Regarding Corporate Tax Returns ("ONTA International Guidelines").
20. CTL, Art. 17(10); CTL-ED. Art. 38.

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parable transactions, the lease payment will be calculated in accordance with methods similar to the methods discussed above with respect to inventory assets. In determining the appropriate amount of the rent, the economic benefits received by the use of tangible property will be considered.

D. *Provision of services*

The methods for the determination of an arm's length price for services are similar to those used for inventory transactions. If there is a comparable service transaction in the same circumstances to that of the relevant cross border service transaction, the payment for the comparable transaction may be viewed as an arm's length price under the CUP method. If there is no comparable service transaction, a normal profit rate of a comparable transaction may be used in calculating an arm's length price. In such event, the normal profit will be added to the cost actually incurred for the services furnished.

There may be several types of ancillary services, such as management, administrative or technical services, that accompany the primary service furnished by the corporation, particularly the foreign parent company. In such case, payments for services furnished in a similar transaction between unrelated parties will be adopted as the basis for calculating an arm's length price of the service at issue.

When calculating an arm's length price under this method, the following factors will be considered:

- whether a written contract for the provision of services was executed in advance;
- whether the fact that a benefit actually flows from the services provided can be specifically proven;
- whether the services provided can be clearly recognized and measured; and
- whether the services are actually provided and directly related to the operations of the company that receives such services, and are or will be used by such company.[21]

Even if these conditions are satisfied, if the services fall into one of the following categories, the compensation for such services will not be deductible as expenses (because they are expenses of the parent company):

- services identical or similar to services a parent company usually provides to its subsidiary free of charge, such as after-service, or services which are not likely to be compensated if the companies were independent entities;
- services the parent company provides for its own benefit or to supervise the subsidiary; or
- services the parent company provides in its capacity as a shareholder of the subsidiary to protect and manage its investment.[22]

E. *Loans and advances (interest)*

In general, if the interest rate under a loan agreement between related parties is inappropriate or the loan agreement does not specify the interest rate, it will be determined by the CUP method. In such a case, according to the ONTA Internal Guidelines, the "deemed interest rate" under Article 47 of the CTL-ED and Article 20(3) of the CTL-ER will be applied. Under current law, the deemed interest rate is the interest rate announced by the ONTA, taking into account the overdraft interest rate of the banks headquartered in Seoul at the end of the taxable year in question.

In determining whether the interest rate on a loan between related parties is appropriate, the following factors will be taken into account:

(i) the amount and maturity date of the loan;
(ii) the nature and purpose of the loan (such as trade credits, mortgage-based credits or general loans);
(iii) the condition in the financial market for the currency of the loan or related currency (strong or weak currency);
(iv) the exchange risk and prevailing interest rate for the currency in the market at the time of the loan;
(v) collateral for the loan and the credit-worthiness of the borrower; and
(vi) differences in the conditions of the financial markets between the country of the borrower and the country of the lender as well as the interest rate in the international capital markets.[23]

If payment is not received within the period customarily permitted and the lender takes no action against such non-payment for a long time, the reason for such non-payment and the appropriateness of overdue interest, if any, will be examined.

Interest on the loan that is deemed a capital contribution or a quasi-capital contribution will not be deductible as expenses. For this purpose, "quasi-capital contribution" includes the following:

(1) a loan for which there is no advance agreement as to the term, maturity date and repayment of principal;
(2) a loan which may be converted into the stock of the borrower or other form of capital contribution;
(3) a loan where the payment obligations are proportionate to the capital contributions made by the capital interest owners of the borrower;
(4) a loan with no separate provisions for sanctions upon failure to pay interest;
(5) a loan with interest rates that vary depending on the operating performance of the borrower; or
(6) a loan which is similar to one of the loans described above.[24]

Under Korean tax law, interest payments are subject to withholding tax at the rate of 26.875 percent (including the surtax). This withholding tax rate is usually reduced to 10 to 15 percent under most Korean tax treaties. Under the U.S.-Korea tax treaty, for example, the effective withholding tax rate for interest payments is 12.9 percent.

IV. COMPLIANCE

A. *General*

With the exception of the definition of the arm's length price determination methods, the priority in application thereof and the reporting requirements, the transfer pricing rules gen-

21. ONTA Internal Guidelines.
22. *Id.*
23. *Id.*
24. *Id.*

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erally take the form of administrative guidelines of the ONTA, which as a legal matter are not binding on taxpayers or the court. The rationale underlying this may be to allow the Korean tax authorities to enforce the transfer pricing rules for a period of time before the rules are incorporated into statutes such as the CTL and the CTL-ED. Once the tax authorities obtain sufficient data and experience in enforcement of the rules, it is foreseeable that the rules might be contained in the CTL or the CTL-ED.

Since the current statutory provisions on transfer pricing are very general, giving the tax authorities broad authority and discretion in applying the provisions, as a practical matter, taxpayers have to comply with the transfer pricing rules in the form of the administrative guidelines. Furthermore, the reporting requirements are mandatory statutory obligations imposed on taxpayers.

If a price in a related party transaction is not deemed appropriate, the tax authorities may determine an arm's length price based on one of the four methods which the tax authorities deem as reasonable.

Korean tax law, in principle, places the burden of proof on the tax authorities. Therefore, the ONTA's determination of price is subject to the basic principle that the tax authorities must base their decision on the books and records provided by the taxpayer as much as possible and show the grounds for the decision.[25]

The ONTA's burden of showing the basis for taxation, however, is substantially relieved by a provision that allows the ONTA to determine the taxable income by estimation where there are no books or evidentiary documents sufficient to determine taxable income of a taxpayer, or where a significant part of the evidence is missing or false.[26] In addition, the transfer pricing rules impose substantial documentation requirements on the taxpayer, as a result substantially shifting the burden of proof (or at least the burden of production of evidence) to the taxpayer.

B. *Documentation*

1. Annual reporting requirements

A taxpayer engaged in transactions with an FRP must submit, together with its annual corporate tax return, a detailed report of transactions with FRPs (Form No. 59).[27] As discussed above, although the branch/head office relationship is not within the ambit of the rules, a Korean branch of a foreign corporation will be requested to report its transactions with the head office on the same form.

If the total amount of the taxpayer's transactions with an FRP is W 5 billion (approximately US$ 7 million) or more in a taxable year, the taxpayer must submit a summarized income statement of the FRP(s) as an attachment to its corporation income tax return. If the total amount of transactions between the taxpayer and the FRPs exceeds W 5 billion, a summarized income statement of the top three FRPs in terms of transaction amount must be submitted.[28]

2. Authority to demand data and documents

The ONTA Regulations list data and documents that a taxpayer may be requested to produce for the tax authorities' determination of the arm's length price. These data and documents include those held by the FRPs as well as those held by the taxpayer.

First, for a documentary analysis, the tax authorities may request the production of the following data and documents:
(a) contracts for the sale or purchase of assets;
(b) price lists of products;
(c) calculation of manufacturing costs of products;
(d) detailed report on transactions in relevant products with unrelated companies; and
(e) in the case of provision of services or other transactions, data and documents similar to those in (a) through (d) above.

Second, for a tax audit or investigation, which is a more serious phase of tax examination than a documentary analysis, the submission of the following data and documents may be requested:
(a) data and documents for a documentary analysis set forth above;
(b) corporate organizational charts and job descriptions;
(c) data concerning the determination of the prices in international transactions;
(d) pricing policy within the group of companies;
(e) accounting standards;
(f) description of activities performed by each of the companies involved in the cross border transaction;
(g) cross border transaction practices in the same industry in the country of the taxpayer or its FRP; and
(h) other data and documents necessary for the price determination.[29]

The breadth of the lists and the open-endedness of the catch-all provision of "other necessary data and documents" in effect may mean that the tax authorities may request any type of information that is deemed necessary for determination of an arm's length price, including certain information held by FRPs.

3. Effect of non-compliance with documentation requirements

The ONTA Regulations provide certain disadvantageous effects for non-compliance with the documentation requirements. Failure to comply with the annual reporting requirement by the time a taxpayer files its corporate tax return may trigger a documentary analysis. If the taxpayer does not produce data and documents upon request by a tax officer during the documentary analysis phase, the ONTA might initiate a tax audit or investigation of the taxpayer. If the taxpayer does not produce data and documents requested for a tax audit or investigation, the ONTA can assess the taxpayer's tax liabili-

25. NBTL, Art. 16.
26. CTL, Art. 32(3); CTL-ED, Art. 93(1).
27. CTL-ED, Art. 82(3)(v); CTL-ER, Art. 45(3)(xxxiv).
28. ONTA Regulations, Art. 11(1).
29. ONTA Regulations, Art. 11(2).

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ties by estimation based on the arm's length price determined by one of the four methods above that the ONTA deems as reasonable.[30]

If there are no books or evidentiary documents sufficient to determine the taxable income, or if an important part of evidence is missing or false, the ONTA may assess taxable income by estimation based on the "standard profit rate" of the taxpayer's industry.[31] In practice, it would not be easy for a taxpayer to overturn the tax liability assessed by the ONTA.

C. *Adjustments to income*

If a price in a cross border related party transaction is determined to be different from the arm's length price, the transaction will be recharacterized on an arm's length basis, which will require an adjustment of the taxpayer's taxable income to reflect the difference between the price adopted and the arm's length price.[32] In the case of an inbound cross border transaction in which the income of a Korean taxpayer is shifted to an FRP, the difference will be reflected in the form of an addition to the taxpayer's revenues or exclusion from the deductible expenses, thus increasing the taxpayer's taxable income in Korea.

Usually, the taxpayer would not have on hand the funds equivalent to the differential, which have already been shifted overseas. The ONTA will not insist on the taxpayer's actual recovery of such funds shifted overseas. Instead, the funds shifted overseas will be treated as an outlay paid from the earnings of the taxpayer and will be characterized as an appropriate item depending on the situation.[33] For example, if the FRP which has benefited from the transaction is the parent company of the taxpayer, the income shifted to the parent company would be treated as dividends from the taxpayer's after-tax earnings.[34]

There may be cases in which the taxpayer has agreed with its foreign related company to recover the income shifted overseas before filing its revised corporate income tax return and such recovery is objectively foreseeable. Then, such income may be treated as a provisional advance payment to the foreign related company and the foreign related company would not be subject to tax.[35]

If all or part of the amount of the income shifted overseas is included in the acquisition price of the assets held by the taxpayer, the acquisition price of the assets may be reduced by such amount for tax purposes.

D. *Transfer pricing tax audits*

There are no *de minimis* rules that would exempt a transaction from application of the transfer pricing rules. However, the ONTA has recently set internal standards for identifying companies that would be subject to selective auditing in respect of transfer pricing.[36] According to the guidelines, corporations likely to be subject to a tax audit are those which are engaged in the manufacturing or distribution business and whose annual sales revenue exceeds W 10 billion (approximately US$ 14.1 million) and whose annual transaction amount with the FRP exceeds W 5 billion.

Furthermore, a taxpayer would be even more likely to be subject to a tax audit if it falls into the category described above, and:

(1) its total sales profits or operating profit rate for the taxable year is 70 percent or less of the national average for the particular industry for the prior taxable year;
(2) the result of its computerized cumulative tax compliance level for the past five years is found to be less than average;
(3) it trades with foreign related companies located in tax haven countries such as the Bahamas, Switzerland, Hong Kong or Panama;
(4) the trade with foreign related companies accounts for 90 percent or more of its total trade;
(5) the total sales profits or operating profit rate for the taxable year is 70 percent or less of its foreign related company's total sales profits or operating profit rate; or
(6) meets other standards separately established by regional tax offices.[37]

In determining the companies to be audited, the Korean tax authorities begin with a comparison of a taxpayer's profit rate with the average profit rate in the relevant industry for the prior year. The tax authorities may further request documents and information, such as contracts for the purchase of property, import/export licences, resale price lists, and monthly or quarterly financial reports. The tax audit will focus on the appropriateness of the prices of goods, royalties from intangible property, interest rates, compensation for services, transportation costs, insurance premiums and other fees.

A taxpayer's subjective intention to avoid or evade Korean taxes is not required for the tax authorities to apply the transfer pricing rules.

The statute of limitations for corporate income tax is five years. This five year period may not be extended.

V. RELIEF PROVISIONS

A. *Corresponding adjustments*

The rules do not provide for any special procedures regarding corresponding adjustments. An adjustment to the taxable income of a foreign related company would not have an immediate impact on the taxable income of the Korean taxpayer. Korea appears to have no "deemed paid" foreign tax credit as provided in Section 902 of the U.S. Internal Revenue Code ("IRC"). In the case of adjustments initiated in a foreign country, recourse will be made to the mutual agreement procedure of the relevant tax treaty (the competent authority procedure). In 1988, the ONTA issued guidelines regarding the mutual agreement procedure with foreign com-

30. ONTA Regulations, Art. 11(2).
31. CTL-ED, Art. 93(2).
32. ONTA Regulations, Art. 13(1).
33. ONTA Regulations, Art. 13(2).
34. CTL-ED, Art. 94-2(1).
35. ONTA Regulations, Art. 13(3).
36. See ONTA Internal Guidelines.
37. *Id.*

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petent authorities in order to facilitate the use of the procedure by taxpayers.[38]

In case of adjustments initiated in Korea, a foreign corporation may seek a foreign tax credit if it is available under its own country's tax law. IRC Section 902, for example, provides for a foreign tax credit for tax paid by a subsidiary of a U.S. corporation. If double taxation is expected to result, the corporation may request the tax authorities of its home country to invoke the competent authority procedure for negotiation with the Korean tax authorities.

B. *Advance determination requests*

The ONTA previously announced that it would adopt an advance determination procedure under which a taxpayer could confirm the reasonableness of its proposed pricing method with the ONTA.[39] Such advance determination procedure, however, has not yet been implemented. According to an ONTA official, the ONTA determined not to adopt the advance determination procedure because of the expected administrative burdens on its limited resources.

C. *Simultaneous examination accord between U.S. and Korean tax authorities*

In June 1990, the U.S. and Korean tax authorities signed an agreement for conducting simultaneous examinations of tax returns.[40] The U.S. Internal Revenue Service has entered into such a working arrangement with nine other countries, including Canada, the United Kingdom, France, Germany, Italy, Japan, Sweden, Australia and the Philippines.

Under the agreement, each tax authority will separately examine taxpayers under its jurisdiction, but during each stage of the examination, they will exchange information in accordance with the U.S./Korea tax treaty. The tax authorities will use the information obtained in the exchanges to supplement the information submitted by the taxpayer. The agreement will increase the ONTA's ability to gather information relating to intercompany transactions between U.S. companies and their affiliated entities in Korea and may increase the risk of tax audits in Korea.

D. *Conformity with customs valuation*

Korean rules do not provide for conformity of transfer pricing with customs valuation. By contrast, the United States, in its 1986 tax reform added to the IRC a provision that the cost basis of property imported from related parties cannot exceed the value claimed for customs declaration purposes.[41]

The Korean Customs Law provides for methods of determining the customs value (or dutiable value) of imported goods based on the arm's length principle; these methods are similar to those prescribed in the transfer pricing rules.[42] Although there are no immediate indications that the Korean tax authorities would refer to the customs value in reviewing the appropriateness of the price in a foreign related party transaction, the customs value declared by the taxpayer would be a relevant factor in determining the arm's length price.

38. Enforcement Regulations Regarding Mutual Agreement Procedure with Foreign Competent Authorities Under Tax Treaties (ONTA Regulations No. 1006, dated 1 February 1988).
39. Draft Proposal of the Operational Regulations Regarding the Transfer Pricing Rules, Art. 8.
40. Working Arrangement between the United States Internal Revenue Service and the Republic of Korea National Tax Administration for the Conduct of Simultaneous Examination under the Terms of the Exchange of Information Provisions of the Convention for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the case of Income and Other Taxes, signed on 20 June 1990.
41. U.S. IRC, Sec. 1059 A.
42. See Customs Law, Art. 9.

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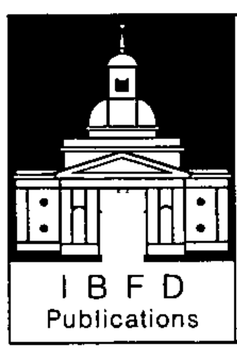

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HONG KONG

ENFORCEMENT

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I. ENFORCEMENT POSSIBILITIES IN GENERAL

A. *Taxpayer obligation to file timely return or declaration*

The taxpayer base is identified in the first instance, for employees, from notifications made by employers of the commencement of employment with that employer;[1] and for businesses, from the applications for registration of new businesses with the Business Registration Office.[2] The Business Registration Office is an integral part of the Inland Revenue Department.

Annual tax returns are issued to taxpayers by post to their recorded address. The return specifies the time allowed for its completion and lodgment with the Commissioner – usually one month in the case of taxpayers who are not represented by professional advisers. Accountants and other professional tax advisers are allowed a longer period to lodge their clients' returns. The length of the extension available depends on the annual accounting date of individual companies, but it can be up to seven and a half months after the end of the year of assessment concerned.[3] Further extensions beyond the standard period are not generally entertained, but will be considered in extenuating circumstances where there are genuine compliance problems outside the control of the taxpayer and his representative.

Notwithstanding that returns are, in general, mailed to taxpayers, neither the non-issue nor non-receipt of the relevant return excuses a taxpayer from fulfilling his obligations. Any taxpayer who has not received a return is required to give written notification of chargeability to the Commissioner not later than four months after the end of the year of assessment.

B. *Obligation of taxpayers to provide additional information*

The diverse nature of business operations makes it difficult to design a return that will apply in all possible circumstances. Returns, therefore, only require a minimum of information on the business and its owners, etc. to be completed within the body of the return itself. The balance of the relevant information is provided by way of supporting accounts and schedules, including, if appropriate, a computation to reconcile the accounting profits with those chargeable to tax. If a taxpayer files a substantially incomplete return, the assessor is empowered to reject it and require a more complete or further return to be made, depending on the circumstances.

On occasion the information contained within a return, while not incomplete, may require further clarification to determine the assessability or deductibility of a particular item. The assessor is authorized to seek further information in such situations. As a rule, these enquiries are made in a simple letter of request. However, if a taxpayer does not provide the full information or fails to reply within a reasonable time a more formal enquiry, citing both the authority for the request and the penalties for failure to comply with it, is issued.

C. *Obligation of third parties to provide information*

Third parties are required, if requested, to provide within a reasonable time relevant information in their possession or knowledge in connection with a taxpayer's obligations under the tax code. The scope of what can be requested is extensive and includes not only information and documents but extends to the production, for

1. Employers are under a statutory obligation to report commencement and cessation of employment of their employees.
2. All taxpayers are required to hold a Business Registration Certificate before they can commence business. Business Registration Certificates are renewed annually upon payment of the prescribed fee.
3. Taxpayers with accounts closing on 31 March are allowed up to 15 November to lodge their returns.

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examination, of deeds, plans, instruments, books, accounts, vouchers and bank statements. Essentially, any document which the assessor considers to be relevant to the issue under enquiry may be requested.

An Assistant Commissioner is authorized to give written notice to a taxpayer or any other person requiring attendance, at a time and place specified, to answer truthfully questions put in connection with either that person's or a third party's taxation affairs.

Government officers and employees of public bodies are, in general, subject to the same provisions as other taxpayers in respect of the provision of information. However, where a person is under an express statutory obligation to observe secrecy in respect of official information obtained by him in the course of his employment, then that person is absolved from having to disclose such information.

Hong Kong does not operate a withholding system or PAYE system of taxation in respect of employment income. Accordingly, all salaries tax is assessed on the basis of the returns lodged by the taxpayers. As an integral part of the verification process employers are required to report, on an annual basis, details of the chargeable emoluments of their employees.[4]

D. *Special protection for third parties*

No special provisions exist to provide special protection to accountants and banks. They are subject to the general provisions of the law and must provide relevant information in respect of an identified taxpayer when required to do so. The Department does not use its powers to obtain financial information at random and enquiries are confined to named persons only.

Lawyers are, in addition to the protection afforded to their clients by legal professional privilege, provided with a special concession in respect of accounts kept in relation to their clients' affairs. It is sufficient compliance with a request for information if a lawyer provides a certified true copy of all the relevant entries in his account in respect of the matters under enquiry.

When the subject of an enquiry to a lawyer is a land or property transaction, that lawyer's claim of privilege is statutorily overruled and cannot constitute a reasonable excuse for failing to comply with the notice concerned. Information requested in respect of property transactions is confined to names and addresses of parties to the transaction, considerationpaid and other similar relevant information.[5]

E. *Obligation to testify under oath*

In the normal course of raising an assessment, a taxpayer is not required to testify under oath – the most that he can legally be required to do is to answer truthfully questions put to him. However, once a dispute arises on the quantum of the assessable income, additional powers arise and the appellant taxpayer and connected third parties can be examined under oath.

For disputed assessments the Commissioner, the Board of Review[6] and the Courts all have the power to examine the taxpayer and other witnesses under oath. The power to examine under oath is used only infrequently by the Commissioner, but invariably by the Board of Review and the Court if the Court is hearing an appeal transferred to it from the Board of Review.[7]

In addition to the power to examine witnesses under oath the Commissioner, Board of Review and the Court can summon any person to attend the hearing to be examined on the matter under dispute. In a hearing before the Board of Review, the strict rules on the admissibility of evidence, as set out in the Evidence Ordinance and established case law, do not apply. The Board may admit or reject any evidence adduced, whether oral or documentary. As a matter of practice, the Board of Review closely follows the principles embodied in the rules of evidence. The Courts, on the other hand, strictly observe the rules. Subject to claims for privilege, where applicable, witnesses answering questions under oath are required to answer truthfully relevant questions put to them.

F. *Privilege precluding compelled testimony*

The established rules of professional legal privilege apply in respect of communications passing between a taxpayer and his legal adviser for the purposes of obtaining legal advice. Other than for privileged communications, a taxpayer cannot refuse, on the grounds of self-incrimination, to supply information reasonably requested by an assessor in the course of dealing with a taxpayer's affairs. In cases before the courts, the usual rules of evidence apply to protect privileged communications from disclosure.

When the Commissioner is personally of the opinion that a person has without reasonable excuse made an incorrect return, or supplied false information that has the effect of understating chargeable profits the Commissioner may, with the consent of the Board of Review, require that person to furnish a statement of assets and liabilities. The statement of assets and liabilities, which can be required for any period of time up to seven years prior to the commencement of the current year of assessment, must give details of the assets and liabilities of that person and his spouse in Hong Kong plus disbursements of funds, including overseas transfers, and other receipts and remittances.

If the Commissioner or a specified authorized senior officer, on oath, satisfies a magistrate that there are reasonable grounds for suspecting that a person has made an incorrect return or supplied false information and thus understated his chargeable income, or that a person has failed to comply with

4. This requirement is in addition to the requirement to report employees' commencements and cessations of employment.
5. Property conveyances in Hong Kong are, in general, processed by lawyers. Privilege claims in such situations would seriously impede the efficacy of taxing property trading transactions.
6. The Board of Review is an independently constituted tribunal consisting of persons with legal and associated backgrounds. Its function is to review, through the appeals system, decisions of the Commissioner which are disputed by taxpayers.
7. By consent, the Commissioner and taxpayers may agree to leapfrog appeals from the Board of Review to the High Court for hearing and determination.

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a court order to lodge a return or supply further information, the magistrate may issue a warrant authorizing access to and seizure of records from any place where it is suspected that documents and records material to the assessment of the taxpayer's affairs are held. Any person whose books and records are seized under a magistrate order is allowed, under the control of the Commissioner, reasonable access to those records for the purposes of examination and making extracts.

G. *Privileged communications*

In general, Hong Kong follows the U.K. practice in respecting the fundamental principle of legal professional privilege. Confidential communications passing between a legal adviser and his client may not be given in evidence if the communication was either for the client to obtain legal advice or it refers to a current or contemplated legal action involving the client. Legal professional privilege is not an implied term of the contractual relationship between the legal adviser and the client but a matter of public policy. This policy arises from the principle that for the perfect administration of justice and for the protection of the confidence which exists between a lawyer and his client, confidential communications passing between them shall not be subject to production.

In order to be privileged, the information must have passed between the client and the legal adviser in the course of that relationship, which must have been in existence at the time that the information was passed. Documents passed in any other capacity cannot give rise to a claim for privilege, notwithstanding that the recipient may have subsequently become the legal adviser to the person who tendered them.

The mere fact that a communication is between a client and a legal adviser does not render it privileged. In order for privilege to apply, the document must have been brought into existence for the purpose of obtaining legal advice. The purpose need not be for the sole purpose of obtaining legal advice, it is sufficient that obtaining legal advice is a dominant purpose. Documents are not privileged when they are neither confidential nor privileged in the hands of the client. The relationship between a tax adviser who is not a lawyer and his client, whilst involving a contractual duty of confidentiality, does not give rise to a claim for privilege.

H. *Compliance aspects of furnishing information*

Taxpayers who fail to furnish information sought by a simple written request for further information will be issued a formal notification requiring production of the stated information and documents. The notification will cite the provisions of the law authorizing the request, the time limit for compliance and the penalties for failing to comply.[8]

Any person who fails to comply with a notice to provide information may be charged before the court with an offence. The court, if the offence is proven, is empowered to impose a fine and to order compliance with the notice. The Commissioner may, before judgment is given, compound any offence and impose an administrative penalty[9] on the condition that the taxpayer fulfills his obligations. In practice, as an administrative expedient, taxpayers are generally invited to compound their offence in the first instance. Only where taxpayers continue to withhold information is resort had to prosecution in the courts. In the majority of circumstances, the administrative penalty imposed by the Commissioner is unlikely to exceed the penalty that would be expected to be imposed by the courts.

Taxpayers who have been ordered by a court to provide information or produce documents, and who fail to do so, will be prosecuted again for failure to comply with an order of the court. Prosecutions within this category are relatively few when compared with the total number of compound offers issued each year.

I. *Collection procedures*

The tax charged on any person must be paid in accordance with the instructions contained in the notice of assessment. Any tax unpaid after the expiration of the due date for payment is deemed to be in default and is recoverable through the court as a civil debt due to the Government.

Tax is payable notwithstanding that the underlying assessment is under objection or appeal. In normal circumstances, however, the Commissioner may allow tax in dispute to be held-over, until the dispute is resolved, conditionally upon the appellant furnishing security for the debt by providing a banker's guarantee or purchasing a Tax Reserve Certificate.[10]

Recovery of outstanding tax may be made through the courts or directly from the taxpayer's debtors. Third parties from whom arrears of tax may be garnisheed include taxpayers, bankers and employers. Where a third party pays over money to the Commissioner in compliance with a garnishee order, that third party is indemnified against all civil and criminal proceedings through having complied with the order.

In normal circumstances, an assessment cannot be issued to a person until the expiration of the due date for lodgment of his return. However, where it appears that the taxpayer is about to leave Hong Kong, or if for any other reason it is expedient to do so, the assessor may make the assessment at any time. Employers of individuals about to leave Hong Kong for a period exceeding one month are required to notify such impending departures. Upon receipt of such notifications, assessments are issued as a matter of urgency, and measures are taken to ensure payment of the tax due prior to departure.

J. *Penalties*

1. Failure to file a return

Any taxpayer who, without reasonable excuse, fails to file a return may be dealt with in one of two ways. The failure to file may be prosecuted through the courts as an offence. The

8. Maximum penalty is a fine of HK$ 5,000.
9. The scale of penalties in the great majority of cases falls between HK$ 400 and HK$ 3,000 depending on the size of the business and the history of previous offences.
10. Tax Reserve Certificates are certificates of deposit issued by the Commissioner of Inland Revenue. They are interest-bearing, but when used in dispute cases, only the amount, if any, subsequently refunded to the taxpayer bears interest.

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penalty upon conviction is a fine not exceeding HK$ 5,000 plus the imposition of an additional fine of up to treble the tax undercharged as a consequence of the failure to file. In most cases the Commissioner will, however, in the first instance, offer to compound the offence administratively by the taxpayer agreeing to file the return and pay a monetary penalty. This notwithstanding, it is departmental practice, where the taxpayer is thought to have chargeable profits, to issue an estimated assessment. The estimated assessment procedure is considered to be effective in the generality of cases because not only does it result in the outstanding return being lodged, but it also establishes due dates for the tax payable.

Estimated assessments, whilst they must be realistic and thus cannot be capricious, are raised taking into account known previous profits of the defaulting taxpayer, profit trends within the taxpayer's industry and the general economic climate. Objections by taxpayers against estimated assessments are only valid if supported by a completed return and related accounts.

The Commissioner is empowered to impose a penalty, administratively, of up to treble the tax assessed where a taxpayer fails to lodge a return.[11] This form of penalty action will be considered in more serious cases where there have been considerable delays in lodging returns and the tax involved is substantial.

2. Understatement of income

Penalties for understating income or over-claiming deductions fall within two broad categories – wilful intent to evade tax and making an incorrect return without reasonable excuse.

Any taxpayer convicted of wilfully evading tax is liable to a fine for each offence, not exceeding HK$ 20,000 plus a further fine of up to treble the tax undercharged and imprisonment for up to three years. Current sentencing guidelines issued by the courts indicate that, in the absence of mitigating circumstances, taxpayers convicted of wilful evasion face an immediate custodial sentence.

The standard of proof to obtain a successful conviction for wilful intent is high and, in most cases, taxpayers who understate their incomes are dealt with administratively. To be liable to an administrative penalty it is only necessary that the understatement be made without reasonable excuse – a much less onerous task than proving a wilful intention of evading tax.

When a decision is taken to penalize a taxpayer administratively for an alleged offence, the taxpayer must be given the opportunity to submit written representations in his defence prior to the penalty being imposed. After the imposition of the penalty the taxpayer, if he considers it to be incorrectly imposed or excessive, may appeal to the Board of Review to have it reconsidered. The Board of Review has the authority to confirm, reduce, increase or annul the penalty assessment, as it sees fit in the circumstances of the case.

Where an understatement of income can be demonstrated to be not due to a wilful intent to evade tax and if there is a reasonable excuse for the omission of the income or overclaims the deduction, there can be no question of any penalty being imposed.

3. Late payment of tax

Tax is payable in accordance with the instructions contained in the demand note. The demand note specifies the total amount payable, whether payment in two instalments is permitted and the due dates for payment.[12]

Any taxpayer who fails to make payments in accordance with the prescribed schedule will, if the default relates to the first instalment, have the option of paying by instalments revoked so that the whole of the tax will become immediately due and payable. In addition, a late payment surcharge of five percent of the total tax due will be imposed. Tax in default for more than six months is subject to a further surcharge of ten percent of the balance outstanding at that time.

K. *Scope of withholding tax*

The tax code does not contain any specific provisions for the withholding of taxes from payments to persons resident in Hong Kong. All taxes due are collected through the assessment process.

Non-residents carrying on business in Hong Kong are chargeable to tax in respect of their profits arising in or derived from Hong Kong. Thus, for example, non-resident entertainers and sportsmen who perform in Hong Kong are chargeable to tax in respect of the payments derived from such performances. In addition, non-resident persons not carrying on business in Hong Kong and without a physical presence here are liable to tax if they receive sums in the form of royalties or licence fees for the use of, or the right to use, in Hong Kong certain industrial or intellectual property. Such receipts comprise sums received from the exhibition or use of cinema or television film or tape, any sound recording, or any advertising material connected with such items and sums received for the use of, or right to use, in Hong Kong a patent, design, trademark or similar property, or for imparting knowledge connected with such item. These receipts are deemed to arise in or be derived from Hong Kong from a trade, profession or business carried on in Hong Kong.

Non-residents deriving profits from Hong Kong are chargeable either directly or in the name of their Hong Kong agent. Persons acting as the Hong Kong agent for non-residents are required to hold back sufficient funds out of the monies due to their non-resident principals to settle those principals' profits tax liabilities.

11. Previously the Board of Review considered that the benchmark penalty was 100 percent of the tax assessed. More recent decisions indicate that the appropriate penalty is 10-20 percent of the tax assessed.
12. The great majority of taxpayers are permitted to settle their tax liabilities in two instalments. Where instalments are available, the balance of the previous year's tax plus 75 percent of the current year's provisional tax is due for payment between January and March, with the balance of the provisional tax falling due for payment between April and June.

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Persons who sell goods by consignment on behalf of non-residents are required to lodge quarterly returns of their consignment sales with the Commissioner. At the same time, they are required to pay a sum, presently set at 0.5 percent of the value of the consignment sales, as the tax attributable to the profits on such sale.

L. *Interest on overpayments and underpayments*

Hong Kong operates a provisional tax system which requires the tax payable on the current year's income, estimated by reference to the previous year's income, to be paid concurrently with the derivation of that income. If actual income exceeds the estimated income upon which the provisional tax has been calculated, no interest is charged on the underpaid tax.

The provisional tax system has a self-assessment facility available whereby taxpayers who expect their actual incomes to be less than 90 percent of the income on which provisional tax has been assessed, may apply for a reduction in their provisional tax liability. No interest is paid on overpayments of tax refunded to taxpayers.

Taxpayers objecting to assessments may be required to purchase a Tax Reserve Certificate for the amount of the tax in dispute. Any interest paid on the principal value of the Certificates refunded to taxpayers is exempt from tax.

If, upon lodgment of an objection, a taxpayer elects not to purchase a Tax Reserve Certificate but, in lieu, is either given an unconditional holdover or permitted to furnish a banker's guarantee for the amount of the tax in dispute, interest will be charged upon the balance of the tax in dispute that is finally determined to be payable. Interest paid in such circumstances is not allowable as a deduction.

M. *Recordkeeping and reporting requirements for transfer pricing*

There are no specific provisions for recordkeeping or reporting requirements in connection with transfer pricing. As a relatively low tax territory,[13] transfer pricing arrangements have, to date, not been noted as causing concern. If anything, there has probably been a tendency for group pricing policies to transfer price profits into Hong Kong for assessment at the lower rates of tax rather than to transfer them out to higher tax jurisdictions.

To deter abuse of transfer pricing arrangements, the legislation permits the Commissioner to examine transactions between closely connected parties to ensure that transactions between them are conducted on a commercial basis. Should non-arm's length transactions involving a non-resident and a resident result in either no profits or a profit less than that which normally would be expected to arise in Hong Kong, that non-resident party is deemed to be carrying on business in Hong Kong and also becomes chargeable on his profits derived from Hong Kong. The Hong Kong resident is deemed to be the agent of the non-resident and is responsible for settling the tax so charged.

Expenses are deductible to the extent that they are incurred in the production of profits. If a Hong Kong taxpayer is considered to be paying an excessive consideration for goods and services to an affiliate located in a subsidiary located in a lower or zero tax jurisdiction, the first line of attack would be to disallow part of the deduction, to the extent that the excess consideration paid is not an expense incurred in earning chargeable profits.

For clearly non-commercial transactions where tax avoidance appears to be the predominant motivator of the arrangements, the anti-avoidance provisions would be brought to bear on the transaction.

II. INTERNATIONAL ASPECTS OF ENFORCEMENT ASIDE FROM TREATIES

A. *Special reporting requirements for international transactions*

Hong Kong's tax regime is based on bringing into charge, on a territorial source basis, income arising in or derived from Hong Kong. As such, the distinction between residents and non-residents is largely irrelevant. It follows then that there is very little in the way of special reporting requirements for international transactions.

In cases where non-residents are considered to have derived income from Hong Kong, often in passive forms such as royalties, use of patent rights, etc., the legislation contains specific provisions. Normally, it will deem a percentage of the income to be the profit attributable to Hong Kong, and then impose an obligation upon the Hong Kong party making the payment to also settle the attributable tax.

B. *Foreign entities subject to local jurisdiction*

Any foreign entity with profits arising in or derived from Hong Kong is subject to Hong Kong taxation on those profits. Where such foreign businesses have a physical presence here, they are required to register those businesses under the Business Registration Ordinance. Once so registered, they will be responsible for the administration of their own taxation affairs.

C. *Special extra-territorial legislation*

Section 6038A of the Internal Revenue Code requires a U.S. corporation or a foreign corporation engaged in a trade or business in the United States, if it is 25 percent foreign-owned, to maintain records of transactions with related parties. Except for taxpayers being required to disclose in their annual returns, whether they carried on business with a closely connected non-resident, Hong Kong has no similar specific reporting requirements in relation to transactions with non-residents.

U.S. taxpayers who consider that their tax position in accordance with general law is modified by a tax treaty are

13. Current rates of tax:
Salaries and unincorporated businesses – 15 percent
Corporations – 16.5 percent.

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required to disclose that position in their returns. Alternatively, if they do not lodge a return, they must file the claim in such form as is prescribed. Hong Kong does not have this type of reporting requirement. Any taxpayer that considers that certain income is not chargeable to tax excludes the amount, under cover of a relevant explanation, in the computation of his chargeable income.

D. *Special penalties and special procedures for foreign documentation*

No special penalties are applicable to the enforcement of non-resident taxpayers' responsibilities. Such taxpayers are only liable to penalties on the same basis as taxpayers in general. Hong Kong has no equivalent of Section 982 of the IRC.

III. TREATY ASPECTS OF ENFORCEMENT

Hong Kong has only one tax treaty. It is with the United States and its application is limited to the granting by the United States and Hong Kong of a mutual exemption from tax on the shipping profits of each other's shipowners. The treaty does not contain any provisions for the exchange of information, simultaneous examinations or collection of tax for the treaty partner. There are no other treaties, such as mutual assistance treaties or tax information agreements, which have any impact on the taxation obligations of taxpayers.

IV. SPECIAL PROBLEMS REGARDING ENFORCEMENT

A. *Problems with admissibility*

Hong Kong closely follows the U.K. position on the admissibility of evidence. Evidence is admissible if a court may properly receive and consider it for the purpose of determining a fact in issue. In order that evidence may be admissible, it must first be relevant. However, even if evidence is relevant, it must also satisfy the other rules of evidence both as to the type and manner in which evidence may be placed before the court. The concept of admissibility is primarily concerned with the nature of the evidence which is sought to be placed before a court and not its quality or probative value. Only in limited circumstances will the court consider the probative value of evidence in determining its admissibility. As a general rule, evidence which is relevant is admissible unless there is a specific rule excluding it.

The strict rules of evidence do not apply in a hearing of an appeal before the Board of Review, and the Board has the authority to admit or reject the evidence adduced. Notwithstanding that the strict rules of evidence do not apply to it the Board of Review has, over a long period of time, adopted a position on evidence closely following the accepted rules for cases prosecuted before the courts.

B. *Public court proceedings*

Board of Review hearings are held in camera and the general secrecy provisions of the local tax code are maintained. Decisions of interest and importance from the Board of Review are published in publications approved by the Attorney General. In all cases, the decisions are edited such that the identity of the taxpayer is not disclosed.

The normal rule for court hearings, based upon the openness of the judiciary system, is that all court cases are heard in open court. This is the situation with tax cases heard by the High Court and Court of Appeal in Hong Kong, and the Privy Council in London. It follows then that once a taxpayer takes his case beyond the Board of Review, the obligation to comply with the secrecy provisions no longer applies and the proceedings and decision are reportable.

It is not necessary for a taxpayer to be represented before either the Board of Review or the courts – he may conduct his own case. In hearings before the Board of Review, taxpayers may be represented by either their lawyer or tax adviser (who need not be a lawyer). If cases proceed to the courts, then any representative appointed by the taxpayer to conduct the case on his behalf must be a lawyer.

It is highly unlikely, in tax cases, that courts would favourably consider the issue of orders to protect secrecy.

C. *Distinction between tax and non-tax exchanges*

The law does not differentiate between tax exchanges and exchanges outside of taxation per se, in court proceedings. The only distinction that arises is in relation to privilege claims.

V. CRIMINAL ASPECTS

The only offences that may be prosecuted as criminal offences in Hong Kong are those where, with wilful intent, a taxpayer makes false statements, keeps false records and accounts and files false returns. Essentially, these are blatant evasion cases.

The burden of proof in a criminal prosecution is heavy as it must be proved beyond all reasonable doubt that not only did the defendant commit the offences, but that he did so wilfully with the intention of evading tax. Criminal prosecutions are undertaken not by the Commissioner, but by the Attorney General. However, prior to the commencement of any criminal proceedings against a taxpayer, the sanction of the Commissioner must be obtained.

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UNITED STATES

ENFORCEMENT

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I. BACKGROUND

The issues of transfer pricing and taxes paid by foreigners on U.S. income have attracted Congress's attention of late for a number of reasons. Concerned that foreign-controlled U.S. subsidiaries may be exploiting loopholes and avoiding taxes, Congress in recent years has enacted legislation to plug the leakage of revenue abroad. In addition, transfer pricing is related to questions of economic competition and fair trade. Grievances arising in these areas, particularly with regard to Japan, spill over into the transfer pricing and tax debate.

In June 1990, the Oversight Committee of the House Committee on Ways and Means, chaired by Congressman J.J. Pickle of Texas, investigated alleged underpayments by foreign corporations and their subsidiaries. Some of the statistics given in the hearings, and by the IRS Statistics of Income Division are as follows:

Foreign-controlled U.S. corporations

In 1985, the latest year for which figures on Pacific Rim activities in the United States are available, taxable income as a percentage of receipts for U.S. corporations controlled by Asian and Oceanic (including Australia and New Zealand) corporations was:

(1) for all Asian corporations – 1.9 percent
  (a) Hong Kong – 0.7 percent
  (b) Japan – 1.7 percent
  (c) South Korea – 0.1 percent
(2) for Oceanic corporations – 1.5 percent

Foreign corporations with "effectively connected" income

In 1985, taxable income as a percentage of receipts for foreign corporations' effectively connected activities was:

(1) for all Asian corporations – 2.0 percent
  (no per country breakdown available)
(2) for Oceanic corporations – 0.6 percent

Domestically-controlled U.S. corporations

By comparison, in 1985, domestically controlled U.S. corporations had a ratio of taxable income to receipts of 3.2 percent.

For the period 1984 to 1987, the IRS Statistics of Income Division determined that 56 percent of U.S. corporations declared profits as compared to slightly more than 40 percent of foreign-controlled domestic corporations. In 1987, foreign-controlled U.S. corporations reported an aggregate net income of US$ 5.6 billion, a significant increase over 1986 when all foreign-controlled domestic corporations reported a loss of $ 1.5 billion.

Assistant Secretary of the Treasury Kenneth Gideon has estimated that, if foreigners operating in the United States had a profit margin similar to U.S. persons operating abroad (directly or through a subsidiary), the U.S. Treasury would collect an additional $ 30 billion in taxes.

While other explanations, such as start-up costs and acquisition indebtedness, exist for the relatively low profitability of foreign operations in the United States, most of the attention in this area has focused on transfer pricing. Simply put, foreign corporations are suspected of deliberately overcharging their U.S. subsidiaries and branches in order to understate their U.S. income and tax liability. Because of the amount of money involved and the difficulty of the IRS in obtaining transfer pricing information in Section 482 examinations of multinational corporations, recent legislation and regulations has given the IRS a much stronger hand in policing and punishing corporations understating their income through transfer pricing.

The IRS has reorganized and expanded its international examination programme and is moving aggressively to assure compliance of multinational corporations with the tax laws. It now has the tools to do so.

II. IRS AUDIT PROGRAMME

A. *Coordinated Examination Programme ("CEP")*

CEP is a special programme for examination of large corporations. A CEP examination team consists of revenue agents and specialists such as an international examiner, an economist, an engineer revenue agent, an employment tax agent and a computer audit specialist, depending on the case and the issues involved. To improve the handling of large cases, a District Counsel lawyer may be assigned to render legal advice and provide expertise in selecting and developing issues but not to participate in the audit itself. The team is under the control and direction of the case manager.

A principal object of CEP is to resolve issues to the extent possible at the examination level. Ninety percent of CEP cases in the last ten years have gone to appeals. The IRS considers this excessive. In 1989, 1,570 CEP cases involving some of the largest domestic and foreign-controlled U.S. cor-

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porations were examined and tax deficiencies and penalties aggregating $ 10.8 billion were recommended.

CEP cases are selected on the basis of a point score. A corporation must be included if it is an industrial company with 12 or more points; if it is a financial institution, utility, insurance company, mutual fund or stock brokerage firm with 15 or more points; and a case may be included in the CEP programmeme although it does not meet the required point score where it is sufficiently complex and would benefit from a team examination.

Points are assigned on the basis of gross asset values, gross receipts, number of operating entities and number of personnel to be assigned and the estimated examination time required as follows:

(1)

Gross assets	*Points*
Up to $ 500 million	1
$ 500 million – $1 billion	2
$ 1 – $ 2 billion	3
$ 2 – $ 5 billion	4
Each additional $ 5 billion	2

(2)

Gross receipts	*Points*
Up to $ 1 billion	1
$ 1 – $ 2 billion	2
$ 2 – $ 3 billion	3
$ 3 – $ 5 billion	4
$ 5 – $ 10 billion	5
Each additional $ 5 billion	2

(3) *Operating entities* (each estimated to require 50 or more staffdays for examination).

Number of entities	*Points*
1	1
2 – 5	3
6 – 9	5
10 – 13	7
Over 13	9

(4) *Multiple industry status*: one point for each major, separate industry (such as a subsidiary, branch or operating division) involved which will require an estimated 100 or more staffdays for examination.

(5) *Team members and specialists*: one point for each.

(6) *Support work by other revenue agents*

Days	*Points*
0 – 49	0
50 – 99	1
100 – 149	2
150 – 199	3
Each additional 50 days	1

(7) *Total direct examination staffdays*: One point for each 125 staffdays of revenue agents and specialists planned for the examination.

The IRS is attempting to improve the CEP programme and expedite cases. There is excessive delay in examining tax years under the CEP programme. More than half of pending examinations involve returns from 1985 or earlier. The goal of the IRS is to become more current so that the examination will include a return that was filed within 18 months of the examination.

Recently, in an interview and in an address before an international trade association, the Executive Director of the IRS Office of Coordinated Programmes outlined some of the initiatives for improving the CEP programme. A formal document describing the new initiatives for CEP is being drafted and should be issued shortly.

Overall, the aims of the new initiatives are to secure voluntary taxpayer compliance so that less enforcement activity will be needed; early identification of recurring issues which may be settled or, if necessary, litigated or resolved by seeking legislation, or dropped if the IRS legal position is weak; and more current examinations.

There is an initiative being followed under which Appellate settlements or agreed issues might be carried forward to the current filed year. This would typically be accomplished by a closing agreement. There are more than 60 corporations participating in the programme at present.

Another approach under consideration which may apply "under very, very restricted circumstances" on "given, limited issues", allows a taxpayer during the examination process to have specific disputed issues referred to Appeals rather than wait until completion of the examination. This approach is being tested in two cases. The procedure would be part of a settlement process and may help in resolving at the Examination level lesser issues which are often kept open to be used as bargaining chips in an Appeals settlement. Apparently, Section 482 transfer pricing issues would lend themselves for this procedure. However, the IRS is trying to develop the parameters of the programme and is having a difficult time doing so.

The IRS will test in examinations of six taxpayers whether there is an advantage in examining a return 30 days after it is filed.

Until recently, Examination had authority to resolve factual issues only and could not reach settlement with a taxpayer. That function was vested in Appeals. Commissioner's Delegation Order No. 236, issued 7 November 1990, expanded Examination's functions by giving limited settlement authority to examination case managers (and their superiors) with respect to rollover and recurring issues in the CEP programme. Case managers may execute closing agreements and Forms 870-AD (in the past within the jurisdiction of Appeals only) to finally settle any rollover or recurring issue.

The case manager may settle rollover and recurring issues where a settlement on the merits was reached by Appeals with respect to the same taxpayer for a prior tax period. A rollover issue involves an adjustment arising from the same legal issue in the same transaction or taxable event and affects more than one tax period; for example, amortization or depreciation of an asset, bad debt losses and inventory adjustments.

A recurring issue involves an adjustment arising from the same legal issue in a separate transaction in which the taxpayer takes the same legal position with respect to the trans-

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action as he had in a prior period; examples include the method of depreciation with respect to similar assets, the use of the same accounting method with respect to similar transactions, computation of deductions such as depletion and certain tax credits.

As stated above, Examination settlements can only be reached when a settlement on the merits had been reached by Appeals in a previous tax period with respect to the same taxpayer and the same issue.

The IRS recently issued Rev. Proc. 91-22, IRB 1991-11, 11 which provides procedures for reaching agreement *in advance* as to a transfer price under Section 482 or a methodology for determining the transfer price which will apply for the future. It is recognized that this Advance Pricing Agreement (APA), which involves a complex and costly process, is feasible for a limited number of taxpayers. It remains to be seen whether the newly constituted APA programme will operate effectively and satisfactorily. The Executive Director of CEP has indicated that the IRS is considering whether the methodology which the IRS and taxpayer agree to use in the future might also be used to resolve similar issues in prior years.

The CEP programme is now being coordinated by a "National Policy Board" of top IRS officials which has been meeting monthly since October 1990 to determine policy and direction for the programme.

B. *Industry Specialization Programme ("ISP")*

The purpose of this programme is to promptly identify and develop industry-wide issues and insure that they are given uniform and consistent treatment nationwide. Studies are conducted to determine which industry should be selected as a "designated industry" with an IRS industry specialist to serve nationwide. Under supervision, the IRS industry specialist, located in the field, is available for consultation with the examination team. The industry specialist also monitors current industry trends and activities which may shed light on areas for future examinations. Case and group managers in CEP cases may call upon the industry specialist for possible solutions to audit problems and suggestions for audit procedures in CEP cases.

Where the examination of a taxpayer is subject to ISP, the IRS by letter to the taxpayer will furnish details about the programme and its purposes.

The industry specialist will check a CEP examination plan to ensure that coordinated issues (major issues of importance to an industry) are being considered. At present there are 85 industry issues and an attempt is being made to reduce the number, by settlement, revenue rulings or revenue procedure, or by litigation or legislation where appropriate.

The IRS has identified 23 industries to be covered under ISP and has pinpointed a number of issues within each industry for special attention (coordinated issues.) The designated industries at this time are aerospace; airline; commercial banking; commodities and financial products; construction; data processing, electronic components; farmers cooperatives; financial services; food; forest products; health care; leveraged buyouts; life insurance, media/communications; mining (study group); motor vehicles; petroleum; property and casualty insurance; railroad; retail; savings and loan; and utilities. The pharmaceutical and beverage industries were recently dropped as industry classifications. Also, Puerto Rican issues are no longer subject to special consideration.

C. *Economic Assistance Programme*

IRS economists are located in certain key district offices to assist the field and District Counsel offices. In particular, they are frequently involved in international transfer pricing issues under Section 482, valuing intangibles and assisting in determining royalty and commission rates. They conduct industry studies for the Industry Specialization Programme. The role of the economist in IRS has been expanding over the years. Litigation of Section 482 transfer pricing issues regularly involve the use of economists as expert witnesses by the taxpayer and the IRS.

D. *Foreign International Support Team ("FIST")*

Four attorneys from the Chief Counsel's Office in Washington, D.C. with expertise in international tax matters, give direction and guidance to field examiners and District Counsel in cases involving international issues so that they may be better developed during the examination stage and in the event of litigation. Different regions of the country have been assigned to three of the attorneys who are responsible for handling cases arising in their respective regions.

III. ENFORCEMENT AUTHORITY OF THE IRS

A. *Recordkeeping requirements*

Under IRC Section 6001 and Treas. Reg. § 1.6001-1(a), every taxpayer liable for tax (with certain few exceptions not relevant herein) must keep permanent books of account or records, including inventories, that are sufficient to establish the amount of gross income, deductions, credits or other matters required to be shown in a tax return. The general rule is that records must be retained so long as they may be material in the administration of an Internal Revenue law.[1] In general, the practical approach has been to determine the retention period based on the particular transaction reflected in the record. Initially, the statute of limitations on assessment has been used by some taxpayers as the starting point for measuring a retention period. But typically a longer period is required where supporting records beyond the statutory period are relevant in determining the tax effect of certain transactions. For example, this can mean that records with respect to the earnings and profits of a corporation may have to be maintained indefinitely.

B. *IRS general summons authority*

1. Scope

Under Section 7602, the IRS has investigative authority to examine any books, papers, records or other data and to take

1. Treas. Reg. § 1.6001-1(e).

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testimony "which may be relevant to the determination of tax liability". The Section 7602 mandate is subject to valid Constitutional or other privilege.

The test, provided by the Supreme Court in *United States v. Powell,*[2] for enforcement of an IRS summons, is that the IRS must show that the investigation will be conducted pursuant to a legitimate purpose; that the inquiry be relevant to the purpose; that the information is not already in the possession of the IRS; and that the administrative steps required by the Internal Revenue Code have been followed.

In *United States v. Arthur Young & Co.*[3], the Supreme Court pointed out that the relevancy test means that the IRS can seek information of potential relevance, regardless of whether that information may be admissible in Federal court. The Court explained that the IRS could hardly be expected to know whether the data it seeks will in fact be relevant until it is examined. Obviously, there is very little, if anything, of business records which may not be relevant to tax determination. Cases involving enforcement of IRS summonses are legion and have, among other things, required production of accountant's audit work papers, tax accrual work papers and internal audit reports. There is no accountant/client privilege under Federal law.[4]

An IRS summons is not self-enforcing. If a person fails to comply with an IRS summons, the IRS must seek enforcement of the summons by filing a complaint in a U.S. district court or the IRS could recommend to the Department of Justice that prosecution be instituted for willful failure to furnish information where the facts warrant, but this latter approach is rare. A person who fails to comply with a district court order to furnish information or testify may be punished for contempt.

2. Third party summons

The IRS has authority to summon not only the taxpayer but any person who has information or records which may be relevant to the determination of tax liability. A third party who is summoned has no legal duty to advise the taxpayer that a summons has been served nor is the IRS required to so notify the taxpayer except in the case of a summons to a "third party recordkeeper".

If a summons is issued to a third party recordkeeper, Section 7609 requires the IRS to notify the taxpayer that such a summons affecting the taxpayer has been issued. A third party recordkeeper is defined by Section 7609 to mean a bank or savings institution, consumer reporting agency, credit card issuer, broker, attorney, accountant, barter exchange and regulated investment company. The third party recordkeeper must produce records with regard to the taxpayer unless the taxpayer intervenes by bringing a proceeding to quash the summons in a U.S. district court. The district court order denying a motion to quash is a final appealable order. The running of the statute of limitations on assessment is suspended during the pendency of the taxpayer's action opposing enforcement of the third party recordkeeper summons.

The taxpayer who intervenes may assert any defense to the summons personal to him and also may assert that the summons is ambiguous, vague or deficient in describing the material sought or that the material is not relevant to the investigation. Generally, the taxpayer has a difficult burden in attempting to quash a recordkeeper summons.

Many foreign countries make it a civil or criminal violation to disclose financial information to foreign governments or foreign courts. Persons summoned by the IRS and subject to the jurisdiction of a U.S. court have frequently raised foreign bank secrecy laws in attempting to defend against summonses, generally without avail. The typical approach of the courts is to balance the interest of the United States in enforcing its revenue laws against foreign secrecy laws. Mostly, the courts have decided in favour of the U.S. interest, notwithstanding the hardship that might result on the summoned person because of the conflicting demands and constraint which may be involved.[5]

IV. PRINCIPAL IRS MEANS OF GATHERING INFORMATION

There is extensive authority that if a summoned party has custody or control over documents located abroad it can be forced to produce those documents. Consequently, a U.S. controlling parent may be compelled to produce the records of its foreign subsidiaries (or foreign branches). However, for many years the IRS was frustrated in its efforts to obtain foreign information or records in the case of a U.S. subsidiary controlled by a foreign parent. Frequently, such information was sought in connection with intercompany transactions usually involving pricing issues. Congress has responded with a number of recent legislative enactments which in practical effect are designed to provide access to the IRS of foreign records and information. Examples include Section 6038A which affords access to foreign records and testimony through a domestic subsidiary concerning intercompany transactions; Section 982 which makes foreign-based documentation inadmissible in litigation under certain circumstances; Section 6503(k) involving the issuance of a "designated summons" which will toll the running of the statutory period for assessment; Section 6662 imposing an accuracy related penalty on certain intercompany transactions subject to adjustment under Section 482; and Section 6621(c) increasing interest for large corporate underpayments. The effect of these legislative enactments to reach foreign documentation will become increasingly evident in due course.

A. *Information Document Request ("IDR")*

Although a revenue agent obtains substantial information orally from taxpayers, an IDR is a revenue agent's written

2. 379 U.S. 48 (1984).
3. 465 U.S. 805 (1984).
4. *Fisher v. United States,* 391 (1976); *United States v. Arthur Young & Co., supra,* note 3.
5. See *United States v. First National Bank of Chicago,* 699 F.2d 341 (7th Cir. 1983); *United States v. Chase Manhattan Bank N.A.,* 584 F.Supp. 1080 (S.D.N.Y. 1984); *Vanguard International Mfg. Inc. v. United States,* 588 F.Supp. 1229 (S.D.N.Y. 1984); *In re Grand Jury Proceedings (U.S. v. Field),* 532 F.2d 440, 532 F.2d 440, (5th Cir. 1976).

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request to the taxpayer for information, normally involving records. The revenue agent does not need the approval of a supervisor to issue an IDR. In general, there is no obligation on a taxpayer to create records that do not otherwise exist if the available records are adequate to determine tax liability, as provided under Section 6001. Section 6038A (discussed below) is an exception. Also, in view of the Section 6662 penalty for certain underpayments of tax, records may be advisable particularly contemporaneous records to justify transfer prices. If a taxpayer fails to comply with an IDR, depending on the facts an IRS summons may be issued or, particularly where foreign records are involved, stronger measures under Section 982 to be discussed hereinafter may be pursued.

B. *Forms 5471 and 5472*

1. Form 5471

A U.S. citizen or resident who is an officer, director or ten percent shareholder of a foreign personal holding company must file a Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations". Form 5471 is required to be filed by U.S. individuals, partnerships, corporations and trusts with five percent or more stock ownership in a foreign corporation. Certain persons who had control or owned stock in a foreign corporation for an uninterrupted period of at least 30 days during the tax year of the foreign corporation also must file. A penalty under Section 6038(b) of $ 1,000 for each failure to file the form may be imposed. If the failure continues after a notice is mailed by the IRS the penalty may increase to a maximum of $ 25,000 for each delinquent Form 5471.

2. Form 5472

This form, "Information Return of A Foreign-owned U.S. Corporation or A Foreign Corporation Engaged In A U.S. Trade or Business", must be filed by a domestic corporation if it is 25 percent foreign-owned or owned by a foreign corporation engaged in a U.S. trade or business. The purpose is to obtain information relating to transactions between the 25 percent foreign-owned domestic corporation, referred to as the reporting corporation, and any party related to either the domestic or foreign corporation. The 6038A, discussed below.

C. *Foreign recordkeeping Sections 6038A and 6038C*

1. Statutory requirements

In view of the difficulty of the IRS in examining international transactions particularly with respect to adjustments under Section 482 involving a U.S. taxpayer controlled by a foreign subsidiary, Congress amended Section 6038A in 1989 and 1990 and added Section 6038C in 1990 which applies to foreign corporations engaged in U.S. business.[6] Essentially, the legislation is designed to overcome jurisdictional impediments in enforcing summonses against foreign parents of U.S. subsidiaries (or with U.S. branches) and to insure that the IRS obtains access to foreign materials.

Under the legislation, a domestic corporation that is at least 25 percent owned by a foreign shareholder and a foreign corporation engaged in a U.S. trade or business (each referred to as a "reporting corporation") is required to maintain, or cause to be maintained, records prescribed by regulations from which the correct treatment of intercompany transactions with related parties can be determined by the IRS.

A "related party" broadly includes a 25 percent foreign shareholder (any foreign person owning 25 percent or more of stock (voting power or value) of the reporting corporation); a foreign or domestic entity related within the meaning of Sections 267(b) or 707(b)(1) to the reporting corporation or any 25 percent foreign shareholder; or any other person related to the reporting corporation within the meaning of Section 482. Certain attribution rules apply in determining whether a corporation is 25 percent foreign owned or is a related party.

Each reporting corporation is required to maintain records prescribed by regulations so that the IRS may determine the correct treatment of transactions between the reporting corporation and related parties. (The foreign record maintenance requirements under the proposed regulations will be referred to below.)

To overcome the contention that the U.S. subsidiary does not control its parent and therefore may be unable to produce foreign records, each foreign person that is a related party of the reporting corporation must appoint the reporting corporation as its agent to accept service of process in connection with an IRS summons for records or testimony about transactions of the related party with the reporting corporation. In this manner, related foreign persons not engaged in business in the United States are reached by an IRS summons through the reporting corporation.

Substantial penalties may be imposed for failure to comply with the requirements. Initially, a $ 10,000 penalty is imposed for each taxable year. If a failure to comply continues for more than 90 days after the IRS notifies the reporting corporation of the failure, an additional penalty of $ 10,000 applies for each 30 day period during which the failure continues after that 90 day period. There is no ceiling on the additional penalties that will be imposed for a continuing failure to comply. In addition, there is a severe "non-compliance rule" which authorizes the IRS unilaterally to determine (with very limited judicial review) the amount of any deduction or cost of purchases of the reporting corporation with respect to related party transactions based on any information which the IRS may have or may choose to obtain. Under the non-compliance rule, the IRC can determine that deductions or cost of purchases involving the related party have not been sufficiently supported and may disallow any part or all of the amounts claimed.

6. None of the provisions of Sec. 6038A amendments and Sec. 6038C are self-executing, but become effective in accordance with final regulations. At this writing proposed regulations have not been issued so that the above enacted statutory rules are not in effect. However, when the proposed regulations become final, they would apply retroactively.

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The legislation has been viewed by some foreign tax administrators as an objectionable infringement on the sovereignty of a foreign country and contrary to the spirit and intent of the exchange of information and mutual agreement articles of income tax treaties.

D. *Proposed regulations*

In December 1990, the IRS issued proposed regulations which describe the types of records which must be maintained, or caused to be maintained, by the reporting corporation. The proposed regulations make sweeping demands for foreign documentation. The proposed regulations apply to foreign-controlled U.S. corporations (Section 6038A) and to foreign corporations engaged in a U.S. business (Section 6038C). However, it is indicated that additional regulations under Section 6038C will be issued in due course. At a hearing held in February 1991, the proposed regulations were criticized as burdensome, unfair, discriminatory and unclear about the records needed for compliance.

A regulatory requirement provides for the maintenance of records that are "directly or indirectly related" to transactions with the reporting corporation (including records relating to dealings with respect to which the reporting corporation is not involved). This requirement could well go beyond the statutory authority of Section 6038A(b)(3) and at least it imposes an unreasonable extraterritorial burden.

The proposed regulations provide a "safe harbour" whereby the regulations are deemed to be satisfied if six categories of records are maintained by the reporting corporation. With respect to four of the categories, there is no requirement to create records that are not ordinarily created by the reporting corporation or its related parties, but if the records exist they must be maintained. However, records must be created with respect to two categories if they do not exist. These are basic accounting records and records to produce segmented profit and loss statements based on product lines, products or models. The safe harbour also includes an extensive "pricing documents" category that includes to the extent otherwise created "all documents relevant to establishing an appropriate price or rate for transactions between the reporting corporation and any foreign related party".

If the safe harbour is not elected, Section 6001 applies, extended to the records of foreign related parties that may be relevant to determine the correct treatment of transactions between the reporting corporation and foreign related parties. The safe harbour is clearly burdensome, and the scope of Section 6001 is uncertain.

The proposed regulations also provide a third regime. The reporting corporation and the District Director may enter into an agreement specifying what records the reporting corporation must maintain, how those records are to be maintained and by whom. The agreement primarily will cover records of foreign related parties. The particular agreement can deal with the material profit and loss aspect of the safe harbour or it may be more comprehensive. It remains to be seen whether such a procedure is effective in ameliorating the unnecessary burdens of the regulations as now proposed. It is questionable whether District Directors and field personnel (yet) have the expertise, confidence and inclination to assume responsibility for agreeing to significant departures from the regulatory list of records.

Final regulations are expected to be issued shortly.

E. *Formal document request and Section 982*

In addition to Sections 6038A and 6038C, the IRS can resort to the Formal Document Request ("FDR") procedure under Section 982 in attempting to obtain foreign records. If a taxpayer fails to furnish the information requested by a revenue agent in an IDR, the IRS may issue an FDR for foreign-based documentation. Foreign-based documentation involves any data outside the United States which may be relevant to the determination of tax and includes documents of a foreign entity whether or not controlled by the taxpayer.

The FDR procedure initially requires that the usual procedures for obtaining information (i.e. an Information Document Request) have been unsuccessful. The FDR must be sent by registered or certified mail and specify (i) the time and place for production of the documents; (ii) the reason the documentation, if any, previously produced is not sufficient; (iii) a description of the documentation sought; and (iv) the consequences of failure to comply with the request.

If a taxpayer fails to substantially comply with an FDR within 90 days after the FDR was mailed, then on motion by the government any court having jurisdiction of a civil tax proceeding involving the examined item may prohibit the taxpayer from introducing the foreign-based documentation covered by the request. The non-admissibility rule for unproduced foreign documentation does not apply where the failure to produce is due to reasonable cause. However, Section 982(b)(2) specifically provides that the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer or any other person for disclosing the documentation is not reasonable cause.

A taxpayer may bring a proceeding to quash the request within the 90-day period after mailing by showing substantial compliance.

The determination whether a taxpayer has substantially complied is to be made on an issue-by-issue basis. Therefore, if a taxpayer receives document requests concerning more than one issue, the failure to comply with respect to one issue will not prevent introduction in evidence of documents related to other issues with respect to which there was substantial compliance.

Whether a taxpayer has substantially complied will depend on all the facts and circumstances. For example, if a taxpayer provides nine of ten items requested by an FDR but fails without reasonable cause to furnish one requested item that appears to a court to be the most significant, a court may decide that there has not been substantial compliance and exclude all items.[7]

7. See the Conference Report (5 Rep. No. 97-530, 97th Cong., 2d Sess. 591).

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Where the taxpayer moves to quash, the IRS has the burden of showing relevance and materiality of the requested documents. There are no regulations promulgated with respect to Section 982. However, the Conference Report[8] provides that in determining whether there was reasonable cause for failure to produce the documents, a court may take into account whether the request was reasonable in scope; whether the requested documents or copies thereof can be found in the United States; and whether the place of production within the United States is reasonable. Minority status of a taxpayer in a corporation may be reasonable cause for the taxpayer's inability to produce foreign documents.

As noted heretofore, foreign non-disclosure laws are not reasonable cause for failure to produce documents. However, reasonable cause may excuse delay in production where, for example, the IRS requires translation of the requested documents.

Grounds to bring an action to quash may include the following: (i) the requested documents are not relevant to the tax issue; (ii) the place of production within the United States is unreasonable; (iii) the requested documents are available in the United States; (iv) there is reasonable cause for failure to produce or delay in production.

F. *Exchange of information pursuant to tax treaties*

An exchange of information article, contained in all U.S. income tax treaties with the possible sole exception of the treaty with the Soviet Union, implements the treaty purpose to combat tax avoidance or evasion by authorizing the competent authorities to furnish and exchange information to enforce their respective tax laws covered by the treaty. Obviously the exchange of information process can be of substantial benefit to the treaty countries in administering and enforcing their income tax laws.

1. Types of exchanges

IRS Internal Revenue Manual Section 42(10)(10).5-.(11) describes the information that generally may be exchanged under a tax treaty to include:

– *Routine*: Information exchanged routinely and automatically generally involving investment income received by a resident of one country from sources within the other country or with respect to withholding taxes on income paid to residents of the other country.

– *Specific request:* Specific requests by a treaty partner for information with respect to a person under tax examination by the requesting country.

– *Spontaneous:* The United States will furnish a treaty partner, without specific request, information discovered during the course of a tax investigation indicating non-compliance with the tax laws of a treaty partner. Such information may involve not only non-resident aliens and foreign corporations but also U.S. citizens and domestic corporations.[9]

– *Simultaneous examinations:* Under this programme, the United States has agreements with treaty partners, Canada, United Kingdom, France, Norway, Italy, Japan and Sweden to engage separately and simultaneously in an examination for the same taxable years of selected multinational taxpayers with related entities in their respective countries. Each country conducts its own audit of the taxpayer subject to its jurisdiction. The auditors of each country coordinate their plans, and in communicating with their treaty counterparts, U.S. examiners must limit themselves to discussing only the facts. Authority to negotiate issues under U.S. tax treaties rests solely with the Assistant Commissioner (International), as competent authority.

– *Industrywide exchanges:* The United States and treaty partner competent authorities may agree to an industrywide exchange of information to achieve a better understanding of worldwide operations of selected major industries and to obtain data on worldwide industry practices and operating patterns. The IRS Internal Revenue Manual Section 42(14)6.32(11) provides that an IRS industry specialist can assist in conducting simultaneous examinations and industrywide exchanges with treaty partners.

– *Exchanges of know-how:* Under this programme, information is exchanged on the patterns and operations of a selected multinational industry, examination techniques, training in various areas of tax law, and views on the role which specialists such as economists, computer audit specialists and engineers may play in tax examinations.

2. Limitations on information available under exchange of information article

Many of the U.S. exchange of information provisions contain a "mutuality clause" providing that a contracting state is not required to carry out administrative practices that are at variance with the laws of either that state or the other contracting state. Many tax treaties provide for limitations on furnishing information involving trade and business secrets.

3. Treaty summonses

Also, under the exchange of information provisions of a tax treaty, the IRS can summons a U.S. entity to furnish information requested by foreign tax authorities in connection with a foreign tax investigation even though the United States has no interest in the investigation and no U.S. income tax liability is indicated.[10] In fact, the U.S. Supreme Court has held that the domestic restriction imposed under Section 7602(c) that no IRS summons may be enforced with respect to a person whose case has been referred to the Department of Justice does not preclude enforcement of an IRS summons issued pursuant to a tax treaty request for information even if the foreign tax investigation has reached a stage analogous to a Justice Department referral. The Court held that the treaty summons should be enforced because Section 7602(c) was intended by Congress to apply to summonses involving possible violations of the U.S. revenue laws and not to IRS summonses issued at the request of a treaty country investigating possible violations of its own tax laws.[11]

8. *Id.*, at 529.
9. See IRM 42(10)(10).(11).
10. *United States v. A.L. Burbank & Co. Ltd.*, 525 F.2d 9 (2d Cir. 1975).
11. *United States v. Stuart*, 489 U.S. 353 (1989)

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At times, the IRS has found that the exchange of information provisions did not work to its satisfaction. In the matter of *X v. The Federal Tax Administration*[12], the Swiss Federal Supreme Court held that under the income tax treaty with the United States, the Swiss tax authorities could furnish the IRS bank information where there was a suspicion of tax fraud. However, the information as furnished was not in a form admissible as evidence in the U.S. courts. The IRS then requested the information in admissible form but this time the Swiss Federal Supreme Court held that the exchange of information provision provided only for the furnishing of information but not evidence necessary under U.S. laws.[13]

Presumably in the light of this experience, the 1981 U.S. model treaty provides in Article 26 that if a competent authority specifically requests, the information is to be furnished "in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other state with respect to its own taxes". Several of the newer U.S. income tax treaties include such a provision.

4. Multilateral Convention for Exchange of Information

Until recently, exchange of tax information by treaty necessarily was on a bilateral basis. However, exchanges on a multilateral basis may soon be possible. A Convention on Mutual Administrative Assistance in Tax Matters drafted by the Council of Europe and the OECD has been ratified by the United States. The treaty is open to member countries of the Council of Europe and of OECD. These include most of the developed countries of the world. This multilateral treaty provides for more extensive exchange of information than occurs under many bilateral treaties. The treaty must be ratified by five countries to be effective. It has been ratified by Sweden, Norway, and the United States. Finland and the Netherlands have signed but not yet submitted instruments of ratification at this time. Once all five have ratified the treaty, it will come into force with respect to them.

The treaty lists six forms in which information may be exchanged, namely:

- on request with respect to a particular person or transaction;
- automatically with respect to mutually agreed upon categories of cases;
- spontaneously, where without prior request information is volunteered about a tax matter of interest to the receiving country;
- in a simultaneous tax examination where each country concurrently examines a taxpayer and may exchange relevant information;
- in a tax examination abroad where one state requests that its representative be present for an appropriate part of a tax examination conducted by the requested state; and
- in the case of conflicting information a party which furnishes information is to be advised by the receiving party where such information conflicts with information which the receiving party possesses.

Also, the parties can exchange information in a form other than as above described.

The information to be exchanged must be "foreseeably relevant" to the administration and enforcement of the tax laws and to the prosecution before an administrative authority or judicial body. A U.S. citizen or resident who is the subject of requested information will generally be notified in advance about the request so that the U.S. taxpayer may take up with the U.S. competent authority whether the exchange is consistent with the requesting state's laws or administrative practice. Secrecy restrictions will apply to the exchanged information.

A requesting state may specify the form in which it wishes the information to be supplied and the requesting state must supply the information or data in the form requested if it is in position to do so. This latter provision could assure that information would be furnished in a form admissible as evidence in a U.S. judicial proceeding.

G. *Designated summons and penalties available to the IRS*

1. Designated summons – Section 6503(k)

A "designated summons" issued by the IRS with respect to a corporate return will toll the statutory period for assessment until such time as there is a final resolution with respect to the summons. A designated summons must be issued at least 60 days prior to the expiration of the assessment period, including extensions. The IRS can issue a designated summons only once for any tax return of a taxpayer. The statute of limitations is also suspended if a court proceeding with respect to any other summons issued within 30 days of the designated summons is ongoing so long as the subsequent summons pertains to the same tax return as the designated summons. The practical effect of the designated summons is to give the IRS unilateral control over the statutory period for assessment.

H. *New Section 482 penalties – Section 6662*

A 20 percent accuracy related penalty applies to substantial understatement of tax attributable to a Section 482 transfer price adjustment for a taxable year that exceeds $ 10 million, or where the price of property or services (including royalties) in any transaction between related entities is 200 percent or more, or 50 percent or less, of the correct amount as determined under Section 482.[14] Where the transfer price claimed on the return is 400 percent or more, or 25 percent or less, of the correct transfer price, or the net Section 482 adjustment exceeds $ 20 million, the penalty is doubled to 40 percent.[15] The penalty will not apply to understatements that are due to reasonable cause.

12. Reported in 71-I USTC 9435.
13. See Michael Edwardes-Ker, ed., "The International Tax Treaties Service", OECD Income Article 26, at 11-13.
14. Sec. 6662(e).
15. Sec. 6662(h).

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I. *Interest on large underpayments or "hot interest" – Section 6621(c)*

With respect to any corporate underpayments that exceed $ 100,000 for any taxable period, the interest rate is increased by two percentage points over the normal underpayment rate. The increased rate only applies for the period after a 30-day letter or 90-day letter is sent to the taxpayer

J. *Additional means for IRS to acquire foreign evidence*

1. Letters rogatory

The IRS may request a U.S. attorney to petition a U.S. court to issue a letter rogatory to a foreign court requesting documents or to depose a witness in the foreign jurisdiction. A letter rogatory may be transmitted from one court to another court unless the foreign country requires that the request be submitted formally through diplomatic channels. The authority of a court to sent a letter rogatory stems from its inherent powers and not from a statute. A letter rogatory may be granted on the basis of the comity that ordinarily exists between nations. A letter rogatory seeking documentary evidence or requesting the taking of a deposition may be issued prior to indictment in a criminal case. Where a deposition is involved, the taxpayer subject to the criminal investigation must be notified and has the right to be present at the deposition.

Because the letter rogatory process generally is slow-moving, Title 18 USC Section 3292 was enacted as part of the Comprehensive Crime Control Act of 1954 to provide that the statute of limitations is suspended for up to three years for any delay relating to an official request for evidence located abroad.

K. *Mutual assistance treaties in criminal matters*

The United States has entered into mutual assistance treaties by which the designated competent authority of each country may obtain legal assistance directly from the other country's central authority. The Attorney General of the United States or his designee is the competent authority for the United States. The United States has entered into mutual assistance treaties with Switzerland, the Netherlands and Turkey and has signed proposed mutual assistance treaties with other countries including Canada, the Cayman Islands and the Bahamas but these treaties have not been ratified.

Legal assistance available under the mutual assistance treaties is broader and more far-reaching than that under tax treaties. For example, the U.S.-Swiss treaty provides for legal assistance in compelling witnesses to testify and produce documents and records unless a privilege under the law of either country applies. Assistance can be provided in locating persons, executing a request for search and seizure, or service of process and authenticating official records and documents. Since the treaties differ in some respects, each treaty should be consulted to determine its coverage.

L. *Grand jury and trial subpoenas*

With increasing frequency, the IRS has succeeded through the U.S. attorney in obtaining grand jury and trial subpoenas for production of banking, financial and business records and other evidence located in a foreign country where the material is under the control of a person or entity within the court's jurisdiction.[16]

V. CONCLUSION

The IRS is now armed with powerful weapons to compel production of foreign documentation and it has a vigorous international enforcement programme underway. Intercompany transactions of multinational corporations are being subjected to special attention because the IRS believes they will yield the greatest return of tax deficiencies, particularly in the case of foreign-controlled U.S. subsidiaries.

16. See *Marc Rich & Co. A.G. v. United States*, 707 F.2d 663 (2d Cir. 1983); and *In re Grand Jury Proceedings (United States v. Field)*,530 F.2d 404 (5th Cir. 1976); *In re Grand Jury Proceedings (United States v. Bowe)*, 694 F.2d 1256 (2d Cir. 1982); and *In re Grand Jury Proceedings (United States v. Bank of Nova Scotia)*, 691 F.2d 1384 (11th Cir. 1982).
In *Marc Rich*, the court found jurisdiction with respect to the corporation and imposed a $ 50,000 per day fine for failure to comply with the subpoena. In *Field*, a non-resident alien was subpoenaed while he happened to be in the United States.

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SINGAPORE

INPATRIATE TAXATION

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I. INCOME TAX

A. *Introduction*

There is only national level income tax and no state or local income taxes. The taxation of income in Singapore is on a territorial basis, that is, income is taxable when it accrues in or derives from Singapore. Income from sources outside of Singapore is taxable only when it is received in Singapore by a resident individual. Capital gains are not subject to tax in Singapore.

B. *Residency status*

The extent to which an individual will be taxed in Singapore depends upon his residency status. For tax purposes, individuals are classified as either resident or non-resident.

A resident is a person who resides in Singapore and includes individuals who are physically present or are working (other than serving on the board of directors of a Singapore company) in Singapore for 183 days or more during the year. Reasonable temporary absences will not affect residency status. A non-resident is a person who is not a resident according to the preceding rules.

Physical presence in Singapore for 183 days or more in the calendar year automatically constitutes residence for tax purposes. However, presence for a lesser period may still be regarded as residence if it is the expatriate's intention to establish residence in Singapore. The practice of the Inland Revenue is to treat an individual as resident if the period of stay in Singapore spans three consecutive calendar years. For instance, assume an individual starts employment in Singapore on 1 September 1989 and leaves on 15 February 1991. The tax authorities would regard the individual as resident for the years of assessment 1990, 1991 and 1992, even though in 1989 and 1991, the taxpayer's physical presence in Singapore would be less than 183 days in each calendar year.

C. *Scope of tax*

Individuals resident in Singapore for tax purposes are liable to tax on all income derived from or accruing in Singapore, and all income derived elsewhere, but received in Singapore from outside Singapore (that is, remitted to Singapore). Non-resident individuals are liable to Singapore tax only on income derived from or accruing in Singapore and are not liable to tax on income remitted to Singapore.

If an individual's employment requires the performance of duties outside of Singapore for a non-Singapore entity, such as regional supervision, the remuneration in respect of the duties performed outside of Singapore may be considered non-Singapore-source income. In this case, where the employment covers the whole year, a resident individual would be taxed on the greater either of the time spent in Singapore divided by 365 times the total remuneration or of the total remuneration received in Singapore.

D. *Area representative status*

While the Singapore tax authorities have in concession accepted this concept of taxation, commonly known as the "area representative basis", they impose the following stringent conditions:

- Individuals must perform their duties in various locations in the region besides Singapore.
- Individuals must be employed by a non-resident employer who has no permanent establishment in Singapore. (This requirement has been relaxed recently).
- The employment costs relating to non-Singapore duties must not be borne by or charged to the accounts of the Singapore permanent establishment.
- Individuals must have a written contract of employment or a letter of assignment stating the specific duties to be performed both within and outside of Singapore.

While the second and third conditions are interpretations by the tax authorities which may not be conclusive, in practice the Inland Revenue will insist that the following information be supplied:

- details of the individual's duties both within and outside of Singapore and the company/companies for which such duties are performed, together with a schedule of absences from Singapore;
- the business nature of the non-resident employer and the Singapore company to whom the employee is assigned;
- whether the salary, allowances and office expenses are charged to the accounts of the Singapore office;
- the contract of employment or letter of assignment with respect to the Singapore employment.

In the case of resident individuals, where the area representative basis is claimed, income attributable to non-Singapore duties must be received outside Singapore and not remitted to

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Singapore in order not to be subject to tax on such income in Singapore

E. *Gross income*

1. Employment income

Individuals are assessed on all "gains or profits from any employment". This term includes all remuneration paid or granted to the employee either in cash or in kind, including the value of food, clothing or lodging provided or paid for by the employer.

Certain items of compensation are accorded special treatment. Examples are:

Home leave airfare: only 20 percent of home leave cost is taxed as income to the employee. This concession covers one return passage per year to the home country for the employee and the spouse, and two passages a year for each child. Where the company has been granted special status such as pioneer status, home leave is tax- exempt.

Housing provided by employer: where accommodation is provided by the employer, for example, if rent is paid by the employer, the amount assessable on the employee as the value of accommodation is limited to the lower of ten percent of Singapore employment income or actual rent paid. If a rent allowance is paid in cash to the employee, the whole of the cash allowance is included in Singapore earnings and is taxable. Where the accommodation is furnished, certain nominal values, ranging from S$ 5 – S$ 30 per month, are imputed for the use of the furniture, fittings and equipment. Where housing provided to directors costs more than their remuneration, the ten percent rule does not apply.

Automobile provided by the employer: with regard to an employer-provided automobile, the taxable benefit is, in practice, calculated at S$ .10 per mile travelled for any purpose other than business if the employee pays for the gasoline, or S$ .30 per mile if the employer pays for the gasoline.

Other payments in kind: with regard to payments in kind, generally, the cost incurred by the employer is used to calculate the taxable benefit.

2. Investment income

In the case of a resident, income from investments – such as interest and dividends from Singapore sources or remitted to Singapore – is taxable. Capital gains are not taxable in Singapore. Investment income of a non-resident from a non-Singapore source is not taxable in Singapore, whether or not remitted.

3. Major deductions

Personal allowances (available to residents only)

Self	S$ 2,000
Earned income	
Age 54 and below	1,000
Age 55 and below age 60	3,000
Age 60 and above	4,000
Wife	1,500
Dependent children	
First child	1,500
Second child – an additional	1,500
Third child – an additional	1,500
Fourth child (born on or after 1 January 1988) – an additional	1,500

There is special relief for children educated overseas and children of families meeting certain qualifications.

4. Life insurance premiums and pension contributions

Approved life insurance premiums and pension and provident fund contributions are usually deductible up to a maximum of S$ 5,000 per year, including Central Provident Fund ("CPF") contributions. Where CPF contributions exceed S$ 5,000, the full amount of the CPF is deductible. For employees earning total wages exceeding S$ 100,000, special rules apply.

For every individual employed in Singapore, the employer must contribute 31.5 percent of the employee's monthly salary with a maximum contribution of S$ 2,370 per month to the CPF. The employer can recover 23 percent monthly from the employee through payroll withholding. There is no ceiling on contributions for special compensation, such as bonuses and tax reimbursements, except in the situation where an individual's total wages exceed S$ 100,000. The employer's contribution is not taxable to the employee when withdrawn, provided the amount contributed does not exceed the statutory rate. The recent Singapore Budget proposed increasing the total CPF contribution to 40 percent of monthly salary (maximum S$ 2,400 per month) of which 22.5 percent can be recovered from the employee (effective 1 July 1991).

For the following expatriates employed in Singapore, application for exemption may be made as soon as possible from the date employment begins in Singapore:

- those provided with social security/pension/provident fund programmes by their home countries or their employers;
- those in Singapore on short-term assignments of not more than six months;
- those employed by a foreign company before arrival in Singapore and employed by the same company or group of companies in Singapore;
- any other employees who are not considered to be in need of old-age protection in Singapore.

Generally, individuals are allowed to withdraw from the CPF the amount credited to their account upon meeting any of the following requirements: the individual has reached age 55; the individual, who is not a citizen of Singapore, has permanently left Singapore with no intention of returning; or the individual is mentally or physically unable to continue employment.

F. *Rates of tax*

1. Non-residents

Income that is derived from employment performed in Singapore for not more than 60 days in the year of assessment by a person who is in Singapore for a temporary purpose and who is not resident in Singapore in that year of assessment is

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tax exempt. For a non-resident employee who is in Singapore from 61 to 182 days in the year of assessment, tax is imposed at a flat rate of 15 percent on employment income or the amount of tax payable by a resident in the same circumstances, whichever is greater.

Directors' fees earned by non-resident directors of companies are taxed at 31 percent. Non-residents who derive Singapore-source income other than from employment are also taxed at 31 percent on such income.

2. Residents

Residents are taxed at graduated rates which range from 3.5 percent to 33 percent.

G. *Filing of tax returns and payment of tax liability*

The tax year, known as the year of assessment, is the calendar year. The tax assessment is based on the preceding year's income.

Normally, annual tax return forms for individuals are issued by the Comptroller of the Inland Revenue by the end of January in the year of assessment. The completed return must be filed within 21 days of the date on the face of the return. However, an extension for filing is generally granted for two to three months.

The tax return is a declaration of the gross income and deductions of the taxpayer. Based on this declaration, a tax assessment is issued by the government. Most assessments are issued in March, April and May in response to filed returns, or estimated assessments, where no returns have been filed.

A person's tax liability must be paid within one month from the date of the notice of assessment. Instalment payments usually can be arranged if required. The maximum number of instalments is 12, beginning from January. An interest charge of five percent is imposed if tax is not paid on the due date. An additional penalty is charged at the rate of one percent for each complete month; the tax unpaid is subject to a maximum of 17 percent overall penalty.

A spouse may elect that earned income, as well as income arising from investments made out of such earned income, be taxed separately from the other spouse.

Employers are not required to withhold tax from employees' earnings, unless instructed by the Inland Revenue to do so in specific cases. Where the employer is not incorporated or registered in Singapore, the employee may be required to furnish a letter of guarantee from a locally established company or bank to cover the estimated tax liability for the next year's assessment.

H. *Individuals leaving Singapore*

Singapore does not tax its citizens on their worldwide income and there is no differentiation in general terms between citizen and non-citizen. An individual leaving Singapore permanently to take up residence elsewhere would therefore be treated as a non-resident from the end of the year in which he leaves and would be subsequently subject to Singapore taxation only on income which arises or accrues in Singapore.

There are no ongoing commitments to social security taxes on leaving Singapore unless exceptionally a Singapore citizen continues to be employed by a Singapore resident employer. In those circumstances, if the employment were a Singapore employment, there would be an ongoing commitment to make payments to the CPF (see above).

Singapore imposes its income taxes solely on the basis of residence which is defined either on the basis of days present in Singapore or on the place of abode (see above). Residence is determined on an annual basis.

On return to Singapore, any income accrued prior to the commencement of the tax year of return but received subsequently in Singapore would be taxable in Singapore if the source of income giving rise to the offshore income existed in the year of assessment in which the income is received in Singapore. Where, however, the source of income had ceased in a prior year then the subsequent receipt here would probably not be subject to Singapore tax. This matter is not, however, free from doubt. Singapore income tax is imposed on a realized basis and accrued income would generally not be subject to income tax.

I. *Individuals moving into Singapore*

Following the territorial basis of taxation, the service income of a non-Singapore tax resident would only be taxed in Singapore if the source of the service income is located in Singapore. The residence tests for income tax purposes are set out above. These rules are modified by Singapore's double tax treaties ("DTAs") which broadly follow the OECD model. In respect of employees, the DTAs usually reserve for Singapore the right to tax director's fees arising from a Singapore company regardless of the tax residence of the recipient. Employee's remuneration earned by a tax resident of a treaty partner country are free of Singapore tax provided that the following conditions are met:

- the employee is resident in Singapore for 183 days or less in the tax year;
- the services are performed for or on behalf of a resident of the treaty partner country;
- the remuneration is subject to tax in the treaty partner country; and
- the remuneration is not directly deductible from the profit for Singapore tax purposes of a permanent establishment in Singapore.

In the case of a dual resident of Singapore and another tax treaty country, residency is decided in the following manner. For the purposes of the treaty, the individual is considered resident in:

- the contracting state in which he has a permanent home, failing which
- the country in which his vital interests predominate, failing which
- the country in which he has an habitual abode, failing which
- the country of which he is a national, failing which
- the matter would be decided by the competent authorities.

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Dual residence has no significance for Singapore tax purposes apart from the specific purposes of the tax treaty.

J. *Temporary employees*

These rules vary from treaty to treaty and reference to the specific treaty is required in each case. There are no specific favourable tax rules for foreign employees working in Singapore on a non-permanent basis. However, employees spending less than 60 days in Singapore in the tax year who are not otherwise tax resident would normally be exempt from Singapore tax on their employment income. These rules do not apply to directors' remuneration.

There is no general social welfare system in Singapore other than contributions to the CPF described above. For unskilled labour, there is a Foreign Workers Levy payable by the employer in which case, the CPF contributions would not apply. Singapore's DTAs do not give any exceptions from the CPF or Foreign Workers Levy payment. As explained above, however, most expatriates can opt out of CPF contributions.

Investment income from a foreign source is only taxable in Singapore if the income is received in Singapore. Most employees therefore take great care to ensure that foreign income remains offshore. Most of Singapore's tax treaties only give tax treaty benefits where the income is actually remitted to Singapore. In some instances, it is preferable to remit the income into Singapore and suffer Singapore tax than suffer withholding taxes in the source location. This will of course depend upon the level of taxation in each country and the precise terms of the treaty. Income received from abroad is taxed on exactly the same footing as income arising in Singapore.

The tax reporting requirements are set out above. In addition, there are two other specific reporting requirements relevant to the expatriate. The employer of the expatriate is obliged to notify the Inland Revenue Department ("IRD") of the commencement of the employment. Even if this is not done, the IRD are given copies of the employment passes issued by the Immigration Department and are therefore notified of new commencing employment. An expatriate requires an employment pass before being able to take up employment in Singapore.

There is also a tax clearance procedure which requires employers to notify the IRD 30 days before the termination of an employment of an expatriate. The employer is also obliged to withhold all payments due to the employee until he is authorized to release them by the IRD or until 30 days have elapsed from the receipt of such notice by the Controller of Income Tax. Failing to comply with this requirement will render the employer liable for any unpaid tax by the employee.

II. TAX PLANNING

Singapore taxes employment income on the earnings basis. That is to say, income is subject to tax in the year in which it is earned and not the year in which it is paid. Therefore, any income earned by the employee prior to his departure but paid subsequently would be still be subject to Singapore income tax. Furthermore, the reporting requirements set out above would require the employer to notify the IRD that such late payment was being made and would be obliged to withhold the funds until the IRD had given tax clearance.

The taxation of stock options is the subject of specific legislation which provides broadly that where stock options are received by reason of any office or employment held by the employee then the profits or gains will be chargeable to income tax when the option is exercised. The amount of profits will be the difference between the open market value of the stock at the date of the exercise and the amount paid by the employee for the option and stock. Therefore, where stock options derive from the exercise of a Singapore employment, they should fall within the scope of Singapore income tax. However, where the stock options themselves are in an overseas parent company and they are exercised after the date of departure from Singapore, any profits or gains may escape Singapore tax as there could well be no one in Singapore with any knowledge that such options had been exercised and there would be no obligation on the employee after he has departed Singapore to file a tax return. This is an area in which careful attention would be required and specific advice needed.

Pensions are assessed on exactly the same basis as employment income. An individual who is neither resident in nor a citizen of Singapore who receives income by way of pension from Singapore will be entitled to a proportion of his personal reliefs based on the ratio of Singapore pension to world income.

Although payment of tax on income from employment is normally the employee's responsibility, the Inland Revenue have the power to make directions so that the employer retains and pays over the tax to the Inland Revenue. Such directions would normally be made where the income arises to a non-resident. In addition, there is a withholding tax requirement of 31 percent for directors' fees.

A. *Tax cost of assets*

As there is no tax on capital gains, it would not normally be relevant to ascertain the tax cost of assets owned by the individual. This would only apply when the individual is importing assets on which he wishes to claim tax depreciation or assets used for the purposes of a trade. These would require specialist's advice outside the scope of this article.

B. *Tax planning prior to arrival*

Most income tax planning for individuals will focus on Singapore's territorial basis of taxation and freedom from Singapore tax on any income which arises offshore to Singapore. Investments should be moved, where possible, to a low tax jurisdiction and the income element segregated from the capital element to facilitate later remittance into Singapore, if necessary. For example, where there are significant cash deposits in a money market, it would be possible to open a money market deposit account with a Hong Kong bank, the interest on which is mandated into a separate interest account. The funds in the interest account would constitute

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income and should not be brought into Singapore; they can be used for offshore spending. The original capital lodged in the money market account is kept clean and can be brought into Singapore free of tax as capital should the need arise.

Turning now to employment income, an individual who is employed in Singapore by a subsidiary or branch of an overseas company is normally assessable to Singapore tax on the total emoluments from this employment notwithstanding that he may spend part of his time overseas in the performance of duties on behalf of the overseas company.

It may, however, be possible to have separate (or dual) contracts catering for a segregation of duties where the employee can be paid by more than one company. The salary paid by the overseas company under the separate contract and in relation to offshore duties would not be assessable to Singapore tax provided that:

- it is not remitted to or received in Singapore; and
- the duties provided in the separate contract are exercised wholly outside Singapore; and
- the salary expense is not recharged by the overseas company to its branch or subsidiary in Singapore.

These rules provide scope for arranging for the offshore contract to be in a location where it would not attract any overseas taxes and therefore could be received tax free. Such arrangements are, of course, only possible where the employee concerned travels extensively during the course of his duties and the dual contract arrangements fully reflect the commercial reality.

Singapore tax legislation provides very few tax shelters. The only one of major significance is CPF contributions (see above). Compulsory CPF contributions are fully tax deductible. It may, therefore, be possible to structure a contract with the right combination of income and bonus to maximize contributions into the CPF. These contributions can be fully tax deductible in Singapore and uplifted free of tax at the end of the contract. It may, therefore, be desirable from a tax point of view to contribute to CPF even where the expatriate has full social security cover in his home jurisdiction.

Given the territorial basis of taxation and the relatively low tax rate, there is normally no great incentive to accelerate or defer income to avoid Singapore tax. Because there is no capital gains tax and investment income is subject to the territorial basis, there is no great incentive to increase tax base costs or to transfer property to other members of the family. Certain actions may be necessary in relation to estate duty, however (see below).

There is no controlled foreign corporation legislation and no personal holding company type legislation in Singapore. There is a general anti-tax avoidance section in the Income Tax legislation. It is seldom applied in the context of expatriate taxation but may occasionally be applicable, e.g. where there are circular schemes to recharacterize income as capital.

The IRD apply a tax-on-tax basis for calculating the tax liability where the employer is responsible for paying the tax. This grossing up effect can be expensive in terms of tax. It is sometimes possible to avoid the grossing up effect by entering into alternative arrangements to ensure that the employee has sufficient funds available to pay his own tax liability.

Interest-free and low-cost loans are permitted without taxing the employee on any benefit derived but only where such loans are made out of the company's surplus cash and where the loan is not made to a controlling director or a director who has significant influence in the company's affairs. This limitation is a recently introduced ruling and it is not yet clear how it is to be applied in practice.

III. ESTATE AND GIFT DUTY

A. *Estate duty*

Estate duty in Singapore is imposed on property passing on the death of a person. In the case of persons domiciled in Singapore at the time of their death, all immovable property situated in Singapore, and all movable property wherever it is situated, is subject to estate duty. For a person not domiciled in Singapore at the time of death, estate duty is imposed only on property in Singapore.

1. Tax base

Estate duty is levied upon the principal value of all property which passes on the death of a taxable person. Gifts inter vivos made within five years prior to the date of death are deemed to be property passing on death.

2. Exemptions

Certain properties, even if they are deemed to pass on the death of the deceased, are exempted. The following do not form part of the principal value of the estate and no estate duty is payable thereon:

(a) the value of any one dwelling house or the aggregate value of dwelling houses to the extent of S$ 3 million;
(b) S$ 500,000 of the aggregate value of all other property, including any interest in any dwelling house which does not qualify for relief under (a) above; and
(c) the excess over S$ 500,000 (if any) of the aggregate amount standing to the credit of the deceased at the time of his death in the CPF and in any designated pension or provident fund.

3. Tax rates and tax credit

Tax rates are five percent on the first S$ 10 million and ten percent on the excess.

4. Tax credit

A tax credit is available against the estate duty payable in Singapore for duty payable in any part of the Commonwealth (including Ireland) in respect of any property situated in such part of the Commonwealth. But the credit may not exceed the estate duty payable in Singapore on the same property. Estate duty payable in a non-Commonwealth country in respect of property situated in such a country may be deducted from the value of that property.

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B. *Gift tax*

There is no gift tax in Singapore.

C. *Estate duty planning*

The expatriate would not normally have a Singapore tax domicile and therefore would pay estate duty only on Singapore-located assets. Before coming to Singapore, the expatriate should ensure that his Singapore assets are kept to a minimum and that they are, wherever possible, owned by an offshore company. It is also to be noted that there are generous estate duty exemptions for residential property in Singapore and for CPF deposits. In addition, certain government securities are also exempt from estate duty.

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AUSTRALIA

TAX ACCOUNTING, PERIODS AND METHODS

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INTRODUCTION

The high level of interest rates in Australia in recent times has focused attention on the value of deferred tax liabilities. Individual taxpayers in particular have been attracted to negative gearing schemes to improve after-tax returns on investments. Corporate taxpayers have refined methods of deferring tax liabilities by accelerating deductions or deferring income, so as to procure what is, in effect, an interest-free loan from the Government. In some industries where favoured treatment is given for the write-off of capital expenditures, a permanent tax deferral would be feasible (for example, the mining industry in relation to its exploration expenditures). Some commentators would argue that the achievement of substantial tax deferrals can be regarded as an equity investment by the Government in the taxpayer's business.[1]

Whilst the sophistication which has evolved cannot be attributed to high interest rates alone, the effect of high interest rates is best illustrated by the rule of thumb that principal doubles every five years at an interest rate of 14 percent per annum compounded monthly. Australia's long-term Commonwealth Government Bond interest rates have hovered in the band of 12.5 – 13.5 percent in recent years up to the end of 1990. The Commissioner of Taxation pays interest at the statutory rate of 14.026 percent on tax refunds due as a result of successful objections against tax assessments. This rate was set in 1983 and represented at the time the weighted average yield for tendered long-term Treasury Bonds.

The fiscal system has responded in three ways:

- first, changes of an administrative type but by statutory amendment to the Income Tax Assessment Act 1936 (the "ITAA") have phased out perceived bias in tax collections which favoured business when compared to the position of an individual subject to regular withholding from salary or wages income under the Pay-As-You-Earn system;
- second, the ITAA has been extensively amended to respond to and anticipate opportunities for tax deferral from timing differences arising from tax accounting methods;
- third, the tax audit programmes following the introduction of self-assessment target tax deferral schemes.[2]

TAX ACCOUNTING VS. FINANCIAL ACCOUNTING

There is little commonality between the principles to be followed in arriving at the taxable income/loss of a corporation under the ITAA and the profit/loss reported to shareholders by the application of accounting conventions and standards. Nevertheless, the two separate paths taken sometimes meet, sometimes run parallel and sometimes cross over. However, it would be rare for taxable income (or loss) to coincide with the profit (or loss) determined under generally accepted accounting principles.

It is important to stress that accounting standards imposed under Schedule 5 to the Corporations Law and other accounting conventions have no recognition as such in tax law. There is no statutory demand for conformity between tax accounting on the one hand and financial accounting, or accounting for statutory purposes under the Corporations Law, on the other hand.

Given that accounting conventions are broad and open to differing interpretations, it is nevertheless useful to recognize that there are basic concepts which inevitably are applied in some form or another in the preparation of financial statements. These would include the matching of costs and revenues within a given reporting period, substance over form and materiality. None of these concepts have explicit recognition in the ITAA. But it is easy to fall into the trap of assuming that these are concepts also embodied in tax law.

Materiality, in particular, is an unacceptable practice in calculating taxable income. A handy illustration is the practice of multinational corporations to balance their books a number of days before year-end so that tight reporting deadlines can be achieved. This is not acceptable to the Australian tax authorities. Early year-end cut off procedures are taken as failure to comply with the law.[3]

Accountants must accept albeit reluctantly that financial statements and books of account will not be determinative of what the tax accounting should be for purposes of the ITAA. As the High Court stated:[4]

> But entries in books of account should evidence real transactions. They are evidence only. Their proper purpose is to record transactions having legal consequences. Making entries does not make

1. George Cooper, "The Taming of the Shrewd", *Columbia Law Review* (May 1985).
2. The Commissioner of Taxation observed: "I make no apology for tackling timing differences which don't work. If a company uses deferral year in, year out, then the amount in question becomes a permanent loan from the Government and the taxpaying public to the company." "Taxation Audits – Facing the Reality", speech by Mr. T.P. Boucher in Adelaide on 2 September 1987.
3. Income Tax Ruling IT 2467.
4. Windeyer J. in *Albion Hotel Pty Ltd v. FC of T*, 13 ATD 435.

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> such transactions. In considering what were in reality the relationships between Tolleys' and Albion, I must have regard not only to what they wrote but what they did. I must regard not only the presence of entries in their books; but also the absences of entries.

And "... what ultimately matters is the concept; bookkeeping methods are but evidence of the concept".[5]

To put into context what follows, it should be understood that Australian tax law levies tax on "taxable income". Taxable income is not accounting profit adjusted for certain items. Taxable income is defined as the amount remaining after deducting from the assessable income of a year all deductions allowable in that year. Thus, in theory, each item of receipt and receivable should be examined whether it is assessable income derived during the year and each loss or outgoing should be examined to see whether it has been incurred during the year of income and whether it otherwise satisfies the requirement for deductibility.[6] These procedures are undertaken independently of each other. The mechanical process of addition and subtraction then produces the figure which is the taxable income or loss.

In practice, short-cut methods may be used whereby the book or accounting profit is used as a convenient starting point but the end result must be to arrive at the taxable income/loss by the precise and correct application of the law.

Nevertheless, occasions arise where Australian tax law is non-specific, vague or simply fails to deal adequately with a given set of circumstances or transactions which have been entered into. In the absence of judicial precedents the Courts have been known to draw assistance from accounting conventions and business practices. This view was summarized by the Full Federal Court in the *Hooker Rex* case,[7] as follows:

> ... the tendency of judicial decision has been to place increasing reliance upon the concepts of business and the principles and practices of commercial accountancy, not only in the ascertainment of income, but also in the ascertainment of expenditure: *C of T (SA) v. Executor Trustee & Agency Co of SA Ltd*, (1938) 63 CLR 108 at 153 *FC of T v. Australian Guarantee Corporation Ltd*, 84 ATC 4642; (1984) 54 ALR 209.

Nevertheless, the Courts do not regard themselves as being bound by accounting practices. This was somewhat dogmatically observed by Lord Denning in the United Kingdom:[8]

> "... The Courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight; but the Courts have never regarded themselves as being bound by it. It would be wrong to do so."

Finally, it is necessary to say something about economic equivalence. There is a tendency in accounting theory to embrace this doctrine when facing the problem of reporting complex financial transactions. Examples are finance leases and certain forms of debt defeasance arrangements.

The ITAA has no room for such concepts. The Commissioner of Taxation has not been deterred from attempting to tax by economic equivalence when it suits the Revenue but up to the present time he has failed. The Federal Court's response to such an argument was as follows:[9]

> However, in taxation matters the Court is obliged to have regard to the actual facts and not their equivalents. In cases where it is appropriate the Court may apply a statutory provision such as Section 260 to get rid of a contract, agreement or arrangement and deal with the case in disregard of that element, but, where there is no statutory warrant for doing so, the Court cannot disregard certain of the facts or decide the case according to its view of substance of the matter.

The Privy Council expressed a similar view on a dispute involving a New Zealand taxpayer: "Taxation by end result, or by economic equivalence is not what the section achieves."[10]

Excursus 1 – income recognition

Given these circumstances, one can but touch upon a number of issues of timing where tax and financial accounting have come together. These are mainly in the recognition of income in a tax year. The assessable income of the taxpayer includes the gross income *derived*.[11] The key word is "derived" but this is not defined in the law.

There is no formal procedure whereby a taxpayer is to be treated as either a "cash basis" or an "accruals basis" taxpayer. Moreover, in the absence of a statutory definition, a variety of treatments will be applied depending on the type of income and the commercial circumstances of the taxpayer. The consequential issue of "cash" versus "accruals" accounting for income is not entirely resolved notwithstanding a long line of cases before the courts over many years. Generally, a taxpayer carrying on a business would be expected to report income from that business on the accruals basis. An individual who receives income by way of salary or wages would be taxable on cash receipts. So would professional people unless a substantial business is conducted. The sale of goods is dealt with the text below. There are, however, exceptions by convention in respect of certain types of income, such as rents or interest where the recipient is not a financial institution.

In respect of dividends, a shareholder is assessable on dividends paid (i.e. not payable) by a company.[12]

In the *Arthur Murray* case,[13] the Full High Court accepted that the amounts earned in respect of fees for dancing lessons paid in advance were those in respect of lessons actually given. In arriving at its decision the Court placed reliance on the accounting treatment adopted by the taxpayer company. The Court observed that:

> The paragraph of the case stated in which the established principles are described does not lead to inference why it is that books are kept in this manner. It is there specifically stated, as an agreed fact, that according to established accounting and commercial principles, in the case of a business, either selling goods or supplying services, amounts received in advance of the goods being delivered or the services being supplied are not regarded as income. We have not been able to see any reason which should

5. *Arthur Murray (NSW) Pty Ltd v. FC of T*, 14 ATD 98 at 100.
6. ITAA Secs. 6(1), 48 and 51(1).
7. *Hooker Rex Pty Ltd v. FC of T*, 88 ATC 4392.
8. *Heather v. PE Consultancy Group Ltd*, (1973) 1 All ER 8.
9. Bowen C.J. in *The Federal Coke Company Pty Ltd v. FC of T*, 77 ATC 4255 at 4263.
10. *Cmmr. of IR (NZ) v. Europa Oil (NZ) Ltd*, 70 ATC 6012 at 6019.
11. ITAA Sec. 25(1).
12. ITAA Sec. 44(1), and see also Sec. 160AQT in respect of franked dividends.
13. *Arthur Murray (NSW) Pty Ltd v. FC of T*, 14 ATD 98.

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lead the Courts to differ from accountants and commercial men on the point.

A similar approach was taken in the *Australian Gas Light Company* case,[14] which dealt with unbilled gas reticulated to domestic and other consumers.

An ancillary rule exists for business taxpayers in relation to the sale of investments and foreign currency gains/losses which are not dealt with under the capital gains tax provisions. The rule here is to apply the realization principle, that is to say, no profit or loss is recognized unless realization occurs. The practice of "marking to market" negotiable securities has no tax consequences notwithstanding the accounting treatment adopted.[15]

The rationalization for either the cash basis or an accruals basis of "derivation" comes from an often quoted passage in *Carden's* case,[16] extracts of which are as follows in the judgment of Dixon J.:

> In the present case we are concerned with rival methods of accounting directed to the same purpose, namely, the purpose of ascertaining the true income. Unless in the statute itself some definite direction is discoverable, I think that the admissibility of the method which in fact has been pursued must depend upon its actual appropriateness. *In other words, the inquiry should be whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's true income.* (emphasis added)

This case, although concerned with the confirmation of the cash basis for the estate of a deceased medical practitioner, is often used to rationalize whichever method of derivation is preferred, whether the business is simple or complex.

Excursus 2 – timing of deductions

The timing of expenses is similarly a matter of some difficulty. The concept of incurrence is fundamental and is discussed below. As will be explained, it is firstly the requirement to identify an "outgoing". That word was explained most recently as follows:[17]

> The word '*outgoing*' is an ordinary English word. It contemplates no more than that there is to be something which flows out from the taxpayer. Ordinarily, although not necessarily invariably, that will involve a monetary payment for which the taxpayer is liable. Thus payment for which the taxpayer is liable. Thus the expression 'outgoing incurred' may be equated with the words 'liability incurred'.

Incurrence requires, as a minimum, liability presently existing. The ITAA is none too liberal when it comes to expenses which are no more than impending (see below). Therefore provisions for various types of expenses and losses (e.g. bad debts) cannot be brought forward no matter how necessary it is to treat such items as a current year expense. The High Court had considered this aspect and commented as follows:[18]

> Of course, it may very well be that in the keeping of commercial accounts it would be proper to make provision against the annual gross profits of some sum related to the amount of the liability which must in due course arise because of the service by the employee during the year of accounting; and to do so before arriving at the profits or gains of the period during which the qualification of the employee is taking place. But the prudence and commercial propriety of such a course has little bearing on the question whether there is present in the year of income a loss or outgoing within the meaning of Section 51(1).

The only conceivable exception to the above is where the trading stock provisions apply. Then, losses representing diminutions in value can be deductible, through the operation of the trading stock provisions to the extent that market value is less than cost.

However, there are some expenses which are deductible only when paid. Principal examples for a corporate taxpayer are:

- contributions to a pension or retirement fund for employees (known as a superannuation fund in Australia);[19]
- liabilities for long service leave, annual leave, sick leave or other leave due to employees or other persons;[20]
- land rates and land taxes.[21]

***

In proceeding to the commentary on the designated topics a number of qualifications should be noted. First, the taxpayer is assumed to be a corporation unless otherwise indicated. Second, there are a number of deviations from general principles where the taxpayer's activities are in special industries such as general insurance, life assurance, the extractive industries and, most importantly, banking. It is not feasible to cover these situations except by brief references in some instances. Third, the discussion is in a domestic setting. The reason for that is the enactment in 1991 of the Taxation Laws Amendment (Foreign Income) Act which imposes an exceedingly complex accruals regime on Australian residents in respect of certain types of income and capital gains which arise in offshore jurisdictions. It would be impracticable to weave into the discussion, the intention and effects of this legislation.

CONSIGNMENT SALES

As a starting point, the treatment of income from the sale of goods is fairly straightforward. Assuming the goods sold are inventory items ("trading stock" in Australian parlance), income is derived for income tax purposes when the trading stock is sold and a debt is created for the sales proceeds. It does not matter that the debt is not payable until a future year.

In *Rowe's* case,[22] a retailer of household goods made sales which included instalment sales. In some cases terms were given for payment by the purchaser over a period of five years. The taxpayer company argued that it should be permitted to recognize assessable income only in respect of the instalments received or receivable in a year or, alternatively,

14. *Australian Gas Light Company v. FC of T*, 83 ATC 4800.
15. Income Tax Ruling IT 2572.
16. *C of T (SA) v. Executor Trustee & Agency Co of South Australia Ltd*, (1938) 63 CLR 108.
17. Hill J. in *Ogilvy & Mather v. FC of T*, 90 ATC 4386 at 4856.
18. Barwick CJ. in *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T*, 81 ATC 4031 at 4035.
19. ITAA Sec. 82AAC.
20. ITAA Sec. 51(3).
21. ITAA Sec. 72.
22. *J Rowe & Sons Pty Ltd v. FCT*, 71 ATC 4157.

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that the profit element in the cash price be assessed on a "profit emerging" basis. These arguments did not succeed. However, it should be recognized that under the Australian system of dealing with inventories the goods sold would not have been treated as part of the trading stock of the vendor. Therefore, had the taxpayer succeeded, a very substantial tax deferment would have been achieved. A full deduction would have been secured for the cost of goods sold but only a small proportion of income recognized on the transaction which transferred title to the customers.

Broadly speaking the tax treatment of consignment sales would follow from the legal analysis of the transaction between the consignor and consignee. Clearly, if the goods held by the consignee can be regarded as stock of the consignor, no sale would have taken place on delivery. This type of transaction is where the goods are regarded as belonging to the consignor until they are actually sold by the consignee. In other instances, the goods become non-returnable to the consignor after some specified period of time and sale takes place when the holding time has lapsed.

The Commissioner of Taxation issued an Income Tax Ruling[23] which takes the position that goods on consignment never become part of the trading stock of the consignee where the consignee acts as agent for the consignor and receives a sales commission for sales eventually made.

Where the goods are delivered on approval or on a sale or return basis, and a sale to the consignee is contemplated, the goods would be regarded as having been sold on acceptance of delivery by the consignee.

A related issue is where goods are exported under long-term contracts. If the goods are sold CIF then the tax position might be taken that no sale has occurred because title has not passed to the buyer or his agent. However, accounting principles would permit a sale to be recorded when the goods have been delivered to the carrier for transport to the buyer.

INSTALMENT BASIS

The instalment basis of tax accounting for transactions of an income nature is not provided for in tax law nor is it acceptable by administrative concession of the taxation authorities unless the circumstances demand that income or profit be deferred or spread over time. For example, a land developer may be permitted to bring to account the profit on sales of land "lots" by reference to the cash received as proportion of the total due on sales proceeds receivable by instalments. However, if the land is treated as inventory (trading stock) then the application of the trading stock provisions would determine the tax result on sales. The origins of this treatment is to be found in *Thorogood's* case decided under legislation which preceded the current ITAA (ITAA 1936).[24]

In respect of the sale of assets subject to the capital gains tax provisions in Part IIIA of the ITAA, the accruals basis of recognizing a net capital gain is specifically provided for.[25] Thus, where the ownership of an asset changes and a capital gain is triggered off to the vendor, the assessable amount enters into the calculation of taxable income, even if no cash has been received whatsoever. Should the proceeds accruing to the vendor never be received, a retrospective adjustment needs to be made to reduce or eliminate the capital gain, which has been subject to tax.[26]

FIXED ASSETS AND PREPAID EXPENSES

Taxpayers are entitled to claim in full, business expenses of a revenue nature *incurred* during a year of income, irrespective of the treatment of the outgoing for accounts purposes. The meaning of "incurred" is discussed below.

This rule is subject to the proviso that if expenditure otherwise deductible as a business expenses of a revenue nature in excess of A$ 1,000 is for the provision of services which will not be wholly performed within 13 months from the day the expenditure is incurred, the deduction will be spread over the service period up to a maximum of ten years.[27] These provisions extend to rent, insurance and interest but salary or wages is excluded. This may be termed anti-prepayment legislation and is recent (effective in respect of agreements entered into after 25 May 1988) but even before then, artificial schemes for the acceleration of deductions for rent and interest were not always successful.[28]

There are also specific anti-avoidance provisions against the creation of artificial timing differences between associated parties, e.g. within a group of affiliated companies.[29]

The acceleration of deductions or the perceived achievement of tax deferrals by financial instruments is covered by provisions which impose an accruals regime where contracts provide for deferred interest, deep discounts and indexation of principal.[30] This regime applies to financial instruments and other contracts in respect of amounts other than periodic interest where the term of the instrument exceeds 12 months.

An important departure from these principles arises from a recent decision of the Full Federal Court.[31] In that case the taxpayer company purchased trading stock for future delivery. The commodity purchased (copper tubing) did not become trading stock of the purchaser on payment, and was not "on hand" at year-end. It must be assumed the arrangement between the taxpayer and supplier was commercially realistic because the Commissioner of Taxation did not rely on anti-avoidance provisions in his challenge of the claim for deductions. The Commissioner issued a warning, however, against taxpayers entering arrangements, predominantly for tax considerations, to purchase trading stock yet to be manufactured or delivered. Anti-avoidance provisions would presumably be invoked if the *Raymor* decision were exploited and legislative amendments to the ITAA might also be expected.

23. Income Tax Ruling IT 2472.
24. *FC of T v. Thorogood*, (1927) 40 CLR 454.
25. ITAA Secs. 160Z and 160ZO.
26. ITAA Sec. 160ZF.
27. ITAA Secs. 82KZL – 82KZO.
28. Income Tax Rulings IT 2317 and 2384.
29. ITAA Subdivision D of Division 3 of Part III.
30. ITAA Division 16E.
31. *FC of T v. Raynor (NSW) Pty Ltd., 90 ATC 4461.*

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The position regarding capital expenditures which can be put under the broad heading of "fixed assets" is beyond the scope of this paper.

Very briefly, Australia has a narrow conception of what are "plant or articles" which qualify for tax depreciation.[32] The meaning of these words is derived from English common law as developed by the Australian Courts.

The Government's Economic Statement of 12 March 1991 promises a liberalization of tax accounting for depreciation including disposals and a modernization of the meaning of "effective life". This will allow depreciable lives to take into account economic life rather than physical life as is the position under existing law.[33]

Buildings do not qualify for tax depreciation but are dealt with separately. The prescribed amortization rate is 2.5 percent per annum of the eligible expenditures.[34]

There are separate rules for writing off the cost of industrial property, i.e. copyrights, patents, registered designs (but not trademarks) over their effective lives subject to certain maximum periods. This is not a favourable regime for the taxpayer.

Capital expenditures which do not qualify under specific write-off provisions are not deductible. The most common examples are the acquisition costs of goodwill and choses in action such as licences, client lists and technical know-how.

ANNUAL PAYMENTS (CASH VS. ACCRUAL)

Generally, the rule is that losses or outgoings *incurred* during a year of income by a business taxpayer are allowable deductions assuming they are revenue expenses of a business nature. This is the broad effect of the basic provision for the deduction of expenses.[35]

The meaning of "incurred" has been the subject of much litigation. Generally speaking:[36]

> Incurred does not only mean defrayed, discharged, or borne, but rather includes encountered, run into, or fallen upon. It is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application. But it does not include a loss or expenditure which is no more than impending, threatened, or expected.

Those familiar with taxation laws of other countries will notice that the words "payment" and "expenses" are not used in Section 51(1).

Normally, an actual payment or a legal discharge of a liability by other means would be regarded as a loss or outgoing but whether it is incurred (e.g. a voluntary prepayment)[37] can be an involved matter to unravel.

The structure of the provision was commented on thus by the High Court:[38]

> The word 'outgoing' might suggest that there must be an actual disbursement. But partly because such an interpretation would produce very strange and anomalous results, and partly because of the use of the word 'incurred', the provision has been interpreted to cover outgoings to which the taxpayer is definitively committed in the year of income although there has been no actual disbursement.

Periodicity as such does not confer deductibility but such an attribute may assist in the characterization of a payment as being of a revenue rather than capital nature.

It should be noted that there is no symmetry in the ITAA in relation to a cash basis taxpayer being restricted to cash basis for expenses and an accruals basis taxpayer being entitled to the accruals basis for expenses. Therefore, it is possible for a cash basis taxpayer to secure allowable deductions in respect of expenses for which a liability has been contracted, but has not yet been paid, if the tests of Section 51(1) have been satisfied.

In summary, unless a cash basis only is prescribed in a specific provision, the structure of Section 51(1) is to permit a deduction for the liability incurred during a year of income irrespective of the cash expended. This implies an accruals basis for business expenses in the ITAA. To ensure this statement is not inadvertently misunderstood it should be assumed that it is a taxpayer carrying on a business who is eligible for the deduction. An individual entitled to work related expenses from salary income would in most instances be allowed deduction for expenses actually paid.

CAPTIVE FACTORING

Captive factoring has not emerged in Australia as a means whereby tax deductions are accelerated or income recognition is deferred. Therefore no comment is made on this topic here.

Factoring transactions with an arm's length financial institution do occur but are uncommon because there are more sophisticated and efficient financing methods now available. Factoring fees in such circumstances would be ordinary tax deductions in terms of Section 51(1).[39]

MANPOWER COMPANIES

Administration and service companies and administration and service trusts are used extensively by businesses carrying on professional services (e.g. accountants, architects, medical practitioners, etc.). These devices had their origins in income splitting and the tax effective provision of retirement benefits rather than in the attempted manipulation of income recognition. Generally, such companies employ non-professional staff and make them available with premises, equipment and working capital to the business carried on by professional persons carrying on a profession, often in the form of a partnership. These structures are no longer used merely because they may be beneficial in the achievement of tax benefits.

32. ITAA Sec. 54.
33. ITAA Sec. 55.
34. ITAA Division 10D.
35. ITAA Sec. 51(1) of ITAA.
36. Dixon J. in *New Zealand Flax Investments Ltd v. FC of T*, 61 CLR 179 at 207.
37. Deane J. in *Foxwood (Tolga) Pty Ltd v. FC of T*, 80 ATC 4096 at 4100.
38. *C of T v. James Flood Pty Ltd*, 10 ATD 240 at 244.
39. Income Tax Rulings IT 2432 and 2538.

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The incorporation of professional practices and administration companies are governed by a series of tax rulings.[40] It is of relevance to note that a cash basis for reporting income may be permitted.

There is, however, a proliferation of "body hire" companies in some industries (e.g. the building industry). These structures are motivated by considerations other than income tax, mainly the avoidance of stringent labour laws and trade union demands.

Where the arrangement is one with a dominant purpose of tax avoidance for the principal shareholder/employee of the company, anti-avoidance provisions in the ITAA might succeed to strike down the scheme.

CHANGE IN TAX YEAR

In Australia the income tax year runs from 1 July to 30 June annually. The same tax year applies for all taxpayers. The Commissioner of Taxation has an unfettered discretionary power to grant a substituted accounting period ("SAP"). However, he grants a SAP only "where there is a substantial business need for making the change".[41] Where the taxpayer is a member of a corporate group which prepares accounts to a balance date other than 30 June that would be an acceptable need. SAPs are not granted to natural persons.

It is to be expected that a SAP will be granted on terms that ensure that tax is not avoided or deferred by adoption of the SAP. Under the new tax collection procedures no compensatory adjustment payment is demanded by the Commissioner[42] for any deferral which might be inferred from a change to say 31 December in lieu of the succeeding 30 June. The company tax collection system which commenced for the 1989/90 tax year requires that 85 percent of the "Estimate Tax or Notional Tax" due for a year must be paid by the 28th day following the year-end.[43]

There are no special provisions governing the computation of taxable income on commencement or cessation of a business. In the case of individuals, who become taxpayers for the first time (part-year residents and students leaving full-time education), the tax- free threshold is prorated.

Where a business ceases and on cessation trading stock is disposed of, the taxation legislation ensures that the value and not the proceeds of disposal of the trading stock is included in the taxpayer's assessable income.

ACCOUNTING FOR LONG-TERM CONTRACTS

The appropriate method of recognizing profits from long-term contracts was a fertile area of disputes between taxpayers and the Taxation Office until the release of an income tax ruling on 1 October 1987. That ruling deals with long-term construction contracts, but the principles outlined by the Commissioner of Taxation have wider application.[44]

The Commissioner of Taxation will not accept the "completed contract" basis of tax accounting. Under this method, profits or losses are not recognized until a contract is completed. This method, being the most conservative available, was in fact commonly adopted by many companies in industries where profitability is difficult to forecast (e.g. the building industry).

The ruling contemplates two methods which are acceptable to the Commissioner of Taxation, namely:

– The "basic" method in terms of which all progress and final payments received in a year (determined on the accruals basis) are to be included in the taxpayer's assessable income. Deductions are those which are losses and outgoings qualifying for deduction under the various provisions of the ITAA.

– The "estimated profits" method which requires the taxpayer to spread the ultimate profit or loss on a long-term construction project over the years to be taken to complete the contract. The basis adopted for estimation and spreading must be reasonable and in accordance with accepted accountancy practices. The ultimate profit or loss can be adjusted from year to year to reflect changes caused by progress on the contract. This can also be referred to as the "percentage of completion" method. It should be noted that no threshold is allowed for a minimum completion (say 10-20 percent) before any profit is recognized under this method.

Under the basic method, "up-front" payments received will be assessable income derived in the year of receipt. Support for this treatment was confirmed in *GP International Pipecoaters*[45] where the High Court held that "establishment costs" of the contractor largely reimbursed by its customer on commencement of the contract were no different from other receipts under the contract.

In the absence of specific provisions in the ITAA and lack of judicial precedents, Income Tax Ruling IT 2450 is accepted by taxpayers as the equivalent of good law. The ruling of the Commissioner would, however, find some support in a 1980 New Zealand decision.[46] In that decision a single Judge of the High Court of New Zealand confirmed an assessment under the "percentage of completion" method notwithstanding the taxpayer's claim for the "completed contract" method. Therefore, as a practical matter, it is not possible in Australia to postpone tax liabilities by excessively conservative estimations of provisions of costs to complete contracts.

CASH BASIS OF ACCOUNTING FOR SERVICE COMPANIES

Service companies as such have no particular prominence in Australian corporate life. The reason may be there are no tax concessions available for the activities of such companies as is the case for example in Singapore. The income derived by

40. Income Tax Ruling IT 2503.
41. ITAA Sec. 18 of ITAA and Income Tax Ruling IT 2360.
42. Income Tax Ruling IT 2433.
43. ITAA Division 1B of Part VI.
44. Income Tax Ruling IT 2450.
45. *GP International Pipecoaters Pty Limited v. FC of T*, 90 ATC 4413.
46. *HW Coyle Limited v. Commr of IR*, (NZ) 80 ATC 6012.

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such companies for tax purposes would be determined on the same basis as for any other corporation. The expectation would be that the accruals basis would apply. This broad rule may be adopted where the *Arthur Murray* principle[47] can be applied.

In respect of certain classes of income generated by service companies a cash basis would be appropriate, e.g. in respect of royalty income.[48] Commission income for sales might be reported on a cash basis in appropriate circumstances unless the receipt of the commission can be regarded as beyond doubt.

INFLATING INVENTORY VALUATIONS TO FAIR VALUE

Valuation of year-end inventories (trading stock) to freshen-up losses is no longer required in Australia. Ordinary (trading) losses incurred in the 1989/90 and subsequent years can be carried forward indefinitely for deduction from income of future years subject to certain restrictions which govern loss recoupment generally by companies. The same applies to capital losses. However, losses cannot be carried back to a prior year.

Inventories at year-end can be valued for tax purposes, at the taxpayer's option, by any one of three methods, namely cost price, net realizable value or replacement price. A different method may be chosen for each class or each identifiable item of trading stock. Furthermore, there is no requirement for consistency from year to year other than the valuation at year-end must be carried over to be the value of opening stock in the next subsequent year. The inventory valuation in the financial statements will have no bearing on the tax valuation.

If the value of an item of trading stock is considered to be less than that calculated under the above mentioned three methods, the Commissioner may, on request, apply a special value. The most common example of such valuation would be to take into account diminution in value through obsolescence. However, an accounting provision for obsolescence will not be acceptable for the purpose of the special valuation under the ITAA.

The valuation of trading stock under Australian tax law requires the following rules to be observed :

- if cost is selected as the value of stock on hand at year-end, full absorption costing must be applied;
- each item of trading stock should be physically identified for valuation. If this is not practicable, which is quite common, FIFO, average cost or standard cost (regularly reviewed) is acceptable. The LIFO method and retail inventory method are not permitted under any circumstances.

The valuation of trading stock at a value in excess of cost might be an issue where rebatable dividend income is received by a company which has suffered a tax loss but for the receipt of the dividend. In that event, the upward valuation of the trading stock to prevent the wastage of deductions is prevented by a specific anti-avoidance provision.[49]

CHANGES IN ACCOUNTING METHODS

If a taxpayer wishes to change his basis of tax accounting, no reference need be made to the Commissioner of Taxation. Prior to the introduction of self-assessment for companies and retirement/pension (superannuation) funds, the Commissioner would have become aware of the changed methods of accounting through the notes to the financial statements which were attached to the tax return. Alternatively, the taxpayer is likely to have made a statement in the tax return which had the objective of making a "full and true disclosure".[50]

Under self-assessment, no schedules or financial statements are lodged with the short form income tax return. Therefore, the Commissioner would not become aware of changes in accounting methods until the taxpayer is subject to review or audit or the taxpayer seeks approval by some method such as a ruling requested for the Commissioner's interpretation of the law.[51]

The consequences of changing the basis on which income is reported as "derived" was judicially considered in *Henderson* and *Country Magazine*.[52]

In *Henderson*, a partnership of professional accountants was taxed on the "cash" basis. The partnership then switched to reporting income on an "earnings", i.e. "accruals" basis. The circumstances were such that a substantial amount of outstanding fees at the end of the last "cash" year was not included as assessable income of the subsequent year in which the change was made, and in which year the cash was received. The High Court agreed that this was the correct result. To come to this conclusion the Court distinguished *Carden*.[53] The Commissioner's remedy would have been to amend prior years' assessments within the restrictions allowed under the law. The Commissioner omitted to do this but it would have been worthwhile only if the numbers worked his way. The position reverse to *Henderson* was subsequently dealt with similarly in *Country Magazine*.

Henderson is also important for having laid down the rule that in a business of a profession, of the appropriate size, the income derived in a year is not the cash collected but, rather fees which have matured into recoverable debts. However, this method whilst resembling accruals does not go all the way since work in progress need not be taken into account.

A change in basis of accounting for deductions has not been similarly reviewed because it has been well established that a loss or outgoing which qualifies for deduction under Section 51(1) must be "incurred" in the year it is claimed. In other words, the taxpayer is not able to choose in which year an allowable deduction is claimed.

47. See text *supra* at notes 5 and 13.
48. ITAA Sec. 26(f).
49. ITAA Sec. 46(7A).
50. ITAA Sec. 170(3) prior to amendment effective for income year 1989/90 and subsequent years.
51. ITAA Sec. 169A.
52. *Henderson v. FC of T*, 70 ATC 4016; *Country Magazine Pty Ltd v. FC of T*, (1968) 15 ATD 86.
53. See text *supra* at note 16.

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Nevertheless, circumstances may arise where a deduction otherwise allowable is claimed in the wrong year. The view of the Commissioner is that if the change is made to the correct basis adopted, only the expenditure correctly calculated may be deducted in the change-over year.[54] This is the application of the *Henderson* principle to deductions. The taxpayer's remedy for the deprivation of deduction (i.e. cash paid in the change-over year to discharge a liability incurred in a prior year) is to seek amendments of past years' assessments to the extent permitted.

CONSOLIDATED RETURNS AND GROUP RELIEF

Companies must file individual tax returns irrespective of the structure of a group of affiliated companies. Consolidation of tax returns is not permitted.

"Group relief" is achieved to the extent that resident companies which have 100 percent common ownership can transfer ordinary revenue losses within the group.[55] One hundred percent common ownership can be direct or through interposed companies and the holding company need not be a resident of Australia. The "income" company can pay consideration to the "loss" company for transfer of the loss. Such payment will not constitute assessable income of the loss company nor will it be regarded as a capital gain. In the capital gains tax provisions the same principle is adopted in respect of capital losses[56] except that the companies need not be resident.

Australian taxation legislation provides for the rollover of assets transferred between group companies. This is a mechanism for deferral of the tax liabilities on the capital gain, if any. Group companies which are non-resident can also avail of this deferral provided the assets transferred are taxable Australian assets and the transferee is not an exempt company.[57]

Regrettably these provisions are exceedingly complex by being circumscribed by restrictions to prevent the creation, or acceleration of capital losses.

Excess foreign tax credits can also be transferred between 100 percent commonly-owned group companies.[58]

INSURANCE PREMIUMS PAID TO OFFSHORE CAPTIVES

There are no restrictions as such on the payment of insurance premiums to offshore captives. (The non-resident is taxed on a notional taxable income of ten percent of the premium received unless the actual profit or loss is calculated under the ITAA.)

The payment of insurance premiums, and for that matter any other payment to a non-resident, requires a determination of whether or not the consideration for the goods, services or property is justifiable as arm's length consideration. Transfer pricing issues in international transactions are extensively covered in the ITAA.[59] Moreover, the use of offshore captives has been caught up in the new regime for the taxation of foreign source income, commonly referred to as the "foreign income accruals legislation" or "controlled foreign company" legislation.[60]

Where an offshore captive is resident in a non-listed jurisdiction (i.e. a low tax or tax haven country) or premiums are designated concession income (i.e. subject to favourable tax treatment) of a company resident in a listed country (comparable tax jurisdiction) then, subject to certain qualifications, the income of the captive will be taxed to the Australian shareholder as the profits are derived by the offshore company and before the profits are remitted to Australia as dividends. This means the tax benefit of having the captive insurer is forfeited to the Australian resident which pays it insurance premiums.

BORROWINGS BY A CASH BASIS TAXPAYER

The raising of loan funds by a cash basis taxpayer on the security of its accounts receivable does not of itself have any tax consequences. Such a transaction would be an attempt at financing by a cash starved taxpayer. The charging of receivables would be a well understood, if uncommon occurrence. It is doubtful that lenders would give a high credit rating to the unpaid fees of an accounting firm.

The concept may be taken a step further. The factoring of debts can be carried out without adverse tax consequences unless tax benefits are to be achieved by the diversion of income.[61] And a further step is to assign the receivables of a cash basis taxpayer. A medical practitioner did just that. He assigned to his wife by way of gift a 99 percent interest in amounts owing to him from patients. Unfortunately, a tax tribunal held that he was still taxable on the cash paid by year end in respect of the debts under general principles of the law.[62]

TAXABLE PERIOD OF A PARTNERSHIP AND ITS PARTNERS

A partnership is more widely defined for Australian income tax purposes than for partnership law purposes. A tax partnership includes an association of persons carrying on business as partners or in receipt of income jointly.

Australian taxation legislation requires that a partnership file an income tax return.[63] It is to be prepared as though the partnership were a resident of Australia.[64] The net income or loss, as the case may be, is distributed to the partners. Thus the partnership is not a taxable entity and is, in effect, a conduit.[65]

54. Income Tax Ruling IT 2613.
55. ITAA Sec. 80G.
56. ITAA Sec. 160ZP.
57. ITAA Sec. 160ZZO.
58. ITAA Sec. 160AFE.
59. ITAA Division 13.
60. Taxation Laws Amendment (Foreign Income) Act 1991.
61. Income Tax Ruling IT 2538.
62. Decision of the Administrative Appeals Tribunal, Case V142 88 ATC 891.
63. ITAA Sec. 91.
64. ITAA Sec. 90.
65. ITAA Sec. 92.

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Partners who have a share in a loss-making partnership are entitled to claim their respective share of the loss from other assessable income of the year derived by them individually. Unutilized losses are carried forward by the partners individually and not the partnership.

A SAP is readily granted to a partnership if the balance date is to coincide with that of the partners. It would, however, be a rare occasion on which the SAP is different to all or at least the majority interest of partners.

If there are a number of partners with different accounting periods then a SAP for the partnership is permitted only if the partners report their respect shares of the partnership net income or loss attributable to their own accounting periods.[66] This rule followed the development of leveraged lease partnerships where the partnership selected a SAP so that part of the loss distribution might be reported earlier by the partners than would have been the case with uniform balance dates (e.g. partnership SAP ending on 30 November each year in lieu of the preceding 30 June).

RESERVES TO REFLECT THE TECHNOLOGICAL OR PHYSICAL DETERIORATION IN INVENTORY VALUES

The options for valuing inventories which are trading stock are described above.

In the context of obsolescence, reference should be made again to the provision which permits the Commissioner to accept a valuation which is less than either of the three methods referred to. This fourth method of valuation would be invoked by the taxpayer where there are special circumstances, principally obsolescence, to depress the value. However, the Commissioner must be satisfied as to the facts which bring about the special circumstances.[67]

Consideration of inventories in Australian tax practice requires the further explanation of the nature of the definition. The term "trading stock" is defined as including "anything purchased, manufactured, acquired or purchased for the purposes of sale, or exchange and also includes livestock".[68]

Case law has established that the definition is wide enough to encompass choses in action (e.g. stock in companies, other marketable securities and in some circumstances, real property). However, it does not cover consumable and spare parts applied in a manufacturing or production process.

The deductibility of these aids to manufacture is dealt with largely by administrative concession. Whilst deductibility of consumables can be achieved on the incurrence basis (i.e. purchases are expensed), the position of spare parts is not so favourable in instances where large stocks are carried in comparison to usage. In this case, the usage basis will be appropriate. However, there is no statutory allowance for a deduction for the cost of spare parts which are lost, destroyed or become useless through deterioration.[69] In practice deductions are often achieved through creative but incorrect tax accounting procedures.

It needs to be emphasized that spare parts which are inventory for accounting purposes and are carried in the balance sheet at year-end, should not be treated as trading stock for tax purposes. This means the variation option for trading stock are not available to write down spare parts below cost price.

100 PERCENT WRITE-OFF FOR CERTAIN INVESTMENTS

In recent years, reform of Australian tax law has attempted to move closer to the neutrality principle by abolishing or not introducing new tax concessions. In populist terms this is the "level playing field" theory. Accordingly, there are no new incentives given for immediate or rapid write-off of what would otherwise be capital expenditures except to the limited extent referred to below.

Capital expenditures on research and development ("R&D") which qualify under stringent tests are deductible outright, and in addition, an additional deduction is granted of 50 percent (25 percent after 1992/93). In other words, the concession is immediate deduction of 150 percent (later 125 percent) of the qualifying expenditures. However, in respect of plant and equipment, including a pilot plant costing less than A$ 10 million, the deduction of 150 percent is spread over three years in annual instalments, i.e. 50 percent in each year. The same concession applies to buildings wholly attributable to R&D.

There are accelerated write-off rules also for what qualifies as scientific research.[70]

Capital expenditures of the petroleum, mining and quarrying industries are dealt with on the cost depletion principle, subject to the following qualifications:

- exploration expenditures are deductible in full in the year incurred, i.e. immediate write-off;
- capital expenditures on mine development facilities, etc. are deductible over the life of the mine or the petroleum field, subject to the write-off period not exceeding ten years.

R&D AND ADVERTISING EXPENDITURE

In respect of R&D advertising expenditures there is no specific provision or rule which governs deductibility. Generally, the long standing practice is to regard such expenditures as a business expense of a revenue nature on the basis that there is no discernible asset created or advantage of an enduring benefit identifiable at the time the expenditure is incurred. This would be so even if a new product is being launched.

The only exception might be in an entirely new business where advertising expenditures may be incurred prior to a decision being made whether or not to carry on a business, i.e.

66. Income Tax Ruling IT 2360.
67. ITAA Subsec. 31(2).
68. ITAA Subsec. 6(1).
69. *Guinea Airways Ltd v. FC of T*, 83 CLR 84.
70. ITAA Sec. 73A.

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the expenses are in the nature of feasibility costs to determine whether or not the product will be made and distributed.

CONCLUSION

The foregoing commentary suggests there are few if any opportunities for the utilization of tax accounting methods to accelerate or to defer tax liabilities. Such an impression would not be entirely accurate. Tax effective financing techniques are still constructed to lower the effective cost of borrowings. Tax arbitrage between taxpayers so that a mis-match between deductions and income will be taken advantage of.

It will also be apparent that there are no consistent and coherent principles underlying Australian tax law which permit simple explanations of rules which can be applied to all taxpayers in all circumstances.

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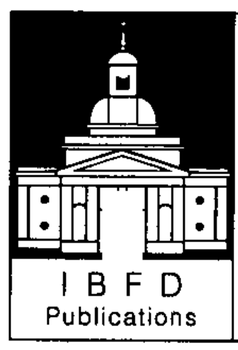

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JAPAN

TAX ACCOUNTING, PERIODS AND METHODS

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I. TAX ACCOUNTING IN GENERAL

In some countries, tax accounting and financial accounting of a corporation are distinct and separate, and a corporate taxpayer is allowed to use one accounting method for financial reporting purposes and another method for tax reporting purposes.

A good example of this would be that depreciation expense is computed on a straight-line method over the estimated useful lives of assets for financial reporting purposes while depreciation for tax purposes can be claimed under an accelerated method over statutory tax depreciation periods. In countries which adopt this type of tax system, a corporate taxpayer is able to report its financial results in accordance with generally accepted accounting principles while taxable income is computed using different methods and tax incentive provisions found in the tax law.

However, in Japan, the tax law requires that taxable income be computed based on the financial statements approved at the general shareholders meeting of a corporation. This basic structure of tax computation is provided in Article 22, paragraphs 2-4 of the Corporation Tax Law ("CTL"). In particular, paragraph 4 (English translation) stipulates as follows:

> The amounts of profit for said accounting period under the provision of paragraph 2 and the amounts as mentioned in respective items of the preceding paragraph shall be those computed, in accordance with the standards of the accounting disposition generally acknowledged as justifiable and adequate.[1]

Except for certain special items,[2] the CTL relies entirely on generally accepted accounting principles for the scope and measurement of income and expenses which will be included in the computation of taxable income.

Furthermore, the tax law requires a taxpayer to record expenses in the books of account if the taxpayer is to claim deduction of certain expenses. This so-called "book/tax compliance requirement" is a fundamental characteristic of the corporation tax system in Japan. An example of this requirement is depreciation expense. Tax law stipulates depreciation periods for all types of fixed assets, such as building, machinery and equipment and furniture, etc. and a taxpayer has a right to adopt either a straight-line or declining balance method for computation of depreciation expense. As long as depreciation is claimed in the taxpayer's books of account using the statutory depreciation period as the adopted method, the depreciation expense is deductible as claimed for tax purposes. Accordingly, it is not possible to use one method for financial reporting purposes and another method for tax reporting purposes in Japan.

The book/tax-compliance requirement was stipulated in the tax law to ensure easier tax administration by the Japanese tax authorities. Since all financial statements are reviewed and approved by shareholders and, in some cases, audited by a CPA, the tax authorities are able to rely on external checks as to the amount of income or loss which becomes the basis to compute taxable income.

Although the book/tax compliance requirement ensures efficient tax administration in Japan, it has given rise to a significant influence over "generally accepted accounting principles". In fact, there is a long history of dispute between scholars of accounting and the tax authorities with respect to the book/tax compliance requirement in the tax law. Over the years, a number of compromises were reached and finally after the 1982 CTL amendment, the disputes seem to have ended.

1. Quoted from EHS Law Bulletin Series.
2. Deductibility of certain expenses, such as donations and entertainment expenses, etc., and taxability of certain income, such as dividend income from domestic corporations, etc. are governed by special provisions of the tax law.

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Nevertheless, Japanese generally accepted accounting principles are still influenced more by tax law than other countries and they are generally viewed the same as tax accounting. For instance, if a corporation records an accrual for employee termination allowance in accordance with the tax law, such amount (although under tax law different from the theoretical amount based on an actuarial computation) is deemed adequate for financial reporting purposes as well.

The Japanese Institute of Certified Public Accountants ("JICPA") issued a number of statements dealing with the treatment of certain accounting methods required by tax law. JICPA has accepted tax accounting as one of the generally accepted accounting principles in Japan. Accordingly, if a corporation keeps its books of account in accordance with the provisions of the CTL, such accounting is generally deemed appropriate for financial reporting purposes as well.

II. TAX ACCOUNTING PERIODS

A. *General*

The tax accounting period (tax year) corresponds with the financial accounting period provided for in the Articles of Association of a corporation. Normally, a corporation adopts an annual accounting period for reporting to its shareholders. However, if an accounting period of a corporation exceeds one year, the corporation is required to close its books of account on an annual basis and report its taxable income to the tax office.

A corporation is required to file its tax returns within two months from the end of the tax year. If a corporation adopts an annual accounting period, it is required to file an interim tax return and make any necessary interim tax payment within two months from the end of the first six months of the tax year.

The interim tax return may be prepared based on either actual operating results until the end of the first six months or on the prior year's tax return. Accordingly, if a company's profit level is growing, it is much more advantageous for the company to pay 50 percent of the actual tax paid in the preceding tax year as an interim tax payment. On the other hand, if a decline of profit level is expected, it would make sense to close the books of account as of the end of the first six months and compute the tax due based on the current operating results.

B. *Change in tax year*

A corporation may change its tax year without approval of the tax authorities. However, since the tax year corresponds to the financial reporting period, shareholder approval is required to change the financial accounting period. After the shareholders approve the change, the corporation must notify, without delay, the applicable tax offices about the change.

Tax deferral can be achieved by changing a tax year in line with the business trends of a corporation. However, frequent changes in the tax year solely to defer or reduce the tax burden will be challenged by the tax authorities. This is particularly true if the corporation falls within the definition of a "family corporation" under the CTL.

C. *Tax year of partnerships*

Generally speaking, there are two types of partnership under the Japanese legal framework, i.e. Nin-I-Kumiai ("NK") and Tokumei-Kumiai ("TK").

NK is very similar to the general partnership found in the Anglo-Saxon legal system and each partner (*Kumiai-In*) participates in the business of the partnership in accordance with the partnership agreement. For purposes of the CTL the profit and loss earned or incurred by the partnership will be allocated to the partners in accordance with their respective shares in the partnership. Since the partnership itself is not a taxable entity, taxable income or loss will be included in each partner's tax return which is filed based on that partner's own tax year.

If the partnership designates a specific accounting period, profit and loss can be determined by this accounting period and allocated to the partners. The partnership accounting period can be determined independently without regard to the accounting periods of major partners.

If the partnership does not designate a specific accounting period, each partner will include in its own taxable income its share of the partnership's profit or loss earned during the accounting period of that partner. Therefore, it is only possible for a partner to defer recognition of partnership income by designating the partnership year-end different from his own. If a loss is expected to flow from the partnership, then it is best to either not designate a partnership year-end or to have the same year-end as the partners.

In strict legal terms a TK is different from a partnership and is merely a contractual relationship between a proprietor and Kumiai-In (anonymous associates). In effect, the Kumiai-In holds an income interest in the business of the proprietor. The TK agreement determines the accounting period of the TK and each anonymous associate is required to include that year's profit or loss allocated from the proprietor in its own tax return for its accounting period ending with or within which the year of the TK ends. The accounting period of the TK can be determined independently from the accounting period of both the proprietor and the anonymous associates.

III. ACCOUNTING METHODS

A. *Special provisions re recognition of income*

As described above, there is a book/tax compliance requirement in Japanese tax law. Accordingly, recognition of income for tax purposes, i.e. timing and amount, should be followed for financial reporting purposes. Accounting methods allowable for tax purposes are generally deemed acceptable for financial reporting purposes as well.

B. *Consignment sales*

Generally speaking, income from the sale of inventory is recognized when shipment takes place. In case of a consignment

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sale, even though the inventory is shipped from consignor to consignee, the title to the inventory remains with the consignor until it is sold to the ultimate customer. Accordingly, recognition of sale will be postponed until the inventory is sold from the consignee to the ultimate customer. The tax law allows consignment sale accounting for recognition of taxable income provided such accounting is reflected in the taxpayer's books of account. Provided it is followed consistently, recognition of sales may be made when the statement of the consignment sales is received from the consignee.

C. *Instalment sales*

There are two types of instalment sales allowable under Japanese tax law. One is instalment sales of merchandise and services, and the other is a deferred payment clause for sales of property and construction contracts.

1. Instalment sales of merchandise and services

An instalment sale is defined as a sale in which collection is made periodically on a monthly, annual or other regular interval basis and the due dates and amounts of each instalment payment are predetermined when the merchandise or services are delivered. In order to apply the instalment basis of accounting for tax purposes, the specifics of the instalment sale must be standardized and be applied to all instalment sales made by the taxpayer. If the instalment basis of accounting is not applied to any single instalment sale, the privilege of tax deferral for all instalment sales will be lost at once.

When the instalment basis of accounting is adopted, the gross profit on each sale will be recognized ratably over the instalment period based on the amount of instalments which become due over the sale price.

2. Deferred payment sales and contracts

When a taxpayer enters into a sales contract for a big ticket item such as machinery, ships or vehicles, or enters into a long-term construction contract and agrees to receive the payment for his contract in instalments, the tax law allows application of the instalment basis of accounting for recognition of income from the contract. In order to apply the instalment basis of accounting for tax purposes, the contract must satisfy the following conditions:

- payment must be made in three or more instalments, either monthly, annually or otherwise periodically;
- the period from the date following the date of delivery of the property under the sale or construction contract to the date of the last instalment must be at least two years; and
- the amount receivable before the delivery date of the big ticket item or the completion of the construction must not exceed two-thirds of the total liability for the contract.

Only contracts which yield profit are eligible for instalment basis accounting and the contracts from which a loss is expected will not qualify.

Unlike the instalment sale of merchandise or services, it is up to a taxpayer whether he adopts instalment accounting for a particular sale or construction contract. However, once instalment accounting is adopted for a particular contract, this accounting method must be used consistently in the books of account until the contract is completed and the final instalment is received.

D. *Income from long-term contracts*

Under Japanese tax principles, income from a long-term contract may be recognized upon completion of the contract. Accordingly, many corporations adopt the so-called "completed contract method" to recognize income from long-term contracts. However, the tax law allows the use of the "percentage of completion method" for certain contracts. In order to apply the percentage of completion method, the contract must generate income and the length of the contract must be longer than one year. As with application of the instalment basis of accounting, the percentage of completion method must be adopted consistently in the taxpayer's books of account.

Since generally accepted accounting principles in Japan include the completed contract method as one of the acceptable accounting methods for reporting income from long-term contracts, many construction companies apply the completed contract method for ordinary construction projects. Application of the percentage of completion method is rather exceptional and is usually limited to special large contracts such as overseas contracts.

E. *Cash vs. accrual*

Tax law requires corporations to recognize income and expenses on an accrual basis. However, it also allows the use of the cash method to account for certain annual payments. Annual payments include such items as insurance, interest and rentals where the benefits are scheduled to be received in one year or less. Instead of recording these as prepaid expenses, they may be expensed as incurred. This special provision is applicable only when such cash basis accounting is consistently applied in a corporation's books of account.

Cash basis accounting is also allowable for recognition of interest income from loans, deposits and security investments earned by non-financial companies. In the case of financial service industries where interest income is the main source of revenue, the accrual method must be adopted for recognition of both interest income and expenses.

For application of the accounting methods explained in (A) to (D) above, taxpayers are not required to apply to the tax office for approval of any specific method. A taxpayer simply applies the adopted method in its books of account and computes taxable income accordingly.

F. *Inventory valuation method*

As in the case of other accounting methods, the tax law follows generally accepted accounting principles for inventory valuation methods. Both the "cost method" and "lower of cost or market method" are acceptable for tax purposes. The tax law lists the following eight methods as acceptable cost methods:

- individual identification;

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- FIFO;
- LIFO;
- weighted average;
- moving average;
- simple average;
- last invoice price; and
- retail method.

A taxpayer may choose any cost method listed above but must report the method adopted to the tax office. Any planned change in method must have the approval of the tax office, and is only effective from the next fiscal period after the application is filed.

If a taxpayer wants to use an accounting method which is different from those listed in the tax law, it must apply to the tax office for approval. If the method is deemed appropriate for computing taxable income of the taxpayer, approval is normally granted by the head of the tax office.

If a taxpayer does not select its inventory valuation method, the tax office may apply the last invoice price method in calculating taxable income. The last invoice price method is the method where the prices of the most recent purchases are used to value ending inventory.

Cost in applying "lower of cost or market method" is the cost determined by one of the methods listed in the tax law, and the cost method must also be reported to the tax office.

G. *Depreciation*

1. Ordinary depreciation

Tax law follows generally accepted accounting principles for the definition and scope of depreciable fixed assets. The National Tax Administration determines useful lives of all fixed assets based on its engineering study.

For tangible fixed assets, a taxpayer may adopt either the straight-line method or declining balance method for computation of depreciation expense. The taxpayer must report the depreciation method adopted to the tax office. Any planned change in method must be approved by the tax office, and is only effective from the fiscal period beginning after the application is filed.

Only the straight-line method is allowed for intangible fixed assets.

Depreciation expenses claimed by a taxpayer which are within the amounts computed using the adopted method over the statutory useful lives stipulated in the regulations will be allowable as deductions from taxable income.

Since the statutory useful lives generally reflect economic useful lives of fixed assets, almost all taxpayers in Japan use the tax useful lives in computing depreciation expense for accounting purposes as well. Accordingly, in most cases depreciation expense (other than special depreciation discussed below) recorded for financial reporting purposes agrees with the amount claimed for tax purposes. In certain exceptional cases where a taxpayer uses machines which are subject to rapid technical obsolescence, that taxpayer may sometimes depreciate its manufacturing facilities faster than the tax depreciable period. Depreciation expense claimed in excess of the tax limit is added back to taxable income in the tax return.

Unlike in the United States, most intangibles are also assigned tax useful lives. For instance, the tax useful life of a patent is eight years and that of a trade mark is ten years.

One notable point in the depreciation (amortization) of intangible fixed assets is the depreciation of goodwill. Goodwill acquired with consideration can be amortized freely at the discretion of the taxpayer. Goodwill can be expensed at once in the accounting period when it is acquired or can be amortized over a certain period. Therefore, for tax purposes, a taxpayer is able to determine the amount of write-off at its own discretion. Due to the book/tax compliance requirement, amortization must be recorded in the books of account to claim a deduction for tax purposes. However, generally accepted accounting principles require that amortization of goodwill be recorded rateably over a five-year period. Accordingly, most large companies whose financial statements are subject to external audit amortize goodwill over five years. On the other hand, smaller companies sometimes decide the amount of write-off depending on the amount of taxable income.

In addition to intangible fixed assets such as patents, trade marks and goodwill, there are a number of deferred charges prescribed in the tax law and they are also eligible for depreciation (amortization). Deferred charges are defined in the tax law as expenditures to enjoy benefits which last more than one year and they include, for example, payments to a software house to develop computer software, non-refundable payments to a landlord to lease a building or space, and lump-sum payments other than royalties to receive a technical licence from a licensor. All of the deferred charges are assigned tax depreciation lives and are available for depreciation on a straight-line method over the assigned lives.

2. Special depreciation

Special depreciation is available as an incentive to a taxpayer for using certain types of machinery and equipment. The deductible limitation of depreciation expense will be the total of the special and ordinary depreciation. The government designates types of machinery and equipment which qualify for special depreciation and makes periodic reviews to add to or delete from the list of qualified properties.

Since special depreciation is an incentive to the taxpayer and does not constitute a proper periodic expense for financial reporting purposes, the tax law provides a special accounting method so that the book/tax compliance requirement is still met. Under this special accounting method, depreciation can be claimed as a deduction for tax purposes even if the taxpayer does not record it as an expense in the books of account. Instead, the taxpayer is able to claim the tax deduction by recording that amount as an appropriation of retained earnings in the statement of retained earnings.

H. *Reserves*

Japanese tax laws allow provisions for certain reserves to be deductible expenses for tax purposes. In order to claim a

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deduction, the provision must be calculated in accordance with the formula prescribed in the tax law and recorded in the books of account as an expense. With some exceptions, most of the reserves allowed for tax purposes are also necessary for accounting purposes. Accordingly, any conflict between tax and financial reporting will usually be whether the amounts allowed for tax purposes are adequate for accounting purposes. From a practical standpoint, if a taxpayer records a reserve such as a bad debt reserve based on the tax formula, such reserve balance will be deemed adequate for financial reporting purposes as well. The JICPA has issued a number of pronouncements with respect to the accounting treatment for these reserve accounts and has accepted that the balance provided based on the tax formula will be deemed adequate for financial reporting purposes.

The following explains representative reserve accounts with respect to their tax deductible limitation calculations.

1. Bad debt reserve

There are two ways to calculate the deductible limitation of the bad debt reserve. One is the use of prescribed percentages in the tax law and the other is the use of a percentage developed by the taxpayer based on its own experience. A taxpayer is able to choose either method on an annual basis. In either case, however, a certain percentage will be applied to the balance of receivables at the taxpayer's year-end to calculate the deductible limitation. Receivables will be identified by customers and any payable to the same customers will be netted to calculate the balance eligible for the reserve.

Tax law stipulates different percentages for taxpayers in different industries. For instance, the percentage for taxpayers in the retail and wholesale industry is 1.3 percent, that for manufacturing is 0.8 percent and that for the financial industry is 0.3 percent.

2. Reserve for bonus payment

Regular employee bonus payments made twice a year, once in June or July and once in December, are customary in Japan. Therefore, the tax law allows the deduction of a provision for bonus reserve in calculating taxable income. The reserve for bonus payments is essentially identical to accrued bonus in terms of accounting terminology. However, the deductible limitation for tax purposes must be computed based generally on the actual amount of bonus paid in the previous period.

Therefore, if a taxpayer is more profitable in the current period than in the previous period and it is planning to pay larger bonuses to employees, the amount of bonus reserve calculated under the tax formula will not be adequate from an accounting standpoint. Practically speaking, however, the reserve for bonus payments computed in accordance with the tax formula will be accepted as an adequate bonus payment liability for financial reporting purposes.

3. Reserve for employee's termination allowance

It is customary for a corporate employer to pay lump-sum compensation to an employee when he terminates his employment with the company. Termination allowance is a part of the total compensation package to employees and is normally covered in the rules of employment. The allowance is paid for both voluntary and involuntary termination, but the amount of the allowance for involuntary termination or for retirement is generally much larger than the amount for voluntary termination.

In order to provide for future payment of the termination allowance, a corporation is required from an accounting standpoint to record the liability in the balance sheet. Tax law follows this accounting requirement and allows a deduction of a provision for termination allowance up to a certain limitation. Generally speaking, the reserve for employee termination allowance is deductible for tax purposes up to 40 percent of the amount required if all employees terminate the employment voluntarily at the year-end.

For accounting purpose, the amount of the reserve must be determined by way of actuarial computation. Many companies, however, do not make an actuarial computation but only apply the tax formula to determine the reserve amount. Some companies provide the reserve at 150 percent of the voluntary amount and some apply only the tax basis (40 percent). Some argue that the tax basis of 40 percent is adequate after taking a discount factor into consideration because the payment is due at some future date.

If a company provides a reserve up to only the 40 percent tax limit, such accounting is also deemed as acceptable accounting practice.

Even though it is also customary to pay a termination allowance to directors, provision for the reserve for directors' termination allowance is not deductible for tax purposes. Termination allowance to directors is deductible only when it is paid and the amount is approved at a shareholders' meeting. Some companies provide the reserve for directors' termination allowance and add back the provision to taxable income for tax purposes. A majority of companies, however, do not reflect the reserve in their financial statements.

I. *Translation of foreign currency transactions and balances*

Tax law rules have also been the basis for the generally accepted accounting practice for translation of foreign currency transactions and balances.

In principal, transactions such as sales, purchases, income and expenses, etc. denominated in foreign currency will be translated into Japanese yen using the exchange rate in effect at the time of the transactions. A taxpayer is allowed to use a simplified method (weekly or monthly average exchange rates) in lieu of the rates in effect at the time of the transactions. Once the simplified method is adopted, it must be applied consistently.

For translation of balance sheet items denominated in foreign currency, the monetary/non-monetary distinction is important. For non-monetary items such as inventories and properties, historical yen amounts translated at the time of the transactions must be carried in the balance sheet and no revalua-

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tion is allowable. This method complies with generally accepted accounting principles in Japan.

For monetary items such as receivables and payables, a short-term and long-term distinction based on a one year rule becomes another important criteria. For short-term receivables and payables, a taxpayer is able to elect either historical rate, or current rate to translate the balances at the year-end. The election must be filed with the tax office and the method adopted must be used consistently.

On the other hand, translation of long-term receivables and payables must be made at the historical rate. This means that the same yen amounts translated at the time when the balances were originated will be carried in the balance sheet unless there is a significant change of exchange rate during the fiscal year. A 15 percent change is considered significant.

Unrealized exchange gains or losses resulting from revaluation of the balances at the year end will be treated the same as realized gains or losses arising from settlement and are taxable or deductible for tax purposes. Unlike with some foreign countries, there is no distinction between capital and trading in the definition of income and loss and all exchange gains or losses are fully taxable or deductible if translation is made in accordance with tax law.

Generally speaking, there is no difference between tax accounting and financial accounting for translation of foreign currency transactions and balances.

J. *Special credit for deferral of certain gains*

For certain transactions involving the sale, exchange, purchase and replacement, etc. of real property, the tax law allows deferral of the capital gain until a future date. Since the objective of this article is not to explain the detailed tax rules but to address tax accounting vis-a-vis financial accounting, I will only summarize representative transactions which qualify for the deferral provisions as follows:

- like-kind exchange of real property;
- acquisition of real property by government grants or subsidies;
- acquisition of replacement property with insurance proceeds;
- acquisition of property with proceeds arising from the sale of certain land.[3]

If a taxpayer earns income or gain from these types of transactions, the capital gain or income may not be recognized currently but may be deferred until a future date at his own discretion. The amount of deferral will be computed generally by applying the percentage of sales proceeds or subsidy used for acquisition of real property. In order to enjoy the deferral benefit, the taxpayer is required to adopt one of the following three accounting methods in its books of account:[4]

(a) Book value of old properties exchanged, destroyed or sold will be carried as the basis of new property acquired. In case of properties acquired using government grants or insurance proceeds, the basis will be the amount of acquisition cost less grants or proceeds used for acquisition. In essence, the amount of gain eligible for deferral will be deducted from the basis of the property acquired and such amount is not recognized as a current taxable gain. The deduction must be recorded as an expense item in the income statement.

(b) The amount of gain eligible for deferral will be recorded as a special credit in the balance sheet. Provision for special credit must be recorded as an expense item in the income statement.

(c) The amount of gain eligible for deferral will be recorded as an earned reserve in the balance sheet. Appropriation to the earned reserve must be reflected in the statement of retained earnings.

After a taxpayer elects one of the three methods for deferral of capital gain, the tax deduction resulting from future depreciation or from disposition will be decreased by the corresponding deferred capital gain. If the taxpayer acquires depreciable property, the tax deduction resulting from depreciation will be decreased in the following manner:

Accounting method (a)
Since the basis of the property was decreased by the deferred gain, depreciation expense will be decreased accordingly.

Accounting method (b)
The amount of the special credit recorded in the balance sheet must be amortized to income over the tax useful life of the property acquired. Thus capital gain deferred will revert to income and be taxable over the life of the property.

Accounting method (c)
Amount of earned reserve must be reversed to unappropriated retained earnings over the life of the property. The amount reversed to the unappropriated retained earnings must be included in taxable income in the tax return.

In the case of land, the capital gain deferred will be recognized in its entirety when the land is disposed of in the future.

Before accounting method (c) was incorporated in the tax law of 1982, there were continuous challenges from scholars and those in the accounting profession about the book/tax compliance requirement. Their position was that in the case of accounting method (a), the book value of the property acquired would not reflect the correct acquisition cost, and in the case of accounting method (b), the special credit has no balance sheet meaning because it is neither a valuation reserve nor a liability. They contended that the book/tax compliance requirement in the tax law impaired fair presentation of operating results and financial positions of Japanese companies.

Accounting scholars tried to convince the tax authorities to abolish the book/tax compliance requirement and to accept that financial accounting be executed separately from the tax provisions. The scholars addressed many other issues such as accounting for special depreciation and various reserve

3. From taxable years starting 1 April 1990, only 80 percent of capital gain is eligible for deferral and 20 percent becomes taxable when it is earned.
4. In case of like-kind exchanges, only accounting method (a) can be used.

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accounts, but the severest challenge was directed at the accounting for deferment of capital gain.

In 1982 based on an agreement among three government entities (the National Tax Administration, the Ministry of Justice which governs the accounting standards for Commercial Code audit, and the Business Accounting Deliberation Council which establishes generally accepted accounting principles), accounting method (c) was adopted by the tax authorities as an acceptable method. After the 1982 amendment, challenges from accounting scholars on various tax accounting methods and the book/tax compliance requirement rapidly weakened in tone. Currently, there are no significant arguments against the book/tax compliance requirement from financial accounting advocates.

Over the years, Japanese financial accounting has been significantly influenced by tax law provisions. Sometimes the book/tax compliance requirement was regarded as a bottleneck for improvement of the Japanese accounting standards. However, as a result of compromise in both the tax and accounting sides over the years, the book/tax compliance requirement is widely accepted as a necessary structure to maintain efficient tax administration and simple bookkeeping systems in Japan.

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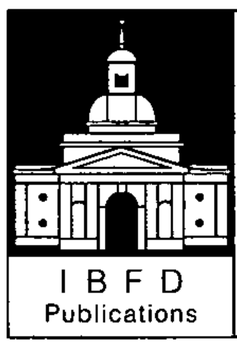

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UNITED STATES:

PROPOSED INTERCOMPANY TRANSFER PRICING AND COST SHARING REGULATIONS

On 24 January 1992, the United States Internal Revenue Service released proposed income tax regulations relating to intercompany transfer pricing and cost sharing under section 482 of the U.S. Internal Revenue Code, as amended by the Tax Reform Act of 1986. These regulations would provide guidance implementing the amendment.

Comments and requests for a public hearing should be sent to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention: CC:CORP:T:R (INTL-0372-88) [for comments on cost sharing provisions] or (INTL-0401-88) [for comments on other provisions], Room 5228, Washington, D.C. 20044, USA.

Further information may be obtained from: Howard Berger (tel.: 202-377-9059), with respect to all provisions except cost sharing, and Lisa Sams (tel.: 202-874-1490), with respect to cost sharing provisions, both of the Office of Associate Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, USA, Attention: CC:CORP:T:R (INTL-0372-88 and INTL-0401-88).

TEXT OF DOCUMENT RELEASED BY THE IRS, INCLUDING PROPOSED REGULATIONS

EFFECTIVE DATE

These regulations are generally proposed to be effective for taxable years beginning after December 31, 1992. However, they will not apply with respect to transfers made or licenses granted to foreign persons before November 17, 1985, or before August 17, 1986, for transfers or licenses to others. Nevertheless, they will apply with respect to transfers or licenses before such dates if, with respect to property transferred pursuant to an earlier and continuing transfer agreement, such property was not in existence or owned by the taxpayer on such date. Although these proposed regulations are generally effective for taxable years after December 31, 1992, the final sentence of section 482 (requiring that the income with respect to transfers or licenses of intangible property be commensurate with the income attributable to the intangible) is generally effective for taxable years beginning after December 31, 1986. For the period prior to the proposed effective date of these regulations, the final sentence of section 482 shall be applied using any reasonable method not inconsistent with the statute. The Internal Revenue Service considers a method that applies these proposed regulations or their general principles to be a reasonable method. A transitional rule is provided at § 1.482-2(g)(8) with respect to cost sharing arrangements entered into under current § 1.482-2(d)(4) in prior taxable years.

BACKGROUND

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 482 of the Internal Revenue Code. Section 482 was amended by the Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085, 2561, *et seq.*

EXPLANATION OF PROVISIONS

INTRODUCTION

The Tax Reform Act of 1986 ("the Act") amended section 482, to require that consideration for intangible property be commensurate with the income attributable to the intangible. The legislative history of the Act states that this change was intended to assure that the division of income between related parties reasonably reflects the economic activities each undertakes. *See* H.R. Rep. 99-281, 99th Cong., 2nd Sess. (1986) at II-637. The legislative history also expresses concern that insufficiently stringent standards previously had been used in determining whether an uncontrolled transfer is comparable to a controlled transfer. The legislative history specifically notes concern about the improper use of comparables with regard to "high profit-potential intangibles," noting that it is especially difficult to obtain realistic comparables with respect to such intangibles because they seldom if ever are transferred to unrelated parties. *See* H.R. Rep. 99-426, 99th Cong., 1st Sess. (1985) at 424.

The Conference Committee report on the Act recommended that the Internal Revenue Service (the "Service") conduct a comprehensive study of transfer pricing and consider whether regulations under section 482 should be modified. In response, the Treasury Department and the Service issued a study of intercompany transfer pricing (Notice 88-123, 1988-2 C.B. 458, the "White Paper") on October 18, 1988. Although the White Paper primarily considered transfers of intangibles, it also addressed the application of section 482 to other transactions. The White Paper specifically discussed the need to modify the regulations dealing with transfers of tangible property to take into account the common incorpora-

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tion of the value of intangibles into tangible property. As described in greater detail below, such changes are found in amendments to § 1.482-2(e).

The White Paper proposed two approaches for determining the proper charge for an intangible under the commensurate with income standard. The first was a pricing approach. It included two methods: the exact comparable method and the inexact comparable method. The second was an income approach. It also included two methods: the basic arm's length return method ("BALRM") and BALRM with profit split. The BALRM generally allocated income to the parties to a transaction by assigning industry average rates of return to their assets.

Many comments on the White Paper criticized the prominent role given to BALRM, arguing that BALRM would be difficult to apply because the information BALRM required generally would not be available, would be unfair to corporations whose rates of return vary considerably from the average, and would allocate too much income to U.S. entities. The Service also was urged to assign a greater role to inexact comparable transactions and to reconsider the use of safe harbor rules. These comments were taken into account in the development of the three pricing methods described in § 1.482-2(d) and (f) of these proposed regulations.

Both the exact comparable and inexact comparable methods, like the methods for determining an appropriate price described elsewhere in § 1.482-2, are intended to apply the general standard of § 1.482-1 (*i.e.*, the price of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer) to specific situations. They should not be applied mechanically or without regard for this purpose. Thus, § 1.482-1(b)(1) has been modified to clarify that its principles are intended to guide application of the specific methods described in § 1.482-2.

The Conference Committee report also noted that Congress did not intend to preclude the use of a cost sharing arrangement to allocate income attributable to an intangible among related parties provided that such an arrangement is consistent with the requirement that the allocation of income among related parties reasonably reflect the actual economic activity undertaken by each. To satisfy this requirement, each participant should bear an appropriate portion of all research and development costs on unsuccessful as well as successful products within an applicable product area, each participant's cost share generally should be proportionate to profit determined before deduction for research and development, and an appropriate return should be provided to a participant that effectively put its funds at greater risk than other participants. *See* H.R. Rep. 99-281, 99th Cong., 2d Sess. (1986) at II-638.

The White Paper concluded that cost sharing arrangements should have standard terms. For instance, the White Paper stated that most shared research and development should be conducted with respect to products that were within the same three-digit Standard Industrial Classification code. This proposal was intended to prevent a U.S. participant from paying for unsuccessful research while receiving little or no benefit from successful research, and to prevent a foreign participant from failing to pay for unsuccessful research while receiving significant benefits from successful research. Other requirements proposed by the White Paper included the assignment to each participant of exclusive rights in developed intangible property, the restriction of membership in a cost sharing arrangement to those in a position to exploit developed intangibles by means of the manufacture of products, and the exclusion of marketing intangibles from the scope of an arrangement's research and development.

Comments on these proposals maintained that the White Paper's approach would unduly restrict the ability of taxpayers to enter into a cost sharing arrangement. Additional comments raised concerns with respect to the White Paper's proposed method for measuring anticipated benefits in computing cost shares (including assignment of exclusive geographic rights), the adjustments of cost shares in subsequent years to reflect changes in subsequent benefits, the exclusion of non-manufacturers as eligible participants, the identification of costs that must be shared pursuant to the arrangement, and buy-in or buy-out rules that govern cases where a portion of the intangible is considered to be transferred (including whether going concern value should be included and whether taxpayers should be permitted flexibility in selecting the form of payment for a buy-in or buy-out). Several comments suggested that the Service model new cost sharing regulations on rules proposed in 1966 and withdrawn in 1968. These suggestions were taken into account in developing § 1.482-2(g).

SUMMARY OF PROPOSED REGULATIONS

Section 1.482-1(b)(1)

Section 1.482-1(b)(1) coordinates existing regulations that explain the scope and purpose of regulations under section 482 with new provisions interpreting the commensurate with income standard. Section 1.482-1(b)(1) also clarifies the general meaning of the arm's length standard and the relationship of § 1.482-1 to § 1.482-2. As revised, § 1.482-1(b)(1) provides that the test to be applied in all instances is whether uncontrolled taxpayers exercising sound business judgment would have agreed to the same terms given the actual circumstances under which controlled taxpayers dealt.

For example, closely related transfers of tangible and intangible property, such as "round-trip" transactions, should be viewed together in determining whether the price of each transaction is arm's length. A round-trip transaction typically begins with a license of an intangible to a related party. The licensee uses the intangible to produce tangible property and sells the tangible property either to the licensor of the intangible or to the licensor's affiliates. Rather than analyzing each of these transactions independently, the proposed regulations allow the district director to consider the price charged for the tangible property as one of the circumstances that should be taken into account in determining whether an uncontrolled taxpayer would have agreed to the same consideration for the intangible property.

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Section 1.482-2(d)

Section 1.482-2(d) replaces current rules applicable to intangible property. Section 1.482-2(d)(1)(i) provides that an arm's length consideration for an intangible must be commensurate with the income attributable to it. Section 1.482-2(d)(1)(ii) defines the terms intangible, transfer, controlled transfer, and uncontrolled transfer. Section 1.482-2(d)(1)(iii) provides that paragraph (d) applies to any transaction that in substance is a transfer of an intangible, regardless of the form of the transaction.

Section 1.482-2(d)(2) outlines how an arm's length consideration for an intangible is determined. Section 1.482-2(d)(2)(iii) prescribes the priority of the methods for determining an arm's length consideration. Ordinarily, the method that relies on the most complete and accurate data and requires the fewest adjustments will most accurately reflect the amount of consideration that an unrelated taxpayer would have charged for the same intangible under the same circumstances. Highest priority therefore is assigned to the matching transaction method. Second priority is assigned to the comparable adjustable transaction method. If those methods cannot be applied, then an arm's length consideration is determined under the comparable profit method. Under § 1.482-2(d)(2)(iv), all relevant facts and circumstances must be considered in applying these methods, including information from the taxable year under review, and from taxable years before and after that taxable year. The regulations do not require the Service or the taxpayer to demonstrate the inapplicability of a higher priority method before applying a lower priority method. However, either the Service or the taxpayer may establish the applicability of a higher priority method.

Section 1.482-2(d)(3) describes the matching transaction method. A matching transaction is an uncontrolled transfer of the same intangible under the same, or substantially similar, economic conditions and contractual terms.

The intangible involved in a controlled transfer will be considered the same as the intangible involved in an uncontrolled transfer only if the protected interest or body of knowledge that is subject to exploitation through the use of each intangible are identical. Geographic or use restrictions are considered differences in contractual terms, rather than differences in the interests transferred.

Section 1.482-2(d)(3)(iii) provides guidance for determining whether the economic circumstances in the controlled and uncontrolled transfers are substantially similar. Economic factors that could affect the amount of consideration charged in the two transactions will be considered. Section 1.482-2(d)(3)(iv) provides guidance for determining whether the contractual terms of the controlled and uncontrolled terms are substantially similar. Contractual terms that could affect the amount of consideration charged in the two transactions will be considered.

Under § 1.482-2(d)(3)(v), adjustments will be made when the economic conditions and contractual terms of controlled and uncontrolled transactions are substantially similar but are not identical. Adjustments may be made to compensate only for a limited number of differences that both alone and combined have only a minor effect on the consideration charged in the uncontrolled transfer. If other adjustments would be required to compensate for differences, the economic conditions and contractual terms are not substantially similar and the matching transaction method does not apply.

Section 1.482-2(d)(4) describes the comparable adjustable transaction method. Under this method an arm's length consideration is determined with reference to the amount of consideration charged in an uncontrolled transfer of the same or a similar intangible under adjustable circumstances, subject to verification by the comparable profit interval described in § 1.482-2(f). Verification of a comparable adjustable transaction by reference to the comparable profit interval is intended to ensure that adjustments under this method do not produce results that are inconsistent with the dealings of uncontrolled taxpayers. The same factors considered under the matching transaction method in determining whether economic conditions and contractual terms are substantially similar are considered in determining whether the economic conditions and contractual terms of controlled and uncontrolled transactions are adjustable. Contractual terms and economic conditions will be considered adjustable if they are sufficiently similar that the effect of any differences on the consideration charged in the uncontrolled transfer can be determined with reasonable accuracy.

The consideration charged in an uncontrolled transfer must be adjusted to compensate for material differences between the controlled and uncontrolled transfers. When more than one comparable adjustable transaction is available, an arm's length consideration should be determined with reference to the transaction for which the necessary adjustments can be most accurately determined.

Section 1.482-2(d)(5) describes the comparable profit method, which applies to determine an arm's length consideration when the matching and comparable adjustable transaction methods are inapplicable. This method requires a comparison of the operating income that results from the consideration actually charged in a controlled transfer ("reported operating income") with the operating incomes of similar taxpayers that are uncontrolled. See § 1.482-2(d)(5)(v) for the definition of "reported operating income." The consideration charged in the controlled transfer ordinarily will be considered an arm's length amount when reported operating income falls within the comparable profit interval but will not be considered arm's length, and may be adjusted, when reported operating income falls outside the comparable profit interval. In the latter case, the transfer price generally may be adjusted to produce operating income that is at the "most appropriate point" in the comparable profit interval. A special rule allows a smaller adjustment to be made when reported operating income is outside of, but corresponds closely to, the comparable profit interval. This special rule is intended to narrow the scope of controversies when reported operating income does not vary significantly from results that are within the comparable profit interval. Section 1.482-2(d)(5)(iv) provides limited exceptions to this special rule.

Section 1.482-2(d)(6) provides guidance regarding transfers of intangibles for more than one taxable year. Section 1.482-

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2(d)(6)(i) provides that all relevant facts throughout the period the intangible is used may be considered. Ordinarily an adjustment may be made with respect to an intangible in the taxable year under examination even though the charge for the intangible was arm's length in an earlier year. Section 1.482-2(d)(6)(ii) provides three exceptions to this rule. The first exception applies only in the case of the matching or comparable adjustable transaction methods. Generally, an allocation may not be made under those methods if an arm's length consideration was charged for the intangible in the year it was transferred, operating income remained in the comparable profit interval for all subsequent years (including the year under examination), and there has been no more than a minor variation in the amount of operating income attributable to the transferred intangible.

The second exception requires that the transferee paid a royalty in exchange for the use of the intangible, the intangible has been used for at least 10 years since the date of its initial transfer, and the royalty was determined to be an arm's length royalty for each year of its use throughout the 10-year period under the matching or comparable adjustable transaction method.

The third exception requires that the relevant agreement contained no provision for adjustments to the royalty to reflect unanticipated changes in profitability, the use of the intangible was limited in a commercially reasonable way, and the transferee's operating income has moved outside the comparable profit interval due to changes in circumstances that were beyond the control of the taxpayers and neither anticipated nor reasonably foreseeable.

Section 1.482-2(d)(7), which will provide rules concerning the treatment of lump sum payments, is reserved. Chapter Six of the White Paper took the position that taxpayers may structure transactions with lump sum payments provided the economic consequences of a lump sum payment resemble those under a periodic payment approach. Chapter 8 of the White Paper suggested that a lump sum payment be treated as an open transaction, with the lump sum invested in a hypothetical certificate of deposit from which arm's length consideration would be subtracted year by year. Another approach would treat the lump sum as the present value of a stream of payments projected by the taxpayer. An adjustment could be made in the year of transfer to the extent the lump sum differed from the properly computed present value of the stream. Annual adjustments could be made to the extent the actual arm's length amount for a particular year differed from the projection for that year. The Service invites comment on these, or any other, approaches to lump sum payments.

Section 1.482-2(d)(8) clarifies the "developer-assister" rules now found in § 1.482-2(d)(1)(ii). New examples are provided illustrating the application of these rules to the development and enhancement of marketing intangibles.

Section 1.482-2(e)

Section 1.482-2(e)(1) modifies the rules applicable to sales of tangible property. Although the commensurate with income amendment to section 482 in the Act addressed the transfer of intangible property, the Conference Report also directed that "careful consideration be given to whether the existing regulations could be modified in any respect." H.R. Rep. 99-841, 99th Cong., 2d Sess. (1986) at II – 637-638. The regulations extend the use of the comparable profit interval to the resale price, cost plus and so-called "fourth" methods (§§ 1.482-2(e)(1)(ii) – (iv)), which are employed when the comparable uncontrolled price method is inapplicable. When one of these methods is employed, the regulations provide that the comparable profit interval is to serve as a check on the result indicated by such method; if the result produced by the method does not fall within the comparable profit interval, then the result should be disregarded for purposes of determining an arm's length price.

This change is necessary because applying the comparable profit interval solely to transfers of intangibles would create an artificial and unwarranted distinction between the treatment of tangible and intangible property, and would lead to disputes in cases involving tangible property incorporating an intangible. Adoption of similar transfer pricing rules for the tangible and intangible components of the transferred property will eliminate or reduce the need to allocate the property's value between its tangible and intangible components and then to determine the profits attributable to each such component.

A similar allocation and valuation problem may arise in cases in which the transfer of services is indistinguishable from the transfer of intangible property. See *Hospital Corporation of America v. Commissioner,* 81 T.C. 520 (1983). The Service solicits comments on how the services regulations (§ 1.482-2(b)) should incorporate the commensurate with income standard.

These regulations modify the priority of methods under § 1.482-2(e). The comparable uncontrolled price method retains the highest priority. Second priority is given either to the resale price method or the cost plus method, depending on which of the two methods more accurately produces an arm's length price in a particular situation. A price determined under either the resale price method or the cost plus method will be considered arm's length only if it yields a level of operating income that is within the comparable profit interval. Other methods still may be applied, but such other methods also must yield a level of operating income that is within the comparable profit interval. The regulations do not require the Service or the taxpayer to demonstrate the inapplicability of a higher priority method before applying a lower priority method. However, either the Service or the taxpayer may establish the applicability of a higher priority method.

The legislative history expressed concern with judicial interpretations of the comparable uncontrolled price method. These regulations clarify that adjustments must be made to comparables when there are differences between them, in order to use them as comparables.

Section 1.482-2(f)

Section 1.482-2(f) describes the comparable profit interval. In general, the comparable profit interval should provide tax-

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payers with greater certainty in establishing their intercompany transfer prices. Many taxpayers should be able to apply objective measures of profitability (referred to as profit level indicators) of similarly situated parties to their own financial data to develop their own estimates of the comparable profit interval and confirm that their transfer prices produce results that fall within the comparable profit interval.

Section 1.482-2(f)(1) states that the comparable profit interval identifies levels of profits that the appropriate controlled taxpayer whose operating income is tested (the "tested party") would have earned if its profit level indicators had been equivalent to those of similarly situated uncontrolled taxpayers. Profit level indicators derived from uncontrolled taxpayers are applied to the financial data of the tested party to yield the "constructive operating income" that the tested party would have earned. The comparable profit interval then is derived from the constructive operating incomes that converge. If necessary, the most appropriate point within the comparable profit interval is selected.

Section 1.482-2(f)(2) provides that data used in constructing the comparable profit interval normally should be based on actual results before, during, and after the taxable year under examination.

Section 1.482-2(f)(3) identifies six steps that must be followed in developing a comparable profit interval. The steps are interdependent and, in some cases, certain steps may have to be repeated to match the availability of data used in later steps with the determination made in an earlier step.

Section 1.482-2(f)(4) provides rules for the first step: selecting the appropriate controlled taxpayer whose operating income should be tested. In the case of the transfer of an intangible, the tested party normally will be the transferee.

Section 1.482-2(f)(5) provides rules for the second step: determining the "applicable business classification" of the tested party. The applicable business classification normally includes the operations of the tested party that relate to transactions with controlled taxpayers, which are referred to as the "tested operations." The tested operations then are compared to the operations of uncontrolled taxpayers. If possible, operations of uncontrolled taxpayers are selected that closely correspond to the tested operations. If it is not possible to obtain reliable data regarding uncontrolled taxpayers with respect to products that closely correspond to the products related to the tested operations, then the scope of the applicable business classification is broadened.

Section 1.482-2(f)(6) provides rules for the third step: computing the constructive operating incomes that are used to determine the comparable profit interval. The constructive operating incomes are derived by applying profit level indicators obtained from a selection of uncontrolled taxpayers in the applicable business classification to financial data relating to the tested operations.

Profit level indicators should be selected that provide the most reliable basis for comparison under the particular facts and circumstances. Some profit level indicators will be more reliable in particular types of cases than others. Section 1.482-2(f)(6)(iii)(C) identifies a number of profit level indicators that may be used in appropriate cases. These include: rate of return on assets, ratio of operating income to sales, ratio of gross income to expenses, and profit splits. Before application of a profit level indicator to the data of the tested party, the data must be adjusted to reflect (1) any significant differences between the business practices of the tested party and the uncontrolled taxpayers, and (2) any other allocations under section 482. The Service invites comment on the specified profit level indicators and on other profit level indicators and the circumstances in which they might be used.

Section 1.482-2(f)(7) describes the fourth step: determining the comparable profit interval. The comparable profit interval normally is derived from a set of constructive operating incomes that are computed by applying various profit level indicators obtained from uncontrolled taxpayers to the financial data of the tested party. Data that tends to converge is used to form an interval that is reasonably restricted in size, and data that diverges significantly from other data is excluded from the interval.

Two tests are generally used to identify converging data. First, when constructive operating incomes computed with different profit level indicators from the same uncontrolled taxpayer converge, such data generally should be included within the comparable profit interval. Such convergence indicates that the uncontrolled taxpayer from which the data was drawn is comparable to the tested party. If the constructive operating incomes drawn from a single uncontrolled taxpayer diverge, such data generally should be excluded from the interval unless adjustments can be made that account for this lack of uniformity. The second type of convergence considered is convergence of constructive operating incomes obtained from one or more profit level indicators from different uncontrolled taxpayers. In determining both types of convergence, the reliability of all data must be considered, and greater weight accorded to data that is more reliable. If the number of uncontrolled taxpayers whose operations correspond to the applicable business classification is large enough to permit the use of valid statistical techniques, then convergence must be determined by using those techniques to identify a reasonably narrow area of concentration among all the constructive operating incomes computed. The Service solicits comments concerning which statistical techniques would be most appropriate for determining such an area of concentration.

Section 1.482-2(f)(8) describes the fifth step: selecting the most appropriate point within the comparable profit interval, when necessary. (It is not necessary to select the most appropriate point, for example, when the comparable profit method applies and the reported operating income was within the comparable profit interval.) If statistical techniques were used to construct the comparable profit interval, then the most appropriate point will be determined by using measures of central tendency. The Service solicits comments concerning which statistical methods would provide the most appropriate measures of central tendency. If statistical techniques were not used to construct the comparable profit interval, the most appropriate point will be determined by considering a number of factors relating to the comparability and reliabili-

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ty of the underlying data. These factors include similarity of functions performed by the tested party and the uncontrolled taxpayer, similarity of products or services, the extent to which different profit level indicators produce converging amounts of constructive operating income, the number and accuracy of the adjustments required to apply a profit level indicator to uncontrolled taxpayers, the extent to which the profit level indicator meets the reliability factors set forth in § 1.482-2(f)(7)(ii), and the extent to which the profit level indicator produces converging results when applied to the uncontrolled taxpayers.

Section 1.482-2(f)(9) describes the sixth step: determining the transfer price for the controlled transaction, when necessary. The transfer price is determined by adjusting the actual charge in the controlled transaction to produce an operating income for the tested party that equals the constructive operating income corresponding to the most appropriate point in the interval.

Section 1.482-2(g)

Section 1.482-2(g) provides rules for qualified cost sharing arrangements. In general, the regulations require that the structure of a cost sharing arrangement reflect the following general principles --

1. Each participant must have a reasonable expectation of using developed intangibles in the active conduct of its trade or business;
2. The costs of all related intangible development must be shared;
3. Each participant's share of the costs of developing intangibles must be proportionate to its share of the income attributable to developed intangibles; and
4. Participants must compensate the owners or developers of intangible property an arm's length amount for the use of that property, unless the property is developed by the participants through the cost sharing arrangement. Likewise, if a participant bears a portion of the costs incurred in developing an intangible, and subsequently transfers or abandons its rights in the intangible, the remaining participants must compensate the departing participant.

Section 1.482-2(g)(1) states that an intangible development cost sharing arrangement will not be considered a qualified arrangement unless it meets the requirements of § 1.482-2(g)(2), and a member of a controlled group will not be eligible to participate in a cost sharing arrangement unless the member meets the requirements of § 1.482-2(g)(3). If the requirements of § 1.482-2(g)(2) and (3) are met (that is, if a qualified cost sharing arrangement exists), the district director may nonetheless make allocations to cost shares, as provided in § 1.482-2(g)(4), to reflect each participant's arm's length share of the costs and risks of developing intangible property.

The requirements of a qualified cost sharing arrangement include the requirements contained in the current regulations (an agreement in writing between two or more eligible participants providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in any intangible that may be produced), and two new conditions. The new conditions are that the arrangement comply with the administrative requirements of § 1.482-2(g)(6)(i), and that participants make a reasonable effort to measure the share of benefit that each expects to receive and divide costs accordingly. Costs shared must include the costs of unsuccessful or less successful intangible development. One of the objectives of this requirement is to prevent "cherry picking" (*e.g.*, U.S. participants bearing disproportionate costs of unsuccessful research, or foreign participants deriving disproportionate benefits from successful research). The district director is also permitted under this paragraph to apply the cost sharing provisions to any arrangement that in substance constitutes a cost sharing arrangement, to the extent that application of the developer-assister rules under § 1.482-2(d)(8) would result in a failure to clearly reflect the income of a group of controlled taxpayers. The Service solicits comments on the appropriate scope of application of this rule. The Service also solicits comments on the appropriate application of the principles of § 1.482-2(g) in the context of partnerships that develop and exploit intangibles.

Section 1.482-2(g)(2)(ii) provides that a U.S. participant's cost share should be proportionate to the benefits that the participant reasonably anticipates it will derive from the research. Depending on the circumstances, anticipated benefits may be measured in several different ways, as long as the measure reasonably predicts the benefits to be shared. If the development activity relates to more than one cost sharing arrangement, the benefits derived by the participant must be compared to the benefits derived by all of the relevant participants, including those in the other arrangements, for purposes of determining an appropriate cost share. An effort to anticipate benefits generally should include annual review of the participants' cost shares, and permit any adjustments necessary to reflect changes in economic conditions and other factors.

To the extent that a cost sharing arrangement fails to divide cost shares in proportion to benefits, the regulations provide for three different types of adjustment. The type of adjustment to be applied is determined by a comparison of the U.S. participant's cost/income ratio and the cost/income ratio of the other participants.

The cost/income ratio used for purposes of the cost sharing provisions is generally the participant's three-year average cost share, divided by its three-year average operating income attributable to developed intangibles. Operating income attributable to developed intangibles is defined as income from the license or sale of developed intangibles plus income earned from the sale of products or services incorporating such intangibles.

First, if the cost/income ratio of a U.S. participant is "grossly disproportionate" to the cost/income ratio of the other participants, the method for dividing cost shares will be presumed not to reflect a reasonable effort to share costs in proportion to benefits, and the cost sharing arrangement will not be considered a qualified cost sharing arrangement. Second, if the cost/income ratio of a U.S. participant is "substantially disproportionate" to the cost/income ratio of the other participants, the cost sharing arrangement will be considered a qualified arrangement, but a partial transfer of intangible proper-

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ty may be deemed to have occurred outside of the scope of the arrangement. In such a "buy-in" or "buy-out" situation, consideration for the transfer of the intangible must be consistent with the provisions of § 1.482-2(d). Section 1.482-2(g)(4)(ii)(D) provides that a U.S. participant's cost/income ratio will not be considered substantially disproportionate if it is less than twice the cost/income ratio of the other eligible participants. Third, if the cost/income ratio of a U.S. participant is not substantially disproportionate to the cost/income ratio of the other participants, an adjustment will be limited to an adjustment of the participants' cost shares.

Section 1.482-2(g)(3) defines an eligible participant. As noted above, there must be at least two eligible participants in order for a cost sharing arrangement to be qualified. In order to be considered eligible, each participant must be able to use developed intangibles in the active conduct of its trade or business. The principles of § 1.367(a)-2T(b)(2) determine whether a participant's activities constitute a trade or business.

An active trade or business may exist even though activities are carried out by independent contractors on behalf of a participant. An intangible will not be considered used in the active conduct of a participant's trade or business if a principal purpose of the participant for entering into the arrangement was to obtain intangible property to transfer to an uncontrolled taxpayer.

One member of a group of controlled taxpayers may participate in a cost sharing arrangement on behalf of other members (the "cost sharing subgroup") for the purpose of meeting the "active trade or business" requirement. However, the intangible property must be transferred from the participating member to the other members of the subgroup on an arm's length basis, either under a separate cost sharing arrangement in effect within that subgroup or otherwise.

Section 1.482-2(g)(4) describes the allocations that may be made by the district director to reflect each participant's arm's length share of an arrangement's costs. First, if the intangible development encompassed by the arrangement is too broad or too narrow, then an adjustment in the participants' cost shares may be necessary to place the arrangement on an arm's length basis. An intangible development area is too broad if any participant will not be able to use developed intangibles in its active business, and it is too narrow if it does not encompass all related intangible development.

Second, if there is a variation between the share of the benefit that each participant expects to receive and the share that is actually received, then, as described above, cost share payments may be reallocated, a buy-in or buy-out may be required, or the cost sharing arrangement may be ignored. Unless another method is more reliable, allocations will be based on a comparison of the U.S. participant's cost/income ratio to the other participants' cost/income ratio, as described above.

Section 1.482-2(g)(5) provides that cost sharing payments will be characterized as costs of developing intangibles to the payor and reimbursements of such costs to the payee. That section also provides that if an arrangement is not considered a qualified arrangement, or if a "buy-in" or "buy-out" is deemed to have occurred, payments with respect to any transfer of intangible property must be treated in accordance with § 1.482-2(d).

Section 1.482-2(g)(6) provides the administrative requirements of a qualified cost sharing arrangement. It also lists the administrative requirements that an eligible participant must satisfy. The paragraph mandates substantial compliance with each requirement. Thus, a minor administrative error will not result in the disqualification of an arrangement or a participant.

Section 1.482-2(g)(7) defines three terms: "specified interest in any intangible," "U.S. participant," and "costs of developing intangibles." The regulations do not specify accounting principles that must be used in determining costs of developing intangibles. The Service invites comments with respect to whether U.S. generally accepted accounting principles, tax accounting principles, or other principles should be used. Section 1.482-2(g)(8) states that existing bona fide cost sharing arrangements, under current § 1.482-2(d)(4), will be considered qualified cost sharing arrangements if modified, as necessary, to conform with § 1.482-2(g) within one year of the publication of the regulation.

Safe Harbor

In the absence of a matching transaction, an arm's length amount of consideration for an intangible may be determined by reference to a comparable adjustable transaction, defined in § 1.482-2(d)(4) as an uncontrolled transfer involving the same or similar intangible under adjustable economic conditions and contractual terms that results in a level of operating income for the tested party that is within the comparable profit interval. In this context the comparable profit interval is intended to verify the reasonableness of the amount of consideration derived by reference to the uncontrolled transfer.

Although the use of the comparable profit interval as a check on a comparable adjustable transaction should increase taxpayers' certainty regarding their transfer prices, a safe harbor for determining the comparable profit interval could provide even greater certainty. The Service solicits comments on whether such a safe harbor should be developed. Such a safe harbor, for example, could be created by multiplying the book value of the licensee's assets by published rates of return. These published rates of return could be based on an average country-wide ratio of operating income to book value of assets. For example, based on data from U.S. publicly-held companies, the average ratio of operating income to assets from 1980-1989 was approximately eleven percent. A safe harbor might be created by reference to a narrow interval of profits surrounding eleven percent.

For licensees with a dollar functional currency, the dollar book value of their assets could be used. For licensees with a different functional currency, the dollar book value of their assets could be calculated using historical exchange rates for their balance sheet assets, and their current operating income could be translated into dollars at the current exchange rate in order to determine whether their operating income falls within the safe harbor interval.

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Such a safe harbor raises significant issues that may outweigh the benefits of simplicity and certainty. Matching a narrowly defined rate of return to the wider variations of returns observed in the marketplace is one problem. Differences in assets held by different taxpayers or shifting of assets among related taxpayers might be more of a problem under a safe harbor that relies solely upon rate of return on assets than under the comparable profit method, which uses rate of return on assets together with other measures.

Due to the difficulty of constructing a workable safe harbor, the proposed regulations do not include a safe harbor and specific comments are requested concerning the feasibility of such an approach and its structure. The following questions are of particular interest. Will a safe harbor simplify the comparable adjustable transaction method? Should a safe harbor be based only on a rate of return on assets method, or are there alternatives? If a safe harbor is included in regulations, how should the problems identified above be addressed? Should a safe harbor be refined so that, for example, adjustments are made to account for differences in taxpayers' debt to equity ratios relative to the country-wide average embodied in the total assets number? Should industry-specific intervals be published? How would such intervals be established? Should there be a provision permitting adjustments to book values of assets by either the taxpayer or the Service to correct distortions in the value of the assets reported by the licensee?

Operation of the Regulations

The regulations described above provide the basic framework for the operation of the transfer pricing rules under section 482 following the amendments made by the Act. The Service recognizes that the promulgation of regulations is only one step in the implementation of these rules, and that the practical effect of the rules proposed in this document will be affected by a variety of other factors. The Service continues to study the overall administration of section 482, and solicits comments on collateral administrative matters not directly relating to these regulations. Comments are particularly requested in the areas described below.

Documentation and Penalties

With respect to documentation, the White Paper noted that a "significant threshold problem in the examination of section 482 cases has been IRS access to relevant information to make pricing determinations." See 1988-2 C.B. at 461. In response to this problem, the White Paper suggested that the section 482 regulations be amended to require that the taxpayer document the methodology used to establish transfer prices prior to filing the tax return and to require that the taxpayer produce such documentation within a reasonable time during examination. The White Paper also suggested that the Government consider whether existing penalties are sufficient to compel production of such documentation. Commentators contended that such requirements would be overbroad and unduly burdensome. They proposed that if contemporaneous documentation is required at all, it be required only in cases of transfers of high profit or high volume intangibles to tax haven entities. Since the publication of the White Paper, Congress has enacted several amendments to the reporting and penalty provisions of the Code. Accordingly, questions regarding documentation and penalties will be addressed in regulations under sections 6001, 6038, 6038A, 6038C, and 6662(e) rather than under section 482. The Service requests comments on the implementation of these rules, and in particular on the appropriate scope of the "reasonable cause" and "good faith" exception to the new section 482-related penalty under sections 6662(e)(3)(B)(i) and 6664(c). For example, should a taxpayer's creation of contemporaneous documentation be a factor that is taken into account in determining whether the exception applies and, if so, what documentation should be required?

Advance Pricing Agreements

The advance pricing agreement procedure permits taxpayers to reach an agreement with the Service concerning the appropriate transfer pricing methodology to be applied in a particular case. See Rev. Proc. 91-22, 1991-1 C.B. 526. Comments are requested concerning any aspect of this program, including the potential impact of these proposed regulations and suggestions for coordination of that program with these regulations.

Improved Resolution of Section 482 Controversies

It is well settled that, upon judicial review, the Commissioner's determination of a deficiency ordinarily is entitled to a presumption of correctness, and taxpayers thus bear the burden of proving that the Commissioner's determination is incorrect in judicial proceedings. *Welch v. Helvering,* 290 U.S. 111 (1933). A principal reason for this allocation of the burden of proof is that taxpayers possess the information necessary to establish the correct amount of their income and deductions. *United States v. Rexach,* 482 F. 2d 10 (1st Cir. 1973). Further, when Congress specifically grants discretion to the Commissioner to make certain determinations, courts will review those determinations with a greater degree of deference. *Dietz Corporation v. United States,* 939 F. 2d 1 (2d Cir. 1991); *Asiatic Petroleum v. Commissioner,* 31 B.T.A. 1152 (1935), *aff'd,* 79 F. 2d 236 (2d Cir. 1935). Accordingly, in section 482 cases, courts generally have held that the Commissioner's determination will be revised only if it is arbitrary, capricious, or unreasonable. *Sundstrand Corporation v. Commissioner,* 96 T.C. 226 (1991); *G.U.R. Company v. Commissioner,* 41 B.T.A. 223 (1940), *aff'd,* 117 F. 2d 187 (7th Cir. 1941).

Some recent section 482 cases have found that the Commissioner's determination of a transfer price was arbitrary, capricious, or unreasonable, *e.g., Merck & Company, Inc. v. United States,* 24 Cl. Ct. 73, 68 AFTR2d 91-5524 (Cl. Ct. 1991). Courts generally have so held when a comparable price has not been available and the courts found that the Service could not demonstrate a suitable alternative method under the current regulations. In that regard, the current regulations dealing with intangibles provide little guidance on methods to be used where comparable transactions do not exist. These proposed regulations provide such methods and prescribe when they should be used.

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The guidance provided by the proposed regulations should facilitate transfer pricing by taxpayers in ways that will lead to less controversy with the Service. Similarly, the regulations should facilitate determinations by the Service of appropriate arm's length pricing. The three pricing methods prescribed in the regulations are intended to reduce disputes between taxpayers and the Service and make it easier to resolve disputes that do arise. In particular, the proposed regulations should facilitate the use of comparable transactions by permitting adjustments under the comparable adjustable transaction method. Further, the comparable profit method addresses the situation in which a comparable adjustable transaction cannot be found.

The Service anticipates that taxpayers will use these regulations to establish transfer prices for controlled transactions using the best available data, and that they will provide the data as early as is practicable in the course of an examination by the Service.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Request for a Public Hearing

Before adoption of these regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request by any person who submits timely written comments on the proposed rules. Notice of the time, place and date for the hearing will be published in the Federal Register.

Drafting Information

The principal authors of these regulations are Howard Berger (all provisions other than cost sharing) and Lisa Sams (cost sharing provisions). Mr. Berger and Ms. Sams are with the Office of Chief Counsel, Internal Revenue Service. Other personnel from the Internal Revenue Service and Treasury Department participated in developing the regulations.

LIST OF SUBJECTS IN 26 CFR 1.481-1 THROUGH 1.483-2T

Accounting, Income taxes, Reporting and record-keeping requirements.

PROPOSED AMENDMENTS TO THE REGULATIONS

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 -- INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 continues to read in part:

Authority: 26 U.S.C. 7805, 68A Stat. 917: 26 U.S.C. 7805. * * *

Par. 2. Section 1.482-1(a)(4) is amended as follows:

1. A second sentence is added at the end of paragraph (a)(4).
2. A new sentence is added at the end of paragraph (a)(5).
3. Seven new sentences are added at the end of paragraph (b)(1).
4. The additions read as follows:

§ 1.482-1 Allocation of income and deductions among taxpayers.

(a) * * *

(4) * * * The term "uncontrolled taxpayer" means any one of two or more organizations, trades, or businesses not owned or controlled directly or indirectly by the same interests.

(5) * * * The terms "uncontrolled group" and "group of uncontrolled taxpayers" mean the organizations, trades, or businesses not owned or controlled directly or indirectly by the same interests.

* * * * *

(b) * * *

(1) * * * In determining whether controlled taxpayers have dealt with each other at arm's length, the general principle to be followed is whether uncontrolled taxpayers, each exercising sound business judgment on the basis of reasonable levels of experience (or, if greater, the actual level of experience of the controlled taxpayer) within the relevant industry and with full knowledge of the relevant facts, would have agreed to the same contractual terms under the same economic conditions and other circumstances. In applying this principle, the district director may consider the combined effect of all transactions of a controlled taxpayer with other members of the group, as well as with uncontrolled taxpayers, before, during and after the taxable year under review, so that allocations described in section 482, taken as a whole, reflect the controlled taxpayer's true taxable income. For example, if a controlled taxpayer's business involves the use of intangibles licensed from another group member to produce finished products, the sale of those products to yet another member of the group, and financing arrangements with uncontrolled taxpayers, the combined effect of these transactions may be considered to determine if they reflect the true taxable income of the controlled taxpayer. The district director also may disregard contractual arrangements, or the absence of contractual arrangements, between controlled

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taxpayers and instead give appropriate consideration to the taxpayers' actual conduct. For example, when a controlled taxpayer that produces tangible property regularly sells its entire output to another member of the controlled group, in determining the producer's true taxable income, the district director may determine from the course of conduct that the producer does not bear the risk that the buyer will fail to purchase its output even if there is no contract requiring the buyer to do so. In the case of any transfer of an intangible between or among controlled taxpayers, the true taxable income of the transferor with respect to such transfer must be commensurate with the income attributable to the intangible. See § 1.482-2(d).

* * * * *

Par. 3. Section 1.482-2 is amended as follows:

1. Paragraphs (d) and (e)(1) are revised.
2. The seventh sentence of paragraph (e)(2)(ii) is revised.
3. Example (4) and Example (5) are added to paragraph (e)(2)(ii).
4. Paragraphs (f) and (g) are added.
5. The additions and revisions read as follows:

§ 1.482-2 Determination of taxable income in specific situations.

* * * * *

(d) *Transfer or use of intangible property* --

(1) *In general* --

(i) *Arm's length standard.* If one member of a group of controlled taxpayers transfers an intangible to another member for other than an arm's length consideration the district director may make appropriate allocations to reflect an arm's length consideration for that intangible or its use. An arm's length consideration for the intangible shall be commensurate with the income attributable to the intangible. See paragraph (g) of this section for special rules relating to qualified cost sharing arrangements.

(ii) *Definitions* --

(A) *Intangible.* For purposes of section 482, the term intangible means any of the following items that have substantial value independent of the services of any individual:

(*1*) Patents, inventions, formulas, processes, designs, patterns, or knowhow;

(*2*) Copyrights;

(*3*) Literary, musical, or artistic compositions;

(*4*) Trademarks, trade names, or brand names;

(*5*) Franchises, licenses, or contracts;

(*6*) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data;

(*7*) Other similar items; and

(*8*) Any interests in any such items.

(B) *transfer.* For purposes of this section, a transfer of an intangible occurs if it is licensed, sold, assigned, loaned, contributed, or otherwise made available in any manner.

(C) *Controlled transfer.* For purposes of this section, a controlled transfer includes any transfer between members of a group of controlled taxpayers.

(D) *Uncontrolled transfer.* For purposes of this section, an uncontrolled transfer is one in which the transferor and the transferee are not members of the same group of controlled taxpayers. These include --

(*1*) Transfers between a member of one group and a party that is a member of a different group,

(*2*) Transfers between a member of one group and a party that is not a member of any group; and

(*3*) Transfers between parties each of which is not members of a group.

(E) *Other definitions.* Definitions of other terms are set forth in connection with other provisions of these regulations. These include the following --

(*1*) Applicable business classifications, defined in paragraph (f)(5)(iii) of this section;

(*2*) Assets, defined in paragraph (f)(6)(iii)(B)(*5*) of this section;

(*3*) Assisters, defined in paragraph (d)(8)(i) of this section;

(*4*) Buy-in and buy-out payments, defined in paragraph (g)(4)(iv) of this section;

(*5*) Comparable adjustable transaction, defined in paragraph (d)(4)(i) of this section;

(*6*) Comparable profit interval, defined in paragraph (f)(1) of this section;

(*7*) Comparable profit method, defined in paragraph (d)(5)(i) of this section;

(*8*) Comparable profit split, defined in paragraph (f)(6)(iii)(C)(*3*) of this section;

(*9*) Constructive operating income, defined in paragraph (f)(1) of this section (see also Operating income, Reported operating income and Operating income attributable to intangibles);

(*10*) Controlled sale, defined in paragraph (e)(1)(i) of this section;

(*11*) Costs of developing intangibles, defined in paragraph (g)(7)(ii) of this section;

(*12*) Departing participant, defined in paragraph (g)(4)(iv)(C) of this section;

(*13*) Developer, defined in paragraph (d)(8)(i) of this section;

(*14*) Eligible participant, defined in paragraph (g)(3) of this section;

(*15*) Gross income, defined in paragraph (f)(6)(iii)(B)(2) of this section;

(*16*) Intangible development area, defined in paragraph (g)(4)(i) of this section;

(*17*) Margins, defined in paragraph (f)(6)(iii)(C)(2) of this section;

(*18*) Matching transaction, defined in paragraph (d)(3)(i) of this section;

(*19*) Most appropriate point, defined in paragraph (f)(8) of this section;

(*20*) Operating expenses, defined in paragraph (f)(6)(iii)(B)(*3*) of this section;

(*21*) Operating income, defined in paragraph (f)(6)(iii)(B)(*4*) of this section;

(*22*) Operating income attributable to intangibles, defined in paragraph (g)(2)(ii)(C)(*3*) of this section;

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(*23*) Profit level indicators, defined in paragraphs (f)(1) and (6)(iii)(C) of this section;

(*24*) Proportionate profits rule, defined in paragraph (g)(4)(ii)(D) of this section;

(*25*) Qualified cost sharing arrangement, defined in paragraph (g)(2) of this section;

(*26*) Related group, defined in paragraph (g)(3)(v)(A) of this section;

(*28*) Related intangible development, defined in paragraph (g)(4)(i)(B) of this section;

(*28*) Reported operating income, defined in paragraph (d)(5)(v) of this section;

(*29*) Sales, defined in paragraph (f)(6)(iii)(B)(*1*) of this section;

(*30*) Same intangible, defined in paragraph (d)(3)(ii)(A) of this section;

(*31*) Similar intangible, defined in paragraph (d)(4)(ii) of this section;

(*32*) Specified interest in an intangible, defined in paragraph (g)(7)(i) of this section;

(*33*) Substantially similar contractual terms, defined in paragraph (d)(3)(iv) of this section;

(*34*) Substantially similar economic conditions, defined in paragraph (d)(3)(iii) of this section;

(*35*) Ten-year test, defined in paragraph (d)(6)(ii)(B) of this section;

(*36*) Tested operations, defined in paragraph (f)(5)(ii) of this section;

(*37*) Tested party, defined in paragraph (f)(4) of this section; and

(*38*) U.S. participant, defined in paragraph (g)(7)(ii) of this section.

(iii) *Coordination with paragraph (e) of this section.* This paragraph (d) applies to any transaction in which the transfer of an intangible occurs through transfers of tangible property or services, if the income attributable to the intangible is material in relation to the income attributable to the tangible property or services to which it relates. For an illustration of this rule, see *Example 3* of paragraph (f)(11).

(iv) *Scope of regulations.* Paragraph (d)(2) of this section provides general rules for determining the form and amount of an arm's length consideration. Paragraphs (d)(3), (4), and (5) of this section prescribe three methods for determining the amount of an arm's length consideration. They are, respectively, the matching transaction method, the comparable adjustable transaction method, and the comparable profit method. Paragraph (d)(6) of this section provides rules for multiple year transfers. Paragraph (d)(7) of this section is reserved for rules for regarding consideration that takes the form of a lump-sum payment. Paragraph (d)(8) of this section provides rules concerning assistance rendered in connection with the development of an intangible. Paragraph (f) of this section provides additional guidance regarding the comparable profit method of paragraph (d)(5) of this section. Paragraph (g) of this section addresses qualified cost sharing arrangements.

(2) *Arm's length consideration -- (i) Standard to be applied.* An arm's length consideration for an intangible is the amount of consideration that an uncontrolled taxpayer would have paid for the same intangible under the same circumstances. The income of the transferor with respect to a controlled transfer of an intangible must be commensurate with the income of the transferee attributable to the intangible.

(ii) *Form.* An arm's length consideration must be in a form that is consistent with a form that would be adopted in transactions between uncontrolled taxpayers under the same circumstances. If the transferee pays nominal or no consideration for an intangible and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty unless a different form is clearly more appropriate.

(iii) *Priority of methods for determining an arm's length consideration.* An arm's length consideration must be determined by applying the matching transaction method, the comparable adjustable transaction method, or the comparable profit method, described in paragraphs (d)(3), (4), and (5) of this section, respectively. Because the matching transaction method requires the fewest adjustments and relies on the most complete and accurate data, an arm's length consideration must be determined under that method if the standards for its application are met. If those standards are not met, an arm's length consideration must be determined under the comparable adjustable transaction method if the standards for its application are met. If the standards for applying neither of these methods are met, the amount of an arm's length consideration must be determined under the comparable profit method. The inapplicability of a higher priority method need not be specifically established before applying a lower priority method. However, an arm's length consideration must be determined under a higher priority method if it is established that the standards for its application are met.

(iv) *Application of methods.* In applying the methods described in paragraphs (d)(3), (4), and (5) of this section, the district director may consider all relevant facts and circumstances throughout the period the intangible is used, including information from before, during and after the taxable year under review. The district director is not limited to considering projections or forecasts, and may consider the actual income derived from the use of an intangible. See paragraph (d)(6) of this section for additional guidance in this regard.

(3) *Matching transaction method* -- (i) *In general.* Under the matching transaction method, an arm's length consideration for a controlled transfer of an intangible is determined by reference to the consideration charged in an uncontrolled transfer of the same intangible under the same or substantially similar economic conditions and contractual terms (a "matching transaction"). If the uncontrolled transfer is under economic conditions and contractual terms that are not the same as, but are substantially similar to, those of the controlled transfer, the uncontrolled transfer must be adjusted as provided in paragraph (d)(3)(v) of this section. If the uncontrolled transfer is under economic conditions and contractual terms that are neither the same as, nor substantially similar to, those of the controlled transfer, the uncontrolled transfer is not a matching transaction but may be a comparable

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adjustable transaction under the method described in paragraph (d)(4) of this section.

(ii) *Same intangible* -- (A) *In general.* A controlled transfer will be considered to involve the same intangible as an uncontrolled transfer if the property, protected interest or body of knowledge that is subject to exploitation through the use of each intangible and the relative stages of development of each intangible are identical. For example, a patented process used to manufacture a specific product is not the same intangible as a different patented process used to manufacture the same product merely because the products produced in each case are identical. Transfers must involve identical intangible property, interests or knowledge in order to be considered transfers of the same intangible.

(B) *Effect of different rights.* Differences in the exploitation rights permitted under two transfers are considered differences in the contractual terms and economic conditions of the transfers rather than differences in the intangible itself. Thus, different geographic or use restrictions are not differences in the intangible itself. For example, the transfer of the right to use a patented process to manufacture, use, and sell a product within a specified market involves the same intangible as a separate transfer of the right to use the same patented process to manufacture, use and sell, the product in a different market. The right to sell a patented product with an attached trademark (or similar marketing intangible), however, is not the same intangible as the right to sell the same product without the trademark.

(iii) *Substantially similar economic conditions.* The determination of whether economic conditions in the controlled and uncontrolled transfers are substantially similar requires a comparison of all economic factors that could affect the amount of consideration in the two transfers. These factors include, but are not limited to --

(A) The similarity of geographic markets, including:

(*1*) The relative size of each market,

(*2*) The extent of overall economic development in each market, and

(*3*) The extent of competition in each market with regard to the uses to which the intangible is applied;

(B) The extent to which the products or services to which the intangible relates have been accepted within each market;

(C) The existence and extent of any collateral transactions or ongoing business relationship between the parties to each transfer; and

(D) The functions performed by the parties and the economic risks associated with those functions.

For example, the transfer of an intangible for use in a developing country would not constitute a transfer under substantially similar economic conditions as the transfer of the same intangible for use in an industrialized country if the overall level of economic development in the markets affects the consideration for the intangible.

(iv) *Substantially similar contractual terms.* The determination of whether contractual terms in the agreements covering controlled and uncontrolled transfers are substantially similar requires a comparison of all contractual terms which could affect the amount of consideration under each agreement. These contractual terms include, but are not limited to --

(A) The amount and form of the consideration charged for the transferred intangible;

(B) The duration of the contracts, and any termination or renegotiation rights;

(C) The portion of the total interests in the intangible to which the contracts apply, including any limitations on the ways the transferee may use the intangible;

(D) Provisions for accelerating or delaying payment; and

(E) Provisions describing the functions to be performed by each party, including any ancillary services (such as technical assistance, marketing, and product development).

For example, if the uncontrolled transfer provides for the transferee to receive a specified level of technical assistance and training, the controlled transfer must contain corresponding rights in order for the contractual terms to be considered substantially similar. If one agreement calls for the transferee to perform significant marketing functions, while in the other the transferor agrees to perform such marketing functions, the contractual terms of the two transfers are not substantially similar.

(v) *Adjustments to economic conditions and contractual* terms -- (A) *In general.* If the same intangible is transferred in a matching transaction under economic conditions and contractual terms that are not the same as, but are substantially similar to, those of the controlled transfer, the consideration charged in the uncontrolled transfer must be adjusted to compensate for those differences. Proper adjustments to the matching transaction will thus reflect the consideration that would have been charged had its economic conditions and contractual terms been the same as those of the controlled transfer.

(B) *Limitation.* Adjustments to an uncontrolled transaction under this paragraph (d)(3)(v) are permitted to compensate only for a limited number of minor differences in economic conditions and contractual terms that have a definite and precisely determinable effect on the consideration for the intangible. The differences for which adjustments will be permitted under this method must be sufficiently limited so that each adjustment alone and all the adjustments combined have only a minor effect on the consideration charged in the uncontrolled transfer. If these standards are not met, then the economic conditions and contractual terms will not be considered substantially similar and the matching transaction method will not apply.

(vi) *Examples.* The following examples illustrate matching transactions:

Example 1. (i) USCo is a U.S. corporation that develops and distributes business software for personal computers. USCo has developed a new line of specialized accounting software that it sells mainly in foreign markets. USCo serves the market in country F for this software by licensing it to an uncontrolled country F corporation, UF. USCo serves the market in country B through its wholly-owned foreign subsidiary, RB. UF and RB have identical license agreements with USCo which entitle them to be exclusive distributors of the product in their respec-

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tive countries in exchange for a royalty of 20 percent of the net selling price.

(ii) In 1996, the IRS audits USCo's 1994 taxable year, the second year in which the agreement was in place. Since the accounting software sold by RB is identical to the software sold by UF, the two transfers involve the same intangible. In addition, the UF license satisfies the requirement of substantially similar contractual terms because the terms of the license that USCo has with UF are identical to the terms of the license it has with RB. Furthermore, RB and UF perform the same functions relating to marketing and distribution of the software. Reliable sales information relevant to these transactions for the years 1993 through 1995 shows that both RB and UF are relatively significant distributors in their respective markets; however, neither holds a monopoly position or a dominant market share. Based on the review of these and other relevant factors, it is determined that the economic conditions with respect to the two transfers are substantially similar and that no adjustments under paragraph (d)(3)(v) of this section need be made. Accordingly, the matching transaction method is applicable, and the royalty rate of 20 percent in the controlled transfer to RB is determined to be an arm's length amount of consideration for 1994.

Example 2. The facts are the same as in *Example 1*, except that the controlled transfer to RB covers all future revisions and updates to the accounting software while the uncontrolled transfer to UF covers only the current version of the software. Since the intangibles transferred in the two transactions are different, the transfers do not involve the same intangible. Therefore, the UF transfer is not a matching transaction.

Example 3. The facts are the same as in *Example 1*, except that the uncontrolled transfer to UF includes contractual terms that require USCo to furnish technical assistance to UF (including information concerning marketing and packaging of the accounting software). The UF agreement provides that USCo will be reimbursed for its costs attributable to any technical assistance it provides. The RB agreement does not contain a similar provision and it provides that the level of technical assistance that can be demanded by UF is relatively modest and will have little effect on the value of the accounting software. Minimal levels of technical assistance are actually provided to UF and RB by USCo. Definite and precisely determinable adjustments to the consideration charged for the accounting software can be made with respect to this difference in contract terms on the basis of the costs to USCo of the technical assistance actually provided. Accordingly, the contractual terms are substantially similar and the UF license is a matching transaction. However, the district director may make an allocation to reflect any differences in technical assistance actually provided.

Example 4. The facts are the same as in *Example 3*, except that USCo is required to provide the same forms of technical assistance at cost to both UF and RB under the contractual terms of the two transfers. In practice, however, the assistance actually provided by USCo to RB involves extensive transfers of knowhow with respect to developing effective distribution networks within the country B market. The marketing function in the uncontrolled transfer, however, is carried on primarily by UF with little actual assistance provided by USCo. The uncontrolled transfer in this case fails to meet the standards for a matching transaction for two reasons. First, because the transfer to RB involves different and more extensive areas of knowhow developed by USCo than the transfer to UF, the two transactions do not involve the same intangible. Second, because the economic conditions of the two transfers involve significantly different functions actually performed by USCo, and any adjustments to compensate for these differences could be relatively large, these conditions are not substantially similar. Accordingly, the uncontrolled transfer is not a matching transaction.

Example 5. The facts are the same as in *Example 1* and no adjustment is made in 1994. Due to RB's capacity for expansion of its distribution network, however, USCo anticipates that future growth in worldwide markets will be met by RB. Beginning in 1995, RB expands its marketing network beyond the country B market. By 1998, RB has significantly expanded its worldwide sales and has developed a dominant market share in several substantial new markets where it is able to charge premium prices for its product. The same factors are not present in country F, and UF continues to hold a relatively stable market share. These changes in economic conditions have a major effect on RB's operations. The adjustment to the consideration charged by UF to account for these differences in economic conditions would be material in comparison to the overall consideration paid to USCo. Accordingly, the economic conditions in the uncontrolled transfer are no longer substantially similar to those of the controlled transfer, and the standards for the matching transaction method are not met with respect to the 1998 taxable year. Nevertheless, the uncontrolled transfer may continue to be a comparable adjustable transaction described in paragraph (d)(4) of this section.

(4) *Comparable adjustable transaction method* -- (i) *In general*. Under the comparable adjustable transaction method, an arm's length consideration for an intangible is determined by reference to the consideration charged in an uncontrolled transfer involving the same or similar intangible under adjustable economic conditions and contractual terms, adjusted as provided in paragraph (d)(4)(iv) of this section. An uncontrolled transfer will not meet the standards of this paragraph (d)(4) if the consideration determined by reference to that transfer results in a level of operating income for the tested party, as defined in paragraph (f)(4) of this section, that is outside of the comparable profit interval, as provided under the rules of paragraph (f) of this section. An uncontrolled transfer that meets the standards of this paragraph ( )(4) is a "comparable adjustable transaction."

(ii) *Same or similar intangible*. A controlled transfer will be considered to involve the same or similar intangible as an uncontrolled transfer if the property, protected interest or body of knowledge that is subject to exploitation through the use of each intangible and the relative stages of development of each intangible are sufficiently similar that the effect of any material differences can be determined with reasonable accuracy.

(iii) *Adjustable economic conditions and contractual terms*. Whether economic conditions and contractual terms are adjustable must be determined using the same factors that apply in determining whether such conditions and terms are substantially similar for purposes of the matching transaction method (as described in paragraphs (d)(3)(iii) and (iv) of this section). The comparable adjustable transaction method does not require that all such terms and conditions be substantially similar, or that adjustments compensate for only a limited number of minor differences. To be considered adjustable, however, the contractual terms and economic conditions must be sufficiently similar that the effect of any material differences can be determined with reasonable accuracy.

(iv) *Adjustments for differences in intangibles, economic conditions, and contractual terms*. If the same or similar intangible is transferred under adjustable economic conditions and contractual terms, the consideration called for in the uncontrolled transfer must be adjusted to compensate for material differences between the intangibles, economic conditions, and contractual terms of the transfers. Adjustments to the uncontrolled transfer will reflect the consideration that would have been charged had its terms and conditions been the same as those of the controlled transfer.

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(v) *Selection of most similar comparable adjustable transaction.* If more than one comparable adjustable transaction is available, the arm's length consideration is determined under this method by using the uncontrolled transfer most similar to the controlled transfer, determined by reference to the factors described in paragraphs (d)(4)(ii), (iii) and (iv) of this section. The most similar comparable adjustable transaction will generally be the uncontrolled transfer for which the necessary adjustments can most accurately be determined. Accordingly, 26 CFR part 1 is proposed to be amended as follows:

(vi) *Examples.* The following examples illustrate comparable adjustable transactions. See also paragraph (f)(11) of this section, which provides examples of the application of the comparable profit interval to test a potential comparable adjustable transaction.

Example 1. X is a domestic corporation engaged in the manufacture and distribution of small plastic products. X has developed and patented certain processes used in the injection molding of its plastic products. In 1994, X expands its operations through a wholly-owned subsidiary, Y, incorporated in country F. Y uses the same manufacturing processes as X and sells its products in country F and other nearby markets. Y agrees to pay X a royalty of 6.5% of gross sales for its use of the injection molding process and related knowhow. In 1996, the district director examines the royalty agreement to determine if the consideration agreed to in 1994 was an arm's length amount. Intangibles related to various types of injection molding processes have been licensed between uncontrolled taxpayers, but none of the processes involve a property, protected interest or body of knowledge which is identical to the process developed by X. Accordingly, these uncontrolled taxpayer licenses do not involve the same intangible and cannot serve as matching transactions. The most similar transaction to the transfer between X and Y involves a process used for injection moulding of soap products that was developed by corporation A and licensed to uncontrolled corporation B, a country F corporation. The royalty rate in the agreement between A and B is 5% of gross sales. B uses the licensed technology to manufacture soap products that it distributes in country F. Reasonably determinable adjustments can be made to reflect the following differences between the two transactions:

(i) The injection molding process developed by X is more sophisticated than the process developed by A and it affects more aspects of the manufacturing process;

(ii) The improved manufacturing technology in Y's plastic business in country F has a significant effect on Y's market share and overall profitability, while improvements to B's manufacturing process in country F have a less beneficial economic effect;

(iii) The contract between X and Y provides for continued technical assistance to be provided at no additional cost by X while the agreement between A and B does not mention technical assistance; and

(iv) Technical assistance has in fact been provided by both A and X to their respective licensees, but the costs of providing the technical assistance has been slightly more in the case of X.

Considering each of the above factors, it is determined that a 1.5% increase over the royalty rate charged in the transaction between A and B is an appropriate adjustment to reflect the differences between the two transactions. In addition, the operating income earned by Y after payment of the 6.5% royalty is within the comparable profit interval described in paragraph (f) of this section. Accordingly, the royalty rate set between X and Y will be an arm's length amount of consideration under the comparable adjustable transaction method.

Example 2. The facts are the same as in *Example 1,* except that the license agreement between X and Y contains a royalty rate of 3% of gross sales and there is no comparable adjustable transaction between A and B. X defends the 3% royalty as an arm's length amount by reference to a license agreement between uncontrolled taxpayers C and D. C is a developer of an intangible that involves improvements to the computer controls in the production of advanced machine tools. D licenses this intangible for use in its country F machine tool manufacturing business and pays C a royalty of 3% of gross sales. The differences between the functions performed with the two intangibles are substantial. For instance, C's process is used for only one step of many stages of the manufacturing of the machine tools and has little effect on the size of D's labor force. By contrast, the injection molding process developed by X replaces or significantly affects each stage of the manufacture of Y's plastic products and results in a major labor force reduction. Due to these differences between the intangibles involved in the two transfers, and the differences in the overall economic benefit to be derived from the cost reductions achieved, compensating adjustments to the royalty charged in the uncontrolled transfer cannot be reasonably ascertained. Accordingly, the transfer of the intangible from C to D is not a comparable adjustable transaction.

Example 3. The facts are the same as in *Example 1,* except that the assistance actually provided by X to Y in the controlled transfer is substantially greater than the assistance provided by A to B in the uncontrolled transfer. The assistance provided in the controlled transfer extends to all aspects of Y's manufacturing and marketing efforts, and constitutes a wide body of knowledge accumulated by X in its manufacturing and marketing of plastic products in the U.S. market. This assistance is a substantial factor in the success of Y's manufacturing and marketing operations. In contrast, B's assistance from A is limited solely to the operational aspects of A's injection molding process. B's other manufacturing expertise, and all of its marketing knowhow, were developed through B's long term experience in country F. Accordingly, there are substantial differences between the intangibles transferred by A and X; the transfer to Y involves knowhow relating to all of Y's manufacturing and marketing operations, whereas the transfer to B is limited to one aspect of the manufacturing process. Due to the lack of reliable data concerning the value to B of its self-developed intangibles as well as the comparative economic effects between the plastic and soap markets resulting from these broader types of intangibles, the adjustments to account for these differences are not reasonably determinable. Accordingly, the transfer from A to B is not a comparable adjustable transaction.

Example 4. The facts are the same as in *Example 1,* except that Y's use of the injection molding processes in 1994 is only in an early stage of implementation within country F. As expected by X and Y, the process becomes fully operational in 1995 allowing Y to significantly reduce manufacturing costs, lower the prices of its products, and expand its market share within country F. By 1998, Y is the largest manufacturer of these products in the market and has significantly increased both its volume of sales and its profitability. As a result, the operating income earned by Y in 1998 (after payment of the 6.5% royalty to X) substantially exceeds the comparable profit interval described in paragraph (f) of this section. Moreover, the economic conditions involved in Y's operations have grown sufficiently different from the economic conditions involved in B's soap production that adjustments to the royalty rate paid by B to account for those differences are no longer reasonably determinable. Accordingly, the transfer between A and B is not a comparable adjustable transaction for the 1998 taxable year.

(5) *Comparable profit method* -- (i) *In general.* If there are no uncontrolled transfers that meet the standards for either matching transactions or comparable adjustable transactions, then an arm's length consideration for the controlled transfer of an intangible must be determined by reference to the comparable profit interval of the tested party under the rules of paragraph (f) of this section. Paragraphs (d)(5)(ii), (iii), and (iv) of this section provide rules concerning application of the comparable profit method based on whether the reported operating income (as defined in paragraph (d)(5)(v)

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of this section) of the tested party is within or outside of the comparable profit interval. These rules do not apply for purposes of using the comparable profit interval to test a potential comparable adjustable transaction, as required in paragraph (d)(4)(i) of this section, or for purposes of testing a result under any method described in paragraph (e)(1)(iii) or (iv) of this section.

(ii) *Effect if reported operating income of the tested party is within the comparable profit interval.* If the comparable profit method applies (*i.e.*, the standards for the matching or comparable adjustable transaction methods have not been met) and the consideration charged in the controlled transfer results in reported operating income of the tested party that is within the comparable profit interval, that amount of consideration will generally be treated for purposes of this paragraph (d) as an arm's length consideration. Accordingly, allocations with respect to those transfers ordinarily will not be made under this paragraph (d). See paragraph (d)(5)(iv) of this section for exceptions to this rule.

(iii) *Effect if reported operating income of the tested party is outside of the comparable profit interval* -- (A) *General rule.* If the comparable profit method applies (*i.e.*, the standards for the matching or comparable adjustable transaction methods have not been met) and the consideration due in the controlled transfer results in reported operating income of the tested party outside of the comparable profit interval, an adjustment under this method may be made to the amount of consideration for such transfer. Except as provided in paragraph (d)(5)(iii)(B) of this section, the adjustment must result in a level of operating income of the tested party at the most appropriate point within the comparable profit interval, as described in paragraph (f)(8) of this section.

(B) *Discretion to limit adjustments.* In determining the amount of any adjustment to be made under this method, the district director will consider how closely the reported operating income corresponds to the comparable profit interval. If reported operating income of the tested party is not significantly outside the comparable profit interval, any adjustments made by the district director will take into account the amount of deviation between the comparable profit interval and the reported operating income. The closer the reported operating income is to the comparable profit interval, the smaller an appropriate adjustment may be. The adjustment must bring the operating income within the comparable profit interval but may be smaller than necessary to reach the most appropriate point in the interval. See paragraph (d)(5)(iv) of this section for exceptions to this rule.

(C) *Examples.* The following examples illustrate an adjustment of the tested party's operating income:

Example 1. The transferee of an intangible is the tested party and the comparable profit interval for the transferee, as determined under paragraph (f) of this section, consists of operating income falling between $1.5 and $2 million. The transferee's reported operating income is $2.1 million. Under all the facts and circumstances of this case, the most appropriate point within the comparable profit interval is $1.7 million. However, the district director determines that the transferee's reported operating income is not significantly outside the comparable profit interval. Consequently, rather than adjusting the transferee's reported operating income to $1.7 million (the most appropriate point within the interval), the district director adjusts the transferee's reported operating income to $1.9 million.

Example 2. Assume the facts are the same as in *Example* 1 except that the transferee's reported operating income is $5.0 million. The transferee's reported operating income lies significantly outside the appropriate profit interval. Consequently, the district director adjusts the transferee's reported income to the most appropriate point, $1.7 million.

(iv) *Exceptions.* If the comparable profit method applies, the district director may make an adjustment that results in a level of operating income for the transferee at the most appropriate point within the comparable profit interval, as described in paragraph (f)(8) of this section, if --

(A) The transferee paid no consideration in connection with the controlled transfer; or

(B) The consideration paid by the transferee in connection with the controlled transfer was substantially disproportionate to the value of the intangible.

In such cases the rules of paragraphs (d)(5)(ii) and (iii)(B) of this section that would permit no adjustment or a more limited adjustment shall not apply.

(v) *Reported operating income.* The term "reported operating income of the tested party" means the operating income of the tested party reflected on a timely U.S. income tax return (or an amended return) filed before the Internal Revenue Service first contacts the tested party or any other member of the same group of controlled taxpayers concerning an examination of the return for the taxable year. If the tested party files a U.S. income tax return, its operating income is considered reflected on a U.S. income tax return if the calculation of taxable income on its return for the taxable year takes into account income attributable to the transferee's use of the intangible or consideration charged for the intangible by the transferor. A written statement furnished by a taxpayer subject to the Coordinated Examination Program will be considered an amended return for purposes of this paragraph (d)(5)(v) if it satisfies the requirements of a qualified amended return for purposes of § 1.6661-6(c) as set forth in those regulations or as the Commissioner may prescribe by Revenue Procedure. If the tested party does not file a U.S. income tax return, its operating income is considered reflected on a U.S. income tax return in any taxable year for which income attributable to the transferee's use of the intangible or consideration charged for the intangible by the transferor affects the calculation of taxable income on the U.S. income tax return of any other member of the same group of controlled taxpayers.

(vi) *Example.* The following example illustrates reported operating income:

Example. USCo, a domestic corporation, wholly owns two foreign subsidiaries F1 and F2. F1 is the developer of an intangible, which it licenses to F2 for a royalty of 5% of gross sales. The royalty received by F1 constitutes foreign personal holding company income under section 954(c). USCo timely files a return for 1994 that includes the amount of the royalty payment as gross income under section 951. The royalty amount has no other effect on the taxable income reportable for 1994 on a U.S. tax return by any person. F2 is the tested party with respect to the controlled transfer of the intangible. In determining whether the royalty paid by F2 was an arm's length consideration, the operating income of F2 will be considered its reported operating income for purposes of applying the comparable profit method.

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(6) *Transfers for more than one taxable year* -- (i) *Timing of review.* If an intangible is transferred under an agreement with a term covering more than one taxable year, the consideration charged in each taxable year may be adjusted to assure that it is commensurate with the income attributable to the intangible. The district director may consider all relevant facts and circumstances throughout the period the intangible is used in determining whether to make allocations in the taxable year under examination. Except as provided in paragraph (d)(6)(ii) of this section, the determination in an earlier year that the amount charged for an intangible was arm's length will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible.

(ii) *Exceptions* -- (A) *Operating income of the tested party remains within the comparable profit interval.* No allocation will be made under paragraphs (d)(3) (matching transaction method) and (d)(4) (comparable adjustable transaction method) of this section for the use of an intangible if:

(*1*) An arm's length consideration (within the meaning of this paragraph (d)) was charged for the intangible in the year it was transferred;

(*2*) The reported operating income of the tested party was within the comparable profit interval (as described in paragraph (f) of this section) in all years subsequent to the year of the transfer, including the taxable year under examination; and

(*3*) There has not been a major variation in the annual amounts of revenue attributable to the transferred intangible.

(B) *Ten-year test.* No allocation shall be made under this paragraph (d) to increase the consideration for the use of an intangible if:

(*1*) The intangible was transferred pursuant to a written agreement that meets the following conditions:

(*i*) At the time the agreement was entered into, the intangible was in existence and was reasonably susceptible of valuation;

(*ii*) The agreement was in effect throughout a 10 year period ending at any time prior to the taxable year under examination; and

(*iii*) The agreement remained in effect in the taxable year under examination;

(*2*) Significant commercial production involving the intangible occurred throughout the 10 year period;

(*3*) The consideration charged under the agreement is set by reference to a royalty rate that was applied throughout the 10 year period and continued to apply with respect to the taxable year under examination; and

(*4*) Either of the following conditions is satisfied:

(*i*) The consideration charged with respect to each of the 10 years previously was determined, or is determined subsequently, to be an arm's length amount under either paragraph (d)(3) (matching transaction method) or (d)(4) (comparable adjustable transaction method) of this section; or

(*ii*) The transferee's reported operating income was within the comparable profit interval throughout the 10 year period and the taxable year under examination.

(C) *Limitation on allocations in subsequent taxable years due to unanticipated events.* No allocation will be made under this paragraph (d) to increase the consideration for the intangible for any taxable year if each of the following facts is established:

(*1*) The controlled taxpayers entered into a written agreement that provided for an amount of consideration with respect to any prior taxable year that is determined to be an arm's length amount under either the matching transaction method or the comparable adjustable transaction method.

(2) The written agreement between the uncontrolled taxpayers that entered into the matching or comparable adjustable transaction contained no provision that would have permitted adjustment or termination due to unanticipated changes of profitability, and no adjustment or termination was in fact made by the uncontrolled taxpayers in any taxable year through the taxable year under review.

(*3*) The written agreement between the controlled taxpayers limited the use of the intangible to a specified field or purpose in a manner that was consistent with industry practices and any limitation in the agreement between the uncontrolled taxpayers.

(*4*) The tested party's operating income moved outside of the comparable profit interval solely because of changes in economic conditions that were--

(*i*) Beyond the control of any member of the group of controlled taxpayers, and

(*ii*) Neither anticipated nor reasonably foreseeable.

(*5*) The written agreement between the controlled taxpayers contained no provision that would have permitted an adjustment of the amount of consideration charged for the intangible, and that agreement remained in effect in the taxable year under review.

(D) *Examples.* The unanticipated events test as set forth in paragraph (d)(6)(ii)(C) of this section is illustrated by the following examples:

Example 1. X is a U.S. corporation with a wholly-owned foreign subsidiary Y. X and Y perform pharmaceutical research, and manufacture and market pharmaceutical products worldwide. X has discovered, patented and obtained FDA approval for Lolip, a cholesterol-lowering drug the active ingredient of which is different from the other competitive drugs which perform similar therapeutic functions. Several of these competitive drugs are licensed to uncontrolled taxpayers in Europe and Asia under long term arrangements which do not provide a mechanism for adjusting the royalty payments in the event of unanticipated changes in economic circumstances. After trial marketing in Europe and Asia to determine expected levels of acceptance, X computes a royalty on the transfer from X to Y of the right to manufacture and market Lolip in Europe and Asia on the basis of the expectation that the competitive drugs will remain in those markets. Two years after X licenses Lolip to Y, a study is published linking the competing drugs to high rates of liver cancer. As a result, in a short time Lolip captures a substantially higher percentage of the European and Asian markets than originally anticipated. Based on reliable documentation, X establishes the five facts listed in paragraph (d)(6)(ii)(C) of this section. Accordingly, no adjustment will be made based solely on the increase in the profitability experienced by Y that was attributable to loss of market share by its competitors due to the liver cancer connection.

Example 2. Assume the same facts as in *Example 1* except that there is no linkage of the competing drugs to liver cancer and the competitors do not lose their anticipated market share. Furthermore, it is determined that the process for manufacturing Lolip generates and releases into the atmosphere high concentrations of a certain pollutant in violation of the U.S. Clean Air Act. Rather than modify the process used in X's U.S. plant, X closes its manufacturing operation and purchases from Y 100

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percent of the Lolip needed to supply the U.S market. The plant closing is not a change that is beyond the control of the parties. Accordingly, the exception described in paragraph (d)(6)(ii)(C) of this section will not apply. Any allocation made by the district director for subsequent taxable years will take into account the fact that Y has acquired the right, in effect, to manufacture Lolip for the US. market.

(7) *Lump-sum payments.* [Reserved]

(8) *Development of an intangible* -- (i) *Identification of the developer.* Except as provided in paragraph (g) of this section, when two or more members of a controlled group undertake the development of an intangible, one member will be regarded as the developer of the intangible, and, therefore, as its owner for purposes of section 482. The other participating members will be regarded as assisters. Which controlled taxpayer is the developer and which controlled taxpayers are assisters will be determined under all the facts and circumstances. In making this determination, greatest weight must be given to the extent to which each member --

(A) Bears the direct and indirect costs and corresponding risk of developing the intangible; and

(B) Makes available without adequate compensation property or services likely to contribute substantially to developing the intangible.

A controlled taxpayer will be treated as bearing the costs and corresponding risk of development only if it is legally bound before the costs are incurred to bear the costs without regard to the success of the project. For this purpose, the risk to be borne with respect to development activity is the possibility that such activity will not result in the production of intangible property or that the intangible property produced will not be of sufficient value to allow for the costs of developing it. Other factors that may be relevant in determining which controlled taxpayer is the developer include the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer controls the project, and the actual conduct of the controlled taxpayers.

(ii) *Allocations with respect to transfers by the developer.* If the developer of an intangible makes the intangible available to another controlled taxpayer (including any assister), the district director may make an allocation with respect to that transfer to reflect an arm's length consideration for the intangible. See paragraph (d)(1) of this section.

(iii) *Allocations with respect to assistance provided to the developer.* The district director may make allocations to reflect arm's length consideration for assistance provided to the developer by another controlled taxpayer in connection with the development of an intangible. Such assistance may include loans, services, or the use of tangible or intangible property. The amount of any allocation required with respect to that assistance must be determined in accordance with the applicable rules of this section. For example, if one member of a controlled group allows another member of the group to use tangible property, such as laboratory equipment, in connection with the latter's development of an intangible, any allocations with respect to the developer's use of the tangible property will be determined under paragraph (c) of this section. If consideration for assistance provided to the developer is not arm's length, instead of making an allocation with respect to the assistance, the district director may treat the difference between the amount of an arm's length consideration for the assistance and the consideration charged by the assister as a loan, either from the assister to the developer (if consideration charged is less than an arm's length amount) or as a loan from the developer to the assister (if consideration charged exceeds an arm's length amount), that is subject to paragraph (a) of this section.

(iv) *Examples.* The following examples illustrate the principles of this paragraph (d)(8). In all these examples, it is assumed X and Y are members of the same group of controlled taxpayers.

Example 1. X, at the request of Y, undertakes to develop a new machine that will function effectively in the climate in which Y's factory is located. Y agrees in writing before X incurs any costs to bear all the direct and indirect costs of the project whether or not X successfully develops the machine. X does not make any of its own property available for use in connection with the project without adequate compensation. The machine is successfully developed and X provides to Y the process necessary to produce it. Y is considered the developer of the process and, therefore, shall not be treated as having obtained it in a transfer subject to the rules of this paragraph (d). The district director may make appropriate allocations with respect to assistance rendered by X. The district director also may treat any use of the process by X as a transfer by Y that is subject to the rules of this paragraph (d) and make allocations with respect to that transfer.

Example 2. Assume the same facts as in *Example 1* except that Y agrees to bear the costs only if the machine is successfully developed. X is considered the developer and Y is regarded as having obtained the process in a transfer subject to the rules of this paragraph (d). Therefore, the district director may make allocations to reflect an arm's length consideration for the transfer of the process.

Example 3. X undertakes to develop a new chemical product M in its research and development department and incur direct and indirect costs of $1,000,000 per year in 1994, 1995, and 1996. X employs the formula for compound N which it developed and owns. The value of the use of the formula for compound N in connection with the project is $750,000. In 1995, four chemists employed by Y spend six months working on the project in X's laboratory. The salary and other expenses connected with the chemists' activities during that period total $200,000 and are paid by Y without charge to X. In 1996, product M is perfected and Y obtains patents on its formula. X is considered the developer of product M because, among other things, it bore the greatest share of the costs and risks incurred in connection with the project and made available valuable property (the formula for compound N). The formula for product M is deemed to have been transferred to Y in 1996 by virtue of Y's obtaining patent rights to product M. The district director may make allocations in that year to reflect arm's length consideration for the transfer. The district director also may make allocations in 1995 with respect to the assistance rendered by Y. If the district director does not make an allocation for 1995 with respect to the services of the chemists in accordance with the principles of paragraph (b) of this section, the district director may treat the amount of an arm's length consideration as a loan to X from Y.

Example 4. X, a foreign producer of cheese, markets its cheese in countries other than the United States under the trade name DR. X owns all worldwide rights to this name. The name is widely known and is valuable outside the United States but is not known within the United States. In 1995, X decides to enter the U.S. market and organizes U.S. subsidiary Y to be its U.S. distributor and to supervise the advertising and other marketing efforts that will be required to develop the name DR in the United States. Y incurs $5,000,000 of expenses promoting

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the name DR in that year for which it is not reimbursed by X. Y is considered the developer of the enhanced U.S. rights to the trade name.

(e) *Sales of tangible property* -- (1) *In general* -- (i) *Arm's length standard.* Where one member of a group of controlled taxpayers sells or otherwise disposes of tangible property to another member of the group ("controlled sale") at other than an arm's length price, the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for that sale or disposition. An arm's length price is the price that an uncontrolled taxpayer would have paid under the same circumstances for the property involved in the controlled sale.

(ii) *Priority of methods.* Paragraphs (e)(2), (3), and (4) of this section prescribe three methods for determining an arm's length consideration. They are, respectively, the comparable uncontrolled price method, the resale price method, and the cost plus method. In addition, a special rule is provided in paragraph (e)(1)(vi) of this section for the sale of an ore or mineral. Because the comparable uncontrolled price method generally will involve the most complete and accurate data and require the fewest and most readily quantifiable adjustments, the amount of an arm's length consideration must be determined under this method if the standards for its application are met. If those standards are not met, the amount of an arm's length consideration must be determined under either the resale price method or the cost plus method, depending upon which method relies on the most complete and accurate data, and requires the fewest and most readily quantifiable adjustments. Use of the resale price method ordinarily is more appropriate when a manufacturer sells products to a controlled distributor which, without further processing or the use of significant intangibles, resells the products in uncontrolled transactions. Use of the cost plus method ordinarily is more appropriate when a manufacturer sells products to a controlled taxpayer that after further processing, or the use of significant intangibles, resells the products in uncontrolled transactions. The inapplicability of a higher priority method need not be specifically established before applying a lower priority method. However, an arm's length consideration must be determined under a higher priority method if it is established that the standards for its application are met.

(iii) *Confirmation of resale price and cost plus methods by the comparable profit interval.* A transfer price determined under either the resale price method or the cost plus method reflects arm's length consideration only if that price results in a level of operating income for the tested party that is within the comparable profit interval described in paragraph (f) of this section.

(iv) *Other methods.* Where none of the three methods of pricing described in paragraph (e)(1)(ii) of this section can reasonably be applied under the facts and circumstances of a particular case, a method of pricing other than those described in that paragraph, or a variation on those methods, may be used, but only if that method yields a level of operating income for the tested party that is within the comparable profit interval described in paragraph (f) of this section. Such methods may include an analysis based on profit level indicators, described in paragraph (f)(6)(iii) of this section. Generally, the best such method will result in operating income for the tested party that is at the most appropriate point within the comparable profit interval as described in paragraph (f)(8) of this section. The inapplicability of a higher priority method need not be specifically established before applying an "other method" under this paragraph (e)(1)(iv). However, an arm's length consideration must be determined under a higher priority method if it is established that the standards for its application are met.

(v) *Product line and statistical analysis.* The methods of determining arm's length prices described in this paragraph (e) are stated in terms of their application to individual sales of property. However, because a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purpose of determining the arm's length price. Therefore an arm's length price may be determined or verified by applying the pricing methods to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the district director may determine or verify the arm's length price of all sales to a controlled taxpayer by employing reasonable statistical sampling techniques.

(vi) *Mineral products.* The price for a mineral product which is sold at the stage at which mining or extraction ends shall be determined under the provisions of §§ 1.613-3 and 1.613-4.

(2) * * * * *

(ii) * * * Some of the differences that may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, sales volume, inventory turnover rate, advertising and warranty practices and the level of the market and the geographic market in which the sale takes place. * * *

Example (4). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except that, in the controlled sales, the transferee bears the warranty obligations that arise in the resale of the product. If the effect of this difference on the price is not reasonably ascertainable, then the uncontrolled sales will not be comparable to the controlled sales.

Example (5). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that the volume of controlled sales is different from the volume of uncontrolled sales and such volume of controlled sales would produce a reasonably ascertainable volume discount. The adjusted uncontrolled sales will be comparable to the controlled sales.

* * * * *

(f) *Comparable profit interval* -- (1) *In general.* The comparable profit interval is composed of various amounts of profit that a tested party would have earned if objective measures of its profitability ("profit level indicators") had been equivalent to those of various uncontrolled taxpayers that performed similar functions. Specifically, profit level indicators derived from the financial data of uncontrolled taxpayers are applied to the tested party to recalculate its operating income. Each recalculated amount is referred to in this section as "constructive operating income." The comparable profit interval is then derived from those constructive operat-

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ing incomes that converge. This comparable profit interval is used to confirm the validity of a transfer price calculated through the use of other methodologies, under the rules of paragraphs (d)(4), and (e)(1)(iii) and (iv) of this section. In addition, under the rules of paragraphs (d)(5) and (e)(1)(iv) of this section, the comparable profit interval may be used in determining the transfer price for the controlled transfer of intangible property. Paragraph (f)(3) of this section describes the six steps of the analysis that is applied in this paragraph (f) to derive the comparable profit interval. While in many cases this analysis will consist of a sequential application of the six steps, the steps are interdependent and certain steps may have to be reapplied to take into account results derived in succeeding steps.

(2) *Data from multiple years.* Unless the circumstances indicate that a different period is more appropriate, the interval will be based on actual results (rather than projections) from the three-year period that includes the taxable year under review, the preceding year and the following year. Circumstances that may warrant the use of a different period include the unavailability of reliable data from the relevant time periods, the normal business cycles of the industry under review, and the life cycle of the products or intangibles being examined. To the extent that reliable data is available, data pertaining to uncontrolled taxpayers and data pertaining to the tested party should relate to comparable time periods.

(3) *Development of a comparable profit interval.* The development of a comparable profit interval consists of the following steps:

(i) *Step 1.* Select the party to a controlled transaction to be tested. This determination is made under paragraph (f) (4) of this section.

(ii) *Step 2.* Determine the applicable business classification of the tested party. This determination is made under paragraph (f)(5) of this section.

(iii) *Step 3.* Compute constructive operating incomes, as described in paragraph (f)(6) of this section.

(iv) *Step 4.* Determine the comparable profit interval, as described in paragraph (f)(7) of this section.

(v) *Step 5.* When necessary, determine the most appropriate point in the comparable profit interval, as described in paragraph (f)(8) of this section.

(vi) *Step 6.* Determine the transfer price for the controlled transaction, as described in paragraph (f)(9) of this section.

(4) *Step 1: Select the party to a controlled transaction to be tested* -- (i) *In general.* The first step in constructing a comparable profit interval is to determine which of the parties to the controlled transaction will be the tested party. The party selected need not be the person that is under examination. For example, if an examination concerns the income of a U.S. parent corporation attributable to the transfer of an intangible to a foreign subsidiary, the comparable profit interval may be calculated with respect to the subsidiary.

(ii) *Basis for selection of the tested party.* The tested party is the party to the controlled transaction whose operating income can be verified using the most reliable data and with the fewest and most accurately quantifiable adjustments. In the case of a transfer of an intangible, the tested party ordinarily will be the transferee. In cases involving the controlled sale of tangible property in which the resale price method applies, the tested party ordinarily will be the buyer. In cases involving the controlled sale of tangible property in which the cost plus method applies, the tested party ordinarily will be the seller. However, the comparable profit interval may be applied to check the operating income of any party to a controlled transaction if the operating income of such party can be more reliably and accurately tested than the operating income of other parties.

(5) *Step 2: Determine the applicable business classification of the tested party* -- (i) *In general.* The constructive operating incomes that are used to establish the comparable profit interval are derived from the operations of uncontrolled parties that are similar to the tested operations of the tested party. This paragraph (f)(5) provides rules for identifying these operations, which are referred to as the applicable business classification. As described in paragraphs (f)(5)(ii) and (iii) of this section, determining the applicable business classification is a two-stage process. First, the operations of the tested party that are related to the transactions between the tested party and the other members of the group of controlled taxpayers are identified (the "tested operations"). Second, the tested operations are matched as closely as possible to similar operations of uncontrolled taxpayers based on the data available to determine the applicable business classification. In some cases, the analyses of the constructive operating incomes discussed below may indicate that there is insufficient reliable data related to the applicable business classification to construct a comparable profit interval. In such a case it will be necessary under this paragraph (f)(5) to identify a different applicable business classification (or classifications) that may be more specific or more general than the original applicable business classification in order to obtain sufficient reliable data to construct the comparable profit interval.

(ii) *Tested operations.* Tested operations include that portion of the tested party's operations that are related to or integrated with the transactions with controlled parties that are under review. These operations may include manufacture and sale of products, product lines, or other product groupings, as well as types of services or other functions that the tested party performs. The identification of tested operations must consider both the types of products and the functions that are related to the transactions between the tested party and controlled taxpayers. For example, if the tested party's only transactions with other members of the group of controlled taxpayers consist of purchases of a single product for resale, and such purchases represent a small portion of the tested party's overall inventory purchases, then the tested operations should be those that relate to purchases and sales of that product. If, however, the tested party engages in multiple transfers of tangible and intangible property with other members of the group of controlled taxpayers, the tested operations should be those that relate to all such transfers. In appropriate cases, the tested operations will include all of the operations of the tested party.

(iii) *Applicable business classification.* The applicable business classification is the broadest category of tested oper-

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ations that most corresponds to the products and functions of uncontrolled taxpayers for which sufficient reliable data is available. If, however, there is insufficient reliable data from uncontrolled taxpayers that corresponds to the tested operations, then the tested operations are divided into more than one applicable business classification, each of which corresponds to products and functions of uncontrolled parties for which reliable data is available. If the tested operations must be divided, each applicable business classification selected must be as broad as possible, while still ensuring that reliable data regarding uncontrolled parties is available. A broad classification that corresponds to the tested operations may not be divided into more specific classifications if there is sufficient reliable data relating to the broad classification. If, however, it is not possible to obtain reliable data regarding uncontrolled taxpayers that perform functions with respect to products that closely correspond to the products related to the tested operations, then the scope of the applicable business classification is broadened to include the functions performed by the tested party and as broad a category of products as is necessary to obtain reliable data. For example, if the tested operations are distribution of compact disc players, in the absence of sufficient reliable data a broader applicable business classification, such as distribution of consumer electronic products, may be appropriate. Although it is not necessary to demonstrate that there is inadequate data relating to a narrow category of products before applying a broad category of products, if it subsequently is established that there is adequate reliable data relating to a narrow category of products, then the applicable business classification will be based on that narrow category.

(6) *Step 3: Compute contructive operating incomes* -- (i) *In general.* Constructive operating income is computed by applying profit level indicators derived from uncontrolled taxpayers to financial data of the tested party. The selection of profit level indicators under this step depends upon two interdependent factors: first, the extent to which reliable data is available concerning similar uncontrolled taxpayers; and second, the extent to which particular profit level indicators provide a reliable basis for comparing profits of controlled and uncontrolled taxpayers under the facts and circumstances of the case.

(ii) *Selection of data relating to uncontrolled taxpayers.* Data relating to uncontrolled taxpayers must be selected from the data used for purposes of selecting the applicable business classification under paragraph (f)(5)(iii) of this section. In determining which data to select, further consideration must be given to the similarity between the uncontrolled taxpayers and the tested party. Similarity with respect to the size of the operations composing the applicable business classification and the relevant markets, as well as other factors indicating similarity, must be considered. When an uncontrolled transfer used in a method described in paragraph (d)(4)(i) of this section, or an uncontrolled transaction used in a method described in paragraphs (e)(1)(iii) and (iv) of this section is tested to determine whether it results in a level of operating income that is within the comparable profit interval, the selected group generally should include the relevant party to such uncontrolled transfer or transaction.

(iii) *Selection of profit level indicators that provide a reliable basis for comparing profits* -- (A) *In general.* Profit level indicators measure the relationship between various factors and income. A variety of different profit level indicators can be calculated in any given case. Thus, this step requires the selection of the profit level indicator (or indicators) that will produce an accurate comparison under the facts and circumstances of the particular case, depending on the nature of the activities being examined and the reliability of the available data from uncontrolled taxpayers. A profit level indicator may provide a reliable basis for comparing profits even if it can be appropriately applied only to some, but not all, of the uncontrolled taxpayers.

(B) *Definitions.* The following definitions apply for purposes of determining profit level indicators and computing constructive operating income:

(*1*) *Sales.* The term "sales" means the amount of total revenue from sales, less discounts and returns.

(*2*) *Gross income.* The term "gross income" means sales less cost of goods sold.

(*3*) *Operating expenses.* The term "operating expenses" includes expenses associated with advertising, sales, marketing, administration, research and development, and a reasonable allowance for depreciation and amortization. It does not include interest expense, foreign income taxes (as described in § 1.901-2(a)), and domestic income taxes.

(*4*) *Operating income.* The term "operating income" means gross income less operating expenses.

(*5*) *Assets.* The term "assets" generally means the book value of total assets (measured by the average of the book values for the beginning of the year and the end of the year). Where recent acquisitions, leased assets, purchased intangibles or currency fluctuations, or other factors create a significant difference between the book value of the assets of the controlled taxpayer and the book value of the assets of the uncontrolled taxpayers that would distort the comparison, appropriate adjustments must be made so that the asset values in each case are measured on a comparable basis.

(C) *Profit level indicators.* Profit level indicators that provide a reliable basis for comparing profits may include the following:

(*1*) *Rate of return on assets.* The rate of return on assets is the ratio computed by dividing the operating income of the uncontrolled taxpayer by the assets of that taxpayer. It may be necessary to make certain adjustments to the assets of the uncontrolled taxpayers as described under the definition of assets in paragraph (f)(6)(iii)(B)(*5*) of this section. This profit level indicator is more reliable when the values of self-developed intangibles held by the tested party and the uncontrolled taxpayers are similar.

(*2*) *Margins.* Margins are ratios that are determined by relationships between income and costs. Different margins divide income and costs in different ways. Accordingly, a number of different margins may be examined, when appropriate, depending on the type of data available from the uncontrolled taxpayers. Reliable margins may include:

(*i*) *Ratio of operating income to sales.* The ratio of operating income to sales is frequently more reliable than other margins. Because it is based on broad measures, it accommodates some variation between the functions performed by

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uncontrolled taxpayers and the functions performed by controlled taxpayers. Nevertheless, similarity of the economic level of production for the functions performed (*e.g.*, manufacturer or distributor) and the type of business generally is necessary to ensure reliability.

(*ii*) *Gross income to operating expenses.* The ratio of gross income to operating expenses is most reliable when the uncontrolled taxpayers perform functions that are similar to the functions performed by the controlled taxpayer. If the functions performed are different, this ratio may not be used because the composition of operating expenses will be different and may lead to inappropriate results. Review of the classification of expenses for consistency is necessary even if the functions performed by the taxpayers being compared are virtually identical. This profit level indicator may be used only when the uncontrolled taxpayers being compared have characterized material items consistently or when adjustments can be made to the accounting entries so that such items are classified consistently.

(*iii*) *Other margins.* Other margins include, but are not limited to the ratio of operating income to labor costs and the ratio of operating income to all expenses other than those included in cost of goods sold. Other margins should be used only when they provide reasonable indications of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length.

(*3*) *Comparable profit split* -- (*i*) *In general.* A comparable profit split is derived from the combined operating income of uncontrolled taxpayers that entered transactions and performed functions similar to those of the members of the group of controlled taxpayers. Each such uncontrolled taxpayer's percentage of the combined operating income is determined and used to divide the combined operating income of the group of controlled taxpayers.

(*ii*) *Methods for determining comparable profit split.* Depending on the reliability of the data, a residual profit split or an overall profit split may be used.

(*A*) *Residual profit split.* Under the residual profit split, income attributable to assets is determined by applying a rate of return to the value of assets held by the uncontrolled taxpayers. This amount then is subtracted from the operating income of each such uncontrolled taxpayer to yield the residual income. The sum of the uncontrolled taxpayers' residual incomes is the residual combined income. The profit split is the percentage of the residual combined income earned by each uncontrolled taxpayer. This profit split then is applied to the tested party to calculate its constructive operating income. The same rates of return that were applied to the uncontrolled taxpayers are applied to the assets of the group of controlled taxpayers, and the resulting amount then is subtracted from the combined operating income of the group of controlled taxpayers. The residual combined income then is apportioned among the group of controlled taxpayers in the same percentages that were determined for the uncontrolled taxpayers. For purposes of this paragraph (f)(6)(iii)(C)(*3*) of this section, assets are defined by reference to paragraph (f)(6)(iii)(B)(*5*) of this section, except that assets do not include intangible property. The rate of return applied to the assets should be an average rate of return earned by uncontrolled taxpayers that perform functions similar to those performed by the controlled taxpayers but that do not have significant intangibles.

(*B*) *Overall profit split.* Under the overall profit split, the group of controlled taxpayers' profit split is determined in the same manner as under the residual profit split, but without first providing a return to assets.

(*iii*) *Rules for application of comparable profit split* -- (A) *Limitations on use of profit split.* A comparable profit split may be used only if reliable financial data is available regarding the members of the group of controlled taxpayers and the uncontrolled taxpayers. In addition, a comparable profit split may be used only if the functions performed by each of the uncontrolled taxpayers are the same as the functions performed by each member of the group of controlled taxpayers. A profit split may not be used if the combined rate of return on assets earned by the uncontrolled taxpayers varies significantly from the combined rate of return on assets earned by the members of the group of controlled taxpayers. Furthermore, a profit split may not be used if an uncontrolled transferee possesses self-developed intangibles that are relevant to the applicable business classification and that contribute significantly more (or less) to the profits derived from the applicable business classification than self-developed intangibles that the related transferee owns. See *Example 8* of paragraph (f)(11) of this section for a case in which a comparable profit split cannot be used as a profit level indicator.

(*B*) *Appropriate uses of profit splits.* A comparable profit split is most appropriately used where the tested party and the other members of the group of controlled taxpayers employ significant self-developed intangibles that are not reflected on their financial statements, and the combined rate of return of the uncontrolled taxpayers is similar to the combined rate of return earned by the members of the group of controlled taxpayers. See *Example 1* of paragraph (f)(11) of this section for a case in which a comparable profit split is applicable as a profit level indicator. Use of the residual profit split generally is most appropriate when the proportion of the combined value of assets held by each of the uncontrolled taxpayers significantly differs from the proportion of the combined value of assets held by each member of the group of controlled taxpayers. The overall profit split generally is more appropriate when the relative book value of assets is approximately equal.

(*4*) *Other indicators.* [Reserved]

(iv) *Applying profit level indicator to controlled taxpayer to compute constructive operating income* -- (A) *In general.* The profit level indicators selected in paragraph (f)(6)(iii) of this section and calculated for the uncontrolled taxpayers selected in paragraph (f)(6)(ii) of this section are applied to the relevant financial data of the tested party, adjusted as provided in paragraph (f)(6)(iv)(B) of this section, in order to compute constructive operating income.

(B) *Adjustments to financial data of the tested party.* For purposes of this paragraph (f), financial data of the tested party must be adjusted in two ways. First, adjustments must be made to reflect any allocations under section 482, other than adjustments made under this paragraph (or made under paragraph (d) or (e) of this section and verified under this paragraph) that affect the tested party's financial data. Second, adjustments must be made to account for material differences between the assets of the tested party and the assets

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of uncontrolled taxpayers, such as differences in the relative amounts of financial assets or inventory held. If the tested party's assets are adjusted, the tested party's operating income ordinarily must be adjusted to reflect income and expenses attributable to the adjusted assets. For example, an adjustment to impute carrying charges attributable to adjusted inventory may affect operating income. See *Examples 5* and *9* of paragraph (f)(11) of this section, illustrating adjustments that may be made to the tested party's assets and operating income.

(C) *Examples.* The following examples illustrate the principles described in paragraphs (f)(6)(iv)(A) and (B) of this section.

Example 1. Assume a selected profit level indicator is the rate of return on assets, the rate of return on assets for selected uncontrolled taxpayer A is 10.4 percent, and the assets of the tested party are $1,000. When using the rate of return on assets the relevant financial data of the tested party is the book value of the assets of the tested party. Therefore, the constructive operating income computed using the rate of return on assets derived from A is $104 (.104 x $1,000).

Example 2. Assume the ratio of gross income to operating expenses is selected as a profit level indicator, the ratio of gross income to operating expenses for selected uncontrolled taxpayer B is 1/3, and the operating expenses of the tested party are $150. In addition, assume that a $10 rental adjustment has been made under paragraph (c) of this section. This adjustment increases the tested party's operating expenses to $160. When using the ratio of gross income to operating expenses, the relevant financial data of the tested party is its operating expenses. Therefore, constructive operating income computed for the ratio of gross income to operating expenses derived from B is $53 (1/3 x $160).

(7) *Step 4: Determine the comparable profit interval.* The comparable profit interval is constructed by selecting amounts of constructive operating income that converge to form an interval that is reasonably restricted in size. If there is a small number of uncontrolled taxpayers whose operations correspond closely to the applicable business classification, two types of convergence should be considered in constructing the comparable profit interval. The first type of convergence is convergence of constructive operating incomes of the tested party derived from several profit level indicators of a single uncontrolled taxpayer. Convergence of multiple constructive operating incomes derived from a single uncontrolled taxpayer indicates that the uncontrolled taxpayer and the tested party are comparable and suggests that constructive operating incomes derived from that taxpayer should be included within the comparable profit interval. When multiple profit level indicators derived from a single uncontrolled taxpayer produce amounts of constructive operating income that diverge, those amounts will be excluded from the comparable profit interval unless the uncontrolled taxpayer's financial data can be adjusted appropriately to account for the factors contributing to this lack of conformity. See paragraph (f)(6)(iii)(C) of this section for a description of potential adjustments. The second type of convergence that must be considered is convergence of constructive operating incomes derived from one or more profit level indicators obtained from multiple uncontrolled taxpayers. Constructive operating incomes that diverge from other points in the interval will be excluded from the comparable profit interval. Factors that must be considered in determining whether the constructive operating income diverges include the relative distance between the constructive operating income and the closest points in the interval compared to the distance between other points within the interval. In determining convergence, greater weight will be given to the more reliable constructive operating incomes. Reliability will be assessed by considering the quality of the underlying data with regard to its relative specificity, the similarity of the products and functions of the uncontrolled taxpayer from which the data is drawn and the tested operations, the similarity of the markets from which data is drawn, and the degree to which it fits the profit level indicator. If the number of uncontrolled taxpayers whose operations correspond to the applicable business classification is large enough to permit the use of valid statistical techniques, then convergence must be determined by using those techniques to identify a reasonably narrow area of concentration among all of the constructive operating incomes computed.

(8) *Step 5: Determine the most appropriate point in the comparable profit interval.* It may be necessary to identify the most appropriate point within the comparable profit interval under this paragraph (f)(8) for purposes of the comparable profit method described in paragraph (d)(5) of this section and other methods described in paragraph (e)(1)(iv) of this section. The most appropriate point must be determined considering all the facts and circumstances. If statistical techniques were used to construct the comparable profit interval, the most appropriate point is determined using statistical measures of central tendency. Otherwise, in selecting the constructive operating income that represents the most appropriate point, the following factors should be considered:

(i) The comparability of each uncontrolled taxpayer from which the constructive operating income was derived. Comparability for this purpose is based on -

(A) The similarity of the functions performed by the tested party to those performed by the uncontrolled taxpayer, and the similarity of the economic risks associated with those functions;

(B) The similarity of the products or services provided by the tested party to those provided by the uncontrolled taxpayer; and

(C) The extent to which different profit level indicators of the uncontrolled taxpayer produce converging results when applied to the tested party;

(ii) The extent to which adjustments are necessary to apply the profit level indicator that generated the constructive operating income. Constructive operating incomes derived from a profit level indicator requiring the fewest and most accurately quantified adjustments is accorded the greatest weight;

(iii) The extent to which the profit level indicator that generated the constructive operating income meets the reliability factors described in paragraph (f)(7)(ii) of this section; and

(iv) The extent to which the profit level indicator that generated the constructive operating income produces converging results when applied to each of the uncontrolled taxpayers used in determining the comparable profit interval.

(9) *Step 6: Determine the transfer price for the controlled transaction.* When the most appropriate point within

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the comparable profit interval has been determined as described in paragraph (f)(8) of this section (or, where appropriate, only the comparable profit interval has been determined under paragraph (f)(7) of this section), a transfer price for the controlled transaction is determined under the principles of paragraphs (d) and (e) of this section. The transfer price is determined by adjusting the actual charge for the controlled transaction to produce an operating income for the tested party that is equal to the constructive operating income corresponding to the most appropriate point.

(10) *Coordination of the use of the comparable profit interval with other allocations under section 482* -- (i) *Allocations that affect operating income.* For purposes of paragraph (d) of this section, the tested party's reported operating income must be adjusted to reflect all other allocations under this section that affect operating income. Similarly, for purposes of paragraph (e)(1) of this section, adjustments must be made to account for allocations that affect operating income before determining whether operating income falls within the comparable profit interval. For example, if the resale price method under paragraph (e)(3) of this section is applied, and a rental allocation is made under paragraph (c) of this section, this adjustment should be taken into account in computing operating income before determining whether operating income falls within the comparable profit interval. As described in paragraph (f)(6)(iv) of this section, such adjustments also may affect the construction of the comparable profit interval.

(ii) *Allocations that do not affect operating income.* Income or expense adjustments under section 482 that do not affect the amount of operating income have no bearing on the application of this paragraph (f). For example, interest expense is an item of expense that is not deducted from gross income in order to calculate operating income. Therefore, any adjustments to interest expense have no effect on the determination of the comparable profit interval.

(11) *Examples.* The application of this paragraph (f) is illustrated by the following examples.

Example 1 -- Comparable profit interval applied to confirm a comparable adjustable transaction -- (i) *Background.* Controlled taxpayer CE is a foreign corporation that is wholly-owned by a domestic corporation, USCorp. In 1994, CE and USCorp conclude a 10-year license agreement pursuant to which USCorp licensed the right to use a patented manufacturing process related to the production of product P in exchange for royalty payments of 5 percent of CE's net sales of P. During the audit of USCorp's 1999 taxable year, the district director reviews whether the consideration charged for the patent is arm's length. Uncontrolled taxpayer UE operates in the same market and performs functions similar to those of CE. UE licenses rights to manufacture and sell its product Q solely from an uncontrolled taxpayer, X, and pays a royalty to X at the rate of 25 percent of its sales. Since the two transfers do not involve the same intangibles (and no other potentially matching transactions are located), the matching transaction method is not applicable. The district director determines, however, that the intangibles involved in the two transactions are similar and that the economic conditions and contractual terms involved in the two transfers meet the standards described in paragraph (d)(4)(iii) of this section. Moreover, the district director determines that differences in the intangibles, contract terms and economic conditions offset one another in such a way that the royalty rate derived from the uncontrolled transaction for purposes of determining an arm's length royalty rate for the controlled transaction should remain 25 percent. Accordingly, the transaction will serve as a comparable adjustable transaction if the royalty rate from the uncontrolled transfer results in a level of operating income for CE that is within the comparable profit interval. To make this determination, the district director develops profit level indicators from UE and other companies that perform functions similar to those that CE performs.

(ii) *Financial data for CE and UE.* In order to develop profit level indicators from UE, financial data is reviewed for both CE and UE. For this purpose, data from years 1998 through 2000 is compiled and averaged. In addition, the profit earned by USCorp and X attributable to products P and Q, respectively, is calculated in order to determine the combined operating income with respect to these products. This review of financial data provides the following results (in $ thousands):

	Data from CE	*Data from UE*
Sales	1,200	1,000
Cost of Goods Sold	(650)	(550)
Gross Income	550	450
Operating Expenses		
Royalty Payments	(60)	(250)
Other	(90)	(75)
Operating Income	400	125
Assets	570	440

	Data from *USCorp*	Data from *X*
Operating Income	170	525
Assets	1000	440

(iii) *Operating income under potential comparable adjustable transaction.* If CE had paid an amount of consideration consistent with the UE license agreement, its royalty payment would have been 25 percent of its sales, or $300 ($1,200 x 25 percent) rather than the $60 it actually paid. Adjusting the operating income of CE by the $240 difference in these royalty amounts ($300 minus $60) results in operating income of $160 ($400 minus $240). The district director determines whether this result would have been within the comparable profit interval.

(iv) *Profit level indicators.* The profit level indicators described in paragraph (f)(5) of this section are first analyzed with respect to the above financial data of UE to yield a percentage for each separate indicator. Those percentages can then be applied to the financial data for CE in order to derive an amount of constructive operating income for CE that conforms to each profit level indicator. The director determines that in the present case, the four following profit level indicators are appropriate, and CE's financial data does not need to be further adjusted in order to make them applicable:

(A) *Return on assets.* The UE data indicates that UE has earned a rate of return on its assets of 28.4 percent ($125 of operating income divided by $570 of assets). If CE had earned 28.4 percent on its assets, its constructive operating income would have been $162 ($570 of assets multiplied by 28.4 percent).

(B) *Ratio of gross income to operating expenses.* The district director determines that given the type of intangible transferred in the controlled transaction and given the fact that royalty payments are included in operating expenses by UE, royalty payments should be included in operating expenses for purposes of applying this ratio. The UE data provides a ratio of gross income to operating expenses in the amount of 138.5 percent ($450 divided by $325). Since the controlled transaction being reviewed for CE (i.e., the royalty expense) is part of the operating expenses in this case, this ratio is applied to CE by determining the level of operating expenses yielding this ratio in relation to gross income of $550. The operating expenses required in this case would be $397 (550 divided by 138.5 percent). If CE had made royalty payments of $307 ($397 of total operating expenses minus $90 of other operating expenses), its gross income would have been $240, and its constructive operating income would have been $153 ($550 gross income minus $397 operating expenses).

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(C) *Ratio of operating income to sales.* The ratio of operating income to sales for UE is 12.5 percent ($125 divided by $1,000). If CE's ratio were the same, its constructive operating income would have been $150 ($1,200 of sales multiplied by 12.5 percent).

(D) *Profit Split.* An analysis of the functions performed and income earned by CE and UE suggests that each has valuable self-developed intangibles. In addition, the combined rate of return on assets earned by CE and US Corp of 36.3% ([400 + 150]/[570 + 1000]) does not differ significantly from the combined rate or return on assets earned by UE and X of 34.1% ([125 + 400]/[440 + 1100]). Based on the foregoing, the district director determines that a profit split is an appropriate profit level indicator in this case. The district director determines that an appropriate return for UE's measurable assets is 15.0% and that an appropriate return for X's measurable assets is 10.0%. Subtracting these amounts from the operating income of each leaves a residual combined operating income of $349 (125 – [.15 x 440] + 400 – [.10 x 1100]). UE's residual operating income of 59 (125 – .15 x 440) represents 16.9% of the residual combined operating income. If CE had earned 15.0% on its measurable assets of 570 and X had earned 10% on its measurable assets of 1000 their residual combined operating income would be $384 (570 – [.135 x 570] – [.10 x 1000]). If CE had earned 16.9% of this residual combined operating income, then CE's constructive operating income would have been $151 ([.15 x 570] + [.169 x 384]).

(v) *Summary of profit level indicators from UE.* The following chart summarizes each of the profit level indicators derived from UE and the profit results when those indicators are applied to CE's financial data:

	PLI *From UE*	Constructive Operating *Income for CE*
Return on Assets	28.4 %	$ 162
Gross Income to Operating Expenses	138.5 %	$ 153
Operating Income to Sales	12.4 %	$ 150
Profit Split	16.9 %	$ 151

(vi) *Weight to be given to UE results.* The data derived from UE should be given significant weight for several reasons. First, the analysis has been performed at a very specific level (by comparable products) and has been derived from the same market. Second, the results from four different profit level indicators converge at an interval of $150 to $162. Finally, the license between UE and X meets the standards for a comparable adjustable transaction and would produce operating income results of $160, which converges with the results produced by the other indicators.

(vii) *Further analysis.* The district director reviews other companies that are less comparable to CE than UE, but that perform functions similar to those performed by CE and operate in similar markets. Data from these other companies is not given as much weight as the data from UE. Nevertheless, the data confirms that any reasonable construction of a comparable profit interval would include $160 as an appropriate amount of constructive operating income for CE. Since the results from other similar companies confirm the above findings, it can be concluded that the royalty rate of 25 percent used by UE would have resulted in CE being within the comparable profit interval and that the transaction between UE and X meets the requirements for the comparable adjustable transaction method under paragraph (d)(4) of this section.

(viii) *Adjustment.* Based on the above review of UE and other similar companies, the district director determines that the royalty rate of 25 percent derived from the license between UE and X, resulting in $160 of operating income for CE, should serve as a comparable adjustable transaction as defined in paragraph (d)(4) of this section. Accordingly, for 1999 the district director adjusts the royalty to be received by USCorp to 25 percent of CE's sales.

Example 2 -- Comparable profit interval applied to disqualify potential comparable adjustable transaction. (i) The facts are the same as in *Example 1* except that a different uncontrolled taxpayer, DE, also is found. DE licenses rights to manufacture and sell its product B solely from an uncontrolled taxpayer, G, and pays a royalty to G at a rate of 5 percent of its sales. CE paid an amount of consideration consistent with the DE license agreement. If DE's license from G were a comparable adjustable transaction, the district director would need to determine whether CE's operating income result of $400 were within the comparable profit interval. The results from other uncontrolled taxpayers derived in *Example 1* suggest that CE's operating income of $400 would have been outside of this interval. Nevertheless, the district director examines DE's financial data to determine if this information suggests that inappropriate weight was given to the results in *Example 1*.

(ii) *Financial data for DE.* Averaged data for DE from years 1998 through 2000 is as follows (in $ thousands):

	Data from DE
Sales	1000
Cost of Goods Sold	(750)
Gross Income	250
Operating Expenses	
Royalty Payments	(50)
Other	(75)
Operating Income	125
Assets	1,190

(iii) *Summary of profit level indicators from DE.* The following chart summarizes each of the profit level indicators derived from DE and the amounts of constructive operating income which result when those indicators are applied to CE's financial data. Insufficient information on G is available to apply a profit split analysis.

	PLI *From DE*	Operating *Income for CE*
Return on Assets	10.5%	$162
Gross Income to Operating Expenses	200.0%	$185
Operating Income to Sales	12.5%	$150

(iv) *Analysis of DE's profit level indicators.* The levels of constructive operating income derived from DE's return on assets and operating income to sales are similar to one another and to the amounts of constructive operating income derived from UE. This information adds further weight to the results derived in *Example 1*. Therefore, the new data suggests that constructive operating income of $400 would not be within the comparable profit interval. The potential comparable adjustable transaction of DE's license agreement is rejected and the allocation described in *Example 1* is not changed.

Example 3 -- Transfer of tangible property resulting in no adjustment. (i) Foreign Parent (FP) is a publicly-traded foreign corporation with a U.S. subsidiary (USS) that is under audit for its 1994 taxable year. FP manufactures a consumer product for worldwide distribution and has developed a trademark that has significant U.S. marketing value. USS imports the finished product and distributes it within the United States under that trademark. USS's income attributable to the trademark is material in relation to the income attributable to the sale of the product alone.

(ii) In accordance with paragraph (d)(1)(iii) of this section, the district director applies an analysis based on paragraph (d)(5) of this section to determine an arm's length price for sales of the product from FP to USS.

(iii) Based on all the facts and circumstances, the district director determines that USS should be the tested party. Accordingly, the district director reviews the financial data of USS for the taxable years preceding and following the taxable year under review. The district director determines that no adjustments to the financial data of USS are neces-

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sary under paragraph (f)(6)(iv)(B) of this section. For the taxable years 1993 through 1995, USS shows the following results (in $ thousands):

	1993	*1994*	*1995*	*Average*
Assets	310,000	310,000	310,000	310,000
Sales	500,000	500,000	560,000	520,000
Cost of Goods Sold	393,000	400,000	412,400	401,800
Purchases from FP	350,000	350,000	365,000	355,000
Other	43,000	50,000	47,400	46,800
Gross Income	107,000	100,000	147,600	118,200
Operating Expenses	80,000	110,000	110,000	100,000
Operating Income	27,000	(10,000)	37,600	18,200

The above data from USS, averaged over three years, results in the following ratios:

Operating Income/Sales (OI/S)	3.5%
Operating Income/Assets (OI/A)	5.9%
Gross Income/Operating Expenses (GI/OE)	118.2%

(iv) To construct the comparable profit interval, the district director obtains data from independent operators of wholesale distribution companies. After examining this data, the district director selects only the companies in the most similar types of businesses and performing the most similar functions in comparison to USS. An analysis of the information available on these companies shows that their profit level indicators do not fluctuate significantly when at least three years are included in the average. Calculating the average ratio of operating income/sales, the average ratio of operating income/assets and the average ratio of gross income/operating expenses for each of the uncontrolled distributors and applying each profit level indicator to USS produces the following constructive operating incomes ("COI") (in $ thousands):

Unrelated Distributor	*OI/S*	*USS COI*	*OI/A*	*USS COI*	*GI/OE*	*USS COI*
A	4.2%	21,840	6.6%	20,460	118.0%	18,000
B	9.6%	49,920	23.3%	72,230	146.7%	46,700
C	7.1%	36,920	16.9%	52,390	139.0%	39,000
D	4.2%	21,840	8.0%	24,800	122.0%	22,000
E	7.1%	36,920	11.5%	35,650	127.2%	27,200
F	3.6%	8,720	6.3%	19,530	117.0%	17,000
G	3.1%	16,120	5.8%	17,980	115.0%	15,000
H	1.8%	9,360	2.7%	8,370	106.9%	6,900

(v) The constructive operating incomes derived from the profit level indicators of uncontrolled distributors A, D, F and G are clustered most closely. USS's average reported operating income of $18.2 million is within the interval that could be constructed from these numbers. Therefore, the district director determines that no allocation should be made under section 482 even though USS's operating income for 1994, a loss of $10 million, is clearly outside of any interval that could be constructed from these numbers.

Example 4 -- Transfer of tangible property resulting in adjustment. (i) The facts are the same as in *Example 3* except that USS reported the following income and expenses (in $ thousands):

	1993	*1994*	*1995*	*Average*
Assets	310,000	310,000	310,000	310,000
Sales	500,000	500,000	560,000	520,000
Cost of Good Sold	370,000	400,000	460,000	410,000
Purchases from FP	320,000	350,000	410,000	360,000
Other	50,000	50,000	50,000	50,000
Gross Income	130,000	100,000	100,000	110,000
Operating Expenses	110,000	110,000	110,000	110,000
Operating Income	20,000	(10,000)	(10,000)	0

Applying the above data, the three profit level indicators described in *Example 3* would now produce the following results for USS:

Operating Income/Sales (OI/S)	0%
Operating Income/Assets (OI/A)	0%
Gross Income/Operating Expenses (GI/OE)	100%

(ii) Applying the same profit level indicators derived from the same uncontrolled distributors to USS now results in the following constructive operating income (COI) for USS (in $ thousands):

Unrelated Distributor	*OI/S*	*USS COI*	*OI/A*	*USS COI*	*GI/OE*	*USS COI*
A	4.2%	21,840	6.6%	20,460	118.0%	19,800
B	9.6%	49,920	23.3%	72,230	146.7%	51,370
C	7.1%	36,920	16.9%	52,390	139.0%	42,900
D	4.2%	21,840	8.0%	24,800	122.0%	24,200
E	7.1%	36,920	11.5%	35,650	127.2%	29,920
F	3.6%	18,720	6.3%	19,530	117.0%	18,700
G	3.1%	16,120	5.8%	17,980	115.0%	16,500
H	1.8%	9,360	2.7%	8,370	106.9%	7,590

(iii) Constructive operating incomes derived from A, D, F and G are most closely clustered. Using the principles described in paragraph (f)(8) of this section the district director determines that F is the most comparable uncontrolled taxpayer, the ratio of operating income to sales is the most reliable profit level indicator, and that $18.72 million is the most appropriate point in the interval. USS's reported operating income in 1994 was a loss of $10 million. Therefore, for 1994 the district director makes a $28.72 million adjustment with respect to USS's purchases from FP.

Example 5 -- Transfer of tangible property with adjustment for inventory. (i) The facts are the same as *Example 4* except that USS has assets of $450 million in 1993, 1994 and 1995. Applying the same profit level indicators derived from the same uncontrolled distributors to USS now produces the following constructive operating incomes for USS (in $ thousands):

Unrelated Distributor	*OI/S*	*USS COI*	*OI/A*	*USS COI*	*GI/OE*	*USS COI*
A	4.2%	21,840	6.6%	29,700	118.0%	19,800
B	9.6%	49,920	23.3%	104,850	146.7%	51,370
C	7.1%	36,920	16.9%	76,050	139.0%	42.900
D	4.2%	21,840	8.0%	36,000	122.0%	24,200
E	7.1%	36,920	11.5%	51,750	127.2%	29,920
F	3.6%	18,720	6.3%	28,350	117.0%	18,700
G	3.1%	16,120	5.8%	26,100	115.0%	16,500
H	1.8%	9,360	2.7%	12,150	106.9%	7,590

(ii) Further examination reveals that USS's ratio of inventory to sales of .60 is substantially higher than the inventory to sales ratios for A through H, which range from .19 to .31. As described in paragraph (f)(6)(iv)(B) of this section, USS's inventory is adjusted to reflect the inventory to sales ratios of comparable companies. The district director determines based on all the facts and circumstances that it is necessary to adjust USS's average value of inventory for 1993, 1994 and 1995 to reflect a ratio of .31 of USS's sales, as set forth below (in $ thousands):

USS	*1993*	*1994*	*1995*	*Average*
Actual Inventory	300,000	300,000	336,000	312,000
Inventory Adjustment	(145,000)	(145,000)	(162,400)	(150,800)
Adjusted Inventory	155,000	155,000	173,600	161,200

(iii) Based on the foregoing, USS's total assets are adjusted under paragraph (f)(6)(iv)(B) of this section, as set forth below (in $ thousands):

1993	*1994*	*1995*	*Average*
305,000	305,000	287,600	299,299

(iv) Furthermore, adjustments to USS's operating income are necessary to reflect a carrying charge for the extra inventory held by USS. The district director calculates the carrying charge by multiplying the amount of the asset adjustment by an appropriate interest rate. Assum-

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ing that the appropriate rate in this case is 4%, the carrying charge for each of the years 1993 and 1994 is $5,800,000, the carrying charge for 1995 is $6,496,000, and the average carrying charge for all three years is $6,032,000.

(v) Based on the foregoing, the district director reduces USS's reported operating income for 1993 and 1994 by $5,800,000, and the reported operating income for 1995 by $6,496,000. Thus, USS's reported operating income for 1993 is $14,200,000, for 1994 it is ($15,800,000) and for 1995 it is ($16,496,000). The average reported operating income for the three years is adjusted under paragraph (f)(6)(iv)(B) of this section to ($6,032,000).

(vi) The comparable profit method under paragraph (d)(5) of this section is then applied, based on the assets as adjusted above, to determine whether the adjusted operating income of ($6,032,000) is within the comparable profit interval.

Example 6 -- Transfer of intangible to offshore manufacturer. (i) DevCo is a U.S. developer, producer and marketer of widgets. DevCo develops and patents new production techniques for the widgets. The widgets are manufactured by Devco's foreign subsidiary, ManuCo, located in Country H. ManuCo and Devco enter a license agreement pursuant to which Devco transfers the right to use the patent to ManuCo in return for a royalty equal to 5 percent of ManuCo's widget sales. ManuCo sells the widgets to MarkCo, a U.S. subsidiary of DevCo, for distribution and marketing in the United States. The price that DevCo charges to MarkCo for the widgets is determined to be a comparable uncontrolled price within the meaning of paragraph (e)(2) of this section. The district director examines whether the royalty rate of 5 percent paid by ManuCo to DevCo for taxable year 1994 is an arm's length consideration for the patent. No matching transactions or comparable adjustable transactions are available.

Accordingly, the district director examines whether the operating income of ManuCo is within the comparable profit interval. To begin this analysis, the district director examines ManuCo's financial data from 1993-1995, which is as follows (in $ thousands):

	1993	*1994*	*1995*	*Average*
Assets	24,000	25,000	26,000	25,000
Sales to MarkCo.	25,000	30,000	35,000	30,000
Cost of Goods Sold	5,000	6,000	7,000	6,000
Gross Income	20,000	24,000	28,000	24,000
Operating Expenses	2,250	2,500	2,750	2,500
Royalty to DevCo (5%)	1,250	1,500	1,750	1,500
Other	1,000	1,000	1,000	1,000
Operating Income	17,750	21,500	25,250	21,500

Based on this data, ManuCo's ration of operating income to sales (OI/S) from 1993 to 1995 was 71.7%, and ManuCo's ratio of operating income to assets (OI/A) was 86.0%.

(ii) In order to compare ManuCo's profits with those of other companies, the district director analyzes companies performing similar functions. No information on uncontrolled taxpayers in country H that perform similar functions is available. Other uncontrolled manufacturers exist in country H. However, the functions they perform are significantly different from those performed by ManuCo. The country H uncontrolled manufacturers produce products at the direction of their purchasers, who maintain supervision over all aspects of the production, including the amount produced. In addition, raw materials are either purchased from the buyer or made at the direction of the buyer and all processes employed in the manufacturing operation are owned by the buyers.

(iii) Since reliable data from comparable country H companies is unavailable, companies performing the most similar functions in the most similar markets are considered. The district director determines that data available in country M provides the best match of companies in a similar market performing similar functions.

(iv) Applying the principles of paragraph (f)(6) of this section to financial information from the uncontrolled country M companies, the district director computes the following constructive operating incomes from the uncontrolled country M companies (in $ thousands):

Unrelated Company	*OI/S*	*ManuCo COI*	*OI/A*	*ManuCo COI*
A	5.3%	1,590	3.3%	825
B	11.6%	3,480	8.2%	2,050
C	17.0%	5,100	16.5%	4,125
D	10.0%	3,000	12.0%	3,000
E	8.6%	2,574	8.5%	2,120
F	14.0%	4,200	15.0%	3,750

Based on this data, the district director determines that the most appropriate point in the comparable profit interval for ManuCo would have resulted in operating income of $3 million, which requires an adjustment of $18.5 million. To reflect this adjustment, the royalty rate is increased from 5% of sales to 66.7% of sales.

Example 7 -- Transfer of intangible to manufacturer/ distributor. The facts are the same as *Example 6* except that ManuCo no longer sells to its controlled affiliate, MarkCo. ManuCo manufactures the widgets for sale in a region outside the United States and is responsible for distribution and marketing in that region. No information on uncontrolled taxpayers performing this set of functions in country H is available. In addition, no companies performing similar functions can be found in country M (since these functions are significantly different from the functions reviewed under the facts of *Example 6*). Companies performing the most similar functions in the most similar market are found in the United States. Therefore, the type of analysis undertaken in *Example 6* is repeated using a selection of U.S. companies to generate profit level indicators which are then applied to ManuCo.

Example 8 -- Transfer of intangible with profit split.

(i) The facts are the same as *Example 7* except that more information is available with respect to RW, an uncontrolled U.S. taxpayer. Specifically, enough information is available to calculate the way that the profits are split between company RW and the uncontrolled taxpayer from which company RW licenses its intangible. The district director examines the following information to determine whether the analysis in *Example 7*, above, should be reconsidered:

Unrelated	*OI/A*	*Percent of Combined OI*
RW	25.0%	75%
Licensor (to RW)	15.0%	25%
Combined	21.4%	100%
Related		
ManuCo	86.0%	75%
DevCo	15.0%	25%
Combined	39.4%	100%

(ii) This information shows that combined operating income is split 25 percent/75 percent in both cases (with 75 percent retained by the licensee). In addition, the licensor in both cases has earned a rate of return on its assets of 15 percent. Although the profits are split in the same way and the rate of return of the licensor is identical, the combined profitability of the products is substantially different. The product manufactured by ManuCo provides an overall rate of return on assets (39.4 percent) that is almost twice the return earned by the uncontrolled taxpayers (21.4 percent). Given this major variance between these combined rates of return, the profit split information from company RW fails to provide reliable information regarding how profits should be divided in the case under review. Accordingly, the analysis in *Example 7* is not modified.

Example 9 -- Transfer of intangible with adjustment for financial assets. The facts are the same as *Example 6*, above, except that ManuCo has assets of $45 million. Examination of ManuCo's balance sheet suggests that ManuCo has an unusually high ratio of financial assets to

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total assets. Based on a comparison of the financial assets held by ManuCo and those held by the comparable companies, the district director determines that $20 million of ManuCo's assets should be segregated as excess financial assets. These financial assets are invested with uncontrolled taxpayers and earn a market rate of return. Segregation of the excess financial assets is necessary in order to enhance the reliability of the ratio of operating income to assets. Therefore, these financial assets are not included in the total assets when calculating constructive operating income and the income earned from these financial assets is not included in ManuCo's reported operating income within this applicable business classification. ManuCo's assets used in the calculation of operating income/assets are adjusted to $25 million and the analysis proceeds as in *Example 6*.

(g) *Sharing of costs and risks* -- (1) *In general* -- (i) *Limitation on allocations*. If a member of a group of controlled taxpayers acquires an intangible as an eligible participant in a qualified cost sharing arrangement, the district director may make allocations with respect to that acquisition to reflect each participant's arm's length share of the costs and risks of developing the intangible, under the rules of this paragraph (g). If a member of a group of controlled taxpayers acquires an intangible from another member of the group through any means other than as an eligible participant in a qualified cost sharing arrangement, then the district director may make appropriate allocations to reflect an arm's length consideration for the intangible under the rules of paragraph (d) of this section.

(ii) *Scope of regulations*. An arrangement for the development of intangibles will be considered a qualified cost sharing arrangement only if it meets the requirements of paragraph (g)(2) of this section. A member of a group of controlled taxpayers will be considered an eligible participant only if it meets the requirements of paragraph (g)(3) of this section. Paragraph (g)(4) of this section describes the allocations that may be made by the district director to reflect an eligible participant's arm's length share of the costs and risks of developing intangible property in a qualified cost sharing arrangement. The character of payments made pursuant to a qualified cost sharing arrangement is described in paragraph (g)(5) of this section. Paragraph (g)(6) of this section sets forth administrative requirements, and additional definitions are provided in paragraph (g)(7) of this section. Paragraph (g)(8) of this section sets forth a transitional rule.

(2) *Qualified cost sharing arrangement* -- (i) *In general*. A qualified cost sharing arrangement must --

(A) Include two or more eligible participants;

(B) Be recorded in writing contemporaneously with the formation of the cost sharing arrangement;

(C) Provide for the sharing among eligible participants of the costs and risks borne by any participant of developing one or more intangibles in return for a specified interest in any intangible that may be produced;

(D) Reflect a reasonable effort by each eligible participant to share all of the costs and risks of intangible development, including the costs and risks of unsuccessful or less successful related development, such that each eligible participant's share of the costs and risks is proportionate to the benefits that each eligible participant reasonably anticipates it will receive from the exploitation of intangibles developed under the arrangement; and

(E) Meet the administrative requirements described in paragraph (g)(6)(i) of this section.

A cost sharing arrangement that includes ineligible participants may still be a qualified cost sharing arrangement but only with respect to its eligible participants. See paragraph (g)(3)(vi) of this section for rules applicable to ineligible participants.

(ii) *Costs proportionate to benefits* -- (A) *In general*. A cost sharing arrangement must establish a method that, under all the facts and circumstances (including information about the markets in which the intangible is likely to be exploited), reflects a reasonable effort to share the costs of developing intangibles in proportion to the benefits that each eligible participant anticipates it will receive from the exploitation of intangibles developed under the arrangement. Under appropriate circumstances, anticipated benefits may be measured by reference to anticipated units of production (where there is a uniform unit of production for all participants), anticipated sales (measured at the same level of the production or distribution process for all participants), anticipated gross or net profit, or any other measure that reasonably predicts the benefits to be shared. If the intangible development benefits more than one qualified cost sharing arrangement, the anticipated benefits of a participant of any of those arrangements must be measured by reference to all such arrangements.

(B) *Adjustments to the method used*. A method reflects a reasonable effort to share costs in proportion to benefits only if it provides that the costs shared by each eligible participant must be adjusted to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement. Such adjustments must ensure that the method continues to reflect a reasonable effort to share costs in proportion to benefits over time, and they should generally be made on an annual basis.

(C) *Presumption based on operating income* -- (*1*) *In general*. A method will be presumed not to reflect a reasonable effort to share costs in proportion to benefits if a U.S. participant's cost/income ratio is grossly disproportionate to the cost/income ratio of all other eligible participants. The U.S. participant may rebut this presumption by establishing that the method used in the arrangement provides a reasonably accurate measure of benefits.

(2) *Cost/income ratio*. The cost/income ratio of a U.S. participant is the average of the cost of developing intangibles borne by the participant divided by the participant's average operating income attributable to intangibles developed under the arrangement. The cost/income ratio of other eligible participants is the sum of the other participants' average costs divided by the sum of their average operating incomes attributable to intangibles developed under the arrangement. For this purpose, the average cost of developing intangibles and average operating income is calculated by using the average of such amounts from the current taxable year and the two preceding taxable years. However, different periods for costs, income, or both may be used if amounts from such periods more clearly reflect the relationship between the cost of developing intangibles and operating income attributable to intangibles developed under the

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arrangement. For example, different periods may be used to reflect the effect of the time between the year in which the development costs were incurred and the year in which the benefits from developed intangibles were realized.

(*3*) *Operating income attributable to intangibles*. Operating income attributable to intangibles developed under the arrangement is all operating income that is directly or indirectly attributable to the intangible development area, without reduction for the cost of developing intangibles and without regard to cost sharing payments. Such income includes income from the license or sale of intangibles developed under the cost sharing arrangement, and income earned with respect to the sale of products or services incorporating developed intangibles.

(*4*) *Cross references*. U.S. participant is defined in paragraph (g)(7)(iii) of this section. Operating income is defined in paragraph (f)(6)(iii)(B)(*4*) of this section. Cost of developing intangibles is defined in paragraph (g)(7)(ii) of this section.

(iii) *Discretion to apply cost sharing*. In unusual circumstances in which application of the developer-assister rules under paragraph (d)(8) of this section would not clearly reflect the income of a member of a group of controlled taxpayers, the district director may apply the rules of this paragraph (g) to any arrangement that in substance constitutes a cost sharing arrangement (notwithstanding a failure to comply with any requirement of this section).

(3) *Eligible participant* -- (i) *In general*. For purposes of this paragraph (g), an eligible participant is a member of a group of controlled taxpayers that agrees to participate in a qualified cost sharing arrangement, if the participant meets the administrative requirements described in paragraph (g)(6)(ii) of this section, and if intangibles developed under the arrangement are, or will be, used in the active conduct of the participant's trade or business. Rules describing whether an intangible is used in the active conduct of a participant's trade or business are provided in paragraphs (g)(3)(ii), (iii), and (iv) of this section. A special rule for the treatment of a group of controlled taxpayers as a single eligible participant is provided in paragraph (g)(3)(v) of this section.

(ii) *Trade or business*. The rules of § 1.367(a)-2T(b)(2) apply in determining whether the activities of a participant in a cost sharing arrangement constitute a trade or business. For this purpose, the term "participant in a cost sharing arrangement" must be substituted for the term "foreign corporation".

(iii) *Active conduct*. In general, a participant actively conducts a trade or business only if it carries out substantial managerial and operational activities. For this purpose, managerial and operational activities carried out on behalf of the participant by independent contractors may be attributed to the participant, but only to the extent that the participant bears the economic risks, and receives the benefits, of those activities.

(iv) (A) *Use of intangibles in the active conduct of a trade or business*. In general, an intangible is used in the active conduct of a trade or business of a participant if it is held for the purpose of promoting the participant's conduct of that trade or business, or is otherwise held in a direct relationship to that trade or business. An intangible is not used in the active conduct of a participant's trade or business if a substantial purpose for participating in the arrangement is to obtain an intangible to transfer to an uncontrolled taxpayer. It will be presumed that a substantial purpose for participating in a cost sharing arrangement is to obtain an intangible to transfer to an uncontrolled taxpayer if there are any significant direct or indirect transfers of developed intangibles to an uncontrolled taxpayer during the course of the arrangement or within four years of the termination of the arrangement.

(B) *Example*. The following example illustrates a substantial purpose:

Example. Controlled corporations A, B and C enter into a qualified cost sharing arrangement for the purpose of developing an improved product X. Costs are shared equally among the three taxpayers. A, B, and C have exclusive rights to sell Product X in North America, South America and Europe, respectively. When an improved Product X is developed, C manufactures and sells the new product in most of Europe. However, for sound business reasons, C licenses the right to use the new product technology to manufacture and sell products, within a small European country, to an unrelated manufacturer. Exploitation of the new Product X technology in that country is not a substantial transfer of the technology. The district director will not presume that C entered into the cost sharing arrangement with a substantial purpose of obtaining intangible property to license or to sell an uncontrolled taxpayer.

(v) *Treatment of controlled taxpayers as a single participant* -- (A) *In general*. One member of a group of controlled taxpayers may participate in a cost sharing arrangement on behalf of one or more other members of the group (the "cost sharing subgroup"). For purposes of applying the rules of this paragraph (g) to such a cost sharing arrangement, the cost sharing subgroup will be treated as a single participant in the arrangement. Whether the cost sharing subgroup is treated as an eligible participant under the arrangement will be determined on the basis of all of the activities performed by members of the cost sharing subgroup. Whether the arrangement establishes a method that reflects a reasonable effort to share the costs of developing intangibles in proportion to the anticipated benefits must be determined on the basis of the benefits that the cost sharing subgroup reasonably anticipates receiving from the exploitation of intangibles developed under the arrangement.

(B) *Transfers within cost sharing subgroup* -- (*1*) *In general*. Any intangible acquired pursuant to a qualified cost sharing arrangement in which a cost sharing subgroup is treated as a single eligible participant will be considered acquired solely by the member participating in the arrangement on behalf of the cost sharing subgroup. Accordingly, any transfer of that intangible by the participating member to any other member of the cost sharing subgroup is a transfer of an intangible subject to the rules of paragraph (d) of this section.

(*2*) *Arrangement within cost sharing subgroup*. The rule of the preceding paragraph (g)(3)(v)(B)(*1*) of this section will not apply if all the members of the cost sharing subgroup have themselves entered into a separate qualified cost sharing arrangement, pursuant to which they have reimbursed the participating member for an appropriate share of the arrangement's costs. In that case, any intangible acquired pursuant to the first cost sharing arrangement will be considered acquired by each member of the cost sharing subgroup that is an eligible participant in the separate cost sharing arrangement. The

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treatment of the separate cost sharing arrangement within the cost sharing subgroup must be determined under the rules of this paragraph (g).

(vi) *Treatment of ineligible participant.* If a qualified cost sharing arrangement has one or more ineligible participants in a taxable year, the costs of developing intangibles incurred by those participants in that taxable year must be taken into account by the eligible participants in determining their cost shares. An ineligible participant that is a member of the controlled group of taxpayers must be treated as an assister under the rules of paragraph (d)(8) of this section. Consideration for the transfer of an intangible that is due from an ineligible participant must be allocated among eligible participants in proportion to the share of costs of each eligible participant. See paragraph (g)(4)(iv) of this section for rules applicable to eligible participants that become ineligible participants in a qualified cost sharing arrangement.

(4) *Allocations with respect to qualified cost sharing arrangements* -- (i) *Appropriate scope of intangible development area* -- (A) *In general.* The district director may make allocations with respect to a qualified cost sharing arrangement to ensure that the intangible development area covered by the agreement is broad enough to encompass related intangible development (as described in paragraph (g)(4)(i)(B) of this section), and narrow enough so that the costs shared are for the development of products or services that are of potential use (as described in paragraph (g)(4)(i)(C) of this section) to each eligible participant. An intangible development area is a classification of products or services with respect to which intangible development is conducted under a qualified cost sharing arrangement.

(B) *Related intangible development.* Related intangible development consists of all intangible development, including basic research, that may reasonably be regarded as leading to the development of any product or service in the stated intangible development area, without regard to whether such products or services are ever successfully developed or sold. Related intangible development also includes any activity, conducted or funded by any participant, relating to similar products or services. Whether products or services are similar for this purpose will be determined by examining all facts and circumstances that demonstrate the practical or scientific relationship between the intangible development activities engaged in with respect to the products or services. For this purpose, consideration will be given to the participants' prior business practices, the business practices of uncontrolled taxpayers in the same or related businesses, and the three-digit Standard Industrial Classification code which includes such products or services. If an intangible development area used in a qualified cost sharing arrangement is determined to be too narrow, the district director may make appropriate allocations to cost shares under this paragraph (g) so that all costs attributable to related intangible development are shared by the eligible participants. See paragraph (g)(4)(iii) of this section for rules pertaining to the taxable years with respect to which allocations will be made and the computation of interest charges with respect to such allocations.

(C) *Potential use of products or services.* An intangible development area covers costs for the development of products or services that are of potential use to an eligible participant if it is reasonable to expect that new products or services within the area will be used in the active conduct of a trade or business of that participant in a commercially significant manner. An intangible development area must exclude any significant area of intangible development if it is reasonable to expect that the intangible development will lead to products or services that are not of potential use to an eligible participant. If an intangible development area used in a qualified cost sharing arrangement is determined to be too broad, the district director may make appropriate allocations under this paragraph (g) so that only those costs attributable to the development of products or services that are of potential use to eligible participants are shared under the arrangement. See paragraph (g)(4)(iii) of this section for rules pertaining to the taxable years with respect to which allocations will be made and the computation of interest charges with respect to such allocations.

(D) *Examples.* The following examples illustrate the appropriate scope of an intangible development area:

Example 1. A group of controlled taxpayers in the automotive industry enters a cost sharing arrangement under which they develop new engine technologies. The group has members in Country A and the United States. Part of the intangible development conducted by the members relates exclusively to electric motors and has no potential application to internal combustion engines. The Country A members of the group do not presently and do not anticipate in the future producing or selling automobiles with electric motors. An appropriate intangible development area for the group's cost sharing arrangement will not include the electric motor development since it is reasonable to expect that such intangible development will lead to products that are not of potential use to the Country A members.

Example 2. The facts are the same as in *Example 1*, above. In addition, one member of the group conducts intangible development related to developing high performance engines that are used in race cars. This intangible development is not directly related to any products that the group markets commercially. However, in the past certain advances made in race car development have been applied commercially, and it is reasonable to expect that the intangible development will continue to yield technologies that will be exploited commercially. An appropriate intangible development area for the group's cost sharing arrangement will include this high performance intangible development, since it is reasonable to expect that new products within the area could be used by each member of the arrangement.

(ii) *Appropriate method for sharing costs* -- (A) *In general.* The district director may make allocations with respect to a qualified cost sharing arrangement to ensure that the method used for sharing costs is an appropriate measure of the benefits reasonably anticipated by each eligible participant. Such allocations may be required when the method chosen fails to accurately reflect the reasonably anticipated benefits over time. Unless another method of sharing costs provides a more reliable measure of the participant's reasonably anticipated benefits over time, an allocation may be made by reference to a comparison of the participant's cost/income ratio and the cost/income ratio of the other eligible participants. Paragraphs (g)(4)(ii)(B) through (E) of this section describe the allocations that may be made to reflect an appropriate method of sharing costs. See paragraph (g)(4)(iii) of this section for rules pertaining to the taxable years with

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respect to which allocations will be made and the computation of interest charges with respect to such allocations.

(B) *Adjustments to costs shared.* If a U.S. participant's cost/income ratio is not substantially disproportionate to the cost/income ratio of the other eligible participants, allocations that may be made under this paragraph (g)(4)(ii) will be limited to appropriate adjustments with respect to the costs of developing intangibles shared by that participant. Paragraph (g)(4)(ii)(D) of this section describes when a participant's cost/income ratio will not be considered substantially disproportionate. The cost/income ratio is defined in paragraph (g)(2)(ii)(C)(2) of this section.

(C) *Adjustments based on a substantially disproportionate cost/income ratio.* If a U.S. participant's cost/income ratio is substantially disproportionate to the cost/income ratio of the other eligible participants, a transfer of an intangible may be deemed to have occurred outside of the scope of the arrangement; in that case, allocations may be made under the rules of paragraph (g)(4)(iv)(A) of this section (buy-in and buy-out) to reflect an arm's length consideration for that portion of the intangible deemed to have been transferred. The portion of the intangible deemed to have been transferred will be measured by the difference between the U.S. participant's cost/income ratio and the cost/income ratio of the other eligible participants. Alternatively, appropriate adjustments with respect to the costs of developing intangibles shared by that participant may be made under paragraph (g)(4)(ii)(B) of this section.

(D) *Proportionate profits rule.* A U.S. participant's cost/income ratio will not be considered substantially disproportionate if it is less than twice the cost/income ratio of the other eligible participants. That is, this rule will apply if:

$$\frac{\text{U.S. Participant's Average Costs}}{\text{U.S. Participant's Average Operating Income}} < 2\text{x} \frac{\text{Sum of Other Participants' Average Costs}}{\text{Sum of Other Participants' Average Operating Income.}}$$

(E) *Examples.* Adjustments described in this paragraph (g)(4)(ii) are illustrated by the following examples:

Example 1. (i) A U.S. participant in a long-standing cost sharing arrangement for the development of manufacturing technology is audited for its 1993 taxable year. In order to determine the type of adjustment that potentially could be made, the district director applies the formula described in paragraph (g)(4)(ii)(D) of this section. Paragraph (g)(2)(ii)(C)(2) of this section requires that this formula generally be applied to the current year and the two preceding years. The following information is known about the participants in the cost sharing arrangement:

		($ Thousands)		
	1991	*1992*	*1993*	*Total*
U.S. Participant				
Cost Share Payment	15	15	20	50
Operating Income	25	30	35	90
Cost/Income Ratio 1991-1993 = 50/90 = .56				
Other Participant				
Cost Share Payment	35	30	25	90
Operating Income	9	75	60	225
Cost/Income Ratio 1991-1993 = 90/225 = .4				

(ii) 2 x Other Participant's Cost/Income Ratio = .8

(iii) Since the U.S. participant's cost/income ratio in paragraph (ii) of this *Example 1* is less than twice the other participant's cost/income ratio, the U.S. participant's cost/income ratio will not be considered substantially disproportionate to the other participant's cost/income ratio. Accordingly, the district director will limit any allocation to an adjustment to the costs borne by the U.S. participant.

(iv) The district director determines, based on all the facts and circumstances, that the intangible development expenses generate only current benefits and that the participants' current operating incomes attributable to the product area encompassed by the cost sharing arrangement accurately reflect the relative benefits that each participant derives from current intangible development expenses. Accordingly, the participants' cost/income ratios for 1993 should be approximately equal. The U.S. participant's cost/income ratio of .56 is not approximately equal to the other participant's cost/income ratio of .4. Therefore, the district director decreases the U.S. participant's 1993 cost share payment in the amount of $3. The district director also increases the 1993 cost share payment of the other participant in the amount of $3, which is treated as a reimbursement of intangible development expenses to the U.S. participant in accordance with paragraph (g)(5) of this section. After these allocations, the U.S participant's 1993 cost/income ratio is .49 ($17/$35), and the other participant's 1993 cost/income ratio is .47 ($28/$60).

Example 2. (i) The facts are the same as in *Example 1*, above, except that the U.S. participant manufactures the product, markets it and distributes it under its trade name, and the other participant manufactures the product and immediately sells it to an unrelated entity. Because the U.S. participant performs significant non-manufacturing functions not performed by the other participant, the district director determines that the participants' operating incomes are not an accurate measure of the relative benefits that the participants derive from intangible development conducted pursuant to the cost sharing arrangement. Rather, the district director determines that the relative benefits that the participants derive are most accurately measured by a comparison of their respective unit sales volumes. The participants' unit sales volumes for 1993 are as follows:

U.S. Participant	
Unit Sales	100
Other Participant	
Unit Sales	215

(ii) Since, as discussed in *Example 1*, above, the U.S. participant's cost/income ratio is not substantially disproportionate to the cost/income ratio of the other eligible participant, the district director will limit an allocation to an adjustment to the costs borne by the participants.

(iii) To reflect accurately the benefits that each participant derived from the research and development conducted pursuant to the cost sharing arrangement, the district director compares the number of unit sales per dollar of cost share payment generated by the U.S. participant and the other participant in 1993. The U.S. participant's ratio of cost share payments to unit sales for 1993 is .2 ($20/$100), and the ratio of the other participant's cost share payments to unit sales for 1993 is .12 ($25/$215). To approximately equalize these ratios, the district director decreases the U.S. participant's 1993 cost share payment by $6, and increases the other participant's payment by $6. After adjustment, the U.S. participant's ratio of cost share payments to unit sales is .14 ($14/$100), and the other participant's ratio of cost share payments to unit sales is .14 ($31/$215).

Example 3. (i) Assume that the facts are the same as in *Example 1*, above, except that the cost share payments of the participants are as follows:

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	($ Thousands)			
	1991	*1992*	*1993*	*Total*
U.S. Participant	20	25	30	75
Other Participant	35	30	25	90

(ii) Based on this data, the cost/income ratio of the U.S. participant is .83 ($75/$90), and the cost/income ratio of the other participant is .4 ($90/$225). The U.S. participant's cost/income ratio (.83) is more than twice the cost/income ratio of the other participant (2 x .4 = .8). The district director further examines the facts to determine whether the U.S. participant's cost/income ratio is substantially disproportionate to the cost/income ratio of the other participant.

(iii) The U.S. participant presents data relating to later years that demonstrates that its cost/income ratio would not be considered substantially disproportionate if data from such years were used. The U.S. participant explains that in its business there normally is a two year lapse between the time that development of a new product is completed and the time that the product is introduced commercially. In order to match its costs and benefits more precisely, the cost sharing arrangement apportions the cost sharing payments among the participants based on anticipated sales two years in the future. Therefore, 1993 costs were apportioned based on anticipated sales in 1995. The relatively high payment by the U.S. participant in 1993 was in anticipation that the U.S. market for the product line was expanding.

(iv) The following data from the years 1990 through 1995 confirms that the U.S. market was expanding relative to the other markets:

	($ Thousands)					
	1990	*1991*	*1992*	*1993*	*1994*	*1995*
U.S. Participant						
Cost Share Payment	20	20	25	30	30	35
Unit Sales	80	90	100	100	250	300
Operating Income	25	25	30	35	50	65
Other Participant						
Cost Share Payment	40	35	30	25	20	15
Unit Sales	400	300	250	215	180	160
Operating Income	100	90	75	60	50	40

(v) Based on all of the facts and circumstances, the district director determines that the research and development benefits the participants two years after the research is performed. Accordingly, the district director applies the proportionate profits rules by using income data for the years 1993 through 1995 and cost share payments for the years 1991 through 1993, as follows:

	($ Thousands)
U.S. Participant	
Cost Share Payments 1991-1993	= (20 + 25 + 30) = 75
Operating Income 1993-1995	= (35 + 50 + 65) = 150
Cost/Income Ratio = 75/150 = .5	
Other Participant	
Cost Share Payments 1991-1993	= (35 + 30 + 25) = 90
Operating Income 1993-1995	= (60 + 50 + 40) = 150
Cost/Income Ratio = 90/150 = .6	

(vi) Based on this data, the U.S. participant cost/income ratio is less than twice the cost/income ratio of the other participant. Accordingly, an allocation by the district director for the 1993 taxable year, if any, will be limited to an adjustment to the cost share payment made by the U.S. participant.

Example 4. (i) The facts are the same as in *Example 3*, above, except that after modifying the analysis, as described in paragraph (iv) of *Example 3*, the U.S. participant's cost/income ratio is still more than twice the cost/income ratio of the other participant. The district director determines that the portion of costs borne by the U.S. participant from 1990-1995 was substantially disproportionate to the portion of costs borne by the other participant. Therefore, the district director may deem a transfer of an intangible to have occurred outside of the scope of the arrangement.

(ii) The district director determines that the portion of the intangible deemed to have been transferred (measured by the difference between the U.S. participant's cost/income ratio and the cost/income ratio of the other eligible participant) is 50%. Pursuant to paragraph (d) of this section, the district director determines that at arm's length the U.S. participant would have charged a royalty equal to 6 percent of sales to an uncontrolled taxpayer using the intangible in the same markets as the other participant. Therefore, the district director determines that the other participant should pay the U.S. participant a royalty for the use of the patent equal to 3 percent of sales (i.e., half of an arm's length royalty).

Example 5. (i) In 1993, a U.S. corporation enters a cost sharing arrangement with a foreign affiliate. Neither party contributes any intangibles to the arrangement. The parties anticipate that the intangible development performed in connection with the cost sharing arrangement will result in commercial sales in 1995, and that the relative benefits that the parties will derive from the intangible development will be most accurately measured by the dollar sales volumes of products incorporating developed intangibles. The written agreement representing the terms of the arrangement provides that the U.S. participant will bear 70 percent and the foreign participant 30 percent of the costs of developing intangibles, respectively. The actual cost share payments by the two participants and their incomes attributable to sales of products incorporating developed intangibles are as follows:

	($ Thousands)					
	1993	*1994*	*1995*	*1996*	*1997*	*1998*
U.S. Participant						
Cost Share Payment	70	35	28	28	21	21
Operating Income	0	0	5	30	50	60
Sales Volume	0	0	30	90	150	180
Other Participant						
Cost Share Payment	30	15	12	12	9	9
Operating Income	0	0	7	70	120	140
Sales Volume	0	0	70	210	350	420

(ii) Pursuant to the examination of the U.S. corporation's 1996 taxable year, the district director applies the formula of paragraph (g)(4)(ii)(D) of this section to determine the adjustments that might be made with respect to the cost sharing arrangement. The district director agrees with the taxpayer that there is a two year delay between the time that intangible development is conducted and the time that commercial sales result from the development. Accordingly, the data that the district director uses for purposes of the proportionate profits formula is the parties' 1994-1996 cost share payments and their 1996-1998 operating incomes, as follows:

	($ Thousands)
U.S. Participant	
Cost Share Payments 1994-1996	(35 + 28 + 28) = 91
Operating Income 1996-1998	(30 + 50 + 60) = 140
Cost/Income Ratio = 91/140 = .65	
Other Participant	
Cost Share Payments 1994-1996	(15 + 12 + 12) = 39
Operating Income 1996-1998	(70 + 120 + 140) = 330
Cost/Income Ratio = 39/330 = .12	

(iii) This data indicates that the U.S. participant's cost/income ratio is more than twice the cost/income ratio of the other participant. Because the U.S. participant bore a substantially greater share of the costs of developing intangibles than the other participant throughout the years for which data is available, and because the parties failed to

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adjust their respective cost shares to better reflect their respective shares of the benefits, the district director determines that the U.S. participant's cost/income ratio is grossly disproportionate within the meaning of paragraph (g)(2)(ii)(C) of this section. Accordingly, the cost sharing arrangement adopted by the parties is presumed not to reflect a reasonable effort to measure anticipated benefits as required under paragraph (g)(2)(i)(D) of this section. The arrangement is not considered to be a qualified arrangement, and the district director may make allocations under paragraph (d) of this section to reflect an arm's length consideration for any intangible property obtained by the other participant as a result of the costs of developing intangibles borne by the U.S. participant.

(iii) *Timing of allocations and the computation of interest charges.* If the district director makes an allocation under the provisions of paragraph (g)(4)(ii)(B) of this section, the allocation must be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year. If such an allocation is made, appropriate interest adjustments must be made in accordance with paragraph (a)(2) of this section. Thus, for example, if the district director allocates additional cost sharing payments from a foreign subsidiary to its U.S. parent corporation, the allocation must include the computation of interest with respect to the subsidiary's underpayment of costs in prior taxable years.

(iv) *Buy-in and buy-out payments* -- (A) *In general.* If an eligible participant in a qualified cost sharing arrangement transfers an intangible that it owns to another member of the group of controlled taxpayers, an arm's length consideration for the transfer must be determined under the provisions of paragraph (d) of this section. Such a transfer may occur, for example, if the intangible is developed outside of the arrangement, if the intangible is developed inside the arrangement but transferred to a new participant in the arrangement, or if the intangible is developed inside the arrangement but additional rights in it are transferred to existing participants upon the departure of a participant. Paragraph (g)(4)(iv)(B) of this section addresses the form of consideration in such cases. Paragraph (g)(4)(iv)(C) of this section addresses transfers accomplished by the relinquishment of rights. In addition, the provisions of paragraph (d)(8) of this section apply to determine whether any member of the controlled group must receive compensation for assistance rendered in the development of the intangible. For the purposes of paragraph (d)(8) of this section, the eligible participants of a cost sharing arrangement may be treated as a single person.

(B) *Form of consideration.* The consideration for a transfer described in this paragraph (g)(4)(iv) may take any of the following forms:

(*1*) *Lump sum payments.* [RESERVED]

(*2*) *Installment payments.* Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with paragraph (a)(2) of this section; and

(*3*) *Royalties.* Royalties or other payments contingent on the use of the intangible by the transferee. The consideration is owed to the person that transfers the intangible to the eligible participant. For example, if a new participant receives rights to an intangible being developed under a qualified cost sharing arrangement, and those rights are limited to the use of that intangible in a portion of the geographic area in which exclusive rights were previously held by a single participant, the consideration is owed solely to the participant who owned the exclusive geographic rights.

(C) *Relinquishment of rights.* An eligible participant in a qualified cost sharing arrangement may be deemed to have acquired rights in an intangible if another participant (a "departing participant") transfers, abandons, or otherwise relinquishes some or all of its rights under the arrangement, to the benefit of one or more of the remaining participants. Once a relinquishment of rights occurs, a departing participant may not subsequently exploit the rights to any intangible deemed relinquished unless it pays the remaining participants an arm's length consideration determined in accordance with the rules of paragraph (d) of this section.

(D) *Examples.* The following examples illustrate payments described in this paragraph (g)(4)(iv):

Example 1. Three members of a controlled group decide to form a cost sharing arrangement for the development of a car that can run at normal speeds without the use of fossil fuels. Based on a reasonable projection of their future benefits, each company agrees to bear an equal share of the costs incurred during the term of the agreement. Each member contributes $1 million. The third member also contributes plans for a motor. The two members contributing only money must pay the member contributing intangible property their share of the fair market value of the motor plans, in accordance with paragraph (d) of this section.

Example 2. In year one, four foreign controlled taxpayers enter into a cost sharing arrangement to develop a commercially feasible process for capturing energy from nuclear fusion. The cost of developing intangibles for each participant with respect to the project is approximately $1 million per year. Based on a reasonable projection of their future benefits, each company bears an equal share of the costs. In year ten, a fifth controlled taxpayer joins the cost sharing group and agrees to bear one-fifth of the future costs in exchange for rights which are anticipated to represent one-fifth of the total benefit. The fair market value of intangible property within the arrangement at the time the fifth company joins the arrangement is $ 45 million. The new member pays one-fifth of that amount to the prior participants (that is, $9 million dollars total, or $2.25 million to each existing member). The principles of paragraph (d) of this section may be used to determine whether the new member's payment was commensurate with the income attributable to any intangible that is eventually developed.

Example 3. Domestic corporation M enters into a qualified cost sharing arrangement with its foreign parent, N, for the purpose of developing new products within the Group X product line. M and N share costs on the basis of the dollar value of sales in Group X products. Under an informal arrangement, M sells products in North America and N sells products in the rest of the world. N sells $10 million of Group X products every year. M sells $1 million of Group X products in the first year of the arrangement. However, each year M's Group X product line sales increase by $1 million resulting in $10 million in annual sales in the tenth year of the arrangement. Accordingly, M increases the share of costs it bears. In the arrangement's tenth year, the Group X product developers make a major breakthrough. N decides to open a manufacturing plant in Mexico, and to sell its Group X product line in North America. M subsequently closes most of its factories, decreasing its total Group X product line sales to $1 million per year, and reducing its share of the costs of developing intangibles accordingly. M may be deemed a departing member of the cost sharing arrangement in the arrangement's tenth year.

Example 4. In year one, domestic pharmaceutical corporation M enters into a qualified cost sharing arrangement with its foreign parent, N, and a sister company, O, to develop a cure for the common cold. For ten years, each company contributes $1 million annually to the cost sharing arrangement. In the tenth year, M withdraws from the arrange-

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ment and is paid a buy-out amount of $10 million, plus interest. This amount is based on the supposition that the value of intangible property within the arrangement is equal to its development cost. Within a short period of M's withdrawal, however, N and O file a new drug application for a cure for the common cold. N and O will be required to pay M an additional amount, consistent with the provisions of paragraph (d) of this section, in consideration for M's ownership of one-third of the property. The amount may be reduced by development costs incurred by N and O after M's departure.

Example 5. In year one, domestic pharmaceutical corporation M enters into a qualified cost sharing arrangement with its foreign parent, N, and a sister company, O, to develop a cure for the common cold. For ten years, each company contributes $1 million annually to the cost sharing arrangement. In the tenth year, N withdraws from the arrangement, and is paid a buy-out payment of $10 million, plus interest. Within a short period of N's withdrawal, however, M and O decide that the intangible development is a complete failure, and they end the cost sharing arrangement. The buy-out payment will be deemed inappropriate on the basis that the group's intangibles were worth less than their cost at the time of N's departure.

(5) *Character of payments made pursuant to a qualified cost sharing arrangement*. Payments made pursuant to a qualified cost sharing arrangement (other than payments described in paragraph (g)(4)(iv) of this section) will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. Any payment made or received by a taxpayer pursuant to an arrangement that the district director determines not to be a qualified cost sharing arrangement, or a payment made or received pursuant to paragraph (g)(4)(iv) of this section, will be considered a payment in consideration for the transfer of an interest in intangible property, and will be subject to the provisions of paragraph (d) of this section.

(6) *Administrative requirements* -- (i) *Cost sharing arrangement*. A cost sharing arrangement meets the administrative requirements of this paragraph (g)(6)(i) if it substantially complies with each of the following rules --

(A) The material provisions of the arrangement are recorded in writing contemporaneously with the formation of the cost sharing arrangement; and

(B) Any change to a material provision of the arrangement is recorded in writing and is reported on the attachment described in paragraph (g)(6)(ii)(A) of this section.

(ii) *Participants*. A participant meets the administrative requirements of this paragraph (g)(6)(ii) if the participant substantially complies with each of the following rules --

(A) The material provisions of the arrangement are summarized in (or a copy of the agreement is attached to) the income tax return filed by the participant, if any, or they are summarized in any attachment to Schedule M of Form 5471 or Schedule N of Form 5472 filed with respect to that participant in each year that the arrangement is in effect;

(B) The participant maintains records that are sufficient to verify the material provisions of the arrangement, the amount of the costs borne under the arrangement by each participant during the taxable year, and the computation of each participant's operating income resulting from the arrangement; and

(C) The records described in paragraph (g)(6)(ii)(B) of this section are produced within 60 days of a request by the district director for such records (and translations of those records into English are provided within 30 days of a request for translations of specific records), or those records are produced (and translations are provided) within a period agreed upon by the district director.

(iii) *Material provisions of a cost sharing arrangement*. The material provisions of a cost sharing arrangement are--

(A) Identification of the arrangement's participants;

(B) The duration of the arrangement;

(C) The intangible development area(s) covered by the arrangement;

(D) The arrangement's method for dividing costs of developing intangibles;

(E) The extent to which any tangible or intangible property not developed under the arrangement is made available to the participants for use in the arrangement;

(F) The extent to which any entity other than an eligible participant is permitted to use intangibles developed under the arrangement (including any entity on whose behalf an eligible participant is sharing costs of developing intangibles under paragraph (g)(3)(v) of this section);

(G) whether any participant has received an exclusive right to use developed intangibles (such as an exclusive right to manufacture particular products or an exclusive right to sell products in a particular geographic area), and, if so, the nature of that right. If a participant receives an exclusive right to use an intangible, permitting another entity to exploit the intangible in exchange for an arm's length consideration does not make the right non-exclusive;

(H) The conditions under which the arrangement may be modified or terminated; and

(I) The general administrative provisions of the arrangement.

(iv) *Example*. The following example illustrates recording and reporting changes in the material provisions of an arrangement:

Example. Corporations A, B and C are members of a group of controlled taxpayers. A, B and C enter into a qualified cost sharing arrangement for the development of an improved Product X. They divide costs on the basis of units of Product X currently produced by each: 60%-30%-10% respectively. A year later, C decides to switch to the production of Product Y, and C leaves the arrangement. A and B compensate C in an amount equal to C's share of the fair market value of the intangible property developed to date, and they change their cost shares to 66%-34%. They also license some of the intangible property already developed to D, an uncontrolled party. All of these changes (participants, users of intangible property and division of cost shares) must be recorded in writing and reported on the appropriate return.

(7) *Definitions*. The following definitions apply for purposes of this paragraph (g).

(i) *Specified interest in an intangible*. A specified interest in any intangible that may be produced pursuant to a qualified cost sharing arrangement is any legally enforceable interest, the benefits of which are susceptible of valuation, and which would ordinarily be transferred between uncontrolled taxpayers acting at arm's length under an arrangement to share costs of developing intangibles.

(ii) *Costs of developing intangibles*. The costs of developing intangibles to be shared under a qualified cost sharing arrangement include all of the direct and indirect costs of the

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intangible development area. When a cost sharing payment is owed by one member of a qualified cost sharing arrangement to another member, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of the amount owed, if the provisions of paragraph (a) of this section so require.

(iii) *U.S. participant.* The term "U.S. participant" means any eligible participant of a cost sharing arrangement whose income or earnings may be relevant for U.S. federal income tax purposes. Thus, for example, a "U.S. participant" includes a controlled foreign corporation as defined in section 957.

(8) *Transitional rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this paragraph (g), if the arrangement was considered a bona fide cost sharing arrangement under the provisions of § 1.482-2(d)(4), but only if the arrangement is amended, if necessary, to conform with the provisions of this paragraph (g) by the date that is one year after publication of § 1.482-2 (g) in the Federal Register.

Par. 4. These amendments are effective for taxable years beginning after December 31, 1992. However, these amendments will not apply with respect to transfers made or licenses granted to foreign persons before November 17, 1985, or before August 17, 1986 for transfers or licenses to others. Nevertheless, these amendments will apply with respect to transfers or licenses before such dates if, with respect to property transferred pursuant to an earlier and continuing transfer agreement, such property was not in existence or owned by the taxpayer on such date. Although these amendments are generally effective for taxable years beginning after December 31, 1992, the final sentence of section 482 (requiring that the income with respect to transfers or licenses of intangible property be commensurate with the income attributable to the intangible) is generally effective for taxable years beginning after December 31, 1986. For the period prior to the effective date of these regulations, the final sentence of section 482 shall be applied using any reasonable method not inconsistent with the statute.

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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):
International Tax Academy, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, The Netherlands. Tel.: +31-20-626 7726; Fax: +31-20-620 9397.

APRIL 1992

International Tax Planning, how to reduce the tax burdens of Multinational Corporations, Amsterdam, 9 and 10 April (English):
Legal Studies and Services Limited, IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom, Te.: (44)716374383. Fax: (44)716313214.

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TRANSFER PRICING IN THE UNITED KINGDOM

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I. LEGISLATION

The main legislation in the United Kingdom is found in Section 770, Taxes Act 1988 which sets out the circumstances whereby the Inland Revenue may make adjustments to assessments on the grounds that the prices at which a taxpayer has conducted business with persons under the same control are not at arm's length.

The scope of Section 770 is very wide and usually would only apply where one party to the transaction is not resident in the United Kingdom. We are, however, seeing from time to time a revenue challenge where all parties are resident but the Inland Revenue suspect that there is tax leakage. Section 770 covers transactions in respect of tangible goods, intangibles (know-how, trade marks, etc.), services (management, treasury, marketing, etc.), loan facilities and guarantees (loans and others).

Section 771, Taxes Act 1988 covers transfer pricing between petroleum companies and it should be noted that the wording is slightly different from that in Section 770. The words "profits" is used as opposed to "price" and this may result in the Inland Revenue seeking to change their approach in any negotiation.

Although not specifically transfer pricing, Section 840, Taxes Act 1988 needs to be considered as this defines "control". One has to have regard for this definition when deciding whether or not the two parties to the transaction are within the rules of Section 770. In this connection it should be noted that the wording of control is wider than merely share ownership and it also covers voting power or powers in the Articles of Association which confer the power to conduct the affairs of a company.

Section 38, Finance Act 1973 covers transfer pricing in respect of exploration and exploitation activities and rights in the United Kingdom or designated areas as they relate to petroleum companies. For this purpose "rights" include shares deriving their value from such rights where the company is not quoted on a recognized stock exchange.

II. CASE LAW

There is no case law in the United Kingdom specific to transfer pricing although the expanded *Sharkey v. Wernher* line of case law relating to arm's length principles would be followed.

III. ARM'S LENGTH PRINCIPLE

The legislation in Section 770, Taxes Act 1988 refers to prices being at arm's length and probably every country in the world, including the United Kingdom, at least in principle, adheres to the belief that transactions between related parties in different countries should be conducted at arm's length prices.

In the United Kingdom, the arm's length principle is described such that the Inland Revenue will adjust the transaction to that which would have applied if the transaction had been between independent parties dealing at arm's length. Having said that, however, unlike the United States, the United Kingdom gives absolutely no further guidelines as to what is meant by an arm's length price or the methodology as to how such price should be arrived at. They do, of course, subscribe to the principles outlined in the 1979 and 1984 OECD reports on transfer pricing. but as I will discuss later these principles are applied in practice in an extremely unstructured manner prima facie on a "what suits us to prove our case best" basis.

IV. TREATY ARTICLES

Certain treaty articles need to be considered, such as the associated enterprises article, business profits, the interest and mutual agreement procedures articles. Generally because of the wide range of treaties entered into by the United Kingdom over a great many years there is different wording - particularly in some of the older treaties - to be found in these articles and these may be used for and against arguments to invoke transfer pricing adjustments (e.g. in the interest articles the wider scope given to the meaning of transactions covered in the newer treaties means that the Inland Revenue find themselves able to invoke a thin capitalization argument more easily than in the case of the older treaties which have a narrower wording and cover the rate of interest only).

The mutual agreement procedures are generally unsatisfactory both from the point of view of the taxpayer and the tax authorities. Apart from anything else they immediately place the tax authorities in an invidious position of one day acting as the tax collector and the next as the protector of the taxpayer that they are seeking to tax. The EEC arbitration proposals would seem to be a route which should be considered for improving these procedures and it can be hoped that such proposals could be taken up on a wider sphere (perhaps through the OECD) to introduce similar procedures throughout the rest of the world.

V. INLAND REVENUE APPROACH

There are no formal procedures for advance clearance in the United Kingdom. In fact, with the exception of arrangements which can usually be entered into with local Inspectors of Taxes in the case of start-up situations, experience shows that the Inland Revenue are most reluctant to deal in advance and

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will usually advise that they are not prepared to deal in what they term as being hypothetical situations. That is not to say that advance agreements are impossible to obtain but much will depend upon the reaction of the local Inspector of Taxes with whom the taxpayer is dealing.

Enquiries on transfer pricing in the United Kingdom usually arise on the negotiations on the annual computations although of course in major cases the head office unit may become aware of particular circumstances which make it worth their while to initiate enquiries themselves. In these circumstances, however, the taxpayer will not always know that head office is involved as often the enquiries are initiated through the local Inspector.

Because there is no structure to the methodology adopted by the Inland Revenue there is no typical enquiry and to date these have always been settled by negotiation. Given the tougher stance being taken by the various Revenue authorities internationally and, thus the greater chance of economic double taxation, the possibility of cases coming to litigation in the United Kingdom must be increasing.

VI. METHODOLOGY

As previously stated, the arm's length principle according to the OECD methods is generally applied, but unlike the United States, the U.K. Inland Revenue refuses to be hide-bound by any one particular method for arriving at what they consider to be an arm's length price.

The Inland Revenue do recognize the four methods of comparable unrelated price, resale price, cost plus and any other method, but one finds that justification of prices because they fall into one of the first three methods does not necessarily mean that they will not seek to invoke another method, and in particular the fourth method (i.e. any other method that suits their purposes).

Much has been said of late regarding the use of a functional analysis approach to transfer pricing and the application of economic theories and such an approach will undoubtedly be very carefully considered by the Inland Revenue if this is put forward. However, unfortunately the Inland Revenue are not geared up in the same way as the IRS. In my experience it appears to have welcomed the amount of information that this can provide in explaining the taxpayer's business and the rationale behind its pricing policies but at the same time seeming to have a deep down suspicion that the whole exercise is designed to make the roles of the various entities involved in the transactions fit the pricing structure required rather than being based on the commercial reality of the transactions involved.

VII. RULINGS

As stated above, there is no such procedure available in the United Kingdom. However, it is usual that when an enquiry has been carried out and a negotiated settlement reached, the agreed pricing policies will be accepted for a period of between three to five years at which time a further review is carried out subject to the taxpayer agreeing to advise of any material changes which affect this policy in the intervening period.

CONTRIBUTIONS 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.

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UNITED STATES:

IRS ACCESS TO FOREIGN TRANSFER PRICING INFORMATION

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I. INTRODUCTION

A. *Focus on transfer pricing*

For the past several years, the U.S. Congress, the Treasury Department and the Internal Revenue Service ("IRS") have focused significant attention on foreign-controlled companies ("FCCs") operating in the United States. Particular attention has been paid to inbound transfer pricing and compliance with the arm's length standard.

In 1989 and 1990, Congress enacted legislation aimed at curbing, and punishing, what is perceived on Capitol Hill as "tax avoidance schemes" by FCCs. Congress also has exercised its tax administration oversight function.

In July 1990, the Oversight Subcommittee of the Committee on Ways and Means of the House of Representatives held well-publicized hearings on tax compliance by FCCs. These hearings were generally referred to as the "Pickle Hearings," after Congressman J.J. Pickle (D.-Tx.), the chairman of the Subcommittee. At the Pickle Hearings, estimates of lost revenues resulting from transfer pricing abuses were in the $ 30 to $ 50 billion range. These transfer pricing activities were labeled rhetorically as "fraudulent and criminal", amounting to "massive tax evasion". For example, Chairman Pickle stated that he was outraged that FCCs did not pay "one thin dime" in U.S. federal income taxes, despite billions of dollars in U.S. sales each year.

In 1991, additional Congressional hearings on U.S. competitiveness also focused, in part, on whether the IRS is using effectively the new enforcement tools enacted by Congress in 1989 and 1990.

In part as a result of these Congressional hearings, and prompting by some sectors of U.S. business, the U.S. media have continued to publicize allegations that FCCs which sell prominent foreign brand name products in the United States are not paying their "fair share" of U.S. taxes. Many of these companies fear a backlash by U.S. consumers because of this adverse attention.

The IRS has devoted substantial additional resources to auditing and litigating against FCCs. In the view of many practitioners, the IRS has taken increasingly aggressive legal and economic positions, and far too often reasonable results for taxpayers can be obtained only in the courts and on occasion in competent authority.

B. *Access to information is key*

The key to recent legislative changes to the Internal Revenue Code[1] in the transfer pricing area has been to increase the legal authority of the IRS to obtain information, especially the data of foreign parent companies and other foreign related parties.

The IRS has long claimed that its effective enforcement of the tax laws against FCCs is hindered by lack of detailed, factual information from the FCCs and their foreign related parties. IRS examination personnel who testified at the Pickle Hearings were described as being "in the trenches" without the weapons necessary to

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1. All references are to the U.S. Internal Revenue Code of 1986, as amended, (the "Code") unless otherwise indicated.

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fight the FCCs high-powered, high-paid lawyers, economists, accountants and other experts.

The result of these recent events is a material and, we believe, permanent change in the "rules of the game" for FCCs operating in the United States. One important consequence of doing business in the United States now is that a foreign parent company's books and records will have to be made available to the IRS.

II. SECTION 6038A AND THE NEW RULES OF THE GAME

A. *Background*

1. The Omnibus Budget Reconciliation Act of 1989 (the "1989 Act")

(a) *Reporting requirements*

The 1989 Act expanded the reporting rules of Section 6038A to require that a U.S. corporation at least 25 percent owned by a foreign shareholder (a "reporting corporation") must provide to the IRS identification of each 25 percent foreign shareholder or any entity related to the reporting corporation or the foreign shareholder (a "related party") that engages in a transaction with the reporting corporation. The reporting corporation must also report to the IRS details of all transactions between the reporting corporation and foreign related parties ("reportable transactions"). IRS Form 5472 is used for Section 6038A reporting purposes.

(b) *Recordkeeping requirements*

The 1989 Act also amended Section 6038A to provide the IRS with the authority to require that a U.S. reporting corporation maintain, or cause to be maintained by related parties, "appropriate" records to determine the correct tax treatment of transactions between the reporting corporation and related parties.

(c) *Authorization of agent requirement*

In addition, foreign related parties are required to designate the U.S. reporting corporation as their agent for purposes of service of process for summons purposes under Code Sections 7602, 7603 and 7604.

(d) *Penalties*

Stiff penalties may be applied if a reporting corporation fails to maintain (or cause to be maintained) and supply records to the IRS when requested, or if the foreign related parties fail to designate the reporting corporation as their agent for service of process. These penalties include (1) a fine of $ 10,000 per day, up to a maximum of 30 days, for any failure to maintain or provide the records required under Section 6038A that continues for more than 90 days after the taxpayer is notified by the IRS of its failure to comply, and (2) if there is a failure to comply with the designation of agent or recordkeeping requirements, the IRS is authorized to determine U.S. income tax deductions (including cost of goods sold) relating to reportable transactions, in the IRS's sole discretion from the IRS's own knowledge or from such information as the IRS may obtain through testimony or otherwise.

2. The Revenue Reconciliation Act of 1990 (the "1990 Act")

The 1990 Act expanded the application of Section 6038A information reporting and recordkeeping requirements so that they apply not only for tax years beginning after 10 July 1989, the original effective date under the 1989 Act, but also to all open prior tax years. Additionally, the 1990 Act added Section 6038C to the Code, which extends the information and recordkeeping requirements to foreign corporations (such as some foreign banks) which are engaged in a trade or business within the United States through branch offices.

3. Issuance of regulations

Proposed regulations under Section 6038A were released on 4 December 1990, written comments were received by the IRS and a public hearing was held 22 February 1991. Final regulations were released by the IRS on 14 June 1991, with a number of significant changes being made to the proposed regulations.

B. *Section 6038A regulations*

The final Section 6038A regulations clarify and provide details regarding the reporting, recordkeeping and authorization of agent requirements.

1. General requirements and definitions

In the definitional section of the regulations, small corporations, defined as corporations with less than $ 10,000,000 in gross receipts, are exempted from the record maintenance and authorization requirements of Section 6038A.

In addition, there is a de minimis rule which excludes reporting corporations from the Section 6038A recordkeeping and authorization of agent requirements, but not the general Section 6001 record maintenance rules or the information reporting (Form 5472) requirement, for any taxable year in which the aggregate value of all gross payments made to, or received from, foreign-related parties with respect to related party transactions is not more than $ 5,000,000 and is less than ten percent of the reporting corporation's U.S. gross income. It is expected that the revised small corporation exception and de minimis rule will exempt a majority of foreign-owned entities from the Section 6038A recordkeeping and authorization requirements.

The status of foreign governments under Section 6038A was clarified. Under the final regulations, a foreign government-controlled entity is subject to the reporting requirements of Section 6038A with regard to the reportable transactions with all related parties, including the foreign government/shareholder, but is subject to the authorization and recordkeeping requirements with regard only to non-governmental related parties.

Other exceptions to the definition of "reporting corporation" added to the final regulations include an exemption from Sec-

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tion 6038A for a foreign corporation doing business in the United States which is entitled to the benefits of the business profits article of a bilateral income tax treaty – does not have, and is not deemed to have, a permanent establishment in the United States.

2. Information return requirements

The regulations clarify that if a reporting corporation is exempt from filing a Form 5472 because a Form 5471 has been filed that provides duplicate information, the reporting corporation is also exempt from the record maintenance requirements and the authorization of agent requirement. Such a reporting corporation, however, remains subject to the general record maintenance requirements of Section 6001.

3. Record maintenance

(a) *General record maintenance requirements*

The final regulations more clearly set forth the general recordkeeping requirements for foreign-owned entities, in an attempt to avoid the confusion created by the proposed regulations. The regulations provide that all corporations, including reporting corporations and their foreign related parties, must comply with the requirements of Section 6001.

Under Section 6001, the final regulations explain, the IRS may require any person to make such returns, render such statements, or keep such specific records as will enable the IRS to determine whether or not that person is liable for any U.S. taxes. Such records must be permanent, accurate and complete, and must clearly establish income, deductions and credits.

Additionally, in appropriate cases, the IRS believes that Section 6001 gives it the authority to require that such records, including sufficient relevant cost data from which a profit and loss statement may be prepared for products or services transferred between a reporting corporation and its foreign related parties, be supplied. This requirement includes records of the reporting corporation itself, as well as records of any foreign related party, that may be – to determine the correct U.S. tax treatment of transactions between the reporting corporation and foreign related parties. The relevance of such records with respect to related party transactions, the regulations point out, shall be determined upon the basis of all the facts and circumstances.

Possibly in an attempt to answer critics who alleged that FCCs were being subjected to discriminatory requirements, the regulations state that Section 6038A and the regulations thereunder do not impose any requirements not already included in Section 6001, but rather they provide detailed guidance regarding the required maintenance of records.

Generally, under the final regulations, documents may be maintained outside of the United States if certain requirements to produce materials are satisfied.

Rules describing how the record maintenance requirements are to be applied to banks and other financial institutions will be set forth in future Section 6038C regulations.

(b) *Negotiated agreement*

As an alternative to the general recordkeeping requirements, the District Director and the reporting corporation may negotiate and enter into an agreement that establishes the records the reporting corporation must maintain, or cause another to maintain, to satisfy the reporting corporation's obligations under Section 6038A.

The agreement may include provisions relating to the authorization of agent requirement, the record maintenance requirement, and time periods for the production and translation of materials.

In a negotiated agreement the District Director will generally require a reporting corporation to maintain only those records specified under the safe harbour provision that permit an "adequate audit" of the income tax return of the reporting corporation and to provide such authorizations of agent that permit "adequate access" to such records. Additionally, the regulations explain that a negotiated agreement with the District Director may be negotiated separately or as part of an Advance Pricing Agreement ("APA").

(c) *Safe harbour provision*

Generally, the final regulations provide that the safe harbour consists of an all-inclusive list of record types that could be relevant to different taxpayers under a variety of facts and circumstances. It is explained that the safe harbour does not constitute a checklist of records that every reporting corporation must maintain. The specific records a reporting corporation is required to maintain, and that the IRS will request, are only those records enumerated in the safe harbour (including material profit and loss statements) that may be *relevant* to the reporting corporation's business or industry and to determine the correct U.S. tax treatment of its transactions with its foreign related parties.

As in the proposed regulations the final safe harbour provision provides categories of documents which should be maintained. These categories of documents are (1) original entry books and transaction records, (2) materials from which profit and loss statements can be created, (3) all documents relevant to establishing the appropriate price or rate for transactions between the reporting corporation and any related party, (4) documents relevant to transactions between a reporting corporation and any foreign related party filed with or prepared for any foreign government entity, any independent commission, or any financial institutions, (5) ownership and capital structure records, and (6) records of loans, services and other non-sales transactions.

The safe harbour does not require the creation of records not ordinarily created; however, there are exceptions to this rule – basic accounting records sufficient to document the U.S tax effects of transactions between related parties must be created, as must records sufficient to produce material profit and loss statements.

In response to criticisms of the requirement to maintain sufficient materials from which profit and loss statements can be created, it is made clear in the final regulations that, for the

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purpose of preparing such statements, it is not necessary to trace actual costs borne by the reporting corporation and all related parties (the "related party group"); rather, any reasonable method may be used to allocate the group's worldwide cost to the revenues generated by the sales of those products or services. The IRS also explains that the profit and loss statement is not being used to determine precise U.S. tax liability of a reporting corporation.

The tests for determining the materiality of profit and loss statements are intended to identify, in broad terms, the relative importance of a particular product, product line or service. A profit and loss statement may also be determined to be material if one of the three tests provided – the existing records test, the significant industry segment test or the high-profit test – is met. If a profit and loss statement is determined to be material, to satisfy the requirements of the safe harbour, records must be maintained from which the reporting corporation can compile and supply, within a reasonable time, such profit and loss statements that reflect profit or loss of the related party group attributable to U.S. connected products or services.

Also included in the final regulations is a requirement that records from which profit and loss statements can be created must be kept under U.S. generally accepted accounting principles ("GAAP"), if they are ordinarily maintained in such manner, and, if not, that an explanation of the material differences between the accounting principles used and U.S. GAAP must be made available.

4. Penalties

The final regulations provide additional detail relating to facts and circumstances that might satisfy the reasonable cause exception to the imposition of the monetary penalties.[2]

Among the specific circumstances that may indicate reasonable cause and good faith are: an honest misunderstanding of fact or law in light of the experience and knowledge of the taxpayer; the taxpayer does not know or has no reason to know (and this belief is consistent with other information reported or otherwise furnished to or known by the reporting corporation) that it is owned by a 25 percent foreign shareholder; and the reporting corporation is related to a foreign corporation solely by reason of application of the control principles under Section 482, and the reporting corporation had a reasonable belief that its relationship with the foreign corporation did not meet the standards for related parties under Section 482.

5. Authorization of agent

The final regulations delete the requirement from the proposed regulations that an annual authorization of agent be filed as part of the reporting corporation's Form 5472. The regulations provide, in place of the annual authorization, that such authorization must be provided within 30 days of a request by the IRS. The final regulations, therefore, adopt as a permanent rule the transitional rule found in the proposed regulations.

6. Coordination with treaties

The final regulations provide that where records of a related party are obtainable on a timely and efficient basis under a tax treaty or tax information exchange agreement, the IRS will generally make use of such procedures before issuing a summons. Information is deemed to be available on a "timely and efficient basis" if it can be obtained within 180 days of the request. To date, two treaty requests have been made under this provision, both involving Japan.

Which countries will be treated as having treaties with the United States that work "efficiently" will be a major issue for the IRS and for FCCs.

Many of those submitting comments to the proposed regulations supported a provision which set forth preferential use of information exchange agreements over Section 6038A. The British-American Chamber of Commerce, for example, strongly suggested a clear expression in the regulations that the IRS would exhaust the information exchange agreement process before seeking information from foreign related parties pursuant to Section 6038A.

The British Embassy in Washington, commenting on the 1990 Act, stated that Section 6038A was unnecessary, given the proper functioning of the U.S.-U.K. information exchange agreements.

IRS and Treasury officials have commented that treaty partners will have a chance to build a new "reputation" for cooperating with treaty requests, and they expect that until a country has gained a post-Section 6038A reputation for untimely responses to treaty information requests, auditors will use the treaty provision (unless constraints, such as time limitations, exist).

Despite this "clean slate" approach, use of Section 6038A is expected quickly in the cases of certain countries, such as Japan, with a history of treaty response delays.

It is expected that a list of "good countries/bad countries" will be developed internally by the IRS. It is not expected that this list will be published.

C. *Other provisions*

In addition to Section 6038A, other provisions of the Code may prove effective tools in permitting IRS access to the books and records of foreign companies doing business in the United States.

Section 982, which provides that foreign-based material not provided in response to a formal document request may not be introduced in civil court proceeding, will continue to be used to gather information. The IRS is expected to issue guidelines discussing the coordination of Sections 982 and 6038A.

Section 6503(k) was added to the Code by the 1990 Act in an attempt to prevent delaying tactics used by taxpayers to exhaust the period of limitations during audits and, thereby,

2. The IRS testified before Congress that as of July 1991 it was proposing penalties under Section 6038A against 124 FCCs, covering 171 tax years.

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interfere with enforcement of tax provisions. These delaying tactics were seen by Congress as a particular problem in large complex transfer pricing audits.

Section 6503(k) provides that the statute of limitations for a corporate tax return, usually three years, is tolled during the period of time that the corporation and the IRS are in court litigating the issue of whether the corporation must comply with a specific type of summons (called a "designated summons") issued by the IRS.[3]

A "designated summons" is defined as any summons: (1) issued by the IRS in an attempt to determine the proper income tax to be imposed on the corporation; (2) issued at least 60 days prior to the running of the period of limitations prescribed in Code Section 6501; and (3) clearly stating that it is a designated summons.

The IRS may only issue one designated summons for each tax return under investigation. The provision applies to all open tax years and is designed to prevent corporate taxpayers from engaging in delaying tactics which hinder IRS enforcement.

III. PLAYING BY THE NEW RULES OF THE GAME

A. *General*

Each corporation operating in the United States which clearly is, or may be, a reporting corporation should identify "Who, What and When" under the Section 6038A requirements. The first step is identifying whether or not the U.S corporation is a reporting corporation. Even more complicated is the identification of "related parties". The 25 percent foreign shareholders of U.S. entities will have to examine their worldwide business relationships.

In addition to the attribution rules included in Section 6038A, examples included in the definitional section of the regulations indicate that the IRS is broadly interpreting the rule that a party is related to a reporting corporation for Section 6038A purposes, if it is related to the reporting corporation under Section 482.

Examples added to the final Section 6038A regulations provide that a publicly traded corporation with a single 25 percent shareholder (and with the remaining 75 percent being owned by numerous small shareholders) is controlled by the 25 percent shareholder for purposes of Section 482 and, therefore, is a related party under Section 6038A.

Clearly, the record maintenance requirements of Section 6038A will have a potentially significant effect on a company's operations. Each member of a foreign-based group should review its current recordkeeping procedures and determine how those procedures must be changed to satisfy the requirements of Section 6038A.

Companies may want to consider forming a "compliance task force" which will bring together technical recordkeeping experts from each member of the related party group, and outside professionals if needed, to discuss developing a coordinated plan to satisfy the requirements of Section 6038A.

In discussions regarding the recordkeeping and information requirements, both within each corporation and among members of the related party group, making necessary changes to internal procedures, coordinating recordkeeping among related party group members, and deciding where and by whom records should be maintained, all must be considered.

Given the broad definition of related party, procedures should be put in place for obtaining, in a timely fashion, accurate data regarding the operations of foreign affiliates. Reporting corporations should also develop procedures for verifying that required materials are being maintained by foreign related parties, especially if an election is made to maintain these records overseas.

In considering whether to make such an election to maintain records outside the United States, the issues of how proper record maintenance is verified, and how the reporting corporation is protected from added penalties, should be considered.

Related party groups may want to consider indemnification of the reporting corporation by the foreign parent for all costs to the U.S. company relating to failures by the parent (or parties related to the parent) to maintain proper records.

It will be costly for foreign related parties to create and maintain records required by Section 6038A. Should U.S. reporting corporations bear the cost of this recordkeeping? If the answer is yes, members of related party groups should discuss whether this cost should be paid separately or as a negotiated part of the transfer price.

Serious consideration should be given to entering a Section 6038A negotiated agreement with the IRS. This is especially important for foreign-control led groups with a history of transfer pricing disagreements with the IRS. The option, for many such groups, of negotiating an APA which includes a Section 6038A agreement may also be appropriate.

The safe harbour provision should be carefully reviewed on two levels. First, a reporting corporation, in consultation with its related party group, should determine if it wishes to attempt to take advantage of the safe harbour. Second, even if no attempt is made to satisfy the safe harbour and even though the regulations state that the safe harbour requirements are not a "baseline," the types of records identified in the safe harbour and relevant to a particular transaction are ones the IRS will likely request in an audit. Most importantly, reporting corporations should maintain pricing documents and identify and retain underlying business records from which profit and loss statements *could be* created.

The effective dates of Section 6038A and the regulations thereunder should be carefully reviewed. The tax years to which these rules apply should be identified.

Materials, once created, should not be routinely destroyed by members of the related party group pursuant to record retention procedures, without first verifying that those particular records do not relate to tax years open to audit and, therefore, covered by Section 6038A. For example, records covered by

3. According to the IRS, one designated summons has been issued in one pending case.

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Section 6038A and in existence on 20 March 1990 must be maintained under the regulations. This is most important for foreign related parties who might have no ongoing knowledge of the status of U.S. tax controversies.

B. *Protecting materials from the IRS*

With the IRS's new authority under Section 6038A and other Code provisions, it will be important to attempt to protect, to the maximum extent possible, internal work papers developed relating to the evaluation and setting of possible transfer prices and transfer pricing methodologies.

Such "work product" ideally should be protected under the attorney-client and attorney work product privileges. If such documents are not successfully protected, it is possible that the IRS can obtain them under Section 6038A.

Care must also be taken to protect the work product of experts, such as economists, assisting a reporting corporation, a foreign related party or their attorneys and accountants on transfer pricing issues. To help protect these materials created by experts, the following steps should be taken:

- Retainer letters with experts should be executed by attorneys advising on transfer pricing disputes.
- The experts must work under the direction and control of the attorneys, and the attorneys must actively supervise the experts' work.
- Given the reach of Section 6038A, requests to experts for materials, and the use of these materials after they are prepared, must be reviewed carefully.

IV. CONCLUSION

The Section 6038A requirements will likely be extremely costly and burdensome to many reporting corporations and their foreign party groups. Companies should begin immediately to review their internal procedures – and develop new ones if necessary – to facilitate compliance and avoid potentially harsh penalties.

Section 6038A, and other recently enacted provisions (such as the new penalty interest rate in tax disputes), create forceful incentives for companies to engage in "advance planning". Companies should develop a transfer pricing methodology and substantiate this methodology with contemporaneous documentation.

In part, these requirements further shift the burden in transfer pricing audits from the IRS to the taxpayer, requiring the taxpayer to show support for its transfer prices and relieving IRS auditors of some of the burden of finding comparables.
Further significant changes in the U.S. transfer pricing rules may be expected in IRS regulations, court decisions and, possibly, additional legislation.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

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: challanges 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.

The New United States Transfer Pricing Regulations, Amsterdam (the Netherlands), 16 March (English):
International Tax Academy (co-sponsor U.S. Branch of IFA) Sarphatistraat 124, P.O. Box 2037, 1000 HE Amsterdam, the Netherlands. Tel.: +31 20-6267726; Fax: +31 20-6209397.
Erfolgreich Investieren in Ungarn, Polen, CSFR, Vienna (Austria), 26-27 March (German):
Dr. Peter Deubner Verlag GmbH, Postfach 410268, 5000 Köln 41, Tel.: 221-403028, Fax: 221-403020.

APRIL 1992

Investitionen in den ehemaligen Staatshandelsländern, München (Germany), 7 April (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG, CH-8022 Zürich: Tel.: (41) 1-2192399. Fax: (41) 1-2193583.

International Tax Planning, how to reduce the tax burdens of Multinational Corporations, Amsterdam (the Netherlands), 9 and 10 april (English):
Legal Studies and Services Limited, IBC House, Canada Road, Byfleet, Surrey KT14 7JL, United Kingdom, Tel.: (+44) 716374383, Fax: (+44) 716313214.

MAY 1992

European Cross-Border Life Insurance Conference – 1992 (focusing on regulatory and tax issues), Luxembourg, 7th and 8th May (English):
Ms. Susanne Due, KMPG Management Consulting, 3, rue Thomas Edison, L-1445 Luxembourg, Tel.: +352.45.55.11.830, Fax: +352.45.73.85.
Euromoney's Second International Tax Planning Forum, Amsterdam (the Netherlands), 13-14 May (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, Tel.: 71-7798602, Fax: 71-7798599.

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OBTAINING RELIEF THROUGH COMPETENT AUTHORITY PROCEDURES AND TREATY EXCHANGE OF TAX INFORMATION

THE U.S. APPROACH

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I. GENERAL BACKGROUND

A. *Why treaties?*

From the U.S. point of view, treaties can be thought of as having two constituencies. First, in the private sector, U.S. multinational corporations have been the most aggressive advocate of tax treaties because they serve to limit source-basis taxation on their offshore investments and business activities. The articles of the tax treaty that have traditionally been most important to such corporations are, of course, the permanent establishment articles, and the articles providing for reduced rates of local tax on interest, dividends and royalties. This advocacy continues to this day, and is probably best personified in the group to which many large U.S. multinationals belong, the National Foreign Trade Council.

The second constituency for treaties has been the U.S. revenue authority, the Internal Revenue Service ("IRS"). In the case of the IRS, the interest lies primarily in those aspects of the treaty that enhance the ability of the United States to obtain cooperation from other countries in the enforcement of tax laws. Such articles include those that provide for mutual agreement procedures and the exchange of tax information. It is probably safe to say that the United States, more than any other country, has made an effort to use these provisions to the fullest extent possible. Indeed, as discussed more fully below, the United States has written and interpreted its domestic law in ways specifically designed to encourage both its residents and foreign governments to resort to these provisions as fully as possible to resolve treaty disputes and prevent international tax avoidance.

B. *Relationship to domestic law*

The attitude of the U.S. competent authority toward, and the growing importance of, treaty mutual agreement provisions need to be understood in light of several features of U.S. domestic law.

1. In general

Under the U.S. Constitution, all revenue measures originate in the House of Representatives, one house of our bicameral legislature, the Congress. By contrast, treaties, which operate in some cases to restrict those revenue measures, are negotiated by the Executive branch, and ratified by the Senate, the other house of our legislature. As a consequence, treaties are closely watched in the House, and have occasionally been overridden by domestic law where, in Congress' view, they do not accord with domestic tax policy.

At times, Congressional staff have gone so far as to specify in legislative history their view of conditions that should be imposed on granting competent authority relief. For example, in a report interpreting the Tax Reform Act of 1986, the Joint Com-

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mittee expressed its view that the competent authority should not grant relief by increasing transfer prices on imported goods unless any additional customs duties are collected that would have been payable at the higher price.[1] It is not clear to what extent this policy has been adopted.

2. The "commensurate with income" standard and the White Paper

In the Tax Reform Act of 1986, Congress amended the basic U.S. transfer pricing statute, Section 482 of the Internal Revenue Code, to provide that whenever intangibles are involved in related party transactions, the owner of the intangible must be compensated for it in a manner "commensurate with the income attributable to the intangible". This phrase, of course, is not especially descriptive, and is open to a variety of interpretations. Moreover, the legislation was accompanied with an explanation in Congressional committee reports that could be read as the abandonment of the arm's length standard by the United Sates.[2]

In 1988, the IRS and the Treasury Department issued a "Study of Intercompany Pricing", the so-called "White Paper", which offered the government's preliminary view on the proper interpretation of this standard, and reiterated its commitment to adhere to arm's length principles. That study generated a great deal of comment and controversy, but no legally binding interpretive rules have yet been issued by the government to describe more precisely what "commensurate with income" means. As a consequence, because so many transactions among affiliated companies involve intangible property in some respect, the U.S. law applicable to many intercompany transactions is uncertain at best, and transfer pricing disputes are likely to arise.

3. Section 6038A: reporting and recordkeeping by foreign-owned firms

In 1989, Congress passed a comprehensive set of rules enhancing the access of the IRS to information relevant to transfer pricing in the hands of foreign investors in U.S. businesses. These rules are enforced by stiff monetary penalties and by giving the IRS the power, in the absence of compliance, to decide at its own discretion the amount of the U.S. business deductions and cost of goods sold in related party transactions. These rules are beyond the scope of this discussion, but signal a significant increase in transfer pricing investigations, with perhaps a corresponding increase in the necessity for competent authority resolution of disputes.

4. Increased penalty exposure on transfer pricing issues

Also in 1989, Congress passed amendments to the penalty provisions of the Internal Revenue Code, which permit the imposition of stiff penalties for "substantial valuation misstatements" in transfer pricing cases. These penalties at first blush appear to apply only in cases of very substantial deviations from appropriate pricing (i.e. the price used was either double or half the amount of the appropriate price). In cases of large multinational groups, however, much more modest swings in transfer pricing can create penalty exposure because the penalty applies where the sum of transfer pricing adjustments exceeds $ 10 million. This amount can be reached very quickly in the case of a company with hundreds of millions of dollars in intercompany transactions. Here again, U.S. internal law has greatly increased the stakes involved in a transfer pricing dispute, and has therefore greatly increased the likelihood that transfer pricing disputes will occur.

II. FEATURES OF U.S. LAW THAT FORCE U.S. TAXPAYERS TO USE COMPETENT AUTHORITY PROCEEDINGS FOR TRANSFER PRICING DISPUTES

A. *Transfer pricing adjustments may be made only by the IRS*

It is a matter of long-standing U.S. law that transfer pricing adjustments may be made after the close of the taxable year only by the IRS. If the taxpayer discovers that its pricing has been in error, it cannot make an adjustment to reflect the appropriate price on its own initiative. Similarly, if a foreign jurisdiction changes the transfer pricing of a foreign affiliate of a U.S. company in such a way as to increase that affiliated company's income, the U.S. company cannot on its own initiative reduce its income to reflect that adjustment. The only aspect of U.S. law that can compel the IRS to make a correlative adjustment in the United States in the taxpayer's favour is the mutual agreement procedure under treaties. Thus, the U.S. taxpayer has no means of obtaining a correlative adjustment without resort to competent authority.

B. *Availability of a foreign tax credit in transfer pricing cases*

U.S. internal law has its own mechanism for relieving double taxation. Under that law, a credit may be taken against U.S. tax liability on income from foreign sources for foreign income taxes paid with respect to that income. In order for that credit to be taken, however, the taxpayer must be able to demonstrate that the purported income tax payment to the foreign government was not in fact voluntarily made, i.e. that it exhausted all administrative remedies available to it to assure that the tax was properly imposed.[3] It is the view of the IRS that a credit may not be taken for increased foreign income taxes resulting from a transfer pricing adjustment initiated by a foreign government unless the taxpayer avails itself of a competent authority procedure; otherwise, in the IRS's view, the taxpayer has not exhausted all of its administrative remedies.[4]

C. *Revenue Procedure 65-17 and the tax-free payment of a U.S.-initiated transfer pricing adjustment*

A longstanding feature of IRS administrative practice is to permit the cash remittance (or recharacterization of a previous cash remittance) from a foreign affiliate without additional

1. See *General Explanation of the Tax Reform Act of 1986*, at 1062 (Jt. Comm. Tax. 1987).
2. See discussion at *id*, at 1011-1018.
3. Reg. §1.901-2(e)(5)(i).
4. See Rev. Proc. 91-23, at Sec. 9.

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U.S. tax consequences in cases where the United States has successfully increased U.S. taxable income through a transfer pricing adjustment.[5] For example, where a transfer pricing adjustment increases U.S. taxable income in a prior taxable year, the taxpayer may set up a current receivable from its foreign affiliate in the amount of that adjustment and cause it to be paid with no additional U.S. tax consequences. Similarly, if a transfer pricing adjustment had been made with respect to a prior year and dividends had also been paid in that year, the taxpayer would have the ability to recharacterize a portion of that dividend payment as a payment made in connection with the transactions with respect to which the transfer pricing adjustment was made. The IRS will not permit this favourable treatment, however, in any case where the taxpayer does not avail itself of the competent authority procedure.[6]

III. TREATY MUTUAL AGREEMENT PROCEDURE

A. *Relevant treaty provisions*

Virtually all current U.S. tax treaties contain an article which sets out the methodology for resolving disputes between the governments in the interpretation of the treaty. The U.S. model is generally consistent with the parallel article in the 1977 OECD model treaty. Essentially, the model article provides for the initiation by a taxpayer of a procedure to obtain assistance from the competent authority of the state in which he is a resident or national to prevent taxation that is inconsistent with the treaty itself. This procedure has been used, of course, by U.S. taxpayers in the full range of issues that might arise in treaty interpretation. Far and away the most important issue, however, in terms of both dollars at stake and number of proceedings, has proven to be transfer pricing disputes between jurisdictions.

As a matter of treaty interpretation the issue in transfer pricing cases relates to the "associated enterprises" article that appears in almost every U.S. treaty in one form or another. That article restates the authority of each jurisdiction to alter pricing between affiliated companies in cases where that pricing does not reflect the pricing that would have occurred between independent enterprises, or arm's length pricing. The article goes on to state that where such an adjustment occurs, the other state should adjust the tax charged to the related company that is resident in it to reflect the same arm's length adjustment. Many U.S. treaties, including the U.S./U.K. treaty, include another provision requiring the respective competent authorities to endeavour to agree on the appropriate arm's length adjustments, if any, under the provisions of the mutual agreement procedure.

One U.S. treaty, the recently ratified treaty with Germany, adds yet another layer of dispute resolution. If the competent authorities are unable to agree on the proper pricing, but can agree that the dispute should be referred to arbitration, the treaty permits (but does not require) such referral. Because the German government advanced this concept, it is not clear the extent to which it represents the current treaty policy of the United States, and it is therefore unclear whether this provision will appear in future U.S. treaties; indeed some more recent treaties have appeared that contain no arbitration provision.

B. *Revenue Procedure 91-23: the administrative rules for pursuing competent authority relief*

The United States, to a degree unmatched by any other country, has promulgated elaborate procedural guidance and rules for pursuing competent authority relief. This guidance is set forth in the recently issued Rev. Proc. 91-23, which revised earlier guidance.

It is probably useful to mention the difficult problems that remain with the competent authority process, and a few strategic points. First, in a shift from prior practice, Rev. Proc. 91-23 clearly signals the intent of IRS to grant relief, for the most part, only in cases where it is able to reach agreement with its foreign counterpart. In the past, if the IRS initiated a transfer pricing adjustment, it would in some cases grant unilateral relief from that adjustment by withdrawing the proposed change if it would result in double taxation because of failure to reach agreement with the foreign competent authority. Such relief will now be granted only in unspecified "extraordinary circumstances", and only in cases when the foreign statute of limitations has expired. In no event will it be granted where the other country does not grant relief in equivalent cases. It is therefore extremely important to pursue whatever remedies might be available under the domestic law of the other jurisdiction in addition to competent authority proceedings.

Also, the procedure does not address relatively common problems that might arise because of different policies between the relevant jurisdictions on such matters as the payment of interest on refunds or deficiencies, or different rules to account for exchange rate fluctuation in the transfer pricing adjustments and payments associated with them. These issues will therefore probably remain unresolved in many cases.

It remains the case under Rev. Proc. 91-23 that there is no guarantee of competent authority agreement. Even if the U.S./German treaty's arbitration provision is the start of a trend, there is no guarantee that the respective competent authorities will agree to submit a particular case to binding arbitration. The degree to which agreements are in fact reached vary widely from country to country. As a result, a taxpayer may expend enormous resources with essentially no return in pursuing competent authority relief.

For years, the competent authority process has attracted criticism that it took too long to resolve those cases that did reach agreement. While some of this criticism has probably been unfair, these proceedings do place a considerable burden on the resources of the respective governments, and backlogs have occurred. Despite recent efforts by the U.S. competent authority to improve the ability to track and monitor cases, this burden will, if anything, increase with the new emphasis in the United States on transfer pricing cases, and the probable response of foreign governments.

To avoid the uncertainty and commitment of resources that attend a competent authority proceeding, a taxpayer has only

5. See Rev. Proc. 65-17, 1965-1 C.B. 833.
6. See Rev. Proc. 91-24, I.R.B. 1991-11 (18 March 1991).

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two real choices. First, it should look very carefully to see if any discrete product or business is suitable for the new advanced pricing agreement procedure. In all likelihood this will be a relatively modest amount of a particular group's business because of the enormous volume and variety of intercompany transactions, the probability that the transfer pricing rules apply differently to different categories of products and services, the enormous investment in representatives and economists implied by the administrative pricing agreement process, the likelihood that advanced agreement can be accomplished cost effectively only in cases where the stakes are high enough and the products distinct enough from the rest of the taxpayer's business, and the natural reticence to raise the pricing of mature products that might give rise to issues in prior years. Otherwise, the taxpayer is well advised to develop pricing policies at the outset of any product's introduction, and to stick to and document those policies. Our experience has been that when we are able to tell a revenue agent from IRS or from almost any other country what our policy is, and to demonstrate that it has logic under arm's length principles and that we have followed it consistently, we have had very few transfer pricing adjustments. Stated another way, most revenue authorities have been willing to take a larger view of transfer pricing issues and accept prices that fall within a range of reasonableness, especially in countries where no significant tax avoidance potential existed because of comparable tax rates on the other side of the transaction. This sensible approach by governments to transfer pricing permits them to focus their attention on cases where tax avoidance potential is significant, i.e. transactions which involve at least one country that imposes little or no tax on business activity. Further, it permits taxpayers to conduct their businesses without the enormous cost, either at the front end with administrative pricing agreements or the back end with competent authority proceedings, of transfer pricing disputes on literally thousands of products and dozens of discrete businesses.

IV. EXCHANGE OF INFORMATION UNDER TAX TREATIES

All of the U.S. tax treaties save the treaty with the Soviet Union contain provisions which permit the exchange of information between tax authorities relevant to the tax liability of resident taxpayers. The United States also has the ability under U.S. domestic law to enter into executive agreements with foreign governments outside of the treaty process for the exchange of tax information.

The exchange of tax information has two principle functions. First, it enables the respective competent authorities to share information relevant to determining tax liability in a mutual agreement proceeding to prevent double taxation. Second, it enables the United States and its treaty partners to obtain information to prevent the avoidance of their respective tax laws through offshore transactions hidden from their respective revenue authorities.

As with mutual agreement procedures, the United States has developed a set of practices and procedures under these exchange of information provisions that is probably the most far-reaching and elaborate in the world. There are a variety of bilateral and multilateral programmes that the United States pursues with its treaty partners in the exchange of information. For example, under a programme of so-called "industry-wide" exchanges, the U.S. competent authority has met with its foreign counterparts to help them understand the practices and the economics of specific industries, and therefore the appropriate taxation of them. Second, the United States has entered into specific competent authority agreements with various treaty partners to permit the so-called "spontaneous" exchange of information where in the course of auditing a taxpayer, information is disclosed which suggests avoidance of another jurisdiction's taxes. Third, the United States exchanges so-called "routine" information with various jurisdictions on such items as U.S.-source dividends and interest. Fourth, the United States has programmes to permit the "simultaneous examination" of taxpayers, which have proven particularly effective in cases where a business evades both jurisdictions taxes through the use of tax havens. Finally, under exchange of information programmes as they are commonly understood, the United States will furnish information to a treaty partner in response to a specific request of that partner with respect to a particular taxpayer. Indeed, unlike many countries, the United States will use its legal powers to obtain information not in its possession (e.g. bank records) at the request of a foreign government authority, so long as that information is potentially relevant to tax liability in that other jurisdiction.

In drafting its domestic law, the United States has expressed on several occasions its support for information exchange programmes by conditioning specific tax benefits on an acceptable level of information exchange with particular foreign governments. For example, the United States permits a reduced tax rate associated with exports that are sold through a special purpose export corporation called a "foreign sales corporation". This benefit is available, however, only to corporations organized in a foreign country with an exchange of information practice that the U.S. government finds acceptable. Similarly, visitors attending a convention in a country in the Caribbean Basin can obtain business deductions for their travel expenses only if their travel is to a country with whom the United States has an exchange of information agreement in place. Finally, funds generated under the favourable U.S. tax regime for "possessions corporations" can be invested in other countries in the Caribbean region tax-free only if an exchange of information agreement is in place.

Lately, the most controversial aspect of exchange of information in the United States has been the possible misuse of exchanged information by foreign government officials. This concern was raised by U.S. residents as the United States embarked on a programme to obtain exchange of information agreements with Caribbean and Latin American countries. As a result of those concerns, various government officials over the past few years have discussed the possibility of creating an administrative procedure that would notify a taxpayer that information exchange was about to take place, and permit him or her to offer proof that such information would not be appropriately used by the foreign government involved. As of now, no such programme has been implemented, although it remains under consideration.

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INTERNATIONAL:

THE IMPACT OF EC TAX DIRECTIVES ON U.S. GROUPS WITH EUROPEAN OPERATIONS

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I. INTRODUCTION

This article focuses on the harmonization of direct corporate taxes within the European Community ("EC"). Although there has been substantial harmonization of indirect taxes, such as VAT, available time prevents this area being covered as well.

The first thing to be said about direct tax harmonization within the EC is the very limited progress which has occurred so far. As explained below, attempts to harmonize the basic tax systems of the EC countries have so far failed and any real future progress in this area is likely to take many years.

What has been achieved in EC direct tax harmonization is the agreement of certain important measures which will facilitate cross border business transactions with respect to mergers and reorganizations and the payment of dividends between subsidiaries and parent companies within the EC together with an arbitration procedure with respect to transfer pricing adjustments. There is also a possibility of the extension of the exemption on cross border dividend payments to certain interest and royalty payments.

The main EC direct tax harmonization provisions which have so far been agreed relate to mergers and reorganizations and the payment of dividends between subsidiaries and parent companies, which are required to be implemented by 1 January 1992, and the Arbitration Convention relating to transfer pricing adjustments, which will come into force when it is signed by the respective states. The U.K. Inland Revenue issued a press release at the time of the 1991 U.K. Budget on 19 March 1991 indicating how these Directives would be implemented in the United Kingdom.

The press release stated that two of the types of transactions dealt with in the Mergers and Reorganizations Directive, namely cross border mergers and cross border divisions were not covered by specific provisions in U.K. company law. Accordingly, the tax provisions in the Directive relating to these transactions would not be implemented until the company law was changed, and this may be dependent upon agreement of the EC Tenth Company Law Directive, which was issued in 1985 but has not yet been adopted.

Implementation of the other provisions in the Mergers and Reorganizations Directive and the Parent/Subsidiary Directive, together with the Arbitration Convention, was to take place in accordance with the required schedule and a Consultative Document with draft legislation was promised for later in 1991. This has not, however, so far appeared.

II. THE PROCESS OF DIRECT HARMONIZATION

Proposals for direct tax harmonization within the EC are generated by the European Commission and normally issued as draft Directives. Currently the Taxation Commissioner responsible for this area is Mrs. Scrivener. Following consideration by the Governments of the EC member states, the draft Directive then has to be agreed by the Council of Ministers in order to become accepted as a Directive. Proposals

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for taxation harmonization currently require unanimity amongst the member states in order for them to be implemented. This has been one of the reasons for the slow progress to date.

The Directives so far agreed have then needed implementation through changes in the domestic tax laws of each EC member state which are required to be in force by a specified date (e.g. 1 January 1992). There is uncertainty in the EC member states as to what is the legal status of the agreed Directives (e.g. the Mergers and Reorganizations Directive and the Parent/Subsidiary Relationships Directive) if they have not been implemented through enactments in each country's national laws by 1 January 1992.

The other recently concluded measure, the arbitration convention, has been agreed in the form of a Convention between the member states rather than a Directive. Accordingly, although the Convention has been agreed by the Council of Ministers, it has yet to be signed by the heads of state of the member countries.

III. EARLY PROPOSALS WHICH HAVE NOT YET BEEN IMPLEMENTED OR HAVE BEEN ABANDONED

A. *Background*

Attempts to harmonize corporate taxes in the EC began in the 1960s (i.e. before the United Kingdom even joined). With one minor exception, however, no progress was made until 1990. This was largely because many of the earlier proposals sought to make fundamental changes to the tax laws of member states which would have had a serious impact on taxation revenue raised and businesses in each country. Consequently, the necessary unanimity could not be obtained.

B. *Corporate tax systems and rates*

At the present time a number of fundamentally different tax systems operate within the 12 EC countries. The most common system is the imputation systems adopted by six countries, namely Belgium, France, Germany, Ireland, Italy and the United Kingdom. Under imputation systems there is some kind of imputation or tax credit whereby a credit is given at the shareholder level for part or all of the taxes paid by the corporation on the profits distributed.

The other EC countries operate different systems, notably the "classical" systems adopted by Luxembourg, the Netherlands and Spain whereby there is no relief for taxation at the shareholder level on profits distributed in respect of taxes already paid at the corporate level, i.e. there is double taxation of corporate profits distributed to shareholders as they are taxed once at the level of the corporation and then again fully taxed in the hands of the shareholder. Another system used in the EC is the two rate system, which Germany now combines with its imputation system. Under this system distributed and undistributed profits are taxed at differential rates.

It has proved to be impossible to agree on what should be the most appropriate basic system of corporate tax which could be harmonized within the EC. In 1963 the Neumark Committee suggested a split rate corporate tax system with distributed profits being taxed at a lower rate. In 1970 the Van den Tempel Report proposed that a classical corporate tax system should be used as the model. In a 1975 proposal of the European Commission as set out in a draft Directive on the harmonization of the systems of company taxation and withholding tax on dividends[1], it was proposed to harmonize the corporate tax systems of the EC countries on the basis of partial imputation systems. This draft Directive also proposed harmonizing corporate tax rates within a band of 45-55 percent and imposing a uniform 25 percent withholding tax on dividends to foreign shareholders.

No real progress was made on the above draft Directive and it has now been withdrawn. Accordingly, there are currently no proposals to harmonize the basic systems of corporate taxation within the EC.

C. *Computation of taxable profits*

Although early attempts at Directives on harmonization of corporate taxes concentrated on tax systems and tax rates, it has since been recognized that harmonization of corporate taxes is impossible unless taxes are charged in each country on the same amount, i.e. the "tax base" is the same. In many cases, however, this would involve even more fundamental changes to existing tax systems than the harmonization of the basic tax systems as there are wide divergencies in methods of computing taxable profits.

A preliminary draft proposal for the harmonization of rules for determining taxable profits of corporations was put out in 1988.[2] It has, however, since been withdrawn as it was believed that it did not satisfactorily deal with the problems involved.

D. *Carryover of losses*

The present tax rules relating to the carryover of losses vary greatly between the different member states. In many countries there is a time limit on the carryover of tax losses, e.g. generally five years in France. In other countries, however, such as the United Kingdom and the Republic of Ireland, tax losses can normally be carried forward indefinitely.

The Draft Directive of November 1985[3] addresses this issue. It proposes a uniform three-year carryback and indefinite carryforward of tax losses. The implementation of such a Directive would be welcome to European businesses as it is more generous than the current system applied in many member states. It has, however, yet to be agreed.

1. Draft Directive Concerning the Harmonization of Systems for Company Taxation and of Withholding Tax on Dividends, *Official Journal of the European Community*, No. C253 CLM (75) 392 Final. 1975.
2. Preliminary Draft Proposals for a Directive on the Harmonization of Rules Concerning the Taxable Profits of Undertakings XV/27/88 1988.
3. Draft Directive on the Tax Arrangements for the Carry Over of Losses of Undertakings. *Official Journal of the European Community*, Nos. C253 1984 and C170 1985. COM (84) 404 Final 1984.

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E. *Withholding taxes on interest*

On 8 February 1989 the EC Commission put forward plans for the introduction of a common interest withholding tax to be imposed by all EC member states on interest paid to residents of EC countries. A minimum withholding tax rate of 15 percent was proposed, although member states were to be free to impose a higher rate if they wished. The mandatory withholding tax was not to apply to interest payments to non-EC residents.

This proposal was largely motivated by the requirement to abolish exchange controls as part of the creation of the single market by the end of 1992. Previously France and Italy had imposed severe exchange controls and were concerned that the elimination of such controls would massively increase the opportunities for tax evasion in respect of interest on securities by the movement of funds to other territories.

Despite subsequent proposals to lower the common rate of withholding tax to ten percent, no agreement could be obtained on this proposal because of opposition by Luxembourg, the Netherlands and the United Kingdom. Accordingly, it was soon dropped.

IV. DIRECTIVES/CONVENTIONS WHICH HAVE BEEN AGREED

A. *Mutual assistance*

The first area where a Directive on corporate tax harmonization was actually implemented was in relation to mutual assistance between the taxation authorities of member states. This is through a Council Directive of 19 December 1977.[4] The purpose of the Directive is to prevent tax evasion and avoidance across the frontiers of member states. The Directive is primarily designed to allow member states to exchange relevant information relating to the assessment of taxes on income and capital. The Directive includes provisions for spontaneous exchange of information without a specific request by another member state.

In practice, however, the provisions of this Directive do not extend much further than the exchange of information and mutual assistance provisions already existing in bilateral double taxation treaties between member states which have existed from many years earlier. Indeed the United Kingdom has comprehensive bilateral double taxation agreements with all of the other EC member states and it is understood that the U.K. Inland Revenue has always found the provisions in these treaties to be adequate in relation to exchange of information and has not needed to use the powers under the EC Directive.

B. *Mergers and reorganizations*

Apart from the Mutual Assistance Directive no substantial proposals for direct tax harmonization were agreed until 1990. In July 1990 two Directives and a Convention were finally agreed. The first of the Directives agreed in July 1990 refers to Mergers, Divisions, Transfers of Assets and Exchanges of Shares.

1. Purpose of the Directive

In the absence of special relieving provisions, major taxation issues and problems arise in relation to mergers and reorganizations. Many countries' tax systems seriously impact on such mergers and reorganizations by:

- treating transfers of assets and shareholdings on the basis that the transfer has been made at current market value and taxing the corresponding gains arising;
- restricting the carryover of losses to which the merging entities are entitled because the entity or business so entitled may not continue in the same form following the merger or reorganization;
- imposing stamp, transfer and registration duties on assets and shareholdings transferred, again frequently on the basis of current market value.

Most EC countries have introduced relieving provisions relating to mergers and reorganizations which are considered commercially desirable within their country.

However, many of these relieving provisions are restricted to domestic transactions involving companies and shareholdings within the country and may often be excluded with respect to cross border transactions. This is, of course, to prevent such mergers and reorganizations moving profits and gains outside the future jurisdiction of the country in which they arise.

The development of the EC, especially the approach of the Single European Market by the end of 1992, has created a need for merger and reorganization activity amongst companies within the EC which has been seriously hampered by the existing tax legislation of member states.

The EC first considered the possibility of relieving taxation on cross border mergers and reorganizations within the EC as long ago as 1969 when a draft Directive was first issued on the subject. The draft Directive was subsequently amended and was finally approved by the Council of the EC on 10 July 1990 as the EC Directive, "On the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States".

The new Directive requires member states to bring into force laws, regulations and administrative provisions necessary to implement the Directive by 1 January 1992, although Portugal is to be allowed until 1 January 1993 to implement the part of the Directive relating to transfers of assets and exchanges of shares.

The Directive relates only to mergers, divisions, transfers of assets and exchanges of shares in which companies from at least two member states are involved.

2. Mergers, divisions and transfers of assets

The main part of the Directive is concerned with what are termed "mergers", "divisions" and "transfers of assets" which involve two or more companies in EC countries.

4. Council Directive Concerning Mutual Assistance by the Competent Authorities of the Member States in the Fields of Direct Taxation and Value Added Tax 77-799/EEC and 70/170/EEC.

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(a) *Mergers*

Three types of transaction are included within the definition of a merger. These are as follows:

(1) where one or more companies are dissolved without going into liquidation and transfer all of their assets and liabilities to another existing company in exchange for that company issuing the shareholders of the first company's securities representing the capital of the receiving company and, if applicable, a cash payment provided that it does not exceed ten percent of the nominal value, or if there is no nominal value, the accounting par value of the securities issued in the receiving company;[5]

(2) two or more companies are dissolved without going into liquidation and transfer all of their assets and liabilities to a new company that they formed in exchange for the new company issuing to the shareholders of the first companies' securities representing the capital of the new company and, if applicable, a cash payment provided that it does not exceed ten percent of the nominal value, or if there is no nominal value, the accounting par value of the securities in the new company;[6]

(3) where a company is dissolved without going into liquidation and transfers all of its assets and liabilities to its parent company.[7]

(b) *Divisions*

This involves a company being dissolved without going into liquidation and transferring all of its assets and liabilities to two or more existing or new companies in exchange for the pro rata issue to the shareholders of the first company of securities representing the capital of the second companies and, if applicable, a cash payment, provided that it does not exceed ten percent of the nominal value or, if there is no nominal value, the accounting par value of the securities of the second companies.[8]

(c) *Transfers of assets*

This involves a company transferring without being dissolved all or one or more branches of its activities to another company in exchange for the transfer of securities representing the capital of the second company. For this purpose a branch represents all of the assets and liabilities of a division of a company which constitutes an independent business.[9]

(d) *Tax reliefs*

On a "merger", "division" or "transfer of assets", the Directive provides that the following tax reliefs are to be available:

(1) capital gains representing the difference between the market value of the assets and liabilities transferred and their base cost or value for taxation purposes shall not be taxed provided that the base costs or values carry over to the receiving company for the purposes of computing future capital gains or tax depreciation;

(2) any tax-free provisions or reserves in the transferring companies are to carry over tax-free to the permanent establishment of the receiving company which will now be situated in the country of the transferring company;

(3) if the country where the transferring company or companies are located would allow a tax loss to carry over to the receiving company, if it were a company of that country, then tax losses of the transferring company or companies shall carry over to the new permanent establishment of the receiving company;

(4) on a "merger" or a "division", any gains accruing to the receiving company on the cancellation of any shareholding it has in the transferring company shall not be liable to tax provided that the receiving company shareholding in the transferring company is greater than 25 percent;

(5) on a "merger" or a "division", the allotment of securities by the receiving company to a shareholder of the transferring company in exchange for securities of the transferring company is not to give rise to any taxation on income, profits or capital gains of that shareholder.

It should be particularly noted that the Directive does not apply to stamp or transfer duties which may arise on any such transactions. Accordingly, these duties will continue to apply in the normal way. In some countries (e.g. France) this could involve very substantial liabilities.

(e) *Effect of provisions relating to mergers, divisions and transfers of assets*

The transactions discussed above would often not be subject to exemption from taxation under the existing tax laws of EC countries (although there are exceptions to this). Accordingly, new legislation will be needed in the EC countries to implement this aspect of the Directive. In a press release dated 19 March 1991, the Inland Revenue indicated, however, that the parts of the Directive relating to mergers and divi-

5. An example of such a transaction would be where a Belgian and a Danish company were dissolved and transferred all of their assets and liabilities to a French company in exchange for the French company issuing shares to the shareholders of the Belgian and Danish company (a cash payment would also be allowed to the shareholders of the Belgian and Danish companies provided that it did not exceed ten percent of the nominal value of shares issued by the French company).
6. For example, a French and a German company dissolve and transfer their assets to a newly established Dutch company in return for an issue of shares by the Dutch company to the shareholders of the French and German companies (a cash payment by the Dutch company to the shareholders of the French and German companies of an amount up to ten percent of the nominal value of securities issued by the Dutch company would also be permitted).
7. An example here would be an Italian subsidiary of a U.K. company being dissolved and transferring all its assets and liabilities to its U.K. parent company.
8. An example of such a division could be a situation where a German company had two operating divisions which it desired to integrate with the businesses of a French company and a Dutch company in the group. The German company could transfer one division to the French company and the other to the Dutch company in return for an issue of shares on a pro rata basis by the French and Dutch company to the shareholders of the German company (a cash payment would also be allowed of up to ten percent of the nominal value of shares issued by the French and Dutch companies).
9. An example of such a transaction could be a U.K. company transferring part of its activities representing a separate branch to a Dutch subsidiary company in exchange for shares of the Dutch company.

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sions would not be implemented in the United Kingdom until there were company law changes to allow cross border mergers and divisions.

Although new tax legislation providing for relief to implement the above provisions of the Directive would be very welcome and useful in some cases, a careful examination of the definitions of "mergers", "divisions" and "transfers of assets" and the examples given will quickly reveal that they will not cover many potential merger situations which European groups are likely to wish to implement under existing ways in which such groups prefer to organize their corporate affairs.

With respect to cross border transactions the provisions generally cover situations where a company in one EC country transfers its business to a company in another EC country which then carries on the business as a permanent establishment in the first country.[10]

Although the provisions may appear to be helpful, in practice very few European groups would wish to organize themselves in this way. Most corporate groups in Europe prefer for commercial reasons to carry on each business through a separate subsidiary company in the country where the business is located and not to operate through branches or permanent establishments (although there are exceptions to this, such as banks).

As a result the complex relieving provisions discussed above will not be helpful in the majority of actual merger and reorganization situations. The only exception to this is in relation to the possible creation of European companies under the proposed European Company Statute discussed further below.

3. Share exchanges

Perhaps of more practical significance are the provisions relating to "exchanges of shares". These were added to the original draft Directive at a relatively late stage.

The provisions relating to "exchanges of shares" cover an operation whereby a company acquires a holding in the capital of another company such that the first company obtains the majority of the voting rights in the second company through the first company issuing shares to the shareholders of the second company together with, if applicable, a cash payment not exceeding ten percent of the nominal value or, if there is no nominal value, the accounting par value of the securities of the first company issued in exchange. On such an exchange of shares the allotment of securities representing the capital of the acquiring company to a shareholder of the acquired company in exchange for the securities of the acquired company shall not, of itself, give rise to any taxation of income, profits or capital gains on that shareholder.

Most EC countries will require new legislation to implement this, but in the United Kingdom and the Republic of Ireland existing reliefs from taxation for paper-to-paper transactions may well already cover many of the requirements of this part of the Directive.

4. Branches in a third country

Where on a "merger", "division" or "transfer of assets" the transferring company has a branch or permanent establishment in a third member state, that third member state is required to renounce any right to tax the branch. However, the country where the transferring company is situated may reinstate in the taxable profits of the transferring company any losses of the branch which have previously been set off against the taxable profits of the transferring company and which have not been recovered.

The third country in which the branch is located and the country where the receiving company is situated are required to apply the provisions of the Directive to the merger, division or transfer of assets as if the third country were the country where the transferring company was situated.

For example, if a Dutch company with a French branch was merging into a German company, France would not be allowed to tax any gain which would arise on the transfer of the French branch to the German company and the German company would take over the French branch at the base values for French tax purposes which previously applied to the Dutch company. However, if the French branch of the Dutch company had previously incurred tax losses of 1,000,000 Dfl. for Dutch tax purposes which had been offset against other Dutch taxable profits of the Dutch company and which so far had not been recovered, the Netherlands would be entitled to add 1,000,000 Dfl. back to the taxable income of the Dutch company.

There is an exception allowed to the above provisions. Where the country in which the transferring company is situated applies a system of taxing worldwide profits (as is the case in the United Kingdom) it will have the right to tax any profits or capital gains of the branch in the third country resulting from the merger, division or transfer of assets on condition that it gives relief for the tax that, but for the provisions of the Directive, would have been charged on those profits or capital gains in the country in which the branch is situated, in the same way and in the same amount as would have been done if the tax had actually been charged and paid.

To take another example, if a U.K. company had a branch in Spain and the U.K. company was being merged into a Dutch company, the United Kingdom would be entitled to continue to tax profits or capital gains arising to the U.K. company from the transfer of the Spanish branch on the merger to the Dutch company provided that it gave a deemed foreign tax credit to the U.K. company equivalent to the Spanish tax which would have been charged on the transfer of the Spanish branch to the Dutch company, but for the reliefs required by the Directive.

5. Use of the European Company Statute

The part of the Directive relating to mergers, divisions and transfers of assets is potentially much more useful when combined with the proposed European Company Statute. The European Company Statute is a proposal to establish a separate category of European companies (known as Societas Europaea or SEs) that will be subject to an EC system of cor-

10. For example, a French company transfers its business (or part of its business) to a German company which then carries on the business as a French permanent establishment of the German company.

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porate law. Such companies would be able to operate equally well in all EC member states. Thus, while at present a European multinational group may have subsidiaries in different member states, such a group structure could be replaced by a single European company operating through permanent establishment in each of the member states in which the existing subsidiaries are located.

For taxation purposes the European company would primarily be subject to taxation in the country in which it is incorporated. Its operations in other member states would be subject to tax in those countries as permanent establishments (branches) of the European company.

If the European Company Statute regulation is approved, the Directive on mergers, etc. could be of much greater use in reorganizing existing subsidiaries of a European group into the European company tax free. This is because the European Company Statute envisages a single company effectively operating through permanent establishments in other member states rather than a series of separate, locally-established companies.

A final draft of the proposed regulation on the European Company Statute was issued in 1989, but the member states have not yet approved it.

6. Anti-avoidance provisions

Two particular anti-avoidance provisions are included in the Mergers Directive.

Firstly, the Directive applies only to companies which are resident in a member state and also which are not, under the terms of any double taxation agreement concluded between a member state and a country outside of the EC, considered to be resident for tax purposes in a country outside of the EC. This is designed to prevent companies taking advantage of the Directive which are dually resident for taxation purposes in an EC country and in another country outside of the EC in circumstances such that the double taxation treaty between the EC country and the country outside of the EC treats them as a resident of the non-EC country so that future profits and gains which might otherwise have been taxed in a EC country could be excluded from such taxation by virtue of the provisions of the double taxation treaty.

Secondly, a member state may refuse to apply or withdraw the benefit of any part of the provisions of the Directive where it appears that the merger, division or transfer of assets or exchange of shares either:

(a) has as its principal objective or as one of its principal objectives tax evasion or tax avoidance. The fact that the transaction is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives; or

(b) results in a company, whether participating in the transaction or not, no longer fulfilling the necessary conditions for the representation of employees on the company organs according to the arrangements which were in force prior to that transaction. This latter condition, however, continues only as long as the EC law provisions contain no equivalent rules on representation of employees on company organs that are applicable to the companies involved in the transaction.

C. *Parent/subsidiary relationships – dividends*

1. Purpose of the directive

The second EC Directive concluded in July 1990 was the Council Directive "On the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States".

This Directive had been originally issued as a draft in 1969, but the Directive was finally agreed on 11 July 1990. The Directive requires member states to introduce the laws, regulations and administrative provisions necessary to comply with it by 1 January 1992. The purpose of the Directive is to harmonize the taxation treatment of profits flowing as dividends from a subsidiary company in one member state to a parent company in another member state and, as far as possible, minimize the taxation on such transfers of profit.

(a) *Scope*

The Directive applies only to companies which are resident in an EC member state and which are subject to corporate income tax in an EC State. For the purposes of the Directive a parent company is defined as a company of a member state which has a minimum holding of 25 percent in the capital of the company of another member state. A subsidiary company is correspondingly defined as a company in a member state in which a parent company in another member state has a shareholding as defined above.

Member states are, however, to be allowed to replace, by means of a bilateral agreement with other member states, the criterion of a holding of capital by that of a similar holding of voting rights.

Member states are also entitled not to apply the Directive to companies in their country where the required shareholdings as described above have not been held for an uninterrupted period of at least two years.

The Parent/Subsidiary Directive has two main provisions:
- elimination of dividend withholding taxes;
- tax relief on dividends at the parent company level.

2. Elimination of dividend withholding taxes between subsidiaries and parent companies

Where a subsidiary company in one member state distributes profits to its parent company in another member state, the distribution is to be exempted from any withholding tax.

At the present time most member states impose substantial withholding taxes on dividends distributed to a company resident in another country. Even though existing double taxation treaties between member states often reduce such withholding taxes substantially from the full rates, typically withholding tax rates of five, ten or even fifteen percent currently

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apply to dividends paid by a subsidiary company in one member state to a parent company in another member state. Accordingly, the Directive will achieve a major reduction in the cost of distributing profits between countries within the EC in many cases.

There will, however, be no change to the position where profits are distributed from companies resident in the United Kingdom or the Republic of Ireland to parent companies in other EC member states. This is because the United Kingdom and Ireland do not impose any dividend withholding taxes. The advance corporation taxes imposed in the United Kingdom and the Republic of Ireland on the distribution of dividends are not withholding taxes, and indeed the Directive specifically excludes such taxes from its application. Similarly excluded is the French précompte.

Parent companies in the United Kingdom and the Republic of Ireland will, however, benefit where they have subsidiaries in other EC member states as the cost of repatriating profits from such subsidiaries will be significantly reduced and in particular the problem of excess foreign tax credits arising in the United Kingdom through foreign tax rates exceeding the U.K. corporate tax rate will tend to be reduced.

(a) *Exceptions*

There are three exceptions to the exemption from dividend withholding taxes under the Directive. These relate to Greece, Germany and Portugal.

(1) *Greece*

Greece has a unique corporate tax system within the EC in that it allows dividend distribution as a deduction from taxable income in computing its corporate income tax, but then imposes a heavy withholding tax on the dividend distribution at rates comparable to that of the corporate income tax. Accordingly, the dividend withholding tax effectively represents the corporate income tax on distributed profits.

Clearly the EC Directive could not apply to the Greek tax system as otherwise Greece would collect no tax at all on profits distributed by a Greek company to a parent company in another EC country. Accordingly, as long as Greece continues not to charge corporate tax on distributed profits it is to be entitled to levy its dividend withholding tax on profits distributed to parent companies in other member states, but the rate of such withholding tax must not exceed the rates provided for in bilateral double taxation agreements.

(2) *Germany*

Germany also has an unusual corporate tax system in that there is a substantial differential between the corporate income tax charged on distributed and undistributed profits. Currently distributed profits are charged to the federal corporate income tax at a rate of 36 percent whereas undistributed profits are charged at 50 percent (ignoring the recently imposed surcharges).

Traditionally Germany has tended to maintain high rates of dividend withholding taxes on dividends paid by a German subsidiary to a foreign parent company under its double taxation treaties in order to discourage foreign parent companies from stripping the maximum possible profits out of German subsidiary companies so as to maximize the profits which enjoy the lower rate of corporate income tax. For this reason Germany was for many years reluctant to agree the Parent/Subsidiary Directive.

As a recognition of the unusual features of the German tax system, Germany is to be allowed to continue to apply a dividend withholding tax of five percent on profits distributed by German subsidiary companies to parent companies in other EC member states as long as it charges corporation tax on distributed profits and a rate at least 11 points lower than the rate applicable to retained profits. This five percent withholding tax may, however, only be continued until the middle of 1996.

(3) *Portugal*

For budgetary reasons Portugal is to be allowed to continue to apply a withholding tax on dividends distributed by Portuguese subsidiaries to parent companies in other EC member states for a period of eight years following the date of application of the Directive (i.e. until 31 December 1999). The rate of withholding tax applied by Portugal may not exceed that under its existing bilateral double taxation agreements with other member states and, subject to this, may not exceed 15 percent during the first five years of the application of the Directive and ten percent during the last three years of the eight year period.

The Directive also provides for the EC Council to consider a proposal from the Commission of a possible extension of the period for which Portugal may apply such dividend withholding taxes.

3. Tax relief on dividends at the parent company level

The second relief provided for under the Directive is from taxation at the parent company level on profits distributed from subsidiary companies in other EC member states. When a parent company resident in one EC member state receives distributed profits from a subsidiary resident in another EC member state, the country where the parent company is located is required to either:

(a) exempt such profits from corporate taxation; or
(b) provide foreign tax credit relief for the fraction of the corporation tax paid by the subsidiary which relates to the profits distributed and for any withholding tax levied on the dividend by the country in which the subsidiary is located.

The above provisions do not apply to a distribution on a liquidation.

Additionally, each member state shall be entitled to retain the option of providing that any charges relating to the holding of the parent company in the subsidiary and any losses resulting from the distribution of profits of the subsidiary may not be deducted from the taxable profits of the parent company. Where the management costs relating to the holding of the

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parent company in the subsidiary in such a case are fixed at a flat rate, the fixed amount may not exceed five percent of the profits distributed by the subsidiary.

The taxation systems of a number of the member states would appear to already satisfy this Directive. For example, the U.K. system of foreign tax credit relief for both direct and underlying corporate taxes in respect of dividends received by U.K. companies from participations of ten percent or more in foreign companies would appear to fully satisfy the requirements of the Directive. Similarly, the exemption systems applied to dividends from substantial participations in a number of member states (e.g. Denmark, France, the Netherlands) appear also to satisfy this Directive in many situations. Other member states, however, may have to make substantial amendments to their existing taxation systems relating to the taxation of foreign dividends in order to comply with the Directive.

4. Planning opportunities

The Parent/Subsidiary Directive will result, in many cases, in important reductions in the taxation currently imposed on distributing profits from a subsidiary company to a parent company within the EC.

Unlike the Mergers Directive, the Parent/Subsidiary Directive does not include any provisions excluding the operation of the Directive where companies are reorganized in order to avoid or minimize taxation (although the Directive shall not preclude the application of provisions in a country's domestic tax laws or under taxation agreements required for the prevention of fraud or abuse). There is, however, a requirement that qualifying companies should be resident in an EC member state and should not be dually resident also in a country outside of the EC under the terms of a double taxation agreement.

There does not, however, appear to be anything to prevent groups of companies operating within the EC from reorganizing their structures in order to take advantage of the exemptions available under the Parent/Subsidiary Directive. This includes situations where a group of companies in the EC is ultimately owned by a company or shareholders outside of the EC.

At first sight it may appear that the role of holding companies within the EC will be much reduced as the favourable double taxation treaties of territories such as the Netherlands and Denmark will no longer be important for minimizing dividend withholding taxes on dividend flows within the EC from 1 January 1992 as the Parent/Subsidiary Directive should itself produce the minimum possible dividend withholding taxes in such situations, provided there is a participation of at least 25 percent.

Holding companies may, however, still be of considerable use where they are located in countries which provide protection from taxation on capital gains arising from future disposals of subsidiary and associated companies. Indeed in combination with the EC Parent/Subsidiary Directive such holding company structures may, in appropriate circumstances, achieve a more favourable overall tax position than previously.

D. *The Arbitration Convention*

The third tax harmonization measure agreed in July 1990 by the EC Council of Ministers was a Convention establishing an arbitration procedure for transfer pricing corresponding adjustments. The provision is entitled "Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises". It was agreed on 12 July 1990. This provision is, however, a Convention between the EC member states rather than a Directive and still requires ratification by the Head of State of each EC country.

The Convention is designed to deal with a particular problem arising on transactions between associated companies or other enterprises within the EC where one of the countries involved makes an adjustment to increase taxable profits because it considers that a transaction between associated enterprises has not been undertaken at an arm's length price. All EC countries have provisions in their domestic tax laws and double taxation agreements which potentially allow such transfer pricing adjustments to be made, in certain circumstances.

Where such a transfer pricing adjustment is made by the taxation authority of one country this will have effect only in relation to the taxable profits of the enterprise located in that country. It will not normally alter the commercial price at which the transaction was undertaken. This means that in the other country involved in the transaction the taxable profits will potentially remain the same as previously. However, in order to avoid double taxation it is necessary for the second order country involved to make a reduction in the taxable profit in its country in order to correspond to the increase in the first involved in the transaction. Whilst many existing country double taxation agreements between countries both within and outside of the EC do include provisions for the making of such corresponding adjustments and for a mutual agreement procedure whereby the taxation authorities may seek to agree such adjustments in practice this process does not work well as double taxation agreements do not require that the taxation authorities of the two countries involved reach agreement and in many cases such agreement cannot be obtained.

The Convention seeks to overcome the problems in this area by firstly providing that with respect to transactions between associated enterprises within the EC, corresponding adjustment shall be available and that there shall be a procedure for the taxation authorities of the countries concerned to consult in order to seek agreement on the appropriate adjustment.

The novel feature of the Convention is, however, the second part which provides for an arbitration procedure where the taxation authorities involved are unable to reach a mutual agreement on a corresponding adjustment. This arbitration procedure operates through the appointment of an advisory commission which includes representatives of the taxation authorities involved together with independent representatives appointed from a panel set up by all the EC member states. The advisory commission is then able to give a binding decision on the appropriate corresponding adjustment to be made.

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Whilst this represents an interesting and welcome development for companies operating within the EC, it remains to be seen as to how effective this arbitration procedure will be once it is operating.

V. CURRENT DRAFT DIRECTIVES

A. *Parent/subsidiary relationships – interest and royalties*

In a draft Directive of 24 January 1991,[11] a further tax relief is proposed for transactions between parent companies and their subsidiaries where both companies are established and resident in EC member states. The draft Directive proposes that interest or royalties paid by a subsidiary company to its parent or a parent to its subsidiary shall be exempt from any withholding tax. A parent/subsidiary relationship is defined for the purposes of this draft Directive in the same way as for the Parent/Subsidiary Directive relating to dividends, i.e. the parent company must have a minimum holding of 25 percent in the capital of the subsidiary.

As usual there are some exceptions to the general rule to take account of those countries with budgetary problems. Greece and Portugal are to be entitled to continue to levy withholding taxes on interest and royalty payments for a period of seven years from the introduction of the Directive. However, this withholding tax is not to exceed ten percent for the first five years and five percent during the last two years of the period unless a double taxation treaty provides for a lower rate. The draft Directive does, however, include provisions allowing the Council of Ministers to extend the period for which Greece and Portugal may continue to apply withholding taxes.

It may be noted that the draft Directive contains a serious weakness in that within a European corporate group interest and royalty payments will not necessarily flow between a subsidiary and its parent company, but may also frequently be paid amongst group subsidiary companies. The draft Directive does not cover the latter type of payment.

The draft Directive indicates that it should be implemented as from 1 January 1993. However, it has yet to be agreed by the Council of Ministers.

B. *Cross border loss offsets*

Potentially the most radical harmonization provision relating to direct taxes which is currently under consideration was announced in a draft Directive of 24 January 1991 with respect to the offset of losses incurred in permanent establishments and subsidiaries in other member states. The draft Directive is entitled "Proposal for a Council Directive Concerning Arrangements for the Taking into Account by Enterprises of Losses of Their Permanent Establishments and Subsidiaries Situated in Other Member States".

The first area dealt with by the draft Directive is the situation where an enterprise (e.g. a company) in one member state has permanent establishments (e.g. branches) in other member states. In these circumstances the draft Directive would require member states to apply one or other of the following systems of taxation:

(1) *The credit method* – this involves including in the enterprise's results for a given tax period the profits and losses of all the enterprise's permanent establishments situated in other member states and, where appropriate crediting the tax paid by the permanent establishments against any tax payable by the enterprise on the profits of such establishments.

(2) *The method of deducting losses and reincorporating subsequent profits* – this involves:

(a) the deduction from the enterprise's taxable profits for a given tax period of the losses incurred in the same tax period by the enterprise's permanent establishment situated in other member states;

(b) the incorporation of subsequent profits of such permanent establishments into the enterprise's taxable income to the extent of the loss deducted pursuant to (a) above.

Under the second method losses which have been deducted are to be automatically reincorporated into the enterprise's taxable profits after five years or when the permanent establishment has been sold, wound up or transformed into a subsidiary, if they have not already been so reincorporated.

The above provisions relating to permanent establishments (branches) in fact, already exist within the existing tax laws of a number of member states. The United Kingdom, for example, basically follows the credit method and Belgium and the Netherlands use a form of deducting losses with subsequent reincorporation.

The radical proposal in the draft Directive relates, however, to losses incurred by a subsidiary company in another member state rather than a permanent establishment. Under the existing tax laws of EC member states a loss incurred by a subsidiary in one member state would only be available for offset against the taxable profits of its parent company in another member state in exceptional circumstances, e.g. where the subsidiary company was dually resident in the country where it is carrying on business and in the country of its parent company or, in certain states, where it can be shown that the loss has resulted in a diminution in value of the parent company's shareholding in the subsidiary and a provision may be deducted for such a loss (e.g. in Spain).

The draft Directive, however, would require member states to allow a loss incurred by a subsidiary in one member state to be offset against the taxable profits of its parent company in another member state where the loss was incurred in the same tax period. The loss offset would, however, only be temporary in that the loss so deducted would have to be subsequently reincorporated in the parent company's taxable profits. The losses would have to be reincorporated in the parent company's taxable profits in the following circumstances:

11. Proposal for a Council Directive on a Common System of Taxation Applicable to interest and Royalty Payments Made Between Parent Companies and Subsidiaries in Different Member States.

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(a) where reincorporation has not already occurred by the end of the fifth year following that in which the loss became deductible;

(b) where the subsidiary company is sold, wound up or transformed into a permanent establishment;

(c) where the parent company's holding in the capital of the subsidiary has fallen below the minimum level required for the offset.

A much higher shareholding is required for the loss offset of the subsidiary against the parent company's taxable profits to be available under this draft Directive than is necessary for the Parent/Subsidiary Directive in relation to dividends or the draft Directive in relation to interest and loyalties. For the purposes of this draft Directive a parent/subsidiary relationship will only exist if the parent company has a minimum holding of 75 percent in the capital of the subsidiary and also has a majority of voting rights.

For the purposes of computing the loss offsets, the loss for tax purposes of the subsidiary will be determined in accordance with the laws of the member states in which it is situated and not in accordance with the tax laws of the country where the parent company is located and where the loss offset will be allowed. It should again be noted that the relief only applies in relation to a loss incurred by a subsidiary, which may be offset against the profits of its parent company in another member state. The draft Directive does not give the parent company the right to offset a loss that it may incur against the profits of a subsidiary or for there to be any loss offset between fellow subsidiaries in different member states.

The draft Directive indicates that it should be implemented by 1 January 1993. The draft Directive has, however, yet to be agreed and it is believed that such agreement may be difficult to obtain.

VI. POSSIBLE FURTHER PROGRESS

As discussed above, in the 1970s and 1980s the European Commission put forward an ambitious programme of draft tax harmonization Directives designed to achieve a largely common system of corporate taxation within EC countries. It was not, however, possible to obtain agreement between member states on these measures because of the differing views of the states and also because the implication of many of the proposals had not been fully examined. As has been explained, most of the more wide ranging proposals have now been abandoned and the European Commission appears to be concentrating on more limited harmonization objectives where agreement can potentially be reached.

Progress towards real tax harmonization in the EC is likely to be dependent upon the progress towards economic and monetary union. In the meantime areas where EC harmonization proposals are likely to be put forward over the next few years include intercompany transfer pricing rules, tax incentives and discriminatory tax practices.

VII. IMPLICATIONS FOR U.S. CORPORATIONS

A. *Parent/Subsidiary Directive*

The implementation of the Parent/Subsidiary Directive relating to dividends may encourage groups to create a European holding company to own subsidiaries within the EC in order to take advantage of the opportunity of paying funds as cross border dividends to a central point in the holding company without incurring dividend withholding taxes.

Where a group of subsidiaries, organized under a European holding company, was ultimately owned by a U.S. parent corporation, there would be certain U.S. tax problems in relation to the structure. US Subpart F rules will continue to treat each European country as a separate jurisdiction so that the same-country exception under Subpart F would not apply to transactions between subsidiaries in different European Community member countries. The use of a European holding company can also create problems on a future sale of subsidiaries as there may be unfavourable foreign tax credit implications arising from the realization of gains on the disposal of subsidiaries through a foreign holding company.

B. *Mergers and Reorganizations Directive*

The Mergers Directive contemplates mergers, transfers of assets, divisions and exchanges of shares. Put in the U.S. tax vernacular, many of these types of transactions have features comparable to U.S. reorganization provisions, but some tax advantages and disadvantages to EC companies remain.

The Directive contemplates:

- tax-free treatment of the transaction to the recipient and the issuer of shares, with carryover basis to the new holder of shares;
- a carryover basis rule, such that assets transferred to the new owner will retain a carryover basis for purposes of computing depreciation and gain or loss on subsequent asset sales;
- the carryover of "provisions and reserves" to the acquiring company (such as insurance reserves or loan loss provisions) and loss carryforwards.

Material differences from U.S. law are evident: 90 percent of the consideration received by the exchanging shareholder must consist of shares in the acquiring entity, while many U.S. reorganization provisions require only 50 percent continuity of interest. On the other hand, the "branch transfer" rule of the Directive permits tax-free treatment for partial asset transfers without requiring the transferor to be in control of the transferee immediately after the transfer, as would be the case under U.S. law. Most importantly, the Directive provides for tax-free treatment, which may be unavailable under domestic law in some EC countries, and presents advantages to EC cross border transactions that a U.S. taxpayer subject to Section 367 cannot hope to enjoy in all cases.

In the case of transfers of assets by a U.S. taxpayer to a foreign corporation, the United States has long sought to retain the ability to tax such transfers, or to tax subsequent transfers by the foreign corporation. After tax reform simplified the taxation of outbound transfers in 1984, Section 367(a)(i) still

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imposes restrictions on the tax-free transfers of assets. Certain transfers remain permissible:

- the transfer of the stock of a foreign corporation under some conditions (Section 367(a)(2)), but with restrictions that affect controlled foreign corporations that are more than 50 percent owned by U.S. (10 percent) shareholders;
- the transfer of the assets of an active business (Section 367(a)(3)), but then not for certain "tainted" classes of property.

In particular, the transfer of a controlled foreign corporation ("CFC") to another corporation, after which the transferred corporation is no longer a CFC or is no longer controlled by the same transferor U.S. shareholders, triggers the so-called toll charge on the untaxed accumulated earnings and profits of the transferee CFC. This results in a dividend from the CFC to the transferor, for which deemed paid foreign tax credits are available.

In some instances, the toll charge may be averted, particularly with straight-forward reorganizations. The transfer of the stock or securities to a foreign corporation may be effected without U.S. tax if it fits within the provisions of IRS Notice 87-85 and Temp. Reg. 1.367(a)-3T(g). Depending on the amount of stock that the U.S. transferor owns in the transferee immediately after the transfer, a U.S. shareholder may obtain tax-free treatment in exchange for a five year or ten year gain recognition agreement. Other reorganizations may not fit as handily at first blush into the provisions of the notice, but a professional adviser may be able to construct a transaction that would receive tax-free treatment by interpretation of the notice and IRS regulations.

Furthermore, some liquidations under U.S. law would fit into the EC Directives without divergent tax results. The (Section 332) liquidation of a second-tier foreign subsidiary into its intermediate holding company (for example, an European Holding Company ("EHC")) could be accomplished tax-free, with a carryover of tax attributes and earnings and profits to the EHC, except for assets used in a U.S. trade or business and U.S. real property under certain conditions.

Absent the availability of planning alternatives, the toll charge features of the Section 367 regulations may create a competitive disadvantage for U.S. shareholders of companies or owners of businesses in branch form in EC member states. The transfer of the stock of a European CFC by the U.S. shareholder would create toll charge taxes not imposed on the equivalent transfer between EC member state companies, and the transfer of a business by a U.S. company would trigger tax on the "tainted assets" of the branch not eligible for the active business exception. Additional taxes, of course, translate into costs of the transaction, which create an economic disincentive vis-à-vis a European owner. The alternatives, a slim possibility of treaty relief with each individual EC member state or a significant about-face in the long standing policy of the U.S. Congress, appear unrealistic at this time.

Assuming that the transfer of assets (of a European subsidiary of a U.S. parent) in the form of an active trade or business takes place, (for example, if a Dutch holding company is established with branches in other EC countries), the U.S.-owned group may still be at a disadvantage, depending on the nature of the income in each location. The inclusion rules of Subpart F for foreign base company sales income, for example, could cause current taxation of sales made by a German branch of a Dutch supplier corporation to the ultimate U.S. parent. Again, foreign tax credits may be available to offset the U.S. tax effect, but some additional cost may be incurred. A Dutch company without a U.S. parent but with sales branches outside the Netherlands would not suffer such income inclusion. Thus the structuring of EC operations under a holding company will have to take into account potential tax consequences arising from Subpart F inclusion.

Another potential drawback of using an EHC is the U.S. tax treatment of the gain on a sale by the EHC of stock in a second-tier foreign subsidiary. The Netherlands (if that is the home of the EHC) would not tax the gain, but in the United States the EHC's gain from the sale would be included as capital gain: foreign personal holding company income under Subpart F, and passive income for foreign tax credit purposes. The Section 960 credit received by the U.S. shareholder would consist of a portion of the foreign taxes in EHC's passive post-1986 foreign taxes – probably a negligible amount – and would not include any foreign taxes imposed on the earnings and profits of the second-tier subsidiary. Only excess passive foreign tax credits in the hands of the U.S. parent could be used to offset U.S. tax on the Subpart F inclusion, and it is unlikely that the U.S. parent would have such credits.

Still another aspect of the use of an EHC involves the application of the worthless stock deduction – a foreign subsidiary owned directly by a U.S. parent would give a worthless stock deduction (ordinary loss, not capital loss) to the U.S. parent, whereas the loss to the EHC would not. This is somewhat tempered by the fact that the ordinary loss to the U.S. parent would most likely have a foreign source, with the attendant loss of foreign tax credits negating in part or in whole the advantage of the ordinary loss.

For these reasons, the use of an EHC should be considered with care and not be viewed as a panacea for the EC Directive challenge. Careful tax planning should be combined with the EHC approach.

Finally, the Mergers Directive expands the possibility of joint ventures within Europe. These may be of some advantage to U.S. companies, but the "non-controlled Section 902 corporation" problem of foreign tax credit baskets must be kept in mind when using the 50-50 ownership model.

On a positive note, the Mergers Directive would permit a U.S. group to acquire the stock of an EC company by an exchange of shares for shares of an EHC without paying taxes in Europe. Stock or shares of a U.S. company could not be used since the Mergers Directive calls for shares in an EC company.

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UNITED KINGDOM:

TAXATION OF FOREIGN NATIONALS

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I. INTRODUCTION

In general, income tax is charged on remuneration for services performed in the United Kingdom and on other income which arises in the United Kingdom, whether an individual is resident in the United Kingdom or not. Under U.K. tax law, there are two types of residence:

- resident but not ordinarily resident;
- resident and ordinarily resident.

An individual who is resident but not ordinarily resident is taxable on remuneration for duties of employment performed within the United Kingdom. For duties of employment performed outside the United Kingdom, the individual is taxable only if the remuneration is remitted to the United Kingdom.

A person who is resident and ordinarily resident is usually taxed on remuneration from any office or employment. The total remuneration is taxable whether or not it is remitted to the United Kingdom and whether or not the duties of the employment are performed in the United Kingdom. The only exception to this rule is when a non-domiciled individual has a separate employment, the duties of which are performed wholly outside the United Kingdom.

II. DOMICILE

In the United Kingdom, domicile may be broadly defined as the country or the state where the individual has a permanent home. The concept of domicile is based on case law, and not on legislation. Under U.K. law, an individual has a country (or, in the case of a federal system, a state) of origin. This is normally that of the father as at the date of birth, although in certain circumstances it can be that of the mother. If the father changes his domicile during the child's minority, the child's domicile will have changed accordingly.

It is possible for an individual to acquire a domicile of choice by becoming a permanent resident of another country, but in order to lose his domicile of origin he must show a clear intention to relinquish his personal and economic ties with his country of origin and establish close permanent connections with his new country of choice.

Upon arrival in the United Kingdom, it is necessary for the foreign national employee to establish his country of domicile (generally outside the United Kingdom). To this end, he needs to complete, sign and submit a domicile questionnaire. Most of the questions are straightforward and generally any problems that arise will be in relation to those individuals who have a domicile of origin within the United Kingdom and wish to prove that they have subsequently changed this by choice.

III. RESIDENCE

If the individual purchases a property in the United Kingdom he will normally be regarded as resident and ordinarily resident in the United Kingdom for tax purposes with effect from the date of arrival. If the individual rents property under a lease for one year or more if it is unfurnished or for two years or more if furnished, then he will be regarded as resident from the date of his arrival.

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If the individual either does not purchase a property, or else leases it for less than the periods covered in the preceding paragraph, the determination of residence and ordinarily resident depends on the length of time he intends to reside in the United Kingdom as follows:

(a) If the individual's stay is to be for two years or more, he will be regarded as resident in the United Kingdom from the date of his arrival. If the individual's stay is to be for less than two years, he will be regarded as resident for any tax year (ending 5 April) that he is in this country for more than 182 days. For this purpose, the day of his arrival in and departure from the United Kingdom are regarded as having been spent abroad.

(b) If the individual's intended stay is for three years or more, he will be regarded as ordinarily resident from the date of his arrival. If his intended stay is for less than three years, he will be regarded as remaining not ordinarily resident.

If, after the date of his arrival, the individual changes his intentions, the position under (a) and (b) above is then redetermined. This also applies if he subsequently purchases or leases a property for more than one year (unfurnished) or two years (furnished).

In order to determine his residence status, the individual needs to submit an appropriate questionnaire to the Inland Revenue when he arrives. The questions on that form are, on the whole, straightforward, but the individual should ensure that his answers clearly indicate that his assignment to the United Kingdom is for a specific period even if this has to be estimated.

IV. LIABILITY TO U.K. TAX

The U.K. tax year begins on 6 April and ends on 5 April. If remuneration is normally paid monthly, the taxable amount is in relation to the year (or period) ended 31 March. Assuming that the foreign national is resident and ordinarily resident in the United Kingdom, his taxable remuneration is determined by adding together the whole of his earnings, whether paid in cash or provided as a benefit.

As indicated earlier, an individual who is resident but not ordinarily resident is taxable on remuneration for employment duties within the United Kingdom; but for employment outside the United Kingdom, he is taxable only if the remuneration is remitted to the United Kingdom. The apportionment of the remuneration (including benefits) is on a working day basis, the numerator being the number of working days spent outside the United Kingdom and the denominator being the total number of working days in the year. To determine the extent of the remuneration received in the United Kingdom, the actual remuneration "remitted" to the United Kingdom, and the benefits arising within the United Kingdom, must be considered.

V. BENEFITS-IN-KIND

The list below sets out the more common benefits-in-kind that are taxable in the United Kingdom, but it is not all inclusive.

A. *Accommodation*

Accommodation that is provided by the employer, including a housing allowance, is taxable in the United Kingdom. The extent of the taxable benefits-in-kind depends upon several factors and each case must be considered independently. If company-owned housing is provided to directors and employees (other than those in representative occupation) it is taxed as a benefit to the extent of a deemed annual rental at the appropriate percentage on the excess of the cost of the property over £ 75,000, less any rent actually paid by the employee. The appropriate percentage is varied from time to time by Treasury order. To the deemed rental must be added the annual rental value of the property (the rateable value) and any costs actually borne by the employee, for example rates, gas and electricity.

B. *Beneficial loan arrangements*

Employers will sometimes grant loans to employees at a beneficial rate of interest. The taxable benefit-in-kind from such a loan is the difference between the "official rate" and the rate of interest paid. The official rate is also varied from time to time.

C. *Medical insurance and fees*

The payment by the employer of medical insurance, or medical expenses in general, is regarded as a taxable benefit-in-kind for foreign national employees. This applies to all payments or reimbursements made in relation to either the employee or the employee's family. There is an exception for the cost of necessary medical treatment abroad that is paid or reimbursed by the employer if an employee falls ill or suffers injury while away from the United Kingdom performing his duties.

D. *Assets placed at the disposal of an employee*

In general, if an asset is placed at the disposal of an employee, the annual taxable benefit-in-kind is 20 percent of the fair market value of the asset. The fair market value is determined at the time the asset was first used to provide a benefit. For example, if an employer provides furniture, the employee is assessable on a benefit-in-kind of 20 percent of the cost of the furniture.

E. *Company cars*

The amount of the taxable benefit is determined by reference to a scale rate table amended annually by Treasury order. The amount of the benefit depends upon both the market value of the car when it is new, and its engine capacity. The scale rate can vary from year to year, but it may be significantly less than the car's annual "fair value".

If the employee is provided with a second car, or if the annual business mileage does not exceed 2,500 miles, the taxable amount is increased by 50 percent. If the employee is provided with petrol for private use, the amount of the taxable benefit is also determined by a scale rate table.

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F. *Home leave*

If the following conditions are met, then:
"... where such employment in the United Kingdom involves absence from the home country for a continuous period of 60 days or more and the overseas employer bears or reimburses the cost of:

(i) a journey to the United Kingdom by the spouse or any child of the employee to visit him during that period; or of
(ii) a journey to his home country by the employee at the end of that period to visit his spouse or any child of his; and of
(iii) a return journey following a journey of the kind described in (i) and (ii), no assessment will be made on the employee in respect of the benefits involved, up to the extent of two such journeys in each direction by the same person in any year of assessment".

G. *Tax payments*

Under U.K. tax legislation, any part of an employee's tax liability borne by his employer may be taxable. Because tax equalization or protection plan payments vary from company to company, it is necessary for each to be considered individually.

VI. ALLOWABLE EXPENSES

A. *Reimbursed expenses*

Technically, all reimbursed expenses are regarded as remuneration for U.K. tax purposes. However, a deduction is given in relation to those expenses incurred "wholly, exclusively and necessarily in the performance of the duties of the office or employment".

Emphasis is placed on the need to fulfil all three requirements, rather than just one or two of them. For instance, it is rare for the Inland Revenue to be prepared to accept that the reimbursement of club subscriptions should be allowable as a deduction for U.K. tax purposes.

B. *Moving expenses*

Where the employee has to change his residence on first joining an organization, moving expenses that the employer pays are not taxable in the United Kingdom, provided that the expenses are reasonable in amount and their payment is properly controlled. However, the Inland Revenue is currently interpreting "change his residence" to mean "sell his home in the home country".

C. *Interest on a residential loan*

Interest on a loan for the acquisition of an employee's principal private residence is a deduction for U.K. tax purposes. The residence must be situated in the United Kingdom. The tax deduction is restricted to the interest applicable to £ 30,000, and the relief is limited to Basic Rate Tax.

D. *Corresponding payments*

A "corresponding payment" is an amount that, if it had been paid in the United Kingdom would have been allowable for U.K. tax purposes. Examples of payments that may qualify for relief under this heading are interest on a loan to purchase a sole or main residence in the employee's home country, and annual contributions to a foreign pension fund that corresponds to an approved U.K. pension fund.

It should be noted that "corresponding payments" can be claimed only if the employee has an overseas employer.

VII. OTHER TAXES

A. *Unearned income and capital gains*

A person who is not domiciled in the United Kingdom for tax purposes will be assessable to U.K. tax on both unearned income and capital gains that arise outside the United Kingdom only to the extent that amounts are remitted to, or paid in, or otherwise received in the United Kingdom. If overseas tax has been paid on such income or capital gains, then tax credit relief should be given in the United Kingdom for the overseas tax incurred.

Any unearned income or capital gains that arise within the United Kingdom are taxable in the United Kingdom during the period that the individual continues to be regarded as U.K. resident.

B. *Inheritance tax (estate and gift tax)*

Inheritance tax applies to lifetime gifts and to estates on death. Generally, an individual domiciled outside the United Kingdom is liable to the tax only if he makes lifetime gifts of assets situated in the United Kingdom or if his estate, when he dies, contains U.K. assets. An individual will be deemed to be domiciled in the United Kingdom, for this purpose only, if he has been resident in the United Kingdom in 17 out of the last 20 tax years. The U.S./U.K. Estate and Gift Tax Treaty provides further exemptions and reliefs in certain cases.

VIII. NATIONAL INSURANCE CONTRIBUTIONS

A. *Employee contributions*

National Insurance Contributions are virtually another form of taxation, although they provide social security benefits including an eventual pension entitlement. Although the National Insurance Contributions are paid with the tax liability of the employee, National Insurance Contributions are recorded by the Department of Social Security, and not the Inland Revenue.

It is important to note that certain benefits-in-kind are not subject to National Insurance.

B. *Employer contributions*

If the Department of Social Security rule that the foreign employer has a place of business, or presence, in the United Kingdom, the foreign employer also may have a liability to National Insurance Contributions on behalf of its employees working in the United Kingdom.

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C. *U.S./U.K. Totalization Agreement*

Since 1 January 1985, if an American company sends a U.S. employee to work in the United Kingdom for a period of up to five years, the employee will continue to be covered by U.S. FICA and will not be liable for U.K. National Insurance Contributions. The employer will also continue to pay FICA and will not be liable for U.K. National Insurance contributions.

Either the employee or the employer must obtain a Certificate of Coverage from the U.S. Social Security Administration.

IX. COLLECTION OF U.K. TAX

U.K. income tax and National Insurance Contributions on employees' remuneration are collected by either withholding or direct collection. Under the Pay As You Earn ("PAYE") system, the employer calculates the amount due, deducts it from the salary and pays it to the Inland Revenue. Under direct collection, an estimated assessment is made on the employee, who has to pay the tax in four instalments.

In the majority of cases, the Inland Revenue insist that the employer operates PAYE. If the foreign national is under the "general control and management" of a U.K. branch or subsidiary, the Inland Revenue have power to require the branch or subsidiary to operate a PAYE system on behalf of the overseas employer. Where there is no branch or subsidiary or other office in the United Kingdom, the Inland Revenue may nevertheless request that the overseas employer operate PAYE and make payment of income tax and National Insurance Contributions in relation to all employees resident in the United Kingdom for tax purposes.

X. TAX PLANNING IDEAS/PITFALLS

A. *Stock and share options*

An employee's stock and share option will be taxable in the United Kingdom if he is resident and ordinarily resident in the United Kingdom for tax purposes both when the options are granted and when they are exercised. Where the employee is resident on only either the date of grant or the date of exercise, care must be taken to investigate the tax position and to ensure that both the employee and the employer are fulfilling their reporting requirements.

B. *Separate employments*

Where it can be demonstrated to the satisfaction of the Inland Revenue that the individual has two separate employments, and that the duties of one of these are performed wholly outside the United Kingdom, then an advantageous U.K. tax situation can apply. The separate employments must be covered by separate contracts of employment or letters of assignment from each employer. The advantages of the separate employments is that the remuneration for the non-U.K. employment is not taxable in the United Kingdom unless it is remitted to, paid in, or otherwise received in the United Kingdom (for example, by the use of credit cards). Any remitted remuneration from the non-U.K. employment is fully taxable.

For separate employments to be tax-advantageous the foreign national employee needs to be able to live in the United Kingdom on only the amount of his U.K. remuneration plus, if appropriate, any remittances to the United Kingdom of capital sums. If the employee requires his total remuneration from all sources to live in the United Kingdom, separate contracts of employment or letters of assignment would be of no advantage.

If separate contracts of employment or letters of assignment are arranged, it is essential that two totally separate employments in fact exist. It is not sufficient merely to set up the documentation in such a format to cover a situation where there is, in practice, only one employment and some of the duties are performed within, and some outside the United Kingdom. Furthermore, the "overseas" employment must not require any duties, no matter how small, to be performed within the United Kingdom. It is also unwise for the non-U.K. employment to be with a company that is resident in a "tax haven" country, for example, the Channel Islands.

With the abolition of favourable tax treatment for foreign nationals, it is expected that the U.K. tax authorities will look closely at the commercial substance of separate employments, particularly as more and more employees seek to obtain separate employments.

Remember that an individual who is resident but not ordinarily resident in the United Kingdom is chargeable to U.K. tax on his earnings for duties performed in the United Kingdom only. Separate employments may therefore not be relevant for someone on a short-term assignment to the United Kingdom who is expected to spend part of his time working outside the country.

C. *U.K.–U.S. double tax agreement*

If a resident of the United States meets all of the following conditions, U.K. tax on remuneration can be avoided:

- the employee is present in the United Kingdom for a period not exceeding 183 days in the U.K. tax year; and
- the remuneration is paid by or on behalf of an employer who is not resident in the United Kingdom; and
- the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the United Kingdom.

Problems occur when an individual is resident in both the United States and the United Kingdom for the same period.

D. *Short assignments*

Individuals transferred to the United Kingdom for periods of up to 12 months and who do not qualify for treaty relief, however, are by concession exempt from tax on the provision of accommodation in the United Kingdom.

E. *Lease premiums*

It may be possible for an employer to pay a capital sum of up to £ 75,000 to acquire accommodation in the United Kingdom which is then provided to an employee. Such a premium, which is clearly not rent, should not be deemed additional taxable income to the employee. However, the gross annu-

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al value of the property and any reimbursed expenses relating to the property would be taxable.

F. *Salary sacrifice*

It may be possible to structure an arrangement where an employee gives up additional salary in return for the provision of accommodation. It may be possible to argue that the taxable benefit to the employee is measured by the salary that is foregone.

G. *Pensions*

New legislation appears to be so widely drafted that distributions from overseas pension plans may be subject to U.K. tax, regardless of whether the funds are remitted to the United Kingdom or not. Therefore, distributions should not be taken during the period of the assignment to the United Kingdom.

Corresponding approval should be requested for all overseas pension plans. Otherwise employer contributions to the plan may be deemed additional remuneration to the employee.

NEWS

BELGIAN/LUXEMBOURG BRANCH

On 15-16 May 1992, the Belgian/Luxembourg branch in cooperation with the French branch will host a seminar on tax decision of the Court of Justice and the tax regime applicable to organizations for collective investment in securities.

HONG KONG BRANCH

The Annual General Meeting will be held on 28 September 1992, and the topic for discussion will be "The views of a United Democrat party member on a suitable tax system".

U.K. BRANCH

The topic of the March technical meeting was "Current Issues Concerning the Credit of Foreign Taxes". Speakers were Mr. Jeremy Maynes, tax partner, KMPG Peat Marwick and Mr. Tim Voak, head of tax, finance, British Petroleum PLC.

U.S.A. BRANCH

The U.S.A. branch held its Awards Dinner in January to honour two prominent members, Sidney I. Roberts and Leonard L. Silverstein.

The Annual Meeting was held in Houston, Texas on 27-28 February 1992. The programme topics included Mexico and the North American Free Trade Agreement, Section 367 update, PFIC and Subpart F simplification rules, transfer pricing, recent treaty developments, international mergers and acquisitions and cross border financial instruments.

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NEW ZEALAND:

TRUSTS AND THE USE OF IMPUTATION CREDITS

Kevin Holmes

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I. Introduction
II. Imputation Rules Applying to Trustees
III. Income Retained by Trustees
IV. Income and Accounting Years
V. Distribution from Subsequent Year's Income
VI. Anti-Avoidance Provisions
VII. Conclusion

I. INTRODUCTION

Since the introduction of the system of full dividend imputation into the New Zealand Income Tax Act 1976 ("the Act") with effect from 1 April 1988, trustees and practitioners have frequently needed to address the question of how to utilize, to the greatest advantage to beneficiaries, imputation and withholding payment[1] credits where a trust receives imputed dividends from a company in which it holds shares.

The utilization of imputation credits through a trust is not generally an issue where a beneficiary has an *entitlement* to income, as stipulated in the trust deed but, in the case of discretionary trusts, the tax planner naturally asks whether there is scope to allocate imputation credits among beneficiaries so that, at least, no credits are wasted. This issue is particularly relevant in the context of non-resident shareholders of New Zealand companies because non-residents are subject to non-resident withholding tax on dividends, which is a final tax. The dividends are *not* included in the non-resident shareholder's assessable income. Since it is the tax on assessable income from which imputation credits are deducted, non-resident shareholders therefore obtain no credit for tax paid at the corporate level by the New Zealand company in which they invest.

Similarly, a shareholder which is a tax-exempt entity cannot utilize imputation credits because it, by virtue of its tax-exempt nature, derives no *assessable* income from the investee company and therefore has no tax liability from which to offset any imputation credits attached to dividends it receives. In these cases, the imputation credits attached to dividends paid by the company are lost. Hence the question: can this wastage of imputation credits be avoided if the shareholder is a trustee and the non-resident or tax-exempt parties are beneficiaries of a trust?

This article examines the ability of trustees to utilize imputation credits in a tax-efficient manner.

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II. IMPUTATION RULES APPLYING TO TRUSTEES

Where a trustee receives dividend income in respect of company shares which he owns in his capacity as trustee (colloquially referred to as shares which the trust owns), the trust deed under which a trust is generally established, and which governs the operation of the trust, will normally specify how that dividend income either must or may be treated insofar as the beneficiaries of the trust are concerned. There may, for example, be a beneficiary or specific group of beneficiaries who are entitled only to the income of the trust or in whom the income of the trust vests absolutely (which is often the case for life tenants of a deceased estate). Other beneficiaries may be entitled only to the capital accretions of the trust.

Where income derived in any year vests absolutely in a beneficiary, the trustees have no discretion to allocate that income to beneficiaries other than the one so entitled. In such cases, dividends and the associated imputation credits constitute beneficiary income of that beneficiary alone. Consequently, if that beneficiary is not subject to New Zealand income tax because, for example, he is a non-resident or a tax-exempt charitable entity, the ability to use the imputation credits to reduce a tax liability is lost.

1. The issues discussed in this paper are applicable to both imputation and withholding payment credits. However, for ease of explanation, generally reference is only made to imputation credits.

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Trustees have endeavoured to overcome this waste of imputation credits where they have the ability under the trust deed to allocate income to particular beneficiaries at their discretion or to allocate no income to beneficiaries in a particular income year but instead retain it as trustees' income in that year. The provisions of a purely discretionary trust give the trustees the ability to allocate income and capital to whatever beneficiaries they choose.

Consider the following simple example:

EXAMPLE 1

A discretionary trust derives the following income during the 1991 income year:

		$	$
Net business profits			100
Dividends	- net cash received	67	
	- imputation credits attached	33	
			100
			$ 200

There are two beneficiaries to whom the trustees may allocate income totally at their discretion:

Beneficiary # 1	- a New Zealand resident individual - marginal tax rate, 33%
Beneficiary # 2	- New Zealand charitable trust - exempt from tax (i.e. marginal tax rate, 0%)

The trustees will clearly wish to allocate the trust income between the beneficiaries in such a manner that the $ 33 imputation credits are fully utilized. Hence, they will desire to allocate the dividend income to Beneficiary # 1 and the business income to Beneficiary # 2, the tax effect of which is:

Beneficiary # 1 (MRT, 33%)

	$
Taxable dividend income	100
Tax thereon	33
Less imputation credit	(33)
Net tax payable	Nil

Beneficiary # 2 (Tax-exempt)

Business income	100
Tax thereon	Nil

Consequently, no tax liability arises to the trustees or to the beneficiaries.

However, Section 394ZD(1)(a) and (3) of the Act are anti-avoidance provisions designed to counter a trustee's attempt to allocate imputation credits to beneficiaries which can make the greatest use of them. In effect, Section 394ZD(3) requires that the imputation credits be averaged over all distributions made to beneficiaries during an income year. Specifically, Section 394ZD(3) prescribes the following formula to quantify the amount of credits able to be utilized by a beneficiary:

$$a \times \frac{b}{c}$$

where a = total imputation (and dividend withholding payment) credits attached to all dividends distributed to beneficiaries during the income year.

b = total distributions (including income, capital, assessable or non-assessable) made to a beneficiary during the income year.

c = all distributions (including income, capital, assessable or non-assessable) made to all beneficiaries during the income year.

Applying this formula to the above example, the imputation credits able to be utilized by Beneficiary # 1 are restricted to $ 16.50 (the balance of $ 16.50 being lost), calculated as follows:

Beneficiary # 1 (MRT, 33%)

	$
Taxable dividend income	100.00
Tax thereon	33.00
Less imputation credit*	(16.50)
Net tax payable	$ 16.50

* Calculation of imputation credit

Imputation credit allowed = $a \times \frac{b}{c}$

where a = 33 (i.e. all imputation credits attached to all dividends distributed)

b = 100 (i.e. distribution to Beneficiary # 1)

c = 200 (i.e. total distributions to both beneficiaries)

Therefore,

Imputation credit allowed = $33 \times \frac{100}{200}$ = $ 16,50

Beneficiary # 2

	$
Business income	100
Tax thereon	Nil

Thus, the imputation credits that are able to be utilized to reduce Beneficiary # 1's tax liability are restricted to $ 16.50, resulting in an overall tax cost of $ 16.50.

The imputation credits have been statutorily allocated in proportion to the total distributions to all beneficiaries, i.e. one half of the total distributions went to Beneficiary # 1, so he is entitled to one half of the imputation credits attached to his

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dividends. Had Beneficiary # 2's income included dividends with imputation credits attached to them, he would have been entitled to a tax credit for only one half of the imputation credits but, as he is exempt from tax, they would have been of no use to him.

This treatment emphasizes two points:

- in respect of distributions made in any particular year, the formula constrains the allocation of imputation credits to those beneficiaries which can best use them; and
- care must be taken in allocating imputation credits to a particular beneficiary in proportion to the underlying distributions from all sources where, for example, cash flow considerations warrant a disproportionate allocation of imputation credits.

The latter point can be illustrated by way of an example:

EXAMPLE 2

Assume a trust derived total income for a year of only dividends amounting to $ 1,100, comprising net cash dividends received of $ 800 and imputation credits of $ 300.

There are two beneficiaries: Beneficiary # 1 with a marginal tax rate of 24 percent and who is liable to pay tax on income of $ 271 derived from sources other than the trust, and Beneficiary # 2 who has losses from other sources of $ 550.

Assume the trustees wish to allocate the income equally between the two beneficiaries but, given the above circumstances of the beneficiaries, they also wish to allocate the maximum amount of imputation credits to Beneficiary # 1 in order that he obtains a cash flow advantage by reducing the amount of his tax payment liability (to zero) now. In cash flow terms, this course is preferable to waiting for the benefit of a reduced tax liability in a future year, arising from the gross-up into a loss carried forward of Beneficiary # 2's excess imputation credits.

Consequently the trustees' proposed treatment would be:

Beneficiary # 1

	$
Dividend income allocated	550
Imputation credits allocated (maximum: $\frac{33}{67}$ x $ 400)	197
Assessable income:	
Dividend income allocated	550
Other income	271
	$ 821
Tax thereon	197
Less imputation credit	(197)
Net tax payable	Nil

Beneficiary # 2

Dividend income allocated	550
Imputation credits allocated (Balance: $ 300-197)	103
Assessable income	
Dividend income allocated	550
Less loss brought forward	(550)
Assessable income	Nil
Tax thereon	Nil
Less imputation credits	(103)
Excess imputation credits	$ (103)
Loss available for carry forward (i.e. excess imputation credits grossed up at 28%)	$ 367

Therefore, no tax liability will fall upon the beneficiaries (or trustees on behalf of the beneficiaries) in the current year.

However, the formula in Section 394ZD(3) will inhibit Beneficiary # 1's full utilization of the credits allocated to him in the above manner. The effect of the formula is as follows:

Beneficiary # 1

	$
Tax on assessable income (as above)	197
Less imputation credit*	(150)
Net tax payable	$ 47

* Calculation of Imputation Credit

$$\text{Imputation credit allowed} = a \times \frac{b}{c}$$

$$= 300 \times \frac{550}{1100}$$

$$= \$\ 150$$

Beneficiary # 2

Tax on assessable income (as above)	Nil
Less imputation credits	(150)
Excess imputation credits	$ (150)
Loss available for carryforward (i.e. $ 150/.28)	$ 536

Hence, application of the formula generates a "slide" between the amount of imputation credits available to be used in Year 1 and those available for a loss gross-up the benefit of which can be utilized in future years.

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III. INCOME RETAINED BY TRUSTEES

It will be noted that the application of the formula in Section 394ZD(3) is confined to distributions made *during an income year* (i.e. during the standard fiscal period, 1 April to 31 March).

Where the trustees retain dividend income in a particular year (i.e. they do not pay or apply that income to or for the benefit of beneficiaries within six months of the end of the trust's accounting year), it is taxed as the trustees' income. Imputation credits attached to those dividends can therefore be used to reduce the trustees' tax liability. That dividend income is thereby accrued into the trust capital and, assuming it is a qualifying trust, may be subsequently distributed tax-free to beneficiaries entitled to such distributions.

Therefore, if beneficiaries have different tax statuses (i.e. taxable, exempt, non-resident, different marginal tax rates) such that the ability to utilize imputation credits differs, it is advantageous, from the viewpoint of containing the ultimate tax cost on dividends derived in trust, to:

(a) make distributions, which include the imputed dividends, only to the beneficiary(ies) who can utilize the imputation credits, in the year the trust derives those dividends, and make no distributions of any sort to beneficiaries who can not take advantage of the imputation credits; or

(b) retain the income in the trust, utilize the imputation credits there, and subsequently (i.e. more than six months after the trust's balance date) distribute the net amount tax-free to beneficiaries; or

(c) undertake a combination of (a) and (b) above.

Note that Section 394ZD(1)(a) and (3) applies only to imputation credits in relation to beneficiaries of a trust and subsection (3) applies only on a year-by-year basis and not over periods longer than an income year.

To illustrate the point, consider the following example:

EXAMPLE 3

Reconsider the situation in Example 1 where, by the application of Section 394ZD(3), $ 16.50 (or one half) of the imputation credits were lost. Assume now that the dividends are retained as trustees' income in Year 1 and distributed to Beneficiary # 1 in Year 2. Beneficiary # 2 is allocated the business income in Year 1 and nothing in Year 2. The trustees' marginal tax rate is 33 percent.

The tax effect is as follows:

YEAR 1	
Beneficiary # 1	
Income allocated	Nil
Tax thereon	Nil
Beneficiary # 2 (Tax-exempt)	
	$
Business income	100
Tax payable	Nil
Trustees	
Taxable dividend income	100
Tax thereon	33
Less imputation credit	(33)
Net tax payable	Nil
YEAR 2	
Beneficiary # 1	
Capital distribution from (qualifying) trust	100
Tax thereon	Nil
Beneficiary # 2	
Income allocated	Nil
Trustees	
Taxable dividend income	Nil

To defer the distribution to Beneficiary # 1 in this way ensures that the imputation credits are fully utilized and no net tax liability arises. Such an approach is particularly advantageous where a beneficiary is not a tax resident in New Zealand and who, as well as not being able to take advantage of imputation credits attached to dividends otherwise derived by him, is also subject to non-resident withholding tax upon payment of any dividend income to him. The liability to pay non-resident withholding tax is circumvented by the trustees converting dividend income into a capital distribution to the non-resident beneficiary in the above manner.

IV. INCOME AND ACCOUNTING YEARS

A difficulty with the formula in Section 394ZD(3) is that the variables a, b and c, which determine the quantum of imputation *credits* available to a beneficiary, are measured during the *income year* in which the *distributions* of the dividends to which credits attach are made. The subsection simultaneously provides that such a credit is allowed in respect of dividends *derived* during an *income year*.

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However, Section 226(1) of the Act defines "beneficiary income", in relation to a beneficiary of a trust in any income year, to include income derived during that income year by a trustee which is paid or applied by the trustee to or for the benefit of the beneficiary within six months after the end of that income year.

Section 227(7) goes on to say that where a trust's balance date is other than 31 March and beneficiary income arises during the trust's accounting year, the beneficiary is deemed to have derived that income during the income year corresponding to the trust's accounting year. Consequently, there can be a mismatch between the derivation and return of beneficiary income (based on the trust's accounting year) and the availability of imputation credits (based on the income year in which the distribution occurs).

Given that the provisions of Section 227(7) apply for the purposes of the whole Act, in determining the income year referred to in Section 394ZD(3), a timing difficulty arises with the utilization of imputation credits where *distributions* to beneficiaries are not made during the *income year* to which the trust's accounting period relates.

An example illustrates the problem:

EXAMPLE 4

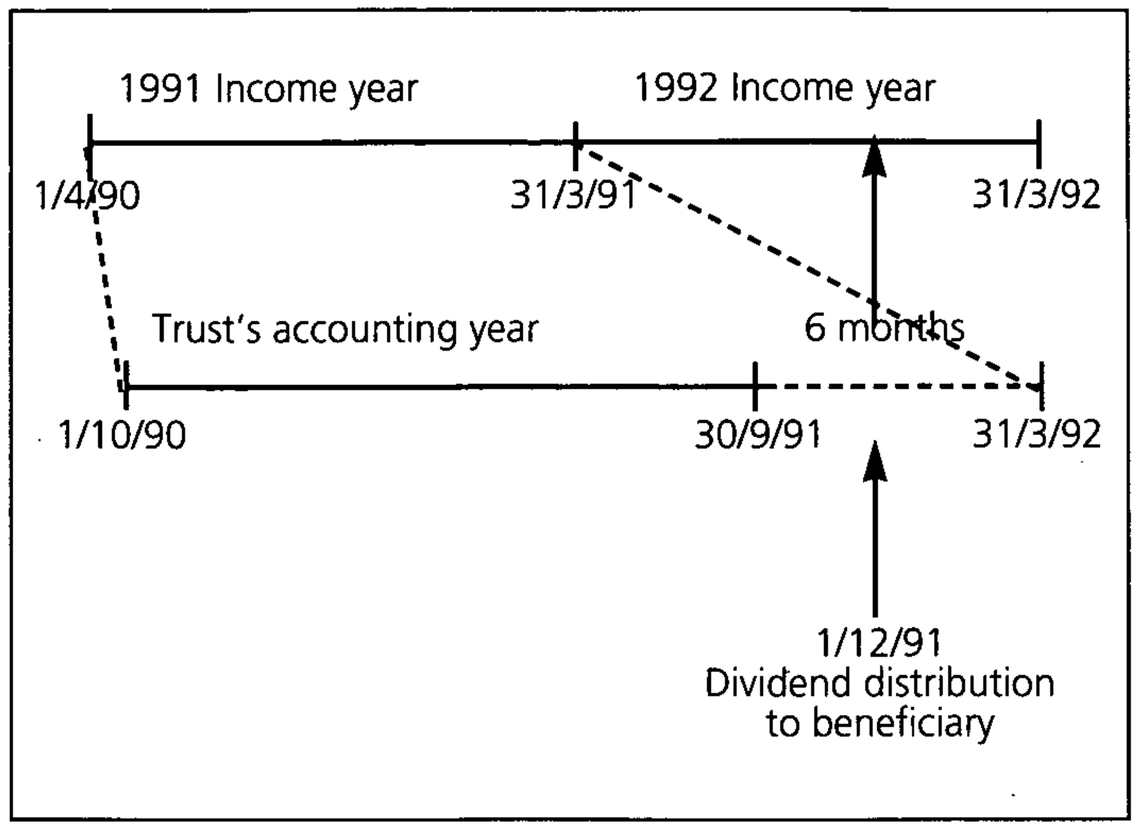
Assume a trust's accounting year ends on 30 September 1991 and no distributions were made to any beneficiaries during the 1991 income year. A distribution of fully-imputed dividend income is made to a beneficiary on 1 December 1991. The alignment of income and accounting years is illustrated in Figure 1.

Pursuant to Section 227(7), the dividend distribution on 1 December 1991 constitutes beneficiary income *derived* by the beneficiary during the 1991 income year. However, on the language of the legislation, no imputation credits are deductible from the beneficiary's 1991 tax liability.

Applying the provisions of Section 227(7) to Section 394ZD(3), the salient question is whether any *distributions* were made during the 1991 income year, i.e. the income year corresponding to the trust's accounting year in respect of which the dividend distribution on 1 December 1991 is made. As there were no *distributions* in the 1991 *income year*, application of the formula in Section 394ZD(3) yields a zero result meaning no imputation credits are available in the 1991 year to be offset against the beneficiary's fully-imputed dividend derived and returned in that year. The imputation credit will be available to him in the 1992 income year (i.e. the income year in which the distribution is made) *provided he also derives dividends with an imputation credit during that year* because that is the prerequisite to the activation of the formula in Section 394ZD(3). This absurdity applies to any distribution of dividend income from 1 April 1991 to 31 March 1992, in the above example.

Even if the provisions of Section 227(7) did not apply to reading Section 394ZD(3), the ludicrous result of deferring the claiming of the imputation credit until the 1992 year still prevails since that is the year the distribution is made. Section 227 still applies to tax the dividend in the 1991 income year. Again, the claiming of the imputation credit in the 1992 year is still dependent on further imputed dividend income being derived by the beneficiary from the trust in that income year. Although the interaction of Sections 226 and 394ZD(3) is not clear, this latter situation also appears to be the case for trusts with a standard 31 March balance date, which make dividend distributions to beneficiaries within the six-month period after balance date.

FIGURE 1



Neither of the above resulting mismatches could have been contemplated by the legislature and, although prevailing practice is to claim the imputation credit in the year in which the dividend income is returned by the beneficiary, the legislation ought to be amended to give that logical practice a valid statutory base.

V. DISTRIBUTION FROM SUBSEQUENT YEAR'S INCOME

It should be noted that the definition of "beneficiary income" in Section 226(1) of the Act requires that, to constitute beneficiary income for a particular income year, a distribution to a beneficiary must be sourced from income first derived by the trustee during that income year. An effective way of ensuring imputation credits are not wasted in applying the Section 394ZD(3) formula is to make distributions during the six-month period to one beneficiary out of the trust's Year 1 income and to another beneficiary out of Year 2 income. Consider the following example:

EXAMPLE 5

Assume a trust's balance date is 31 March 1991. The trustees distribute $ 100 of fully-imputed dividends to Beneficiary # 1 (a New Zealand resident; marginal tax rate, 33 percent) from 1991 trust income on 1 June 1991 and $ 100 of business income to Beneficiary # 2 (a tax-exempt charity) from 1992 trust income (derived by the trust between 1 April 1991 and 30 August 1991) on 1 September 1991. There are no other distributions. This scenario is illustrated in Figure 2.

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Following the practice of claiming the imputation credits in the year a beneficiary derives the dividend income, the imputation credits will be fully utilized by the two beneficiaries, as follows:

1991 YEAR

Beneficiary # 1 (MRT, 33%)

	$
Taxable dividend derived on 1 June 1991 from trust's 1991 income	100
Tax thereon	33
Less imputation credit*	(33)
Net tax payable	Nil

* Calculation of Imputation Credit

$$\text{Imputation credit allowed} = a \times \frac{b}{c}$$

where a = 33 (i.e. imputation credits attached to all dividends included in 1991 beneficiary income distributed to Beneficiary # 1; there was no such distribution to Beneficiary # 2)

b = 100 (i.e. distribution of 1991 income to Beneficiary # 1)

c = 100 (i.e. all distributions of 1991 income to all beneficiaries)

$$\text{Imputation credit allowed} = 33 \times \frac{100}{100} = 33$$

Beneficiary # 2

Taxable business income	Nil
Tax thereon	Nil

1992 YEAR

Beneficiary # 1

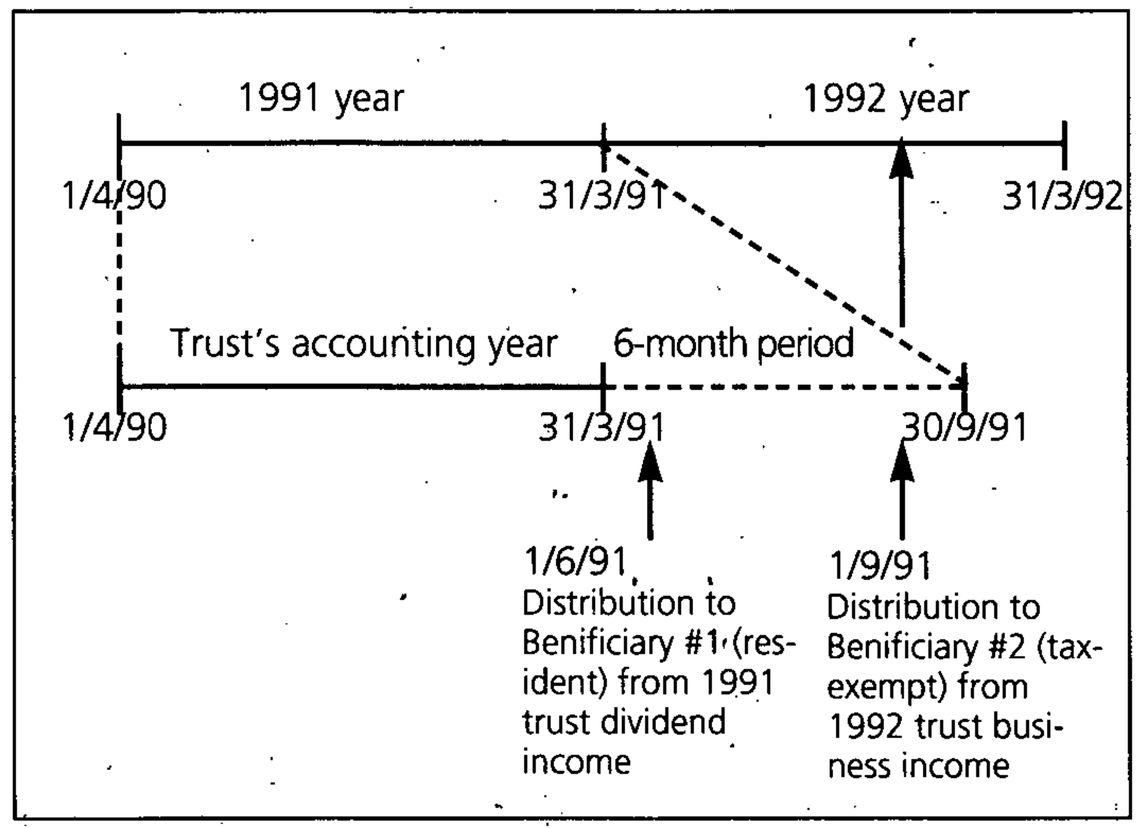
Taxable dividend income	Nil
Tax thereon	Nil

Beneficiary # 2 (tax-exempt)

Taxable business income derived on 1/9/91 from trust's 1992 income	100
Tax thereon	Nil

Therefore, the sourcing of distributions from the trust's income of consecutive years can ensure that imputation credits attaching to dividend distributions are fully utilized.

FIGURE 2



VI. ANTI-AVOIDANCE PROVISIONS

The question that now arises is whether the courses of action described above, if adopted by trustees, are subject to any provisions of the Act which would render them void; in particular, the anti-avoidance provisions of Section 394ZF and G and Section 99. None of the anti-avoidance provisions in Section 394ZF and G would defeat the above actions by the trustees and beneficiaries. Specifically, Section 394ZF (as amended in August 1991) concerns itself with dividend election and stapled stock arrangements between a company and its shareholders (including a trustee) which is not applicable to the use of a trust discussed in this article.

Section 394ZG(2)(a) is concerned with a disposition of shares and subsection 2(b) addresses only a *company* which streams dividends, both of which are inapplicable in the circumstances of the trustee shareholder described above. Because subsections (3), (4), (5) and (6) depend upon the criteria of Section 394ZG(2) being met, it is submitted that those subsections will also not defeat the trustees' allocation of credits between themselves and the beneficiaries.

That then leaves the issue of whether the general anti-avoidance provision, Section 99 of the Act, can attack the trustees' action. The Commissioner could strongly argue that the trustees' actions suggested above constituted an arrangement to avoid tax as the term *arrangement* is defined in Section 99(1).[2] But do the actions give rise to a tax avoidance arrangement or do they merely amount to tax mitigation – the concept evolved by the Privy Council in *CIR v. Challenge Corporation Limited*[3] – to which Section 99 does not apply? Lord Templeman decided that:

> Income tax is mitigated by a taxpayer who reduces his income....in circumstances which reduces his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an "arrangement" but from the reduction of income which he accepts....

2. See TRA Case M29 (1990) 12 NZTC 2,174 on this point.
3. (1986) 8 NZTC 5,219.

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Lord Templeman cites an example of a taxpayer, in making a settlement, who deprives himself of the capital which is a source of income and thereby reduces his income. It was reasoned that this reduction in income reduces his assessable income and that the tax advantage resulted from the reduction of income.

It is at least arguable that, on similar reasoning to the above example cited by the Privy Council, the retention of income of a trust in Year 1 by the trustee reduces the income of the beneficiaries in that year and that the reduction in the beneficiaries' tax liability in that year is as a consequence of the reduction in their assessable income. For the trustee to retain the income (thereby increasing his assessable income), rather than distribute it to a beneficiary (thereby reducing his assessable income), is an option open to him under paragraph (b) of the definition of "beneficiary income" in Section 226 of the Act. In Lord Templeman's words:[4]

> Section 99 does not apply to tax mitigation where the taxpayer [the beneficiary] obtains a tax advantage by reducing his income....in circumstances in which the taxing Statute affords a reduction in tax liability.

On a cautionary note, however, it is observed that in the Court of Appeal decision in *Hadlee and Sydney Nominees Ltd v. CIR*,[5] Cooke P took something of a "comparative advantage" view of the tax benefits arising from the assignment of professional income in that case. The test appeared to be whether, in an income assignment case at least, the taxpayer obtained a tax advantage *over other taxpayers*, in which event Section 99 would apply. Cooke P stated:[6]

> As Lord Templeman analyzed *Nicol*,[7] "She attempted to obtain a tax advantage over other actresses and other taxpayers who paid tax on their earnings". That, too, was seen as a case to which Section 99 would apply.... As I see it the present case is not materially distinguishable. The partner is trying to obtain a tax advantage over other chartered accountants and professional people and other earners who pay tax on their earnings. That is contrary to the intent of the Act as a whole and Section 99 in particular....

In the light of these comments, one must ask whether the retention of dividends by a trustee who utilizes the attached imputation credits, then subsequently distributes the accrued trustee income to a beneficiary who can not utilize imputation credits, is "materially distinguishable" from *Nicol* and *Hadlee*.

It is submitted that there is a distinction: the facts in the above cases specifically concerned assignments of income from personal services, an action for which the Act does not afford a reduction in tax liability. On the contrary, it can be argued that the provisions of Sections 226, 227, 228 and 230 contemplate retention of trust income by a trustee in any year with distributions to beneficiaries in a subsequent year. This option is open to all taxpayers falling within those provisions.

On the above analysis, some readers may conclude that there is scope to interpose a trust between a company and its present shareholders to effectively stream imputation credits. It is submitted that to alter the existing ownership structure of a company in such a manner may fall foul of Section 99 in that the "arrangement" is now something wider than the mere allocation of imputation credits to beneficiaries of a trust which is a presently existing shareholder of a company. The interpositioning component of this broader arrangement is unlikely to be readily explained by the operation of provisions in the statute affording a reduction in tax liability.

VII. CONCLUSION

This article has addressed the provisions of the Act in respect of the allocation of imputation credits by trustees to beneficiaries. It notes the shortcomings in the manner in which the legislation integrates Sections 226, 227 and 394ZD and the need for amendment to the Act. The article suggests two methods of protecting against the loss of imputation credits attached to dividend income derived by trustees as shareholders when distributions are made to beneficiaries:

- retaining the dividend income as trustees' income and, beyond six months after the trust's balance date, distributing that amount tax-free to beneficiaries; and
- varying the source of distributions, as between beneficiaries, and the years in which the trust derives income subsequently distributed as beneficiary income.

Such approaches are particularly advantageous to non-resident and tax-exempt entities which cannot otherwise benefit from imputation credits. It is considered that these techniques would fall outside the specific anti-avoidance provisions in Part XIIA of the Act and arguable that Section 99 could not be validly invoked. From the taxpayer's viewpoint, these options represent opportunities to enhance the wealth of beneficiaries. Conversely, from the Revenue's point of view, they are likely to represent tax leakage and opportunities for legislative amendment!

4. *Id*, at 5,226.
5. (1991) 13 NZTC 8,116.
6. *Id.*, at 8,122.
7. *Black Nominees Ltd. v. Nicol* (1975) 50 TC 229.

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MALAYSIA:

THE 1992 BUDGET AND RECENT CHANGES

Veerinderjeet Singh*

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VI. Conclusion

I. INTRODUCTION

The Honourable Minister of Finance, Datuk Seri Anwar Ibrahim, presented the 1992 Budget on 1 November 1991. The 1992 Budget has been formulated to take into account the strategic challenges faced by the country as well as the aspirations and commitments contained in "Vision 2020" under which Malaysia aims to achieve developed nation status.

For 1991, it is expected that the growth in the GDP will be 8.6 percent. The rate of economic growth is expected to be a rather buoyant 8.5 percent for 1992. The manufacturing, construction and services sectors are the major sources of growth. The primary factor contributing to economic growth is domestic demand which is expected to grow at a rate of 13 percent in 1991. The increase in domestic demand has contributed to higher imports of goods which is expected to grow by 32 percent in 1991. A major proportion of these imports includes capital and intermediate goods required by the manufacturing sector. This is expected to result in a large deficit in the current account in the balance of payments. This deficit is a consequence of strong growth and the large inflows of foreign investment. The deficit will decline as new investments generate more exports. Private investment is anticipated to grow moderately by 15.2 percent in 1992 compared to 24.3 percent in 1991. Foreign investment, while still significant, is projected to register a slower growth of 3.4 percent in 1992 to reach M$ 9 billion compared to M$ 8.9 billion in 1991.

The continued increases in development and operating expenditures puts pressure on the nation's revenue. The ratio of revenue to GNP has declined from 28 percent in the first half of the 1980s to 26 percent in the second half, with tax revenue declining from 23 percent to 19 percent. Similarly, revenue buoyancy with respect to GNP has also declined during this period from 1.05 to 0.94 with tax buoyancy declining significantly from 1.14 to 0.84. This means that the increase in revenue has not kept pace with the growth in the economy. The reasons for this decline are mainly the narrowness of the tax base and the large amount of exemptions and reliefs given. This declining trend will continue unless steps are taken to strengthen the tax base.

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With the above matters taken into account, the 1992 Budget strategy is aimed at:

- ensuring sustainable growth with price stability;
- strengthening the balance of payments;
- instilling greater prudence in order to encourage greater savings; and
- strengthening national economic resilience.

This strategy is indeed appropriate in the sense that it is intended to help achieve the objectives of the National Development Policy and the Sixth Malaysia Plan which were launched in mid-1991.

This article examines the various measures introduced in the Budget and the Finance Bill with regard to direct and indirect taxation.

II. BUSINESS TAXATION

A. *Corporate tax rate*

Currently, the rate of income tax and development tax applicable to companies is 35 percent and three percent, respectively.

The income tax rate has been maintained at 35 percent. However, in line with the commitment to eventually abolish development tax, the rate of development tax will be reduced from three to two percent with effect from the year of assessment 1992. Further, it has also been announced that development tax will be abolished with effect from the year of assessment 1993. With these changes, the overall corporate tax rate would be reduced to 37 percent for the year of assessment 1992 and to 35 percent thereafter. With the proposed changes, Malaysia's corporate tax rate would be fairly competitive with the rates in other ASEAN countries.

It is, however, felt that the modification of the investment incentives (discussed below) should be matched over time with a corresponding reduction in corporate tax to a rate of around 30 percent. This will be feasible once the indirect tax base is further broadened in line with the international trend to shift the tax mix towards indirect taxes.

B. *Capital allowances*

Some changes have been introduced so as to clarify how qualifying expenditure for a business would be determined in respect of used plant and machinery. Capital allowances (tax depreciation) at the prescribed rates can then be claimed on such qualifying expenditure. This treatment will be effective from the year of assessment 1992. The changes are as follows:

- the qualifying expenditure on plant or machinery which had been in use for a non-business purpose prior to it being used for business purposes, shall be the market value of the plant or machinery on the day it was brought into use for business purposes;
- the qualifying expenditure on plant or machinery which had been in use for the purposes of a business during an exempt period (granted under the Income Tax Act, 1967) and continues to be used in respect of a business after the exempt period, shall be the market value or the net book value (whichever is the lower) on the day the exemption ceases; and
- the qualifying expenditure on plant or machinery which had been in use outside Malaysia and is brought into use for the purposes of a business in Malaysia, shall be the market value or the net book value (whichever is the lower) on the day it is brought into use in Malaysia.

Other than stating how the qualifying expenditure is to be determined, the proposed amendment also states that no initial allowance (usually 20 percent) will be available for such plant or machinery. Therefore, only annual allowances at the prescribed rate would be allowed. These proposed changes will create some practical problems in determining market value of the used plant and machinery. Further, the reference to net book value does not seem appropriate as different organizations may have a different policy in accounting for depreciation for similar types of plant and machinery, thus resulting in different net book values for the same type of asset. In normal circumstances, market value or the purchase price should be applied in respect of used assets acquired for use in a business. There may be a need for some administrative guidelines to be issued by the tax authorities to ensure effective resolution of any anomalies or disputes that may arise.

Besides the above changes, it should be noted that with effect from the year of assessment 1992, initial allowance on qualifying expenditure will be 20 percent or such other fraction as may be prescribed. Therefore, there is now the provision to vary the rate of initial allowance.

C. *Deduction of cost of equipment for disabled employees*

Currently, it may be possible for an employer to claim a deduction by way of capital allowances in respect of the cost of equipment provided to assist disabled employees[1] in the performance of their duties. Thus, the cost will be deducted over a number of years. With effect from the year of assessment 1992, the cost of such equipment will be allowed as a deductible expense in the year of acquisition. Further, once a deduction for the expenditure is allowed, no capital allowances can be claimed on such expenditure.

This change is in line with the Government's aim of fostering a caring society and to encourage the employment of the disabled. The claim for a tax deduction must be accompanied by a letter of certification from the Department of Social Welfare. It is hoped that such a certification would be granted in a timely manner by the Department.

D. *Donations to approved institutions*

Currently, donations in cash made to an approved institution or organization are deductible in arriving at the total income of the donor. The term 'organization' is now broadened to include a Government-assisted organization engaged solely in addressing problems relating to industrial and commercial development and promoting and enhancing the relationship

1. A "disabled person" is defined to mean any individual certified in writing by the Department of Social Welfare to be a disabled person.

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between the public sector and the private sector, and a Government-assisted organization established and maintained exclusively to administer and augment a fund established or held solely for promoting national unity. This change has retrospective effect from 1 January 1990. As such, donations made from that date to such organizations which are approved by the tax authorities would be allowed as deductions.

E. *Waiver of assessments*

Currently, under Section 95(1) of the Income Tax Act, 1967, an assessment is waived if the tax charged on any person for a particular year of assessment is less than M$ 5. With effect from the year of assessment 1992, the threshold is increased to M$ 25. This change would ease the administrative workload of the tax authorities.

F. *Deductibility of premiums paid on re-insurance of a risk*

Currently, where an insurer carries on a general insurance business and re-insures the risk with a re-insurer who either does not carry on the business of insuring such risks in Malaysia or does not re-insure the risk through a branch in Malaysia, only 95 percent of the re-insurance premiums paid are allowed as a deduction.

With effect from the year of assessment 1992, this restriction will also apply to re-insurance premiums paid to an insurer in Labuan (i.e. Malaysia's international offshore financial centre) licensed under the Offshore Insurance Act, 1990. This change is meant to treat re-insurance premiums paid to an offshore insurance company in Labuan in the same manner as such premiums paid to any other offshore insurer. It removes the anomaly whereby general insurers could get a 100 percent deduction by re-insuring the risk with offshore insurers in Labuan.

G. *Tax rates for cooperative societies*

Currently, cooperative societies are subject to income tax at rates ranging from five (for the first M$ 10,000 of chargeable income) to 40 percent (for chargeable income in excess of M$ 500,000).

Whereas the corporate income tax rate and the personal income tax rate have been lowered in the past, the rates for cooperative societies have not been reviewed for a long time. With effect from the year of assessment 1992, the income tax rates for cooperative societies have been reduced to a scale ranging from four to 35 percent. This change has been introduced to further support the cooperative movement which is a vehicle that could mobilize the economic potential of the medium and low income group.

III. PERSONAL TAXATION

A. *Development tax rate*

Currently, individuals are subject to development tax at the rate of three percent on income from a development source (i.e. business and rental of property) in excess of M$ 5,000. The maximum tax rate for an individual with development income amounts to 38 percent. With effect from the year of assessment 1992, the development tax rate will be reduced to two percent. The development tax will be abolished with effect from the year of assessment 1993. Thus, the maximum tax rate for an individual would be 35 percent.

B. *Relief for the purchase of equipment for a disabled person*[2]

Currently, no personal relief is available for the cost incurred on the purchase of equipment for the use of a disabled individual. With effect from the year of assessment 1992, a relief of up to a maximum of M$ 3000 would be allowed on expenditure incurred by an individual for the purchase of any necessary basic supporting equipment for his own use (if he is a disabled person) or for the use of his wife, child or parent who is a disabled person.

It would appear that one must prove that the expenditure was incurred for a disabled person (by submitting the certification by the Department of Social Welfare). Further, it is obvious that evidence of expenditure incurred must be submitted to justify the claim for a relief. However, this is not specified in the relevant provision of the Finance Bill unlike the relief for medical expenses incurred by an individual on his parents (which was introduced in the 1991 Budget) where relevant receipts are required as evidence.

C. *Wife relief*

Currently, where a resident individual ceases to live together with his wife or he and his wife cease to be husband and wife, he is entitled to wife relief which would be pro-rated by reference to the period for which they were living together in the relevant year. With effect from the year of assessment 1992, this specific provision is removed. This implies that such an individual would be entitled to the full amount of wife relief irrespective of whether they cease to live together or cease to be husband and wife in the relevant year. This makes it easier for an individual to claim wife relief in the year separation occurs.

D. *Child relief*

Currently, the age limit for the purpose of child relief as well as increased child relief is 16 years. Further, child relief in respect of a disabled child is M$ 1,000, and is only applicable to an unmarried child over the age of 16 and not receiving full-time instruction at any university, college, school or other similar educational establishment by reason of physical or mental disability. With effect from the year of assessment 1992, the age limit for the purpose of child relief is increased to 18 years. In addition, the relief for an unmarried disabled child is increased to M$ 1,600 irrespective of age provided that it is proved to the satisfaction of the Director General of Inland Revenue that the child is physically or mentally disabled.

2. *Id.*

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With the raising of the age limit for child relief, the increased child relief for children undertaking higher education abroad can now be claimed only in respect of children over 18 years of age. A relief of M$ 1,600 can now be claimed for maintaining a disabled child irrespective of the child's age and regardless of whether the child is receiving full-time instruction.

E. *Contributions to approved pension/provident fund and insurance premiums*

In the case where the wife elects for her total income to be aggregated with the total income of the husband, such contributions to approved pension/provident funds or insurance premiums paid by the wife are deemed to be paid by the husband. However, the husband in such a case is allowed a maximum relief of up to M$ 7,000 (i.e. M$ 3,500 for each person) for such payments/contributions. It was unclear whether this applied in the case where the wife did not have any total income.

An amendment has been proposed to correct the anomaly created in the law. As such, where a wife does not have any total income to be aggregated with that of her husband, he is entitled to claim relief for her contributions and insurance premiums in addition to his own. However, the relief will be restricted to M$ 3,500. This change is to have retroactive effect from the year of assessment 1991.

F. *Exemption on royalty income from literary work*

Currently, a resident individual enjoys a tax exemption of M$ 6,000 on income derived from royalty or payment in respect of the publication of, or the use of or the right to use, any literary work. With effect from the year of assessment 1992, the exemption limit on such royalties is to be increased to M$ 12,000. This doubling of the exemption level should encourage local writers to produce more literary works. It should be noted that the existing exemption limit on royalties earned by other artistes remains at M$ 6,000.

G. *Exemption on income from translation of books*

Currently, a resident individual is entitled to an exemption of M$ 3,000 on payments received for translation of books or literary works at the specific request of an agency of the Ministry of Education or the Attorney General's Chambers. This exemption does not apply to an individual who receives it as part of his emoluments in the exercise of his official duties. With effect from the year of assessment 1992, the exemption limit is to be increased to M$ 6,000. This is intended to encourage translation work to overcome the shortage of books and literary works in the national language.

H. *Exemption of interest on corporate bonds*

Currently, only interest paid or credited to any individual in respect of securities or bonds issued by the Malaysian Government is exempt from tax. With effect from the year of assessment 1992, this exemption is to be extended to include interest earned from bonds (other than convertible loan stock) issued by public companies listed on the Kuala Lumpur Stock Exchange. This measure is intended to promote savings by individuals as well as to broaden the capital market and encourage dealings in these types of bonds.

I. *Exemption of interest on savings accounts*

Currently, interest income earned by resident individuals on savings deposits of up to M$ 5,000 placed with commercial and financial institutions and up to M$ 10,000 placed with registered cooperatives, Bank Pertanian Malaysia Bhd, Malaysia Building Society Bhd and Borneo Housing Mortgage Finance Bhd is exempt from the withholding tax of five percent.

As a measure to encourage savings and to curb inflation, the exemption limit has been increased to deposits of up to M$ 50,000. Although this proposal is stated in the Budget speech to be effective from year of assessment 1992, one would have to await the gazette order to be certain of this. Such an order may also have to deal with the situation where the relevant financial institutions have already deducted the five percent withholding tax (based on the existing exemption limit) and paid it over to the tax authorities.

J. *Abolition of estate duty*

With effect from 1 November 1991, estate duty is abolished. As such, the relevant legislation is repealed. However, the estate of a person who died before the repeal would continue to be subject to estate duty, if applicable.[3] The abolition had been expected largely because the revenue generated by estate duty was not substantial. In fact, it is estimated that the Government will lose only M$ 10 million from the abolition. Further, the maximum rate of estate duty had been reduced from 60 to ten percent over the years, thus pointing to the eventual demise of the duty. Further, there had been various difficulties faced by beneficiaries since all estates required clearance from the Estate Duty Office before executors or administrators were able to obtain grants of probate or letters of administration to manage the estates. This had caused undue delays and inconveniences.

IV. REAL PROPERTY GAINS TAX

A. *Retention of monies by acquirer*

Currently, upon the disposal of a chargeable asset for a consideration consisting wholly or partly of money, the acquirer is required to retain the whole of the money consideration subject to an amount not exceeding a sum arrived at by applying the relevant tax rate to the total value of the consideration. The relevant amount must be withheld by the acquirer until he receives the certificate of clearance in respect of the disposal from the Director General.

With effect from 1 November 1981, the acquirer is required to retain the lower of either the whole of the money consider-

3. Estate duty is levied on the value of property which passes or is deemed to pass on the death of an individual. The duty is imposed on the estate of an individual (who died domiciled in Malaysia) which has a net value exceeding M$ 2 million and on the estate of an individual (who died domiciled outside Malaysia) where the net value exceeds M$ 400,000. The rate of duty ranges from five to ten percent.

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ation or a sum not exceeding five percent of the total value of the consideration until he receives the Director General's certificate of clearance in respect of the disposal.

This change is more practical in the sense that a rate of five percent is stated, unlike in the previous situation where the acquirer had to determine the relevant rate applicable to the transaction. This makes it simpler for the acquirer to calculate the retention sum.

B. *Circumstances where an assessment is raised on the acquirer*

Currently, there are three circumstances where an assessment may be raised on the acquirer of a chargeable asset. Further, under all such circumstances, the assessment shall include an increase of ten percent of the tax applicable. With effect from 1 November 1991, an assessment may be raised on the acquirer to include an increase of ten percent only where both the acquirer and disposer fail to submit a return as required under the Real Property Gains Tax Act, 1976. This is a more logical and equitable move in that the 'penalty' of ten percent is only to be imposed where there is a failure to comply with the provision of the legislation.

V. TAX INCENTIVES

A. *Pioneer status*

Currently, the Promotion of Investments Act 1986 ("PIA") provides that a company granted pioneer status is given a tax holiday for five years (which may be extended to ten years) and the income is fully exempt from tax commencing from the 'production day' (which is normally the day when the company has reached 30 percent of its operational capacity).

With effect from 1 November 1991, a company which applies for and is granted pioneer status (on or after 1 November 1991) will no longer enjoy total tax exemption. Only 70 percent of the statutory income (from the pioneer business) for each of the five years will be abated. As such, the balance of 30 percent of that statutory income will be taxed at the current corporate tax rate.

	M$
Statutory income (pioneer business)	100,000
Less: Abatement (70%)	70,000
Chargeable income	30,000
Income tax @ 35%	10,500
Effective tax rate	10,5 %

From the above example, it can be seen that the effective tax rate on statutory income from the pioneer business is 10.5 percent. It is assumed that development tax will not be applicable since when a company applies for pioneer status on or after Budget day, it is likely to reach 'production day' in early 1992 which would fall into the year of assessment 1993 (when development tax is expected to be abolished). The amount of statutory income abated will be exempt from tax and will be available for distribution as exempt dividends. As such, in the above example, M$ 70,000 would be exempt income available for distribution. Further, no extension of the pioneer period will be granted to companies applying for pioneer status on or after 1 November 1991. In addition, pioneer status will not be granted to companies which have previously benefited directly or indirectly from pioneer status or investment tax allowance in respect of a similar promoted product or activity.

However, the Government recognizes that there may be a need to give more favourable tax relief on a case-by-case basis, including a 100 percent tax exemption, to a very limited number of strategic projects of national importance. Such projects would be those with heavy capital investment and high technology which can generate extensive linkages and have a significant impact on the economy.

The changes in the pioneer status incentive and other incentives (discussed below) are measures to strengthen the tax base through the reduction of the exemptions and reliefs given under the present regime of tax incentives. In the past, tax incentives were provided to create an environment favourable to investment and economic growth. This policy has been successful in attracting labour-intensive industries. The Government's emphasis now is on capital and technology-intensive industries as well as on industries that will be competitive internationally. As such, the review of the tax incentive package is timely especially since it was felt that too many incentives were being given to the extent that the loss in terms of tax revenue foregone was tremendous.

Further, investors do not look at generous tax holidays as a primary reason for investing in a country as there are other more important factors such as political stability, administrative efficiency, liberal regulations on investment and a good infrastructure system.

There are currently about 268 companies enjoying pioneer status and another 2,000 have been given approvals but have yet to receive the pioneer certificate because they have not started production or have not yet reached the 30 percent operational capacity. As a result of so many approvals being made, it would take some time for the new system to improve the tax base. It has been indicated that companies which have applied for pioneer status before 1 November 1991 and are granted pioneer status after that date should continue to enjoy the incentive under the current legislation. However, this would depend on the actual wording of the amendment to the legislation. The relevant bill has not yet been issued.

B. *Investment tax allowance*

Currently, a company which produces a promoted product or participates in a promoted activity is eligible for an investment tax allowance of up to 100 percent in respect of the qualifying capital expenditure incurred within five years from the date of approval of a particular projet. The adjusted income of such a company is abated to the extent of the investment tax allowance and any unutilized investment tax

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allowance will be allowed in the subsequent years of assessment. With effect from 1 November 1991, companies which apply for and are granted investment tax allowances (on or after 1 November 1991) will be eligible for allowances of up to 60 percent on the qualifying capital expenditure incurred. In addition, the amount of investment tax allowance to be utilized for each year of assessment will be restricted to a maximum of 70 percent of the statutory income from the business source. Therefore, the balance of 30 percent of the statutory income will be taxed at the current corporate tax rate. Any unutilized investment tax allowance will continue to be carried forward to subsequent years of assessment until it is fully utilized.

Further, it has also been proposed that with effect from 1 November 1991, investment tax allowance will not be granted to a company which has previously benefited directly or indirectly from pioneer status or investment tax allowance in respect of a similar promoted product or activity.

C. *Abatement for export performance*

Currently, the PIA provides that the adjusted income of a resident company which exports (directly or through agents) its locally manufactured products shall be abated by an amount equal to:

(i) a rate which is equivalent to 50 percent of the proportion of export sales to total sales; and
(ii) five percent of the value of indigenous Malaysian materials incorporated in the manufactured products which are exported.

With effect from the year of assessment 1993, the abatement scheme in (i) will only be granted to resident companies located in the Principal Customs Area[4] and which are 70 percent owned by Malaysians. In addition, the abatement will be applied to statutory income (i.e. adjusted income less capital allowances) of the company instead of the adjusted income. The abatement scheme relating to the use of indigenous Malaysian materials will be abolished from year of assessment 1993.

This change in the abatement scheme will affect a large number of export-oriented companies which are foreign-owned. Although the liberal equity ownership rules allow 100 percent foreign equity in certain cases, such companies will no longer enjoy the export abatement incentive.

D. *Export allowance*

Currently, the PIA provides that a resident company engaged in the export of certain types of agricultural produce or locally manufactured products will be eligible for a deduction in respect of export allowance of five percent of the FOB value of export sales. With effect from the year of assessment 1993, this deduction will only be available to resident companies located in the Principal Customs Area and which are 70 percent owned by Malaysians.

4. The Principal Customs Area means any part of Malaysia excluding a free zone declared to be a free commercial zone or free industrial zone under the Free Zones Act, 1990. Thus, companies, situated in Free Trade Zones, Labuan and Langkawi would no longer be eligible for this incentive.

E. *Other abatement schemes*

The other abatement incentive schemes which are currently provided under the PIA are:

- abatement for location in a promoted industrial area;
- abatement for small scale companies;
- abatement for compliance with government policy on capital participation or employment in industry; and
- abatement for purchases from small scale companies.

With effect from the year of assessment 1993, the above abatement incentive schemes will be abolished. These changes in tax incentives are intended to facilitate a transition to lower import-content, higher value added and capital and technology-intensive industries, to strengthen industrial linkages and to enhance greater export capabilities.

F. *Equity ownership and employment guidelines*

The Government will continue to maintain its current liberal policy on foreign investments in Malaysia. The present relaxed equity ownership guidelines will be extended as follows:

- companies that export 80 percent or more of their production will not be subject to any equity conditions;
- companies which export between 50 to 79 percent of their production can have 100 percent foreign equity ownership if the following conditions are satisfied:
  (a) investments in fixed assets amount to M$ 50 million or more; or
  (b) projects implemented have at least 50 percent value added.

Further, the products must not compete with products being manufactured locally for the domestic market. These guidelines will not apply to sectors where the Government places limits on the maximum foreign equity participation.

In addition, the Government has also announced the continuation of the current guidelines on employment of expatriate personnel for manufacturing companies as follows:

- for new investments where the foreign paid-up capital is US$ 2 million or more, the company will be automatically allowed five expatriate posts (including key posts);
- where foreign paid-up capital is M$ 500,000, one key post will be considered.

Other than the above, it was indicated in the Budget speech that the procedures for obtaining long-term visit passes (business) as well as that of recruiting foreign workers will be simplified. Further, permanent residents will be exempted from obtaining work permits under the Employment (Restriction) Act, 1968.

Such policy/guidelines are essential as investors do not only look at fiscal incentives. Thus, the incentive package is sufficiently attractive with the maintenance of liberal policies relating to equity ownership, employment of foreign workers and expatriates, establishment of schools for the children of expatriates as well as other facilities.

However, to prevent over-dependence on a foreign workforce and to safeguard employment opportunities for local Malaysians, an annual levy will be imposed on the employ-

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ment of expatriates (ranging from M$ 1,200 in the technical category to M$ 2,400 in the upper management level) and foreign workers in the estate, service, construction and manufacturing sectors (ranging from M$ 360 for a general worker to M$ 900 for a skilled worker).

G. *Venture capital companies*

Currently, the incentives introduced (through Section 60D of the Income Tax Act, 1967) to promote investments in high risk ventures or new technology are as follows:

(i) gains arising to a venture capital company from the disposal of shares in a venture company are tax-exempt. However, gains from the disposal of shares in a venture company more than two years after the date on which such shares are listed for quotation on the Kuala Lumpur Stock Exchange ("KLSE") are not tax-exempt;
(ii) gains exempt from tax are available for distribution as tax- exempt dividends;
(iii) a loss arising from the disposal of shares in a venture company is not deductible in arriving at aggregate income or total income of the venture capital company. Such a loss cannot be carried forward to subsequent years of assessment;
(iv) any unutilized permitted expenses are not available to be carried forward to subsequent years of assessment.

With effect from the year of assessment 1992, changes have been introduced to (i), (iii) and (iv) above, as follows:

(i) gains arising from the disposal of shares in a venture company within three years of its listing on the KLSE are tax exempt;
(ii) a loss arising from the disposal of shares in a venture company or on liquidation of a venture company is deductible in computing aggregate income or total income. Any unutilized loss would be available to be carried forward;
(iii) any unutilized permitted expenses are available to be carried forward.

The above changes would make the venture capital incentives more attractive for investors.

H. *Operational headquarters company*

Under the existing incentive available to an approved Operational Headquarters Company ("OHQ"), even though a Malaysian resident approved OHQ is subject to a ten percent concessionary tax rate on its chargeable income from providing qualifying services, tax at the rate of 35 percent has to be deducted from the gross dividends distributed by the OHQ. As such, an approved OHQ is penalized for repatriating its profits by way of dividends due to the fact that there was no provision for distribution of dividends which are subject to the reduced rate of ten percent or which are tax- exempt. Therefore, the distribution of dividends by such an OHQ will give rise to an additional 25 percent tax charge thereby nullifying the benefit of the concessionary rate of tax.

With effect from the year of assessment 1992, this disincentive to the distribution of dividends by resident OHQs has been removed. The chargeable income of a resident OHQ (arising from the provision of qualifying services) after deduction of the tax shall be credited to an exempt account from which tax-exempt dividends can be distributed to its shareholders. This treatment is in line with that given to offshore insurance and inward reinsurance businesses. The dividends declared by the OHQ are subject to a two-tier exemption, i.e. a corporate shareholder receiving tax- exempt dividends from an approved OHQ resident in Malaysia would be able to frank those dividends as tax-exempt dividends to its own shareholders.

VI. INDIRECT TAXATION

A. *Duties on cigarettes and alcoholic beverages*

As a move to discourage smoking and drinking of alcohol as well as to bring in more revenue, import duties and excise duties on cigarettes and alcoholic beverages are to be increased as follows:

- import duties on cigarettes are to be increased by 54 to 56 percent per kilogram and by 55 to 65 percent per kilogram for cigars, cheroots and cigarillos. Further, the excise duty of ten percent per kilogram will also be increased on these items;
- import duties on beer, stout and other alcoholic beverages are to be increased between 50 to 185 percent. The excise duty of ten percent will also be increased on these items.

In order to simplify administration, these duties will be consolidated, standardized and levied at specific rates only.

B. *Duties on other products*

In continuing the objective of reviewing tariff protection so as to improve relative efficiency and competitiveness of the local industries, import duties on a number of products have been either reduced or abolished. These include textiles and garments, printing materials and machinery, foodstuffs, chemicals and non-ferrous metal products.

Due to the substantial increase in the importation of non-monetary gold bullion (i.e. gold in its utility form) over the past few years (from M$ 122.4 million in 1984 to M$ 3.6 billion in 1990), an import duty of ten percent is to be introduced in respect of such an item so as to curb the growth of imports of non-essential consumption goods. However, producers of jewellery who export their products are exempt from such import duty. The Government expects to earn revenue of M$ 254 million from the imposition of this duty. The above stated changes came into effect on Budget day.

To encourage the usage of unleaded petrol, the excise or import duties on unleaded petrol will be reduced through the Petroleum Pricing Mechanism effective 1 December 1991 for a period of nine months. Thereafter, appropriate measures will be taken to discourage oil companies from producing and selling leaded petrol and users of leaded petrol will eventually have to pay more for its use.

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C. *Service tax*

Currently, service tax is levied under the Service Tax Act, 1975 whereby service tax at the rate of five percent is imposed on the provision of prescribed goods or prescribed services by or in prescribed establishments such as:

- hotels, night-clubs, dance halls, cabarets, health centres and massage parlours;
- restaurants, bars, snack-bars and coffee houses located in hotels;
- restaurants, bars, snack-bars and coffee houses located outside hotels including all private clubs having an annual sales turnover of M$ 500,000 and above;
- all places licensed as public beer houses.

The service tax is confined: prescribed services such as the provision of rooms for lodging or sleeping accommodation; premises for meetings or for promotion of cultural or fashion shows; services by or in health centres and massage parlours and provision of dancing partners, social escorts and services on which cover charges are imposed by or in night-clubs; and prescribed goods which refer to food, drinks and tobacco.

The persons carrying on the business of providing such prescribed goods and services are required to collect the service tax and remit it to the Royal Customs and Excise Department with the submission of a return within 28 days after the end of the taxable period (which is currently two calendar months).

With effect from 1 January 1992, in an effort to widen the tax base and to increase government revenue, the service tax of five percent is extended to include the following:

- professional and consultancy services provided at private hospitals and by legal, engineering, surveyor, architectural, accounting and other consultancy firms having an annual sales turnover of M$ 300,000 and above;
- services provided by advertising firms with annual sales turnover of M$ 500,000 and above;
- services provided by insurance companies to all business organizations (thus excluding individuals); and
- services provided by motor vehicles service and repair centres as well as forwarding agents having an annual sales turnover of M$ 150,000 and above.

With this change, professional services are now included as prescribed services. However, the term 'consultancy' may need to be explained further as it is very wide in scope. With the minimum turnover level imposed on the different types of establishments, it should not burden the low income group, including small practitioners.

It is not clear as to why different turnover levels are applied to different types of services. It may be based on the average turnover of such businesses obtained through a survey or a census undertaken by the Statistics Department.[5]

The imposition of service tax will give rise to multi-stage taxation (i.e. create a cascading effect) where professionals seek assistance from other professionals in the course of advising a client. It is left to be seen if any mechanism will be introduced to overcome the cascading effect.

Whilst the proposed legislation is silent on what constitutes annual sales turnover, it would appear that disbursements (i.e. out of pocket expenses) do not form part of annual sales turnover and therefore should not attract service tax.

The service tax is generally directed at the hotel and tourist industry (or the so-called leisure and pleasure industry) which operates largely on a cash system. However, the professional establishments which are now to be covered by service tax generally operate on an accrual system. Services may be rendered over a long period of time. As such, there would be a time lag between the rendering of the service and the issuing of an invoice for that service. At which point of time would service tax be chargeable? Other administrative difficulties may arise due to the nature of such professional establishments. How would irrecoverable debts (on which service tax has been paid) be dealt with? What if turnover falls below the prescribed limit towards the end of the year and service tax has already been collected from clients? These practical difficulties would have to be resolved in a dialogue with the Royal Customs & Excise Department.

Finally, in the case of services provided to foreign corporations, service tax would have to be charged by a prescribed professional establishment. In the case of Malaysian insurance companies, this could affect their overseas competitiveness. There is no exemption of service tax in respect of such services.

The broadening of the scope of service tax can be seen as laying the foundation for the eventual introduction of value added tax on the basis that if a large number of goods and services are already subjected to a type of consumption tax, it would be easier to switch over to a value added tax. The proposed change is expected to generate additional revenue amounting to M$ 146 million.

D. *Stamp duty*

Stamp duty on a number of instruments has been abolished with effect from 1 January 1992. This is aimed at reducing administrative costs incurred in recovering rather small amounts of stamp duty.

The instruments on which stamp duty has been abolished are bills of exchange, bills of lading, receipts and transfer instruments of copyright, trade mark and patent. With regard to transfer of copyright, trade mark and patent, the stamp duty was based on the greater of the stated consideration or market value of the property. It is extremely difficult to determine the market value of these transfers. As such, the exemption from stamp duty is largely a measure to avoid the difficulties in determining the value of intellectual property transferred.

Other than the above, stamp duty on instruments of transfer of low-cost houses (other than houses under the Special Low Cost Housing Schemes approved by a State Government or a local authority which are exempt from stamp duty) has been reduced from a maximum of M$ 320 to a maximum of

5. With regard to motor vehicles service and repair centres, it has been clarified by the Treasury that the service tax is to be applied only to labour charges and not to the cost of spare parts.

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M$ 100 for new purchases. Other instruments in connection with such purchases are exempted from stamp duty. These changes are effective from Budget day up to 31 December 1995.

V. OTHER CHANGES

The Government has announced the setting up of the Labuan Development Authority so as to accelerate the orderly development of Labuan as an international offshore financial centre. Certain amendments have been proposed to the Labuan Offshore Business Activity Tax Act 1990 and the Offshore Companies Act 1990. These amendments are not part of the 1992 Budget proposals. The relevant bills were tabled in Parliament before the Budget presentation.

A. *Non-chargeability to tax*

Currently, an offshore company in Labuan carrying on an offshore trading activity (such as banking, insurance, trading, management, etc.) is subject to tax for a year of assessment at the rate of three percent on its net profits within three months (or any extended period as may be allowed by the Director General) from the commencement of that year of assessment to be charged to tax of M$ 20,000.

With effect from the year of assessment 1992, an offshore company in Labuan carrying on an offshore trading activity will not be charged to tax for a year of assessment if in that year of assessment it pays a fee of M$ 20,000 to the Registrar of Companies. However, that offshore company is required to file a statutory declaration in the prescribed form with the Director General within a period of three months (or any extended period as may be allowed by the Director General) from the commencement of a year of assessment.

This amendment seeks to provide more flexibility to offshore companies carrying on offshore trading activities particularly those wishing to dispense with the requirement of paying tax as well as the requirement of filing a return of its profits and its audited accounts. Offshore companies carrying on offshore non-trading activities such as the holding of investments in securities, stock, shares, loans, deposits and immovable properties continue to be exempt from tax.

B. *Requirement for an audit*

Currently, an offshore company is required to appoint an auditor within 90 days of its incorporation. It is now proposed that an offshore company will not be required to appoint an auditor unless it carries on the business of offshore banking or offshore insurance, or it makes a public offering of its shares or debentures or accepts deposits from any member of the public.

To enjoy the exemption from an audit, the members of the offshore company must resolve at a meeting of the members that an appointment of an auditor need not be made in respect of each financial year.

This proposal is obviously made to enhance the attractiveness of Labuan as an international offshore financial centre particularly as other well-known centres such as the British Virgin Islands and the Cayman Islands do not have any audit requirements. It would also appear that if an auditor is not appointed, there is no requirement to lodge accounts with the Registrar of Companies.

C. *Shareholding and directorship*

Currently, a Malaysian resident is prohibited from holding shares in an offshore company. Exceptions to this general rule are: a trust company which may hold shares in an offshore company in a nominee or trustee capacity; and domestic banks and insurance companies which are permitted to hold shares in a subsidiary licensed to carry on the business of offshore banking or offshore insurance. Further, only an officer of a trust company may act as a resident director of an offshore company.

It is proposed that a Malaysian bank or insurance company be permitted to hold shares in an offshore company. Further, Malaysian-owned offshore banks and offshore insurance companies may now appoint resident directors who are not officers of trust companies.

D. *Restrictions on deposit-taking and lending of money*

Currently, an offshore company is not permitted to accept deposits from or to lend money to Malaysian residents. It is proposed that this restriction be lifted so that a licensed offshore bank will be allowed to accept deposits from and to lend money to Malaysian residents. The proposed change seeks to promote the development of offshore banking business in Labuan by allowing Malaysian residents to deposit and to borrow money from licensed offshore banks in Labuan. This is a very significant amendment as interest earned from deposits made by residents in a Labuan offshore bank is specifically tax-exempt.

E. *Exemption from compliance with legislation*

Current legislation does not exempt any offshore company from complying with the Offshore Companies Act and any other written law. Under the proposed amendments, the Minister is empowered, on the recommendation of the Registrar of Companies, to exempt any offshore company from complying with any of the provisions of the Offshore Companies Act. Further, the King (the Yang Di-Pertuan Agong), by order published in the Gazette, may provide that any written law shall not apply to an offshore company, a trust company, offshore bank or offshore insurance company. The proposed legislation will allow a greater degree of flexibility to users of Labuan. They may now be able to apply for a waiver from compliance with the companies legislation or any other written law in the event that such law is found to be too cumbersome or onerous in their particular circumstances.

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VI. CONCLUSION

As stated by the Honourable Minister, prudent financial management and a fiscal and monetary policy that controls inflation and improves the balance of payments will help ensure the continuing success of the nation. However, inflation will continue to exist as long as demand exceeds supply. A prudent expenditure policy is also followed whereby priority in the allocation of funds is to be given to productive projects. It is noted that inflation is also due to psychological factors or the expectation of price increases. Greater consumer awareness may help to overcome this. The fight against inflation is not only the Government's problem. All of us have a role to play, the most important of which is to practice moderation in our spending patterns.

The deficit in the services account of the balance of payments is high. No specific measures were stated in the Budget other than the setting up of a Cabinet Committee on Services which will coordinate policies relating to the development of the services sector.

The proposals in the 1992 Budget are an attempt at managing an economy that has recorded solid growth over the last four years. Overall, the measures introduced are in line with the prudent policies announced in the past. It sets the stage for sustained economic growth in the future.

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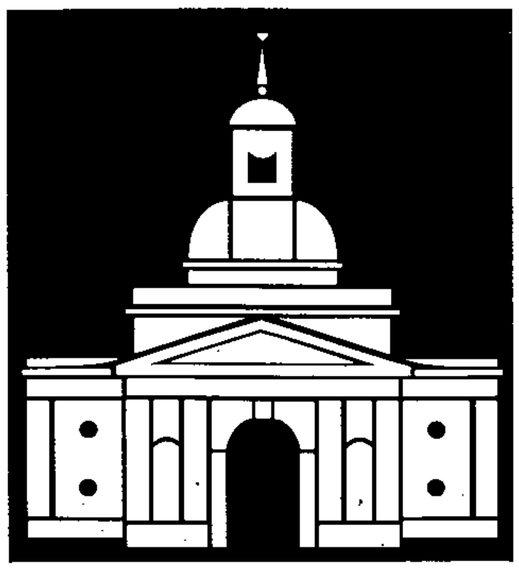

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INTERNATIONAL:

TAX ADMINISTRATION CONCERNS IN THE REFORM OF SUBSTANTIVE PERSONAL INCOME TAX LAW IN EMERGING ECONOMIES[1]

Richard Gordon

I. INTRODUCTION

The first key to effective income tax administration lies in the design of the substantive income tax law itself. This fact is particularly relevant when the tax being reformed is in a developing country, where administrative resources tend to be particularly limited. Concern for the administration of the income tax should therefore always play an important role in the process of reform of a developing country's substantive tax law.

There are a number of areas in which reform of the substantive tax law can significantly improve administration. In general, the most successful reforms result in three important benefits: they reduce the complexity of the system, they reduce tax administrator's dependence on those facts which were difficult to verify, and they reduce the number of individuals who were required to file returns (McLure and Pardo R., 1991).

Particularly with regard to developing countries, the most important role of the first two benefits, i.e. simplicity and reliability, is to permit the last, i.e. reducing the number of filers. The fewer the number of people who must themselves file returns (including those people whose final income tax is remitted by their employer, and who themselves do not have to file returns), the fewer the number of returns which must be processed, the fewer the number of refunds which must made, and often, the fewer the number of audits which will be required.

A. *Complexity*

The "simplification" of substantive tax law is often presented as a primary method in easing tax administration, and is often a starting point in modern tax reforms. While eliminating special tax "incentives" usually results in a law which is easier to administer, reducing the overall theoretical complexity of the law may not. For example, the theoretically least "complex" income tax system would tax a flat percentage of every person's "global income", that is, the actual net accretion to wealth, plus consumption, of an individual over a specific period of time. Many tax policy experts would contend that such a system would be optimal from an economic perspective.

Of course, determining actual global income would be virtually impossible, and such a system would therefore be unadministrable. Special provisions would be necessary which would approximate, defer and exempt certain types of income. In order to do so, elaborate definitions of what income would be treated specially, and how such income would be treated, would be required. Such a system might also be unwise from the viewpoint of certain compelling policy reasons; graduated tax rates, for example, may be chosen as a way of reducing inequality, or at least the perception of inequality, in an economy. These complexities in the theoretically simplest and purest income tax, however, should only be added when administration would be simplified or when there are compelling policy reasons to do so. Other complexities should be avoided whenever possible.

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1. This essay will appear in an edited version with the tentative title "Administration Concerns in the Reform of Income Tax Law: Comments Regarding 'Improving the Administration of the Colombian Income Tax, 1986-88' by Charles E. McLure and Santiago Pardo R." in Richard Bird and Milka Casanegra de Jantscher, eds., *Tax Administration and Tax Policy* [tentative title] (Washington, D.C.: International Monetary Fund, forthcoming 1992).

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When looking at the initial design of the tax system, one of the most important aspects of tax "simplicity" is the treating of all taxpayers and all income as alike as possible. By so doing, incentives for shifting income from taxpayer to taxpayer, or from type to type, are reduced. This also reduces problems regarding defining different types of taxpayers or income.

In most cases, treating different taxpayers as alike as possible includes keeping the number of marginal tax brackets relatively small. Also in most cases, treating most different characters of income alike includes eliminating deductions and credits which are not a legitimate part of determining real income. As suggested above, different taxpayers cannot always be treated alike. Most tax jurisdictions conclude that a zero bracket, and at least a small number of graduated rates, are desirable. Although graduated rates complicate administration (and although they rarely result in much progressivity in actual practice) (Bird, 1991, p. 318), they nearly always constitute a compelling policy reason for violating the first simplicity principle.

Treating all forms or characters of income alike can also result in substantial administrative problems. For example, capital gains can usually only effectively be taxed on realization. Because the timing of realization is often under the control of the taxpayer, deductibility of capital losses must normally be limited in some way to net capital gains. If not, taxpayers would tend to realize losses and not gains. Other examples of determining and verifying certain types of income make their inclusion in a "global pot" highly problematic.

There are also substantial administrative problems, in addition to policy concerns, in treating all taxpayers alike. Individual taxpayers at the higher end of the income spectrum normally owe more in tax than do individual taxpayers at the top. It is therefore usually preferable for tax administrations to expend more resources in evaluating and confirming an upper income individual's income than a lower. In sum, the process of simplification of income tax administration often requires making exceptions to the rules of taxing all taxpayers and income alike.

Reducing the tax administrator's dependence on those facts which are difficult to verify, and reducing the number of individuals who are required to file returns, are important factors in improving the ease of administration. In effect, accomplishing these two objectives also means making exceptions to the "treat alike" rule (although in some of the examples cited by the authors, it also means sticking to the "treat alike" rule).

Even if the substantive law levies taxes on a more or less global basis, administrations are usually forced to make the exceptions outlined above: administration must stray from the letter of the substantive law. As a result, even a theoretically "global" income tax, because of administrative constraints, becomes an essentially schedular tax. Bird notes that, in most countries, there are four 'income' taxes: "(1) a more or less progressive tax imposed through a withholding system on money wage income in the modern sector; (2) a set of more or less effective levies on the self-employed; (3) flat-rate withholding taxes on certain forms of capital income; and (4) a tax on the profits of large, especially foreign, business." (Bird, 1989, p. 328).

Part of the process of designing an administrable substantive income tax is recognizing those areas where administrative constraints require changes in the global nature of an income tax, and designing those changes so as to keep the straying from the global tax to a minimum. First, as will be discussed at greater length below, in some instances it is possible to limit the schedular nature of the tax only to certain minimum amounts of income, or only to certain groups of taxpayers. This would tend to minimize the "straying".

Second, there are substantial benefits to writing administrative practice into substantive law. In general, it provides for less discretion, allowing for a more predictable and organized administration, less chance for bribery and less chance for political manipulation (Bird, 1989, Gordon, 1988, p. 11).

B. *Approximation*

One of the most important methods of reducing administrative complexity is to substitute approximations of certain types of income for actual income, and to restrict the applicability of those approximations (or restrict their effect) to certain taxpayers. As discussed above, while tax policy theory suggests that an income tax should be based upon the taxpayer's global income, the accurate measurement of global income can often be difficult. In general, the greater the accuracy of measurement, the more emphasis will be placed on facts which will be difficult to verify, and which will vary from individual to individual. Other things being equal, the rougher the approximation of income, the easier the system will be to administer.

Individuals will normally have income from various sources. The process of approximating income and collecting tax will involve two steps. The first will be to make relatively accurate assessments of some types of income. The second will be to approximate other types of income. In many instances, "approximation" will involve exempting certain amounts of certain types of income (Bird, 1983, p. 4).

First, in order to make accurate assessments of income with ease, that income must be relatively easy to identify and verify. Tax on that income must also be relatively easy to collect. As will be discussed below regarding employment income, with regard to most taxpayers, virtually all of their income will fulfil these criteria.

It should be noted, however, that it will not always be easy to identify and verify all substantial sources of income. In some cases, large amounts of income will not be easy to identify. In those instances either approximation (and simplified collection techniques) or relatively difficult, expensive and time consuming evaluation and collection techniques will be required.

Second, whenever possible, approximations should be concentrated on those types of income which are relatively small in size, and which constitute a relatively smaller part of the taxpayer's total income. As one might readily guess, in most instances, if the income fulfils the first criteria, it will fulfil the second. Though this will not always be possible, it should be the goal.

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Individuals at the lower end of the income spectrum not only receive a relatively smaller amount of income compared to those at the top, but also normally pay reduced rates on that income. In general, for them, approximation of the tax base will have less of an effect on taxes due than would approximation of the tax base of wealthier individuals. This frequently makes them an appropriate subject for income approximation. In contrast, taxpayers at the top of the income spectrum should normally be less subject to income approximation. In most cases, this means that a smaller percentage of their total income should be subject to income approximation.

Of particular importance is the fact that there are fewer taxpayers at the top of the income pyramid than at the bottom. Relatively speaking, by limiting income approximations to taxpayers from the relatively lower income groups, and by making more accurate income evaluations of taxpayers from the relatively higher income groups, the number of taxpayers whom the tax administration would need to examine carefully would be limited.

Therefore, tax policy theory would suggest that, in the trade off between accuracy and ease of administration, income approximations should be limited to (1) smaller amounts of income, (2) a smaller part of a taxpayer's total income, and (3) to the lower proportion of income earners. On the other hand, a more accurate measurement should be made of income (1) which is relatively easier to assess and verify, (2) which is relatively large, (3) which constitutes the majority of a taxpayer's income, and (4) which is earned by wealthier taxpayers. While many of these criteria virtually always coincide, not every one can always be satisfied. In general, however, they should be used as guides in making tax policy choices.

When referring to "income", it should be understood that income is equal to gross income minus deductions. Those issues regarding verification and approximation of gross income also apply to deductions. Deductions are discussed in greater detail below.

C. *Wage income*

Certain types of income are relatively easy to identify and verify, and on which taxes are easy to collect. Such income does not need to be approximated. The most important is wage income. Depending upon how much of an economy is organized into entities, and the extent to which the organized sector is concentrated in relatively larger firms, wages can constitute a substantial portion of an economy's personal income. At the relatively lower end of the economic spectrum, they often constitute virtually all of a taxpayer's income.

Salary income is usually easier to verify than other types of income. Companies can be required not only to report gross wages to the taxation authorities, but to calculate the amount of tax actually due. If the taxpayer has no other income or deductions (a big if, which is addressed below), the company's calculation will equal the employee's final tax due. The company can then remit the taxpayer's final income tax due as part of a wage withholding system, making the filing of a return by the employee unnecessary. In effect, the taxpayer need have no contact with the taxation authorities at all. The employer acts as a "mini-assessing authority" for the government (Bird, 1982, p. 8).

Audits at the company level are easier and more efficient to perform than audits at the level of the individual taxpayer. Deductions at the company level for wages paid are linked to the amount of wages declared as income to the employee, and the relative ease of audit means that substantial tax penalties for misreporting employee wage income have a deterrent effect.

Therefore, companies should be required to compute, withhold and remit income taxes due on wage income of employees. Which entities should count as "companies" for withholding purposes is an empirical question. Often, the answer is any entity registered or incorporated, or any entity with more than a small number of employees, or any entity with a capital value or turnover in excess of a small amount.

The obvious problem with treating withholding tax on wages as a final tax lies in the phrase "if the taxpayer has no other income or deductions". However, in most cases the lion's share of most taxpayers' income will be employment income, and deductions will be few. The treatment of non-wage income, and of deductions, is addressed further below.

Another problem arises when an employee has more than one salaried employment. In a system without graduated rates (including a zero rate) of income tax, this would not be a problem. However, the existence of graduated rates means that a single taxpayer would often owe more tax on the same income if earned by two different taxpayers.

In systems which maintain substantially graduated rates, and where multiple wage employment is common, this problem can be alleviated by requiring the taxpayer to provide information to his employers about his other employment. Although this complicates the system somewhat, the use of uniform taxpayer ID numbers and simple cross-checking may make the administrative burden less onerous. How effective this technique would be will depend on facts unique to the economy, including the degree of concentration of the wage economy into a limited number of firms, the extent to which salaried individuals work at different jobs, the completeness of taxpayer ID records and the degree of computerization of the tax administration.

Many tax jurisdictions use certain taxpayer specific criteria to reduce tax on those taxpayers, such as number of dependent children. If supplied by the taxpayer, these criteria could be used by the employer to compute total tax owed. As discussed above, distinctions among different taxpayers should be avoided wherever possible. This is particularly true when the information is hard for the employer, and the taxation authority, to verify.

In certain circumstances, however, policy planners will insist on deductions based on such information. One way of reducing any problems caused is to disallow an amount of cumulative deductions. The technique of limiting deductions in this way, which is really a variation on approximating income, is discussed at greater length below. When the deduction is based on information which is difficult to verify, a specific

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limit on the amount of deduction can also be helpful. For example, a deduction could be allowed for each child, up to a limit of two. It might then simply be assumed that everyone will declare two deductions.

D. *Business income*

It is much more difficult to estimate the income of farmers, sole proprietors and small partnerships. When a taxpayer's total income consists of only a small amount of business income, it might make sense to exempt from tax a small amount of business income. As suggested earlier, excluding income from the tax base is merely another method of approximating income. The issues involved in excluding minimum types of income are discussed at great length below.

Taxing business income in excess of the exempt amount is more problematic than taxing employment income. It will require some contact between tax administrators and taxpayers, in that there is no easily identifiable middleperson to asses the amount of tax due and to collect it.

One possible alternative to this is to enact withholding on certain types of payments to the taxpayer. Withholding would not only serve as a mechanism for ensuring that tax payments are remitted, but would also serve as an approximation of tax due by the taxpayer. Estimates can be made as to the average profit made on a particular input (e.g. purchases) or output (e.g. sales or services). Tax can then be withheld, on a gross percentage basis, of the cost of that input or output in an amount equal to the estimated profit. The sum of gross withholding taxes could be treated as a final tax. Which inputs and/or outputs should be subject to withholding will depend on the particular facts and circumstances unique to the economy. However, inputs and/or outputs of businesses which normally have income which is relatively greater than those at the bottom of the income spectrum, but who are particularly hard to tax, might be good subjects for such withholding taxes. Those might include the income from the major professions, as well as contractors (Gilson, 1984; Soos, 1991).

It should be noted that, in most instances, the general applicability of withholding will ensure that any "exempt" amount of business income would in fact be subject to tax anyway; in such instances the tax authority might choose to allow smaller taxpayers to prove that their tax owed is less than the amount of gross withholding taxes. In some instances, however, no inputs or outputs may in fact be subject to any kind of gross withholding tax. In such cases, the income would, in essence, be exempted from any tax.

As suggested by the general principles of income approximation, estimates of business income should be relied upon less when it is relatively large or constitutes a large percentage of the taxpayer's income, or constitutes income of taxpayers at the upper level of the income spectrum. Of course, the exemption discussed earlier accomplishes some of this. But gross withholding taxes should therefore not serve as final tax on large amounts of business income, although they can serve as a minimum tax, at least in some cases.

Taxpayers with sufficiently large amounts of business income should be required to keep detailed books of account. The income of such taxpayers would, if large enough, justify the difficult and time consuming audits necessary to verify the taxable income computed by the taxpayer.

For taxpayers whose business income lies between the exempt amount and the amount for which "books of account" would be required, it will often make sense to make approximations of income more accurate than withholding but less complicated than keeping books of account. Such approximations would be based upon simple and relatively easily verified facts, such as a *forfait*-style system. These approximations could also serve as a minimum tax for the "books of account" cases. In some instances, one might want to give taxpayers the opportunity to challenge the forfait-type approximations, although methods might be devised to discourage this. The cut-off amounts for exemption, approximation, and "books of account" systems, as well as the methods of implementation to be used, need to be determined by an empirical analysis of the facts in the particular economy.

E. *Exclusions*

The first and most obvious type of exclusion is the zero tax bracket. Excluding the lowest income earners from the income tax system entirely can eliminate a large number of filers. However, in excluding these taxpayers, attention must be paid to the operation of any withholding system. As noted above, withholding can serve as a method of approximating income tax due as well as a method of ensuring collections. Withholding on payments made to income tax exempt taxpayers would still act as final gross taxes, an issue discussed in greater detail below. The refunding of such withholding would necessarily complicate tax administration, and require the exempt taxpayers to file.

One of the advantages of salary income is that the company can determine the amount of gross wages to be paid to an employee over the course of the year. However, income received outside of the employment context cannot easily be taken into account by the employer. This problem can be dealt with by having the taxpayer report all income to her or his employer, if he or she had one. The employer could then adjust withholding, using a PAYE system. In such systems, in effect, the employer really becomes the tax administrator. But such a system creates a number of problems. Verifying that the employee has in fact reported all income to the employer can be difficult indeed. A substantial amount of additional paperwork would be involved between employee, employer and tax administration.

However, excluding at least some of such income from the income tax base would constitute an administratively easier method of solving the problem. This has already been suggested above with regard to business income. Employees at the lower end of the income scale are unlikely to have much income outside of their salary or part-time business income. By excluding such income from tax, only the employees' salary income would be subject to tax. This would greatly increase ease of administration.

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Probably the most common form of such income is bank interest. As noted above, part-time business income may also be important. In some economies, dividend and capital gain income is also important, particularly where mutual funds are a common form of investment for those taxpayers at the relatively lower end of the income scale.

Other forms of non-employment income, such as rent or royalties, are likely only to be earned by a relatively small number of people, or are likely to be earned only by upper-income wage earners. In the case of such income, the administrative benefits of exclusion are unlikely to outweigh other considerations; they therefore need not normally be subject to an exclusion. The one exception to this rule might be imputed rent on owner-occupied housing.

Relying again on the principles of income approximation outlined above, non-employment income should be excluded (1) only if it is small, (2) only to the extent to which it constitutes a relatively small portion of the taxpayer's income, and (3) so that, where possible, it primarily effects taxpayers from the lower end of the income spectrum. The exclusion amount should be set low enough to satisfy the above criteria, but high enough to ensure that most taxpayers do not need to file returns. In that way, lower-income taxpayers for whom a substantial percentage of their total income constitutes non-employment income would still be taxed on a substantial portion of that non-employment income. Upper-income taxpayers, whose income normally includes a substantial amount of non-employment income, would be taxed on most (relatively speaking) of that non-employment income. Estimation would be largely confined to the lower-income taxpayers. However, estimation would be confined only to a relatively small proportion of the lower-income taxpayer's income. Administrative resources would be concentrated on a more accurate evaluation of the real income of upper-income tax payers, who are fewer.

Withholding tax on interest and dividends would act as a final gross tax on the exempt amount. Capital gains would go untaxed for the exempt amount. In most instances, a single fixed amount of exclusion should be set for the sum of interest, dividends and capital gains. In other instances, separate amounts might be set for each category.

In income tax systems where company and personal income taxes are integrated at the top personal bracket rate, it may be wise to exempt all dividend income of individuals. The net result would be that all dividend income would be "withheld" upon at the company level at the highest personal rate. While lower-income taxpayers would invariably be over-taxed, and upper-income taxpayers occasionally over-taxed, the administrative benefits would be substantial. Largely because lower bracket taxpayers are more likely to have interest income than dividend income, interest income is usually withheld at a rate lower than the top personal marginal rate. Therefore, it would usually be unwise to exempt all interest income from income tax and treat the withholding tax as final. The question of withholding taxes on periodic income is addressed again below.

However, the optimal nature and size of fixed exempt amounts of income, and of withholding tax rates, can only be determined by an empirical analysis.

F. *Deductions*

As is the case with gross income, deductions of expenses related to the earning of income, as well as deductions for special incentives, create two problems. Deductions may be difficult to verify, and by allowing deductions, income computation is made more complex. Also as with the case of gross income, deductions can be estimated and limited, particularly with regard to the smaller portion of a taxpayer's income, and to relatively lower-income earners.

First, as is discussed above regarding PAYE systems, deductions which have little or no economic basis (meaning that they are no legitimate expenses in the earning of income) should be disallowed. This would apply particularly to deductions which are difficult to verify. In some instances, those tax expenditures which have valid social goals could be replaced with spending, targeted to the intended groups of beneficiaries. They can also be limited in other ways, as suggested earlier.

Some other deductions might also be denied, even though they may have some economic validity. These might include deductions which are likely to have a personal component, or a component which is hard to value and therefore prone to abuse. Expenses relating to passive or investment income, commuting expenses and entertainment expenses usually fall into this category. As is the case with the exclusion of non-employment income, only an amount of deductions in excess of a certain amount should be taken into account by the tax system. The rationale of such a system is nearly identical to the rationale for excluding minimum amounts of non-employment income.

In most instances, a single fixed amount can be set for the sum of all allowable deductions. In other instances, some of which are discussed below, separate limitations might be set for different categories of deductions.

While the exclusion of income from tax is generally likely to be popular with taxpayers, excluding deductions is likely not to be. Therefore, it may make political sense to provide a "general deduction" for taxpayers, up to the excluded amount. Brackets can be adjusted accordingly.

G. *Withholding*

As discussed above, withholding on payments and transactions can serve a number or purposes. First, withholding can help ensure that payments of tax owed under an income tax are actually remitted to the government. Second, withholding can serve as a final tax, acting as a replacement for an income tax. In theory, in both cases withholding rates must be set based upon factual information as to (1) what a particular taxpayer's liability should be, and (2) as to what rate of withholding is likely most closely to approximate that liability.

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First, it is necessary to determine what income should be subject to withholding. As noted above, employment income in firms with over a certain number of employees, and certain payments, should be subject to withholding.

In a system with graduated rates, taxpayers' liabilities should differ based upon their total income (Dixon, 1985, pp. 39-40). Withholding rates should, therefore, vary on the basis of the personal circumstances of any particular taxpayer. The lowest- income taxpayers should suffer no withholding, while the highest- income taxpayers should suffer relatively higher withholding.

With regard to wage income, the personal circumstances of a taxpayer can be taken into account. Withholding at the company level can be based upon the total amount of wages which the taxpayer will earn. But with regard to other types of withholding, it would be administratively difficult to vary withholding based upon the personal circumstances of the individual taxpayer. This makes it impossible to satisfy criterion (1) above in all cases. The problem is compounded by the fact that certain types of income, most particularly interest and dividends, will have an amount excluded from income tax. This means that the withholding tax will serve as a final tax. If it is too high, this tax will result in a heavy burden being born by lower-income taxpayers. However, if the withholding rate is too low, it will mean that upper-income earners will be under-withheld.

There are a number of ways of alleviating this problem. They include adjusting brackets to take into account that lower-income taxpayers might be paying withholding tax on interest or dividends. Other practices, such as exempting the exempt amount of interest or dividends from withholding tax, are very difficult to administer and are prone to abuse. It is probably better to compromise by having a withholding rate which yields an amount less than the amount which should be due for upper-income earners. For upper-income taxpayers, additional tax can be collected when the taxpayer files. One possibility would be to set the rate so that it yields an amount which the average taxpayer would normally owe.

Problem (2), that is, determining the rate of withholding likely most closely to approximate a taxpayer's final liability, is also impossible to determine easily. An income tax is, by its very nature, based on income, not upon gross amounts. One cannot tell with any degree of certainty what a final taxpayer's income will be by looking at any gross amount which contributes to the computation of that income, whether the gross amount be interest, dividends or gross input purchases.

First, some factual analysis can help set withholding amounts. In general, it can be determined that, to most individual taxpayers, interest and dividend income is net income; in a pure global income tax system, interest and dividends would properly be taxed at the taxpayer's marginal rate. As discussed above, the fact that gross amounts will apply as final taxes primarily to taxpayers at the relatively lower end of the income scale suggests, however, that these amounts should be less than the top taxpayer's marginal rate.

The rate of the most typical taxpayer would probably be appropriate for most interest income. The rate for dividend withholding might possibly be set higher, if it is far likelier that dividend recipients would be higher-income taxpayers than interest recipients (Jenkins, Owens and Roxan, 1991, p. 10). However, such a differentiation might set up a disincentive for equity investment, or create an incentive to disguise dividends as interest.

Withholding on other forms of periodic income would also vary with regard to circumstances. Withholding on inputs or outputs in a business enterprise can be even more problematic. Empirical analysis is of even greater importance here.

H. *Loss limitations*

There are a number of other approximations which often help in making an income tax system more easily administrable. One, discussed earlier, relates to the usual "realization" requirement before capital gains or losses are taken into income. Because taxpayers may control realization events, a limitation on the deductibility of capital losses – allowing them only to be deducted up to the amount of capital gains – restricts the ability of the taxpayer to realize only losses.

Other limitations include restricting the deductibility of business costs and expenses only against business income, passive losses against passive income or foreign losses against foreign income. In these instances, restrictions on loss limitations usually makes it easier for a tax administration to avoid repeated detailed investigations as to the economic validity of the losses.

II. SOME TECHNIQUES FOR ENFORCING THE SUBSTANTIVE LAW

Part of the process of enforcing the substantive law is implicit in the substantive law itself. In fact, the line between substantive law and administration is difficult to draw. The use of withholding, for example, is neither clearly substantive nor administrative. Depending on different statutes, one will find withholding provisions either in the income tax law itself, or in the section on administration.

Many of the at least nominally substantive tax law changes outlined above involve the use of income approximation, particularly for those at the lower end of the income scale. The different types of approximations, based on exclusions, withholding and certain types of loss limitations, are based both on character and on total amounts of income. In general, the goal is to reduce the different types of information needed to assess tax due, and, in turn, to make it unnecessary for large numbers of taxpayers to file returns.

This short section will mention only a few techniques which have a substantive air about them.

A. *Verification*

Verification of the information still relevant to the tax administration will always be necessary (McLure and Pardo R., 1991). For the lower end of the income level, this will often

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mean verification of employment income, an issue discussed above. But it is also necessary to verify who actually inhabits the lower end of income distribution.

Withholding allows the taxation authority to collect at least some of the income which is likely to be owed to the government. In some cases it also allows for a final approximation of income tax due. Of equal importance is the reporting of various income producing transactions, particularly the payment of wage and passive income. Such reporting can help tax administrations in verifying how much income should be subject to exclusion, and whether additional tax is due. In most instances, transactions subject to reporting requirements will also be transactions subject to withholding. This may not always be the case, however.

The use of taxpayer identification numbers, and the reporting of income by ID number to the tax authority, can play an important role in this process even in developing countries. A taxpayer ID system can allow some matching of income, particularly employment, interest and dividend income. These numbers can determine whether or not a taxpayer has exceeded various exclusion amounts, and whether they should have filed tax returns. The services of banks can often be used in assisting the tax administration in this task (McLure and Pardo R., 1991).

Reporting of types of transactions involved in business income, along with any withholding, can also help identify taxpayers as to whether they should be filing returns. In all cases, the reporting of transactions by ID number can be of use when verifying the returns of taxpayers who exceed the amounts for exclusions and who should be filing.

There is always the danger that tax administrations might be flooded with information that they cannot efficiently use. There are great benefits in a requirement that information be, whenever possible, supplied in machine readable form (McLure and Pardo R., 1991). What information should be reported, as suggested above in the various discussions regarding withholding, would depend on the facts and circumstances of the particular economy.

There are other sources of information, from bank accounts to credit card accounts to notices of real estate transactions. These may indicate where taxpayers have been hiding income which is statutorily subject to tax, and where taxpayers (and perhaps withholding agents) should have filed returns.

B. *Penalties*

I have written in detail about the design of taxpayer penalties (Gordon 1988), and I would refer the reader to that discussion. However, there are a few points which might be emphasized.

Penalties for failure to carry out a legally required act are designed to encourage the taxpayer to carry out that act. Optimal penalties are often expressed in terms of probability of detection and potential tax savings (Mansfield, 1987, pp. 18-19). But, as with any aspect of tax administration, the most effective penalties are those which relate to activities most easily discovered and verified. Therefore, they should be used sparingly to increase the likelihood that transactions which are difficult to discover or verify are brought into the tax net.

Some of the most effective penalties are those which apply to withholding agents: employers, companies and banks. Because the transactions are relatively easy to define, because the amount of tax owed is relatively easy to evaluate, and because the taxpayers are therefore relatively easy to audit, stiff penalties can act as a substantial deterrent effect. With regard to most withholding agents, investigation for failure to carry out withholding and reporting requirements is often quick and easily resolved.

Interest penalties are not "penalties" at all, but are adjustments designed to ensure that neither taxpayer nor tax authority gains the time value of money from a delayed payment or refund. However, an interest-like penalty can be used to encourage taxpayers to settle disputes. A sliding scale of penalties has sometimes been suggested, depending on when taxpayers settle claims. Another possibility is to base the applicable penalty on a multiple of the applicable interest rate. This would ensure that for each day a taxpayer failed to settle, his or her penalty would increase at a rate greater than the cost of money.

III. CONCLUSION

The design of the substantive income tax law can play an absolutely crucial role in determining the ease of tax administration. To rephrase Milka Casanegra de Jantscher, Director of the Tax Administration Division of the Fiscal Affairs Department at the International Monetary Fund, tax policy is (also) tax administration.

The design of a tax law requires not only the identification of effective ways of easing implementation, or of the careful scrutiny of facts unique to the particular economy. It also requires careful legislative and administrative drafting. As the process of tax reform continues, the process of identification of methods, examination of facts, and drafting of provisions, will continue to improve..

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PEOPLE'S REPUBLIC OF CHINA:

THE IMPLEMENTING REGULATIONS FOR THE NEW CONSOLIDATED INCOME TAX ON FOREIGN INVESTMENT

Jinyan Li

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The October 1991 issue of the *Bulletin* featured an article by this author which discussed the new income tax on foreign investment in China – the Law of the People's Republic of China Concerning Foreign-Invested Enterprises and Foreign Enterprises (the "Tax Law").[1] The present article discusses the Detailed Rules and Regulations for the Implementation of the Tax Law (the "Regulations") which were issued by the State Council on 30 June 1991 and came into effect on the following day.

The new Regulations contain 114 articles; although rudimentary by the standards of developed countries, they nonetheless represent the most comprehensive and sophisticated tax legislation in China since 1949. Many of the principles reflected in tax treaties and international tax practice are found in the Regulations, which have not only consolidated the implementing rules for the Joint Venture Income Tax Law (JVITL) and the Foreign Enterprise Income Tax Law (FEITL) and other regulations issued by the State Council, but have also clarified many of the confusing and ambiguous aspects of the previous legislation. This article discusses the most salient aspects of the Regulations, including the definition of "establishment", the computation of taxable income, transfer pricing rules, the non-resident withholding tax system, tax incentives, the foreign tax credit, and tax administration with respect to the consolidation of income and losses among branches and establishments.

I. TAX JURISDICTION

Foreign-invested enterprises (FIEs), including Chinese-foreign equity joint ventures, cooperative joint ventures and wholly foreign-owned enterprises, are taxed on their worldwide income under Article 3 of the Tax Law. Foreign enterprises carrying on business in China through an establish-

1. See Jinyan Li, "The New Income Tax on Foreign Investment", 45 *Bulletin for International Fiscal Documentation* (October 1991), at 482.

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ment or deriving investment income in China are taxed only on Chinese source-income.

A FIE is, in effect, taxed as a resident of China if it maintains a head office in China and has the status of a legal person under Chinese laws. A "head office" is defined in Article 5[2] to mean the central establishment set up in China by a FIE to be responsible for the operations, management and control of the enterprise. Article 4 of the Chinese Civil Code recognizes equity joint ventures, cooperative joint ventures and wholly foreign-owned enterprises as legal persons if they are established in accordance with Chinese laws,[3] possess the necessary property or funds, have their own name, organizational structure and premises, and are able to assume civil obligations independently.

Under the Cooperative Joint Venture Law, however, a cooperative joint venture may or may not be incorporated as a legal person. Under Article 7, the joint venture is a partnership rather than a legal person, the parties to the venture are taxed separately, although they may, with the approval of the tax authorities, elect to have the venture taxed as one entity. If the election is not made, the foreign party is taxed as a foreign enterprise carrying on business in China through an establishment. If the joint venture is incorporated as a legal person, the venture itself is a taxpayer for tax purposes, and the parties do not have the option of being taxed separately.

II. DEFINITION OF ESTABLISHMENT

The term "establishment" is defined in Article 3 to include "management offices, business sites, offices, factories, places of extraction of natural resources, sites for contracted projects such as construction, installation, assembly or exploration projects, sites for the furnishing of services, and business agents".

The current definition is broader than the definition under the previous FEITL and regulations in two important respects. First, the list of examples of establishments or sites in China that give rise to tax liability has been expanded to include sites for the furnishing of services, including consultancy services. It should also be noted that there is no requirement that a site for the furnishing of services be in operation for any minimum period of time. China's tax treaties, which are based on the OECD and U.N. model conventions, normally limit China's jurisdiction to tax non-resident companies that provide consultancy services in China to situations where such services are provided in connection with a single project for an aggregate period of six months or more within a 12-month period.

Second, Article 4 defines the term "business agent" in accordance with the provisions of China's tax treaties. The previous legislation used the term business agent, but did not define it, and in practice Chinese tax authorities rarely relied on the term. A foreign enterprise is deemed to have an establishment if an agent in China

- habitually negotiates purchasing matters, concludes purchase contracts and purchases commodities in the name of the foreign enterprise;
- has concluded an agency agreement with the foreign enterprise and habitually stores products or commodities belonging to the foreign enterprise and delivers such products or commodities to third parties on behalf of the foreign enterprise; or
- has authority to conclude sales contracts or to accept orders in the name of the foreign enterprise.

This definition of business agent lowers the threshold of Chinese tax jurisdiction over business income earned in China by a non-resident. If strictly enforced, it may significantly increase the risk of Chinese taxation of foreign companies conducting trade in China through an agent. By not distinguishing between dependent and independent agents, the definition of business agent is also broader than the definition of permanent establishment contained in China's tax treaties. Under the treaties, the activities of dependent agents normally give rise to a permanent establishment of the non-resident principal, whereas the activities of an independent agent do not unless the agent is an exclusive agent and habitually exercises the power to conclude contracts on behalf of the non-resident.[4] Furthermore, the treaties do not deem a non-resident to have a permanent establishment in China if the non-resident maintains a fixed place of business solely for the purpose of storing, displaying, delivering or purchasing goods or merchandise. Consequently, it may be advisable for a multinational corporation to have the purchase and sales transactions conducted through a company resident in a treaty country rather than a company resident in a country or territory which has no treaty with China.

III. COMPUTATION OF TAXABLE INCOME

A. *Basic concepts*

Article 1 of the Tax Law provides that a FIE is taxable on its income from production, business and other income. Article 2 defines "income from production and business" to include income from manufacturing, farming, transportation, construction trading, financing and services, and other trades. "Other income" includes profits (dividends), interest, rentals, gains from the disposition of property, income from the provision or assignment of the right to use patents, proprietary technology, trade marks, copyrights (i.e. royalties) and non-operating income.

1. Taxable income

Taxable income of a taxpayer is the amount of revenue for each taxation year less costs, expenses and losses.

2. Taxation year

Article 7 requires that the taxation year be the calendar year. Where a taxpayer experiences difficulty in computing its tax-

2. Where the name of the legislation is omitted, the provision referred to hereinafter is from the Regulations.
3. For instance, the "Law of the People's Republic of China on Chinese-Foreign Joint Ventures", promulgated on 1 July 1979; the "Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures", promulgated on 13 April 1988; and the "Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital", promulgated on 12 April 1986.
4. Jinyan Li, "The Concept of Permanent Establishment in China's Tax Treaties", 7 *International Tax & Business Lawyer* (1989) 120.

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able income according to the calendar year, the taxpayer may apply to the local tax authorities for approval to use its own 12-month fiscal period as a taxation year. A short taxation year is permitted where the taxpayer commenced or terminated its business in the year or in the case of reorganizations.

3. Accrual method of accounting

Article 11 requires taxpayers to compute income on an accrual basis. In case of hardship where payments for goods and services are deferred to future years, the Regulations allow the recognition of revenue to be deferred in the following situations (apparently at the election of the taxpayer):

- where goods are sold against payment by instalments, sales revenue may be recognized on the date of delivery or the date of issuing the invoice, or alternatively, the revenue may be deemed to be realized on the date due for payment under the purchase and sales contract;
- where a construction, installation or assembly project, or provision of services continues for a period exceeding one year, revenue may be realized according to the portion of work completed during the year; and
- where the processing or manufacturing of large machinery, equipment, vessels, etc. for an enterprise lasts more than a year, revenue may be determined based upon the work in progress or the portion of work completed during the year.

In the case of cooperative joint ventures, if the joint venture agreement provides that parties to the venture share products instead of profits, Article 2 deems a party to have realized income when it receives its share of products at a price equal to the market value of the products.

4. Net income

Article 4 of the Tax Law defines taxable income as the amount of income after deduction of costs, expenses and losses. This definition is expanded in the Regulations, which require income to be computed on a source basis. For purposes of computing income, Article 10 makes a distinction between enterprises engaged in manufacturing industry, commerce, service trades and other activities:

- for taxpayers in the manufacturing industry, taxable income[5] is equal to the amount of profit from product sales *plus* other business profit *plus* non-operating revenue *less* non-operating expenditure;[6]
- for taxpayers in commerce, taxable income is equal to the amount of sales profit *plus* other business profit *plus* non-operating revenue *less* non-operating expenditure;[7]
- for taxpayers in service industries, taxable income is equal to the amount of net business revenue *plus* non-operating revenue *less* non-operating expenditure; and
- income of enterprises engaged in other trades or activities is computed by reference to the criteria noted above. Income from property, such as rent, can presumably be computed by deducting expenses from income.

If a taxpayer is unable to submit complete, accurate evidence of its costs and expenses and accurately to compute its income, Article 16 authorizes the tax authorities to compute its taxable income by using a profit rate determined by reference to the profit rate of other enterprises in the same or similar industries. Article 17 deems the taxable income of foreign enterprises engaged in international transportation to be five percent of their gross revenue derived from the transportation of goods and passengers inside China.

5. Inventory valuation

The rules with respect to calculating income largely follow standard internationally-accepted accounting principles. A clear distinction is made between capital and revenue expenditures, and inventory must be taken at least once a year. According to Article 51, inventory is valued at actual cost, which can be determined according to one of the three methods: first-in first-out (FIFO), shifting average and weighted average, and last-in first-out (LIFO). Once a method is chosen, it may not be changed without approval of the tax authorities.

6. Intercorporate dividends

Article 18 provides that profits received by a FIE from another enterprise resident in China are excluded from the income of the recipient. The term "profit" is not defined for this purpose, but is defined for the purpose of non-resident withholding tax in Article 60 to refer to "income derived by virtue of an investment ratio, equity rights, stock or other non-creditor's right to a share of the profit". Thus, profits are defined as dividends under Western corporate law. Intercorporate profits (dividends) are not taxed in the hands of the recipient in order to avoid any double taxation.

Article 18 also provides that expenses and losses arising from such investments may not offset income from other sources. It is not clear whether such "expenses and losses" refer to those incurred by the shareholder in relation to the disposition of the equity investment (e.g. shares), or to the shareholder's share of business losses of the payer enterprise. If they refer to the former, expenses and losses should be allowed to offset the gains provided that the gains are taxable. The current Tax Law and Regulations do not tax gains from selling shares or other equity rights; therefore such expenses and losses should not be deducted from income. If "expenses and losses" refer to the latter, unless the payer enterprise is a partnership or contractual joint venture and the investor is taxable on its share of profit, such expenses and losses should not be deductible. At the moment, China has no corporate law, and the securities market is in its infancy. There is no

5. The term "taxable income" is used here, although it refers to "net income" that is subject to tax.

6. For the purpose of this formula, the relevant terms are defined as follows: "Profit from product sales" refers to "net product sales *less* cost of product sold *less* sales taxes *less* marketing, administrative and financial expenses"; "Cost of products sold" refers to "current period product cost *plus* opening inventory of products *less* closing inventory of products"; and "Current period product cost" refers to "current period production cost *plus* opening inventory of semi-finished products and products in process *less* closing inventory of semi-finished products and products in process".

7. The relevant terms under this formula are defined as follows: "Sales profit" refers to "net sales *less* cost of sales *less* sales taxes *less* expenses"; and "Cost of sales" refers to "opening inventory of goods *plus* [purchases over the current period *less* (purchase returns *plus* purchase allowances) *plus* purchasing expenses] *less* closing inventory of goods.

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Western-style definition of share ownership, although in practice the Western notion of company law exists in China. An enterprise is treated as an entity independent of its owners. Presumably, shareholders' liability is limited to their equity in the enterprise, and they do not share the business losses of the enterprise. The purpose of Article 18 is probably to entrench the idea of tax-free treatment of intercorporate dividends in anticipation of future developments in Chinese corporate law; at present, it also helps to avoid confusion between equity investment and partnership investment.

7. Capital gains

Chinese law has no separate concept of capital gains, as opposed to other forms of income. The Tax Law and Regulations currently provide that some gains be recognized as income and taxed in the same manner as income from business and property.

"Gains" are defined in Article 61 to refer to the proceeds from the transfer of property (such as buildings, structures, facilities ancillary to such buildings and structures and land use rights) which exceed the original cost of the property. Under Article 1 of the Tax Law, gains are taxable as "other income" if they are derived by a FIE, or if derived by a non-resident, they are subject to non-resident withholding tax. The term "property" is not defined. The Constitution prohibits the transfer of land which is owned by the State or collectives. Apparently, gains from the disposition of other property, such as shares, personal use property and intangible property, are not subject to tax.

The following gains are specified to be taxable as ordinary income:

- gains from the liquidation of a business, which is the net asset value of the remaining property (i.e. the balance of all of the taxpayer's assets net of all debts and losses) to the extent that it exceeds the amount of the paid-up capital (Article 18 of the Tax Law and Article 29 of the Regulations);
- foreign exchange gains and losses that are earned or incurred by a taxpayer in the course of preparing or carrying on production or business operations (Article 23); and
- gains realized from the disposition of depreciable property where the proceeds exceed the undepreciated portion of the cost of the property and selling expenses (Article 44).

B. Deduction of expenses in computing income

1. Current expenditures

Expenditures are classified as capital and current expenditures. Expenditures incurred by acquiring fixed assets or by developing intangible assets are not deductible in the year the expenditures are incurred, but can be depreciated or amortized over the years. Expenditures incurred in the course of carrying on business, such as cost of goods sold, taxes on sales, manufacturing costs, marketing expenses, administrative expenses and financial expenses, are deductible in computing income in accordance with Article 10.

2. Limitations on deductibility

Article 19 lists a number of items which are not deductible as costs or expenses. These are (1) expenditure for the purchase or construction of fixed assets; (2) expenditure incurred acquiring or developing intangible assets; (3) interest on capital (which presumably refers to interest payable on a loan incurred by a party to obtain funds for its capital contribution to the joint venture or wholly foreign-owned enterprise); (4) income tax payments; (5) fines for illegal operations and losses resulting from the confiscation of property; (6) other fines; (7) the portion of losses from natural disasters or accidents that are indemnified; (8) donations other than for public welfare and relief purposes inside China; (9) royalties paid to the head office (normally such payments are not deductible in computing the income of a permanent establishment under tax treaties); and (10) other expenses that are not related to production and business operations.

3. Management fees

Under Article 20, management fees paid to the head office by an establishment in China are deductible if the fees are reasonable and are related to production or business operations of the establishment. Such fees may be subject to withholding tax under Article 67 if they are paid to a non-resident company. A FIE can apportion to its branches the management fees relating to the business of such branches; however, Article 58, which forms part of the transfer pricing rules to be discussed below, prohibits a taxpayer from deducting as expenses management fees paid to its affiliates as expenses.

4. Interest expenses

Interest expenses are deductible in calculating income if they are incurred in connection with the business activities of the taxpayer and the amount of the interest is reasonable. The deduction is subject to approval by the local tax authorities, to whom information concerning the loan and payment of interest must be provided. Interest expenses incurred for acquiring fixed assets or intangible assets are not currently deductible, but can be added to the cost of the assets and be amortized. An interest payment is considered reasonable if the rate is not higher than the rate applicable to ordinary commercial loans.

5. Entertainment expenses

Entertainment expenses incurred for the purpose of earning income from a business are treated as current expenses and are deductible in computing income. The maximum amount of the deduction is limited under Article 22 to either:

(a) 0.5 percent of the net annual sales where sales are 15 million yuan or less, and up to 0.3 percent of the portion of sales in excess of 15 million; or
(b) one percent of the annual business revenue where the business revenue is 5 million yuan or less, and 0.5 percent of the portion of the revenue exceeding 5 million yuan.

Enterprises engaged in industrial manufacturing, construction, commerce and agriculture are subject to the limit in (a) based upon sales income; other businesses, such as hotels,

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restaurants, transportation, and financial and service industries, are limited according to total business income as set out in (b).[8]

6. Wages and welfare benefits

Wages and welfare benefits are deductible if they are paid to employees; payments to foreign social insurance plans on behalf of an employee working in China are not deductible under Article 24.

7. Reserve for bad debts

Articles 25, 26 and 27 are new provisions; they allow taxpayers to claim an annual reserve for bad debts if they are engaged in granting credit, leasing and other similar businesses. Taxpayers engaged in other business activities may not claim this reserve. The maximum reserve that can be deducted in a year is limited to three percent of the year-end balance of funds outstanding (not including inter-bank loans) or of the year-end balance of receivables.

A debt is considered bad when the debtor is bankrupt and the debt cannot be collected after liquidating the debtor's property; the debtor has died, and the debt cannot be collected from the debtor's estate; or the debt is not paid after two years after it becomes due.

When a debt becomes bad, if the actual losses from the debt exceed the amount of reserve claimed in the preceding year, the excess portion of such losses can be deducted from the taxable income for the current year; if the actual losses are less than the preceding year's reserve, the excess portion of the reserve must be included in income for the current year. It should be noted that only the amount of the preceding year's reserve is relevant in determining losses or excessive reserve. There is no requirement that a taxpayer include the amount of reserve claimed in the previous year in income for the current year when a debt remains doubtful. However, in calculating the amount of actual losses from bad debts, the total amount of reserve claimed in the previous years should presumably be taken into account, so that only the portion of the debt for which no reserve has been claimed generates actual losses. If the debt is subsequently fully or partially collected, the amount collected must be included in income in the year of collection.

C. *Depreciation and amortization of capital expenditures*

As mentioned above, a distinction is made between capital and current expenditures; in computing taxable income for the year, no deduction may be made for expenses of a capital nature. However, Part III of the Regulations provides that allowances may be claimed in respect of depreciation of fixed assets and in respect of amortization of certain capital expenditures with respect to fixed business assets and intangible assets.

1. Fixed assets

The term fixed assets is defined in Article 30 to mean "buildings, structures, machines, machinery, means of transportation and other equipment, appliances and tools used for the purpose of production and business operations with a useful life of more than one year". Some assets are deemed not to be fixed assets for the purpose of depreciation if they have a cost of less than 2,000 yuan and are not part of the main equipment used in production and business operations, or if they have a useful life of less than two years. The cost of acquiring such assets can be deducted currently.

Depreciation of fixed assets is computed on an annual basis. For the purpose of calculating depreciation, fixed assets are valued at original cost. According to Articles 31 and 45, the original cost is determined as follows:

- purchased assets: the purchase price plus freight and installation expenses and other related expenses incurred before they are put into use (such as insurance premiums);
- fixed assets that are manufactured or constructed by the taxpayer itself: the actual cost of production or construction;
- assets contributed as investment in a joint venture or wholly foreign-owned enterprise: the original cost is deemed to be the reasonable value of the assets determined on the basis of their age and pursuant to an investment contract or their value appraised on the basis of the age and market price of the assets, plus relevant expenses incurred before they are put into use; and
- fixed assets that are acquired as a gift by the taxpayer: the original cost is the reasonable price after appraisal.

Under Article 32, a claim for depreciation can begin only when fixed assets are put into use. In the case of offshore oil and gas exploitation, development costs are deemed to be capital expenditures and can be depreciated one month after the oil or gas field goes into commercial production.

Depreciation of fixed assets used by a taxpayer is computed annually on a straight-line basis on the assumption that there will be a residual salvage value of ten percent of the original cost. In other words, only 90 percent of the cost of an asset may be written off. Approval from the local tax authorities must be obtained before a taxpayer may claim a lower (or no) salvage value on an asset. Once an asset has been fully depreciated, no further deduction may be claimed. Additional expenses in respect of a fixed asset, such as substantial repairs or improvements, are added to the cost base of the asset and amortized accordingly. If the useful life of the asset is extended as a result of repairs or improvements, the depreciation period may be extended by virtue of Article 42.

Depreciable assets are grouped into classes for the purposes of depreciation; the period over which each class may be written down is prescribed in Article 35 as follows:

- 20 years for buildings and structures, and the facilities attached to them for use in production and business operations and for the provision of living quarters or welfare services for staff and workers;

8. Ministry of Finance Notice (86) *Cai Shui Zi* No. 331 of 31 December 1986. The interpretation of the previous tax legislation contained in bulletins and notices issued by the Ministry of Finance and the State Bureau of Taxation are expected to apply to the new Tax Law and Regulations since the latter are largely a consolidation of the previous laws and regulations.

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- ten years for railway rolling stock, vessels, machines, machinery and other production equipment, including locomotives, passenger cars, freight cars, motorized vessels and all kinds of machines, production lines and power, and transmission and conduction equipment;
- five years for electronic equipment, means of transportation other than railway rolling stock and vessels, appliances, tools, and furniture; and
- six years for assets used in the exploitation of petroleum and natural gas.

Under Article 40, the State Bureau of Taxation may approve accelerated depreciation in certain cases, such as:

- where machinery and equipment are exposed to highly corrosive materials, or where buildings are in a state of vibration throughout the year;
- where machinery and equipment is in operation 24 hours a day throughout the year; and
- where fixed assets of a joint venture which has an operation term shorter than the prescribed depreciation period of the assets, and the Chinese party to the venture takes title to such assets upon the termination of the joint venture contract.

If used assets are acquired, and the remainder of the useful life of the assets is shorter than the prescribed period of depreciation, the depreciation period is deemed to be the remainder of the useful life of the asset. If an asset remains useful after it has been fully depreciated, no further depreciation can be claimed.

Article 44 provides that where a depreciable asset is disposed of, the taxpayer may either realize a recapture of the previous depreciation deducted if the proceeds of disposition exceed the undepreciated balance of capital cost or residual salvage value and relevant expenses; or realize a terminal loss if the proceeds of disposition are less than the undepreciated capital cost or residual salvage value and expenses. The recapture or terminal loss is treated as income or loss for the year in accordance with Article 44.

2. Amortization for intangibles

In addition to fixed assets, the cost of acquiring intangible assets such as patents, proprietary technology, trade marks, copyrights and site use rights may be amortized on a straight-line basis in accordance with Article 45. The cost of acquired assets is deemed to be the reasonable purchase price. The cost of self-developed intangibles is the actual expenditure incurred on research and development, and the cost of assets contributed as investment in a FIE is deemed to be the reasonable price set out in the investment contract.

Amortization is made over the useful life of the asset from the time it is acquired. The amortization period is specified by the Regulations to be ten years for most intangible assets, five years for start-up costs, one year for offshore oil and gas development and exploration expenses, or the useful life of some asset as specified under an agreement. For instance, in cases where intangible assets are contributed as equity investments or obtained by the taxpayer (and the useful life of which is set forth in the contract), the amortization period is the prescribed useful life period.

Start-up costs, such as incorporation costs, expenses connected with conducting feasibility studies and legal fees, may be amortized for five years after the commencement of production and business operations in accordance with Article 49.

Expenditures incurred in the production of petroleum may be amortized for one year, but only against revenues derived from oil fields that are currently in commercial operation. If the project is terminated because no oil or gas is discovered, the taxpayer can only realize a loss. Because of the high risks involved in oil and gas exploration, the Regulations allow a special deduction of expenses from income generated from a future project of the same taxpayer if the taxpayer has no consecutive contracts for the exploration of oil and gas, and has no establishment in China engaged in similar business but, within ten years from the date of termination of the first project, enters into a new project. There is no provision, however, allowing a taxpayer engaged in exploitation of two or more contract areas to amortize exploration expenses of a terminated area (or areas) against revenue of other areas. It appears that such amortized expenditures could be carried over as a loss to offset income of other establishments or branches of the taxpayer.

D. *Losses*

Current losses are deductible by a taxpayer in computing taxable income. Under Article 11 of the Tax Law, losses incurred by a taxpayer in a tax year may be carried forward for five years; no provision is made for the carryback of losses. No distinction is made between capital losses and ordinary business losses, since capital gains are taxed the same as ordinary income. There is no provision for carryover of losses in cases of corporate reorganizations or where control is changed. Losses realized by one branch can be used to offset income from another branch.

IV. TRANSFER PRICING

The transfer pricing rules of the Tax Law and Regulations are similar to those contained in the tax legislation of many developed countries. Article 13 of the Tax Law requires that FIEs and foreign companies with an establishment in China deal at arm's length with their affiliates. Chinese tax authorities are authorized to make reasonable adjustments where such transactions are not conducted at arm's length and Chinese income tax liability is accordingly reduced.

A. *Definition of "affiliates"*

The term "affiliate" is defined in Article 52 to refer to "a company, enterprise or other economic organization that has any of the following relations with a taxpayer:

(a) direct or indirect ownership or control in terms of funds, business operations, sales and purchases, etc.;
(b) direct or indirect ownership or control of both entities by a third party; and
(c) other affiliate relationships arising from mutual interests".

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Therefore, a company is an affiliate of a taxpayer for the purpose of the Regulations if it owns or controls (de jure control or de facto control) the taxpayer; if it is a sister company of the taxpayer; or if it shares some common interest with the taxpayer such that they do not deal with each other at arm's length.

Transactions that are subject to the transfer pricing rules include purchases and sales, provision of services, lending or financing, leasing, licensing and transferring of property between affiliates. There are no rules concerning the "purpose" of the transaction, "sham" transactions, or "step" transactions.

B. *Determination of "arm's length" price*

Under Article 13 of the Tax Law and Part IV of the Regulations, the Chinese tax authorities may recompute the taxable income of an enterprise if it is determined that an enterprise has reduced its tax liability by paying more or receiving less than the arm's length price in a transaction with an affiliate. An arm's length price is deemed to be the price charged between independent enterprises, that is, between non-affiliated firms conducted at fair prices and in accordance with common business practices.

With respect to purchase and sale transactions, Article 54 provides that the tax authorities may determine the arm's length price by one of four methods. They are set out below in order of preference they are given by the tax authorities:

(a) prices charged for the same or similar business activities where conducted between independent enterprises (the comparable uncontrolled price method);
(b) the profit margins of prices charged to non-affiliated firms for the sale of products or goods purchased (the resale price method);
(c) the cost plus reasonable expenses and profit (the cost-plus method); or
(d) any other reasonable method.

With respect to lending and financing transactions, the arm's length price is deemed to be the "normal interest rate" which is presumably the market rate or the rate that would be used in the absence of the affiliation. For services, the arm's length price is deemed to be the "normal rates charged for similar services", and for the transfer of property or licensing and leasing transactions, the arm's length price is deemed to be the amount that would be agreed upon in the absence of the affiliation.

These methods for determining an arm's length price appear to be borrowed in substantial part from the U.S. income tax regulations (Section 482 of the Internal Revenue Code) and the 1979 OECD Report on *Transfer Pricing and Multinational Enterprises*. It remains to be seen whether these transplanted methods will fully achieve their intended objectives under the different market and regulatory conditions in China. The Chinese tax authorities suffer from a chronic shortage of trained personnel and lack of adequate data- gathering and processing facilities. These problems are certain to impede efforts to deal with the complex issue of transfer pricing.

C. *Information reporting*

Information reporting is required under Article 53. Taxpayers are obliged to provide the local tax authorities with relevant information on prices and expenses in respect of business transactions with their affiliates. Failure to report this information may subject the taxpayer to penalties imposed under the Tax Law.

V. NON-RESIDENT WITHHOLDING TAX

Foreign enterprises deriving income from Chinese sources are subject to Chinese tax under Article 19 of the Tax Law and Part V of the Regulations. If the income is attributable to an establishment of the foreign enterprise in China, it is taxable in China as part of the profits and taxed at the combined rate of 33 percent, subject to any tax concessions. If the income is not attributable to an establishment in China, or if the foreign enterprise has no establishment in China, it is subject to withholding tax at 20 percent of the gross amount. The withholding tax rate is normally reduced by tax treaties to 10 or 15 percent.

Withholding tax is levied when a payment of the Chinese-source income is made to a foreign enterprise. Payment is defined in Article 62 to mean "payments in cash, payments by remittance, payments by account transfer as well as payments made by conversion into money of non-monetary assets or non-financial rights and benefits".

A. *Income subject to withholding*

Withholding tax is imposed on a non-resident receiving profits (dividends), interest, rentals, royalties or other income from Chinese sources.

1. Profits

Profits are defined in Article 60 to mean "income derived by virtue of an investment ratio, share rights, stock or other non-creditor's right to a share of profit", which is in effect dividend income. Article 63 further states that, for the purpose of withholding tax, profits received by a foreign investor from a FIE include income from the after-tax profit earned by the FIE, and income from the profit earned by a FIE that is exempt from tax as a result of tax incentives.

2. Interest, rentals and royalties

Interest is defined in Article 6 to include interest on deposits, loans, bonds, advances, and deferred payments. Rentals refer to compensation received for the lease of property to lessees. Royalties are defined in Article 59 to include fees charged for the provision of patents and proprietary technology, as well as fees for drawings, information, technical services and personnel training related to such royalties and other related fees. Because it includes service charges, the definition of royalties in Article 59 is broader than that found in most of China's tax treaties.

3. Other income

Other income is defined under Article 61 to include capital gains realized by a non-resident from the disposition of property in China. Capital gains refer to "gains from the transfer of property in China such as buildings, structures, facilities

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ancillary to such buildings and structures and land use rights". The gain subject to tax is deemed to be the net gain, that is the proceeds of disposition less the original cost of the property. Gains from the sale of other properties, such as shares or other equity entitlements of a company resident in China, are apparently not subject to tax.

4. Management fees and consultancy fees

Under Article 67, management and consultancy fees charged by a non-resident for services provided in China may also be subject to withholding tax if the tax authorities designate the payer as a withholding agent. The withholding tax is presumably levied at the rate of 20 percent on the gross amount. Income derived by a foreign company engaged in projects such as construction, installation, assembly and exploration projects is also subject to withholding tax. It is not clear whether the withholding obligation under Article 67 is meant to be a true withholding tax, or merely serves as a collection vehicle to guarantee compliance with Chinese tax laws by a foreign enterprise on profits earned in China. Management fees and revenues from construction and installation are normally considered part of the profit earned by a non-resident in China and are therefore subject to tax on a net income, establishment basis. It is possible that the Chinese authorities have not yet decided whether to tax such income as business profits on a net basis or as income on a withholding basis; as a result, they may have chosen to give wide discretion to the tax authorities to determine how such income should be taxed. In any event, these types of income are treated as business profits under China's tax treaties; they are not taxable in China if the non-resident has no permanent establishment in China, or if the income is not attributable to an establishment in China.

5. Branch tax

No withholding tax is imposed in China on the after-tax profits of a branch or establishment of a foreign enterprise.

B. Exemptions from withholding tax

Both Article 19 of the Tax Law and Part V of the Regulations provide for exemptions from withholding tax, which are summarized as follows:

- dividends (profits) are exempt from Chinese withholding tax if they are paid by a FIE;
- interest income is exempt from withholding tax if it is paid on loans extended to the Chinese Government or China's state banks by international financial organizations, or on loans given at a preferential rate by foreign banks to China's state banks;[9]
- royalties are exempt from withholding tax, or taxed at a reduced rate of ten percent, if they are received for the transfer of proprietary technology to China with respect to scientific research, the development of energy resources, the development of transportation and communications, and production relating to agriculture, forestry, animal husbandry, and fishing, and so on.[10]

VI. TAX INCENTIVES

Part VI of the Regulations consolidates all the earlier legislation on tax incentives, and explains in detail the eligibility criteria for many tax incentives.

A. *Tax holidays*

1. Production enterprises

A taxpayer must be engaged in production activities in order to be eligible for a tax holiday. The Regulations set forth for the first time a definition of "production enterprises" for this purpose; as would be expected, a FIE engaged in manufacturing and processing qualifies as a production enterprise. In addition, Article 72 specifies that enterprises are production enterprises if they operate in the following industries: energy (excluding the exploitation of petroleum and natural gas); metallurgical, chemical and building materials; light industries, textiles and packaging; medical apparatus and pharmaceutical industries; agriculture, forestry, animal husbandry, fisheries and water conservation; construction; communications and transportation (other than passenger transport); scientific and technological development, geological surveying and industrial information consultancy that directly serve the purposes of production, and maintenance services for production equipment and precision instruments.

Taxpayers engaged in property development do not appear to be eligible for a tax holiday. FIEs carrying on business in the service industry are no longer eligible for a tax holiday unless they are located in the Special Economic Zones (SEZs) with a foreign investment of over US$ 5 million (see below).

2. Ten-year tax holiday

Under Article 75, a ten-year tax holiday (including a tax exemption for the first five profit-making years and a 50 percent tax reduction for the following five years) is available to three types of enterprises whose scheduled term of operation is 15 years or more:

- equity joint ventures engaged in port and pier construction projects;
- FIEs engaged in infrastructure projects or in agricultural development in the Hainan SEZ; or

9. Article 65 states that "China's state banks" include the People's Bank of China, the Agricultural Bank of China, the Bank of China, the People's Construction Bank of China, the Bank of Communications, the China Investment Bank and other financial institutions engaged, with the approval of the State Council, in credit operations with foreign entities such as foreign exchange deposits and loans.
Article 64 defines "international financial organizations" to mean "international financial organizations such as the International Monetary Fund, the World Bank, the Asian Development Bank, the International Development Association and the International Fund for Agricultural Development".

10. The Regulations specify the types of technologies that are eligible for the purpose. For instance, technologies relating to production in agriculture, forestry, animal husbandry and fisheries include technology for the improvement of soil and grassland, the development of barren hills and the full utilization of natural resources; technology for the cultivation of new animal breeds and plant varieties, and the production of high-efficiency, low-toxicity agrochemicals; and technology for scientific management and production, for preserving the ecological balance and enhancing resistance against natural disasters.

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- FIEs established in the Pudong New Area of Shanghai engaged in construction projects in energy and transportation.

3. Five-year tax holiday

Article 8 of the Tax Law provides for a two-year tax exemption, followed by a three-year 50 percent tax reduction, for any FIEs engaged in production that operate for a period of ten years or more. A further reduction of 15 percent to 30 percent for the next ten years may be granted if the FIE operates in farming, forestry, or animal husbandry or is located in a remote, economically underdeveloped area.

4. Three-year tax holiday

A one-year tax exemption, followed by a two-year 50 percent tax reduction, is granted to the following FIEs whose scheduled term of operation is ten years or more, and they may not be production enterprises:

- branches of foreign banks and joint venture banks established in the SEZs. To qualify, these banks must have foreign investment capital or, in the case of branches, working capital allocated by the head office exceeding US$ 10 million;
- equity joint ventures that have been established in the State High-Technology and New-Technology Industry Development Zones; and
- FIEs established in the SEZs with a foreign investment of over US$ 5 million that are engaged in the service industry.

5. First profit-making year

Tax holidays commence with an enterprise's "first profit-making year", which is defined in Article 76 to be the first profitable year after the enterprise has commenced production or operations and in which earlier losses have been carried forward and set off against income. The duration of the tax holiday must be calculated without interruption from a taxpayer's first profit-making year, and may not be postponed as a result of losses suffered during subsequent years. Where an enterprise commences actual production operations in the second half of a taxation year and becomes profitable in the same year, Article 77 allows the enterprise to elect to pay income tax on the profits earned during that year and to begin using the tax holiday during the subsequent year.

To qualify for a tax holiday, a taxpayer must be engaged in actual production or business operations for the specified minimum period of 10 or 15 years. If a taxpayer has been granted a tax holiday and then terminates the operation before the end of the minimum period (except as a result of losses suffered due to a natural disaster or an accident), Article 79 requires the taxpayer to pay back the amount of income tax exempted.

B. *Tax rate reductions in special areas*

In addition to tax holidays, Article 7 of the Tax Law and Article 73 of the Regulations provide for reduced tax rates of 24 percent and 15 percent (the regular central rate is 30 percent).

The 24 percent reduced rate is applicable to FIEs that are engaged in production in the Open Coastal Economic Zones (OCEZs), and in the old urban areas of the coastal cities where the SEZs and the Economic and Technological Development Zones (ETDZs) are located.

The 15 percent reduced rate is applicable to equity joint ventures engaged in port and pier construction projects in any part of the country, and to the following enterprises in the special areas:

- FIEs and establishments of foreign enterprises that are established in the SEZs and engaged in production activities;
- FIEs that are established in the ETDZs and engaged in production;
- FIEs that are established in the OCEZs or in the old urban areas of cities where the SEZs or ETDZs are located and that are engaged in technology-intensive or knowledge-intensive projects, projects with a minimum foreign investment of US$ 30 million with a long payback period, or energy, transportation or port construction projects;
- foreign bank branches and equity joint venture banks established in the SEZs or in other special areas approved by the State Council, provided that the capital invested by the foreign investor or the working capital allocated to the branch by its head office exceeds US$ 10 million, and provided that the term of operation of the branch or the joint venture bank is ten years or more;
- FIEs established in the Pudong New Area of Shanghai that are engaged in production, and FIEs in Pudong that are engaged in construction projects in the areas of energy, transportation and communications (including airports, ports, railroads, highways, power stations, etc.);
- FIEs established in the State High-Technology and New-Technology Industry Development Zones (including Beijing Experimental Zone) for the development of new technology industries, that are considered by the relevant authorities as high or new-technology enterprises; and
- FIEs established in other zones, to be specified by the State Council, and engaged in projects encouraged by the state (this leaves open the possibility of further tax incentives being granted in future).

FIEs can benefit from the tax exemption and reduction offered under the tax holiday regulations and the reduced rates at the same time. For instance, a joint venture in a SEZ which is engaged in manufacturing is exempt from income tax for the first two profit-making years, and is taxed at half the usual 15 percent during the next three years.

Article 73 does not define some key concepts, such as "technology-intensive or knowledge-intensive", and "long payback period". Taxpayers may have to negotiate with the local tax authorities in order to qualify for the tax concessions.

C. *Export-oriented and technologically-advanced enterprises*

Export-oriented enterprises (EOEs) and technologically-advanced enterprises (TAEs) may be entitled to further tax concessions under Article 76.

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Export-oriented enterprises are FIEs whose products are mainly for export. Where, in any year after the expiration of the tax holiday mentioned above, the value of exports of any EOE constitutes 70 percent or more of the enterprise's total output value for that year, the enterprise may be granted a further 50 percent reduction in the applicable national tax rate (for example 15 percent if no tax concession is available). EOEs established in SEZs or ETDZs, or that are eligible for the reduced rate of 15 percent mentioned above, and which export more than 70 percent of their products, may pay income tax at the rate of ten percent. As long as the conditions noted above are met, the tax reduction applies without any time limitation.

Technologically-advanced enterprises are FIEs which possess advanced technology and are engaged in developing new products, or in upgrading and replacing products in order to earn more foreign exchange from exports or from import substitution. If a TAE remains technologically advanced after the expiration of the regular tax holiday, it may be granted a 50 percent reduction in the central tax rate for three years. The criteria for "technologically-advanced" are not specified in the Regulations, and may be subject to standards set out by local governments.

D. *Tax refund for reinvestment*

Article 10 of the Tax Law provides for a refund of the income tax already paid by an enterprise on profits that are reinvested in China. The Regulations specify the circumstances under which the refund is available. To obtain the refund, a foreign investor must either use its profits derived from a FIE to increase the enterprise's actual registered capital (before such profits have been distributed) or use the profits that have been distributed from the enterprise to establish another FIE.

Article 80 requires foreign investors to provide evidence confirming the taxation year to which the reinvested profits are attributable when calculating a tax refund. If the foreign investor is unable to provide such evidence, the tax authorities may determine the relevant tax year by means of a reasonable method of calculation. The foreign investor must also provide the tax authorities with evidence of either the capital increase or the new capital contribution to another enterprise. In order to qualify for a refund, the funds must be reinvested in China for at least five years; if the reinvestment is withdrawn before five years have elapsed, the refunded tax must be paid back. In addition, foreign investors must apply to the tax authorities for a tax refund within one year after the date of actual reinvestment.

A 40 percent tax refund is available to any foreign investor who has made a qualifying reinvestment in China.

A full tax refund is available to foreign investors if profits are reinvested in the establishment or expansion of an export-oriented or technologically-advanced enterprise. If the enterprise established or expanded with the reinvested funds fails to meet the requirements for an EOE or TAE within three years, 60 percent of the tax refund obtained must be paid back, i.e. only the regular 40 percent tax refund is applicable.

The full refund is also available to foreign investors with respect to profits from FIEs in the Hainan SEZ that are reinvested in enterprises engaged in construction of infrastructural facilities or in agricultural development in the Hainan SEZ.

The amount of the tax refund for reinvestment is computed by applying the formula specified in Article 82:

> Tax refund = [reinvested amount *divided by* (1 – the original combined central and local tax rates actually applied)] x the original tax rate actually applied x the refund rate.

For instance, if a joint venture is subject to the combined central and local tax rate of 33 percent and the foreign partner in the venture is eligible for a 40 percent tax refund for 100 yuan reinvested in the same venture, the amount of tax refund is equal to

$$(100 \times \frac{100}{100-33}) \times \frac{33}{100} \times \frac{40}{100} = 19.7$$

Thus, in effect the refund amounts to 19.7 percent of the reinvested amount. Where a lower rate of tax has been paid, the refund will be correspondingly lower.

VII. FOREIGN TAX CREDIT

Article 3 of the Tax Law provides that a FIE with its head office in China is taxable on its worldwide income; Article 12 of the Tax Law provides for a credit for the amount of income tax paid outside China. Part VII of the Regulations describes in detail the mechanics of the foreign tax credit, which is similar to the foreign tax credit in many developed countries.

The amount of credit deductible from Chinese tax payable is limited to the lesser of

- the amount of foreign tax paid, which is limited to the amount of income tax actually paid to a foreign government and does not include any tax payment that was subsequently compensated for or tax payments that were borne by others on behalf of the taxpayer; and
- Chinese tax otherwise payable on the amount of income derived from a foreign country, which is determined according to the formula specified in Article 84 as equal to

$$\text{total tax payable} \times \frac{\text{income from a foreign country}}{\text{worldwide income}}$$

The amount of income from a foreign country is computed in accordance with Chinese laws. Costs, expenses and losses may be deducted if they are attributable to the foreign-source income. Foreign-source income and foreign income tax paid are computed by on a by-country rather than a by-item basis. There is no requirement that the foreign tax be a direct tax. Underlying corporate taxes paid in a foreign country may also be eligible for the credit.

Where the foreign income tax paid is less than the amount of Chinese tax otherwise payable, the taxpayer can deduct only the amount of foreign tax paid. If the amount of foreign tax paid exceeds the amount of Chinese tax otherwise payable, the excess portion cannot be deducted as a tax credit or as a business expense; it can, however, be carried forward for five years.

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III. CONSOLIDATION OF INCOME AND LOSSES AMONG BRANCHES AND ESTABLISHMENTS OF FOREIGN ENTERPRISES

According to corporate law principles, a company is a legal person and a separate taxpayer for income tax purposes unless the tax laws permit a group of corporations to file a consolidated tax return. A branch is not an independent legal entity, but only part of a company; therefore, companies compute their taxable income by consolidating all income and losses generated by the branches. Since China does not yet have a body of standard company law, Articles 89 to 93 provide that for tax purposes, FIEs or foreign companies are separate entities, and branches or establishments are not. These provisions help to avoid any confusion between FIEs and branches or establishments and foreign companies.

According to the Regulations, where a foreign enterprise has two or more establishments in China, it may, subject to approval by the tax authorities, designate one of the establishments to file returns and pay income tax on a combined basis, provided that two conditions are met:

- the designated establishment is responsible for supervision and administration of the business operations of all the other establishments; and
- it maintains complete accounting books and vouchers that accurately reflect the revenue, costs, expenses, profits and losses of all the establishments.

If all establishments are profitable and subject to different tax rates as a result of the different tax incentives, the taxable income of each establishment is calculated separately and tax is paid at different rates. In cases where some establishments have profits while others have losses, and profits remain after losses have been set off against profits, the applicable tax rate is deemed to be the one applicable to the profitable establishment. Establishments that incurred losses are required first to set off their losses against profits earned in subsequent years and, if there are still profits after the setoff, to pay tax at the applicable rate.

It is interesting to note that Article 92 contains a "Californian unitary tax" type of provision to allow the tax authorities to allocate income to each establishment where the designated establishment is unable to compute the taxable income of each establishment separately. The tax authorities may allocate the amount of income according to the ratio of operating revenue, the ratio of cost and expenses, the asset ratio, or the ratio of the number of staff and workers or the amount of wages.

Under Article 93, similar rules apply to branches of a FIE. The head office of a FIE is required to pay income tax on the income derived by its branches inside and outside China on a consolidated basis.

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INTERNATIONAL:

A Comparative Analysis of Tax Reforms in Singapore and Hong Kong

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I. INTRODUCTION

In a span of about four decades, both Singapore and Hong Kong have achieved a high-income country status.[1] While they share many similar structural characteristics, such as relatively small population and compact size,[2] and extremely high degree of external orientation,[3] there are also important differences. Among them is the role of government which is interventionist and large, if not pervasive in Singapore, but fairly limited in both the economic and social sectors in colonial Hong Kong.

In the past, there has been a certain degree of competition between the two jurisdictions.[4] This was particularly noticeable in the financial sector as both strived to be the second most important financial centre in Asia after Tokyo, and in the desire to attract regional headquarters of transnational firms.

With the approach of the year 1997, when Hong Kong is to become a Special Administrative Region (hereinafter "HKSAR") of the People's Republic of China ("PRC"), the Singapore government has attempted to attract Hong Kong based workers and professionals by relaxing immigration requirements for them, and by active recruitment in the colony. The Singapore government has also announced plans to make large investments in Hong Kong, including investment in the controversial new airport. Thus, Singapore's policymakers envisage using the colony as an additional channel to participate in the economic activities of both the PRC and Hong Kong.

It is in the above context that this article attempts a comparative analysis of the recent tax reform initiatives and future directions in tax policy in Singapore and Hong Kong.

The article is organized as follows. Since tax reform implies an incremental change in the existing tax system, Section II sets out the main characteristics of the present tax systems of the two jurisdictions. The major recent tax reform initiatives are analysed and compared with the current international trends in tax reform (Section III). The next section examines some of the tax reform proposals under discussion, and possible future directions (Section IV). The final section offers some concluding observations.

II. EXISTING TAX SYSTEM

The budgetary revenue consists of tax and non-tax revenue.[5] An important characteristic of the fiscal systems of both Singapore and Hong Kong is the significance of non-tax rev-

1. In 1989, Singapore's per capita GNP was US$ 10,450, while Hong Kong's per capita GDP was US$ 10,350. The average annual growth rate of per capita income during the 1965/89 period was 7.0 percent for Singapore and 6.3 percent for Hong Kong. (World Bank, 1991, Table 1, at 204-205). Both are classified as high-income economies by the World Bank.
2. In mid-1989, the population of Singapore and Hong Kong was 2.7 and 5.7 million, respectively, while land areas were 625 and 1,071 square kilometres, respectively (Ng, 1990, Exhibit 1).
3. In 1989, the ratio of merchandise trade alone to GDP was 192.0 for Hong Kong, and 332.2 for Singapore (World Bank, 1991, Tables 3, at 208-209, and Table 14, at 230-231). If services, investments and other economic linkages are included, the exposure to and dependence on the international economy would undoubtedly be much greater.
4. Singapore is officially a city-state and Hong Kong a colony (to become a Special Administrative Region of the PRC in 1997). For convenience, the term jurisdiction will be used throughout the article to refer to Singapore and Hong Kong.
5. For an overview of the fiscal system in Singapore, see Asher, 1989b, and for Hong Kong, see Ho, 1988.

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enue. This category includes income from investments, sales of land, sales of goods and services, fines and various regulatory charges. In Singapore, slightly more than a third of total revenue came from this category in the 1970s. However, since 1985, revenue from this category has exceeded tax revenue – the average share during the period 1985/88 was 58.3 percent. This is primarily due to a sharp increase in the importance of income from investment, whose share in non-tax revenue increased from about half in the early 1980s, to more than four fifths by 1987. This in turn is a result of continual accumulation of balances in various funds constituting Singapore's budgetary system. According to the 1991/92 budget, total balances in various funds and cash at hand amounted to S$ 90.8 billion (US$ 1= S$ 1.73) on 1 April 1991, or about 145 percent of the 1990 GDP of S$ 62.7 billion.

The share of non-tax revenue is also high in Hong Kong, although not as high as in Singapore. Thus, during the 1970s, the average share of non-tax revenue in total revenue was 40.1 percent, and it increased to 45.7 percent during 1980/81 to 1986/87 (Ho, 1988, Table 3.4, at 23). The non-tax revenue exceeded the tax revenue in only two years during this time. At the beginning of the 1991/92 financial year (April-March), the fiscal reserves of Hong Kong were HK$ 73 billion or 14.9 percent of the 1989 GDP.[6] This is much lower than the 145 percent of GDP for Singapore. As a result, the importance of revenue from investments is also lower in Hong Kong.

The above suggests that, in both jurisdictions, taxes are not the only or even predominant sources used to raise additional revenue. Also, in analysing the economic effects of the fiscal system on stabilization, the cost of doing business, and incentives to work, save, and invest, exclusive attention to tax revenue is likely to be inadequate. A corollary is that a part of the non-tax revenue is in the nature of a tax,[7] and therefore, conventional tax levels need to be augmented.[8] This task, however, is beyond the scope of this article, which deals with the conventionally defined tax system.

A classification of taxes according to three tax bases, i.e. income, consumption and wealth, and according to whether the tax is levied in a personal or an in-rem form, for 1988/89, for Hong Kong and Singapore is presented in Tables 1 and 2, respectively. This classification refers to the statutory, not economic, incidence. The following observations may be made from the data in these tables.

The overall tax to GDP ratio for Singapore (15.34 percent) is higher than for Hong Kong (11.24 percent). While this has been the case for at least two decades, the differences between the two ratios have narrowed in recent years. Thus, during the 1970s, this ratio averaged 9.2 percent for Hong Kong (Ho, 1988, Table 3.4, at 23), but 15.7 percent for Singapore (Asher, 1989, Table 5.2, at 144). This ratio reached its peak in 1983/84 in Singapore (21.2 percent), and in 1986/87 in Hong Kong (11.9 percent). These ratios are quite low when compared to the OECD countries. Thus, in 1988, the OECD average for this ratio was 38.4 percent if social security taxes are included, and 29.3 if they are excluded (OECD, 1990).

TABLE I
HONG KONG, TAX REVENUES BY TYPE AND FORM 1988-89

Type of Tax	Personal		In-Rem		Total	
	% TTR	% GDP	% TTR	% GDP	% TTR	% GDP
Income Based	25.5	2.87	36.4	4.10	61.9	6.97
Earnings & Profits Tax[a]	25.5	2.87	35.2	3.96	60.7	6.83
Others[b]	-	-	1.2	0.14	1.2	0.14
Consumption-Based	-	-	23.5	2.65	23.5	2.65
Duties	-	-	8.5	0.96	8.5	0.96
Betting & Sweepstake Duties	-	-	8.4	0.94	8.4	0.94
Motor Vehicle Taxes[c]	-	-	4.1	0.45	4.1	0.45
Others[d]	-	-	2.6	0.29	2.6	0.29
Wealth-Based	0.9	0.10	13.5	1.52	14.4	1.62
Real Estate (Property Tax)[e]	0.9	0.10	3.1	0.35	4.0	0.45
Property Development & Transfer[f]	-	-	10.4	1.17	10.4	1.17
Total	26.4	2.97	73.5	8.27	100.0	11.24

Notes: Details may not add up to the total due to rounding.
– nil or negligible.
TTR = total tax revenues. In 1988/89, they amounted to HK$ 48,811 million.
GDP in 1988 was HK$ 434,081 million.

a. the corporate profits tax is classified as in-rem, all other components as personal.
b. includes revenue from royalties and concessions.
c. data are not available to divide the revenue into consumption and wealth-based.
d. includes entertainment tax, hotel accommodation tax, taxi concessions, air passenger departure tax, andCross Harbour Tunnel Passage tax.
e. the personal form includes estate duties, while in-rem form includes general rates.

Source: Calculated from the Hong Kong, *Annual Digest of Statistics*, 1990 edition, Table 8.2, p.121.

The share of personal taxes in Hong Kong (26.4 percent) is nearly double that of Singapore (14.9 percent). Given the high-income status of the two jurisdictions, the share of personal taxes can be regarded as low. The individual income tax share alone in 1987 in the OECD countries averaged 30.7 percent, while as a percentage of GDP, the average was 12.0

6. The figure for the fiscal reserves is from the speech by the Financial Secretary at the end of the Second Reading of the Appropriation Bill, 1991, on 17 April 1991, para. 62, at 13. The GDP figure is from the *Hong Kong Annual Digest of Statistics*, 1990, Table 7.2, at 111.

7. To the extent regulatory and user charges and prices of goods and services by the government reflect the use of administrative discretion or monopoly power, they may contain tax (subsidy) elements.

8. The Singapore government has had a budgetary surplus since 1968. However, the internal public debt has increased rapidly from S$ 4.0 billion in 1974 to S$ 51.4 billion in 1990 (*Yearbook of Statistics*, 1974 and 1990). Since these funds are not needed for government expenditure, they are invested by the government. The Central Provident Fund ("CPF"), the main social security institution of Singapore, is a large holder of government debt (it held S$ 32.1 billion at the end of 1989). However, the interest received by the CPF on government securities is pegged to the average of savings and one-year deposit rates of the four largest locally-owned commercial banks. The difference between the interest rate paid to the CPF and rate of return earned by the government is regarded as investment income in the budgetary account. A case, however, can be made that at least some of the difference is in the nature of a tax.

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TABLE 2
SINGAPORE, TAX REVENUES BY TYPE AND FORM, 1988-89

Type of Tax	Personal		In-Rem		Total	
	% TTR	% GDP	% TTR	% GDP	%TTR	% GDP
Income based	14.7	2.25	27.9	4.32	42.6	6.53
Individual Income Tax[a]	14.7	2.25	-	-	14.7	2.25
Company Income Tax[a]	-	-	24.5	3.76	24.5	3.76
Payroll Tax[b]	-	-	h	h	h	h
Foreign Workers Levy	-	-	3.3	0.51	3.3	0.51
Others[c]	-	-	0.1	h	0.1	h
Consumption based	-	-	33.1	5.07	33.1	5.07
Selective Sales Taxes	-	-	7.1	1.10	7.1	1.10
Liquor Products	-	-	1.5	0.23	1.5	0.23
Petroleum Products	-	-	4.8	0.73	4.8	0.73
Tobacco Products	-	-	0.8	0.13	0.8	0.13
Motor Vehicle Taxes	-	-	11.1	0.70	11.1	0.70
Import Duties	-	-	8.9	1.36	8.9	1.36
Liquor Products	-	-	1.9	0.28	1.9	0.28
Tobacco Products	-	-	2.7	0.41	2.7	0.41
Motor Vehicles	-	-	3.7	0.57	3.7	0.57
Others	-	-	0.6	0.09	0.6	0.09
Betting/ Sweepstake Duties	-	-	4.3	0.66	4.3	0.66
Cess on Hotel Rm. & sales Tax on Tourist Establishments	-	-	0.6	0.09	0.6	0.09
Others[e]	-	-	1.0	0.16	1.0	0.16
Wealth based	0.2	0.03	24.1	3.70	24.3	3.73
Real Estate (Property Tax)	-	-	11.7	1.80	11.7	1.80
Private Property	-	-	7.0	1.07	7.0	1.07
Others	-	-	4.8	0.73	4.8	0.73
Property Development and Transfer[f]	0.2	0.03	5.8	0.89	6.0	0.92
Motor Vehicles[g]	-	-	6.6	1.01	6.6	1.01
Total Tax Revenue	14.9	2.29	85.1	13.05	100.0	15.34

Notes: Details may not add up to the total because of rounding.
TTR = Total Tax Revenues. In 1988/89 they amounted to S$ 7,398 million.
GDP in 1988 was S$ 48,223 million at current market prices.

a. A breakdown of total tax revenue into income tax components is estimated as follows: the ratio of the assessed income tax on companies to total assessed income tax for the year 1988 is applied to the actual income tax revenue for 1988/89. Thus, the company income tax is estimated to be 62.5 percent of the S$ 2897.8 million actually collected. The remaining amount is allocated to individual income tax.
b. This tax has been suspended from 1 April 1985.
c. Includes royalties and other minor levies.
d. Includes ad valorem registration fees, special tax on heavy oil engines, and new registration and transfer fees on motor vehicles.
e. Includes entertainment duty, tax on utility bills, and other minor items.
f. Includes estate duties (personal development charges (in rem) and stamp duties (in rem).
g. Includes road tax, non motor vehicle licences, and passenger vehicle seating fees.
h. Negligible.

Source: Calculated from Republic of Singapore, Accountant General's Departments, Financial Statements, 1988/89.

percent (OECD, 1990). If the relative importance of personal taxes is taken as an indication of the desire to fine-tune the tax system in order to distribute the tax burden according to individuals' ability to pay, then there seems to be no excessive pre-occupation with such fine-tuning in Singapore and Hong Kong.

The share of income-based taxes is much higher in Hong Kong (slightly more than three fifths) than in Singapore (slightly more than two fifths). In both jurisdictions, the share of company income taxes far exceeds that of the individual income tax. This contrasts with the OECD countries, where the 1987 average for the corporate income tax was 7.9 percent of total tax revenue or 3.0 percent of GDP (OECD, 1990).

In addition to the individual and company income tax, Singapore also imposes a Foreign Workers Levy[9] and a payroll tax. The latter, however, has been suspended since 1985. The Skills Development Fund Levy, a tax earmarked for workers' training and providing mechanization incentives, is currently levied at a rate of one percent on that part of the payroll which is accounted for by those earning less than S$ 750 per month. The revenue from this source, however, has not been included in Table 2. As nominal wages increase, unless the tax base is also increased, the revenue from this levy can be expected to decline.

In contrast to the income-based taxes, the share of consumption and wealth-based taxes is higher in Singapore. In both jurisdictions, the excise tax system is confined to traditional commodities and selected services. However, the importance of motor vehicles taxes (slightly more than one fifth of the total if both consumption and wealth-based components are combined) in Singapore is quite high. In contrast, in Hong Kong the share of motor vehicle taxes was only 4.1 percent in 1988/89. In Singapore, less than one tenth of the tax revenue is derived from import duties. In 1988/89, three items (tobacco products, alcoholic products and motor vehicles) accounted for more than nine tenths of the revenue from import duties (Table 2). There is no general tariff on goods entering Hong Kong, but duties are charged on six groups of commodities whether they are imported or produced domestically. These are alcoholic products, tobacco products, certain hydrocarbon oils, methyl alcohol and, since February 1988, certain non-alcoholic beverages and cosmetics. The share of property tax is also much smaller in Hong Kong (3.1 percent) than in Singapore (11.7 percent). In contrast, the share of gambling taxes in Hong Kong (8.4 percent) is almost twice that of Singapore (4.3 percent). The personal taxes on wealth are of negligible importance.

Neither jurisdiction levies a general consumption tax. However, as discussed below, the governments in both jurisdictions have announced plans to introduce such a tax at an appropriate time.

9. The Foreign Workers Levy was first introduced in 1982, but both its rate and scope have been expanded considerably since then. In August 1990, the levy was S$ 250 per month for foreign maids, and S$ 300 per month for others. The government not only determines the rate of levy, but also retains control over the overall number and sources of foreign workers allowed into Singapore. Recently, there has been a proposal to auction foreign labour beyond a certain pre-determined level.

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III. RECENT TAX REFORM INITIATIVES

Major tax reform initiatives undertaken by Singapore and Hong Kong in recent years are discussed in this section.

A. *Income tax*

The nature of the income tax in Singapore and Hong Kong differs. In Singapore, there is a partial integration of personal and company income taxes through the withholding or the dividend-received credit method. This system has remained unchanged since independence and no change is contemplated.

The income tax in Hong Kong (called the Earnings and Profits tax) is of a schedular type. Until 1 April 1989, there were four separate and distinct taxes on income, namely property tax, salaries tax, profits tax and interest tax. The latter tax was abolished on 1 April 1989, leaving three separate taxes. Each of the taxes is assessed without regard for the individual's or company's income from other sources. However, in appropriate circumstances, an individual may combine income from all relevant sources and elect for a personal assessment (Flux, 1990, at 3). A personal assessment may reduce tax liability as compared to the separate assessment because personal allowances and progressive tax rates that only apply automatically to salaries tax, can be extended to total income if personal assessment is chosen (Flux, 1990, at 13).[10] No change in the schedular form is contemplated for Hong Kong.[11]

Both Singapore and Hong Kong use the territorial source principle. While Singapore distinguishes between resident and non-resident taxpayers, no such distinction is made in Hong Kong. Therefore, as Flux has noted, "... determination of source of income is probably the single most important factor in determining liability to tax in Hong Kong" (1990, at 5).

As may be expected, application of the source principle has been far from smooth and has given rise to considerable complexity. Until recently, implementation of this principle was based on various Commonwealth cases which essentially involve the operations test (Harris, 1988, at 5). Under this test, profits or income is sourced where the operation of business is carried on. In recent years, the authorities have sought to assess profits from transactions outside of Hong Kong on the grounds that the activities which gave rise to profits took place in Hong Kong. This has been called the mind and management test (Harris, 1988, at 5). The interpretation of the authorities was rejected by the Privy Council of the United Kingdom on 8 October 1990 in *Commissioner of Inland Revenue v. Hang Seng Bank Ltd.* (for details see Toh, 1990b).

The imputation system used by Singapore requires withholding of tax. There are no withholding taxes on dividends or other sources in Hong Kong, though withholding was applied when tax on interest income was in existence. Even though Singapore uses the source principle, it still has double taxation agreements with more than 30 countries. Given the extensive use of incentives, the tax sparing clause has been of particular importance to Singapore. The 1986 budget provided for unilateral tax relief on certain types of income, based on the average rather than the marginal rate of tax. Tax concessions have also been granted for losses incurred on certain types of direct investment overseas by Singapore firms. Unilateral tax credits on income derived by operational headquarters from non-treaty countries were provided in the 1988 budget. The 1991 budget allowed local companies with foreign earnings to repatriate the earnings and pass them on to shareholders without the penalty of a Singapore tax charge on the dividend payment. This measure was also designed to remove a deterrent to transnational firms from using Singapore as a regional holding company location. Thus international aspects of taxation have received increasing attention in Singapore, and this trend is expected to accelerate in the 1990s as Singapore strives to increase the share of net factor income from abroad in its national income. This implies that in the future, Singapore authorities will stress the growth rate of the gross national product ("GNP") rather than the gross domestic product ("GDP"), the difference between the two being the net factor income from abroad.

Hong Kong has not entered into double taxation agreements, although a limited agreement with the United States relating to shipping income does exist (Flux, 1990, at 344). However, relief is available where tax is payable under any of the income sources and Commonwealth income tax has been paid (Flux, 1990, at 345). Limited relief as an expense is also available in certain cases (Flux, at 344). In 1987, the Salaries Tax section of the Inland Revenue Ordinance was amended to exclude from Hong Kong chargeable income any income on which tax was paid elsewhere (Harris, 1988, at 10). This was done as the PRC had become an important base for the Hong Kong companies, and certain profits and salaries were being subjected to double taxation (Harris, 1988, at 10).

In Singapore, the nominal company income tax rate remained unchanged at 40 percent between 1966 and 1986. It was reduced to 33 percent from the year of assessment 1987, to 32 percent in 1990 and to 31 percent in 1991. Consistent with the organic nature of the Singapore state and the activist fiscal policy, the government continued to introduce incentives for a wide variety of activities. In the early 1980s incentives focused on knowledge-intensive industries, while in the late 1980s, the focus shifted to developing Singapore as a total business centre. In the early 1990s, the focus is on expanding international economic linkages.

Tax incentives in Singapore appear to be well targeted, designed and administered. The extensive set of incentives implies that the effective rate of taxation varies significantly among activities and sectors. No empirical studies estimating such differentials in effective rates are available. However, using the statutory tax rates and depreciation and other relevant provisions for 1982, Agell found the subsidy rates, i.e.

10. Separate taxation, with an option for personal assessment gives rise to anomalies. These arise when to obtain the advantage of personal allowances, an individual must elect personal assessment, but his income is too large to benefit from it. Thus, two individuals having same total income but from different sources may have widely divergent tax liabilities, thus violating horizontal equity. For numerical examples, see Flux, 1990, at 4.

11. The Third Inland Revenue Ordinance Review Committee recommended a shift from schedular to global income taxation. This recommendation was made in 1976, but no action has been taken as yet, nor has another Review Committee been set up (Flux, 1990, at 5). However, during the last half of the 1980s, a Joint Liaison Committee on Taxation ("JLCT") was set up in Hong Kong, as a part of the tax consultative process. For details, see Harris, 1990.

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subsidy as a percentage of the cost of capital, to be 180 percent for regular and 76 percent for the pioneer firms in Singapore, assuming the rate of inflation to be five percent (1986, Table 4.7, at 70). Singapore's subsidy rate for the regular firms was almost twice that of the country with the next highest rate, 94 percent for Malaysia. For the pioneer firms, Singapore's subsidy rate was the lowest. The relevant rates were, however, bunched together, with the highest rate being only ten percentage points higher at 86 percent for Indonesia (Agell, 1986, Table 4.7, at 70). While lowering the nominal rates of company tax is consistent with tax reform trends in other countries, the extensive and indeed increasing use of incentives is not. The above trends are also contrary to the Economic Committee's recommendation that the income tax should have a low nominal rate, a broad base and be neutral (1986a, Ch. 8). Hong has indicated that the extensive use of incentives for selected activities has generated concern by foreign governments over the erosion of their tax bases (1988, at 3). This aspect could become even more important during the 1990s as the term "level playing field" is increasingly likely to be applied to the fiscal and related areas.

While Hong Kong does not formally offer fiscal incentives, certain provisions could still create non-neutralities. Thus, Ho (1990) has shown that the structure of depreciation rates, investment allowances, tax treatment of interest expenses and interest income, and other such provisions lead to divergent effective rates of taxation.[12] He finds that in Hong Kong, investment in all types of assets are subsidized at the margin, provided they are debt financed (1990, at 15). The effective rate for equity-financed investment is positive, but it does vary among assets.

The company income tax structure of Hong Kong is relatively simple, and the use of tax incentives to promote investments minimized. Even so the tax is not neutral among assets and modes of financing, as Ho's simulations reveal. This indicates a need to better conceptualize the term neutrality in taxation, and for greater work on design and implementation issues. This is particularly important as this objective has been suggested as an alternative to efficient or optimum taxation.[13]

We now turn to the individual income tax.

1. Unit of taxation

In Singapore, the unit of taxation has been the individual, though during the 1960s and the 1970s, there were restrictions on married women claiming unearned income under their own name. Given that all the major allowances are on an individual taxpayer basis, it is advantageous for a working spouse to be taxed separately. Changes in the structure of various allowances during the 1980s have increased the advantages of separate taxation even further for married women in Singapore.

Until recently, Hong Kong had the family as a unit of taxation. Thus, for the salaries tax, income of husband and wife had to be aggregated. However, in the 1988/89 budget, a "working wife" allowance of HK$ 15,000 was granted. Effective from the year of assessment 1989/90 (1 April 1989 – 31 March 1990), Hong Kong has shifted to an individual basis of taxation.[14] Given the schedular nature of the income tax in Hong Kong, only families with two salary income earners are likely to experience significant changes in tax liability. However, separate taxation is expected to increase the number of files to be processed by 180,000 (Harris, 1988, at 9).[15] Monitoring of allowances and the rules concerning transferability of allowances are also likely to increase the administrative burden of the Inland Revenue Department.

The main reason for the move appears to be the domestic pressure from certain groups and the need to be internationally competitive, especially as emigration has become a serious problem in a run up to 1997. The disincentive aspects of higher marginal tax rates for secondary workers in the case of family taxation have not been considered serious in view of the low rates prevailing in Hong Kong (the maximum marginal rate being 25 percent) (Ho, 1988, at 27).

The move to separate taxation has come about in spite of reservations of the Finance Secretary. In his speech moving the Second Reading of the Appropriations Bill 1988 on 2 March 1988, he considered the move to separate taxation inappropriate in Hong Kong. The main reason advanced was that the revenue foregone could be better utilized to provide relief to low income groups. Byres (1988, at 40) also argued against separate taxation on the ground that it would favour a relatively small band of taxpayers, and replace one set of inequities with another.

The move to separate taxation, however, is consistent with international practice (Cnossen and Messere, 1990, at 44-47). While both Singapore and Hong Kong now have an identical unit of taxation, the interaction of the tax unit, tax relief, rate schedule and the nature of tax (global in Singapore, schedular in Hong Kong) could still produce different effects on unmarried, one-earner and two-earner couples at the same and varying levels of income.

2. Rate structure

In Singapore, there has been a significant reduction in the marginal rate of tax, which has led to a rate structure which is nominally less progressive. In 1966 the rates ranged from 6 to 55 percent with 15 brackets, and the highest rate was applicable to incomes exceeding S$ 750,000. By 1980, the rates

12. The marginal effective tax rate is derived by comparing the rate of return net of depreciation of an investment project with an assumed after-tax real rate of return (Ho, 1990, at 7). This procedure is based on the cost or rental price of capital.
13. See, for example, Gillis, 1990.
14. According to Law (1990), the revenue loss was estimated to be HK$ 600 million per year. However, as the simultaneous abolition of the "working wife" allowance was expected to save HK$ 355 million, the net loss is HK$ 245 million, or only 3.1 percent of the 1987/88 revenue from the Salaries Tax. Separate taxation is mandatory though where lower tax liability could result from joint taxation, there is a provision for electing it.
15. According to the 1988 Budget speech by the Finance Secretary, there were 700,000 taxpayers in 1988/89, of which 53,000 or 7.6 percent were expected to pay tax at the standard rate, but contributing 56 percent of the total salaries tax. The number of taxpayers was 1.05 million in 1990/91, and the government expects it to increase it to 1.2 million in 1991/92 (South China Morning Post, 7 March 1991). The number of taxpayers in 1988/89 represented about a quarter of the 1989 labour force, a much lower proportion as compared to Singapore where in 1988, 70.3 percent of the employed persons paid income tax.

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ranged from 4 to 55 percent with 15 brackets, but the highest rate was applicable to incomes exceeding S$ 600,000. Since the year of assessment 1987, the rates have ranged from 3 to 33 percent,[16] with 14 brackets, and the highest rate is applicable to incomes exceeding S$ 400,000. While the rate structure has remained unchanged since 1987, there has been increasing use of one-off rebates on total income tax liability. A five percent rebate on total tax liability was given in both 1990 and 1991. The rationale underlying the rebates is that they are a more flexible and better targeted instrument for motivating the work force than rate reductions which cannot be sustained for any period of time. The use of reliefs also confers greater control on the policymakers.

The rate structure for Hong Kong has fluctuated within a narrow range. Between 1950/51 and 1965/66, both the standard rate and the corporate profit rate were 12.5 percent. They increased to 15 percent between 1966/67 and 1974/75. Since then, there has been a slight divergence between the two, with the corporate profits rate being slightly higher. It was during the period 1984/85 to 1986/87 that both the standard rate (at 17.0 percent) and the corporate profits rate (18.5 percent) reached their peak. Since then, both rates have been declining gradually, reaching 15.0 and 16.5 percent, respectively in 1991/92.

Recent years have witnessed more frequent adjustments in the rate structure. In 1970/71, the rates ranged from 2.75 to 30 percent, with ten brackets, with the maximum rate applicable at a chargeable income of HK 45,000. In 1980/81, the rates ranged from 5 to 25 percent, with five brackets, while the maximum rate was applicable at a chargeable income of HK$ 40,000. In 1988/89, the rates ranged from 3 to 25 percent, and the number of brackets was increased to eight, while the income at which the maximum rate becomes applicable was increased to HK$ 70,000. In 1989-90, the rates ranged from 2 to 25 percent, but the other aspects remained unchanged. Since 1991/92, the rates have the same range, but the number of brackets have been reduced to four.[17] The current rates are 2, 9, 17 and 25 percent, with the maximum rate applicable at a chargeable income level of HK$ 60,000. The standard rate remains at 15 percent. This is the rate at which tax on property income is levied.

Implementation of the flatter rate structure is also consistent with international practice (Cnossen and Messere, 1990, at 44-47). Singapore, however, has not followed this trend as evidenced by the 14 brackets in its income tax rate structure.

3. Base structure

Singapore and Hong Kong have pursued quite divergent policies concerning the base structure. Two areas where such divergence is particularly noticeable are adjustment in personal and other reliefs and allowances, and use of the income tax to promote socio-economic goals.

Singapore has consciously not adjusted personal reliefs since at least the 1960s in order to induct more individuals into the tax net. The rationale has been to make as many individuals as possible aware of the duty to pay for the cost of government services. The government has consciously assumed the increased administrative burden that accompanies a large number of taxpayers, even though the contribution of low income taxpayers to revenue has been quite small. Thus, in 1988, those with assessed income below S$ 20,000 accounted for 74.7 percent of taxpayers, but only 11.4 percent of the tax assessed (*Yearbook of Statistics*, 1990, Tables 13.7 and 13.8). It was only in the 1989 budget that the basic reliefs for wife and children were increased from S$ 750 to S$ 1,500. The relief for children are applicable to the first three children (to the first four children if the fourth child is born after 1 January 1988). For a fourth and fifth child born before 1 August 1973, the relief is S$ 300 each. Over time the real income at which an individual becomes liable to income tax has been declining in Singapore.

In contrast, there have been frequent revisions in the personal reliefs and allowances in Hong Kong, with the explicit purpose of not pushing lower income individuals into the income tax net, and for mitigating the bracket creep arising from inflation. Success has been mixed. Ho reports that in 1980/81 the real value of allowances for the single taxpayer was below that in 1970/71, while the opposite was the case for married couples, except those with a large number of children (1988, at 27). He also reports that in 1986/87, the real value of the allowances was lower as compared to 1980/81 and 1970/71, thus lowering the tax threshold. In 1991/92, individuals earning up to HK$ 41,000 were exempt from income tax. This is equivalent to 48.2 percent of the 1989 per capita GDP. The corresponding ratio for Singapore was slightly less than 20.0 percent. The upper limit at which a particular marginal rate becomes applicable has also fallen in real terms (Ho, 1988, at 28). Thus, in 1970/71, marginal tax rate of 20.0 percent applied at an income level of HK$ 35,000, but in 1980/81 (at 1970/71 prices) the corresponding amount was HK$ 17,528, and this declined to HK$ 13,889 in 1986-87 (Ho, 1988, at 29).

The use of income tax to promote socio-economic objectives has been quite minimal in Hong Kong. It is mainly confined to allowances for dependent parents and specified charitable contributions. In sharp contrast, in Singapore, the use of income tax to promote various socio-economic goals has been large and is still growing. An indicator of this is the divergence between the assessed income and chargeable income. During the 1970s, the difference was approximately ten percent of GDP, itself a high figure. The divergence was 14.0 percent of GDP in 1985, and 14.1 percent in 1987. Since 1987, more allowances (i.e. deductions from income) have been introduced, particularly for married women with children, as discussed below. The largest deduction allowed is for Central Provident Fund ("CPF") contributions and life insurance premiums. For the year of assessment 1987, this category accounted for 44.5 percent of all deductions, and this includes only the employee's share, as the employer's share

16. This takes into account 15 percent rebate on the first S$ 10,000 of chargeable income provided to all taxpayers.

17. The Finance Secretary has not given any reason for the change in the Budget speech for 1991/92. The flatter rate structure, however, can be expected to mitigate some of the effects of the separate taxation on differentials in tax liabilities among various taxpayers.

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of CPF contributions is not a part of the assessed income of the individuals, but is excluded altogether.

The uses to which CPF balances can be put expanded considerably during the 1980s. This has automatically meant the increasing use of the individual income tax. The schemes under the CPF introduced during the 1980s covered residential and non-residential properties, investments in selected shares and commodities, mortgage, medical and life insurance, promotion of employee welfare at the company level, tertiary education, contributions to parental welfare, etc. The schemes are indeed wide ranging, and additional schemes, such as the one to finance the upgrading of housing estates, may be introduced during the 1990s. A general implication of the complete tax exemption of CPF contributions, interest income, capital gains from shares, commodities and other approved investments, and withdrawals at retirement is that benefits of the treatment vary positively with income levels. For example, the effective cost of one dollar contributed to the CPF is S$ 0.67 to a person in the 33.0 percent tax bracket, but S$ 0.97 to a person in the 3.0 percent tax bracket.

In the above case, the use of the income tax is directly tied to the uses of the CPF scheme. The use of the income tax for areas other than the CPF also grew significantly during the 1980s. Among these, the most important and perhaps most controversial have been the procreation incentives and enhanced child relief for "qualified women", presently defined as women who have passed the GCE examination with at least three subjects at "O" level in one sitting or equivalent qualifications. For 1991, the maximum relief was S$ 15,000 for a child below 12 years old, and S$ 10,000 for a child 12 years old or above. The procreation incentives consist of substantial tax rebates to be used within seven years. For example, for the third or fourth child, a rebate of S$ 20,000 against either or both parent's tax liabilities, and a rebate equal to 15 percent of the wife's earned income in the year of birth of the child against the wife's tax liabilities under separate assessment may be claimed. These were first introduced in 1987, and have been refined and made more generous since that time. This sharply contrasts with the reluctance to increase the basic reliefs and allowances.

There are also reliefs for maintaining parents and handicapped siblings, for adding to (limits are specified) one's own or one's parents CPF accounts, for course fees, for the foreign maid levy (the relief equals two times the levy in 1990), delivery and hospitalization expenses for a fourth child born after January 1988, and gifts to approved institutions.

B. *Estate duties*

The 1984 Singapore budget considerably streamlined and simplified the estate duty structure. To replace the complicated system of remission and taxation, with tax rates ranging from 5 to 60 percent, the 1984 budget introduced only two rates – five percent for the first S$ 10 million of taxable estate, and ten percent on subsequent amounts. This structure still prevails for 1991/92.

Before the 1987/88 Hong Kong budget, estate duty rates ranged from 10 to 18 percent with five brackets. Since 1987/88, they have ranged from 6 to 18 percent, with seven brackets. The taxable value of estate at which the maximum rate is applicable was increased from HK$ 4 million to HK$ 5 million in the 1987/88 budget. Estate duty is not payable on assets situated outside Hong Kong.

C. *Property tax*

In Singapore, the announcement for streamlining the property tax structure (essentially a uniform 23 percent on gross rental value or its equivalent, with minor exceptions), was made in 1979 but implemented over the next five years. As a part of the package to deal with the 1985/86 recession, a property tax rebate was given, and its rate was subsequently increased from 30 to 50 percent. The rebate ended in June 1990. Owner occupied properties have enjoyed a concessional rate of four percent on values based on the 1967 levels. As a part of the 1990 property tax reform, the base of owner-occupied premises was changed to the current annual value. This has led to higher taxes in most cases, except for the Housing Board flats. From 1 July 1990, the flat rate of 16 percent (instead of effective rate of 11.5 percent which prevailed due to the 50 percent rebate) has been introduced for other properties.

In Hong Kong, the property tax (called general rates) is levied annually on the occupation of landed property at a percentage of the assessed rateable value. The tax rate and base have both been changed frequently, often in an offsetting manner. Thus, a general re-assessment of property has usually been accompanied by a reduction in the tax rate. The most recent revaluation occurred after a lapse of five years in 1990. The average increase in the rateable value was 65 percent for domestic property, and 105 percent for non-domestic property, the overall increase being 85 percent (1991/1992 budget speech). Concurrent with the above increases, the 1991/1992 budget reduced the tax rate from 7.5 to 5.5 percent for the whole territory. The maximum increase in the property tax bill for 1991/92, however, was pegged at 25 percent.

D. *Excise and import duties*

In both Singapore and Hong Kong, the excise system is limited to traditional items and certain services, such as gambling, entertainment, hotels and restaurants. In Singapore, petrol is taxed at an ad valorem rate of 50 percent, with minimum amount of duty specified. The other excises are on liquor and tobacco products. The tax structure for both products explicitly protects domestic production. For cigarettes, this protection was increased in the 1989 budget, by levying differential rates on imported cigarettes, import duty on unmanufactured tobacco, and excise duty on domestic production. This was, however, reversed in the 1991 budget so that now the two are equal at S$ 100 per kilogramme. Nevertheless, protection for domestic production continues because the filter paper used in imported cigarettes is taxed, but the paper used for domestic production does not attract any duty. Singapore also levies import duties on selected items, though their number has declined considerably (see Table 2).

In Hong Kong, the duty on petroleum products (hydrocarbon oils) is levied at a specific rate per litre. There have been frequent adjustments in this rate, the most recent being in

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1991/92 when the rate on motor and aircraft fuel was increased from HK$ 3.58 to HK$ 3.76 per litre. The duty on alcoholic beverages has both a specific and ad valorem component. As with petroleum products, there have been frequent adjustments in the taxes on alcoholic beverages, particularly in respect of the specific component.

In February 1988, Hong Kong shifted cigarette taxation from a weight basis (as is still the practice in Singapore) to one based on the number (1,000) of cigarettes. There have been frequent increases in tobacco taxes – in the 1991/92 budget, the duty was increased by 200 percent, from HK$ 240 to HK$ 720 per 1,000 cigarettes. The per cigarette taxation is more neutral as between domestic and imported cigarettes, but lends itself to manipulation by varying the length, weight and other characteristics of cigarettes. Similar manipulations are also possible under the weight-based system.

E. *Payroll, Foreign Workers Levy and related taxes*

As noted above, during the 1980s, Singapore introduced a levy on foreign workers, whose main function is regulatory, though it is also highly revenue-productive (Table 2). Auctioning of foreign labour above a predetermined level can be expected to increase the revenue from this category still further. As this levy is on lower income workers, such as maids and construction workers, and since the incidence of the levy is expected to be largely on the workers themselves, it forms a significant regressive element in the tax system. The payroll tax has been suspended since 1985, but it remains on the statute books. The Skills Development Fund Levy was introduced in 1979 at a rate of two percent. The rate was increased to four percent in 1981, reduced to two percent in April 1985, and to one percent in April 1986. The rate has been unchanged since 1986. The base of the levy, that part of the total payroll accounted for by employees with remuneration of less than S$ 750 per month, also remains unchanged. The incidence of the levy depends on the expenditure structure, i.e. how revenue from the levy is spent. While no firm data are available, it appears that some of the training programmes and mechanization grants have benefitted individuals with incomes higher than the ceiling imposed for the levy. Moreover, not all the amounts have been spent as evidenced by unspent balance of S$ 522.7 million in this fund as of 1 April 1991 (Singapore's 1991/92 budget, at 95).

Hong Kong has no comparable taxes.

F. *Tax avoidance and evasion*

The concern among policymakers about tax avoidance and evasion has been quite evident in Hong Kong. As the Financial Secretary noted during the speech concluding the Second Reading of the 1991 Appropriation Bill: "... on the topic of tax avoidance generally, this has become, unfortunately, a fast growing industry served by a large number of professional advisers". A field audit system was introduced in the 1991/92 budget under which officers may interview taxpayers and check the relevant records at their business premises, thus implying that low tax rates alone are inadequate to tackle tax avoidance and evasion. Prudential regulation, effective administration and political will to levy penalties are also necessary.

In Singapore, the tax avoidance and evasion problem has been handled less publicly through discretionary administrative action. No empirical estimates of avoidance and evasion are available for either jurisdiction.

The above analysis of the recent tax reform initiatives in Singapore and Hong Kong suggests the following. First, the 1980s witnessed frequent changes in the tax policies of both jurisdictions. Maintaining macro-economic stability and international competitiveness have been important objectives. In the case of Singapore, socio-economic and regulatory objectives have also been important. Correspondingly, traditional equity and efficiency objectives have been less important. Secondly, while tax reforms in both jurisdictions have been consistent with recent international trends in areas such as income tax rate reductions, in other areas such as base broadening, and in the case of Singapore vigorously using tax policy as an active instrument of industrial policy and social engineering, there has been divergence. Third, issues surrounding the taxation of international income flows have assumed increased importance, particularly in Singapore. Fourth, both jurisdictions have been attempting to reduce the revenue importance of income-based taxes, though for different reasons. In both jurisdictions, introduction of a general consumption tax is under active consideration, though for different reasons. This issue is discussed in the next section.

IV. TAX REFORM PROPOSALS

In both jurisdictions the main tax reform proposal concerns the general consumption tax. Neither jurisdiction has any experience with such a tax, so its introduction would require major adjustments in the tax administration. In both jurisdictions it is envisaged that the role of income tax will be reduced but not eliminated. Thus a change in the tax mix towards more reliance on an in-rem consumption tax is envisaged. Since the traditional debate between the income and consumption tax is based on both taxes being of the personal type, care must be taken to apply the conclusions on saving, work effort and other aspects of the traditional debate to the proposals for the consumption tax in the two jurisdictions.

While the tax reform discussion in both jurisdictions centers on the consumption tax, the reasons advanced for it and its form differ considerably.

In Singapore, the Finance Minister, in his 1991/92 budget speech, announced that work on a draft legislation for a Goods and Services Tax ("GST") has been completed. Since services can only be taxed at the retail level, it may be surmised that a comprehensive value added tax ("VAT") up to the retail level is the most probable choice. He indicated that a White Paper and draft legislation will be tabled in Parliament at the appropriate time. In the 1990/91 budget speech, the Finance Minister did not envisage actual implementation of the GST for some years.

In Hong Kong, a proposal for a general consumption tax was first officially mentioned in the 1987 budget speech. In the 1991/92 budget speech, the Finance Secretary indicated that

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work on the proposal for a sales tax, probably at the wholesale level, is continuing.

While in Singapore both goods and services at all stages of production and distribution are expected to be in the sales tax base, in Hong Kong, a single stage tax at the wholesale level is envisaged. The economic effects are likely to differ accordingly. The proposed GST in Singapore is likely to be more revenue-productive (assuming the same rates), more neutral among commodities and methods of doing business, and more effective in exempting exports and investment goods. However, it will have higher administrative and compliance costs. Particularly troublesome areas will be the tourist and financial sectors and provision of credit for exports (Asher and Strazzullo, 1991). The equity effects will depend on the concurrent changes in the income and other taxes, and whether essential commodities such as food and clothing are exempt.

The reasons advanced for the adoption of a general consumption tax also vary between Singapore and Hong Kong. In Singapore, the Economic Committee has argued for the introduction of a consumption tax on the grounds that it is economically preferable (mainly due to positive effects on saving) to income tax, and to compensate for the revenue loss from the proposed reductions in the income tax rates and introduction of additional fiscal incentives (1986a at 91-93).

The Economic Committee envisaged only a change in the tax mix in favour of in-rem taxes. The Finance Minister, in his 1990/91 budget speech, indicated that the proposed consumption tax is needed as a complement to direct taxes to finance additional expenditure programmes. In addition, he argued, consumption tax will be a more stable source of revenue than the income tax.

The main concern in Hong Kong has been the dependence on the income tax, particularly the vulnerability of income tax revenue, to fluctuations in the economy (1991/92 budget speech). Since the emphasis is on a more stable source of revenue for financing recurrent expenditure, only a change in the tax mix is envisaged. It appears that the main reason for opting for the wholesale rather than retail level or VAT in Hong Kong is administrative ease, some technical problems notwithstanding. Greater complexity of the distribution channel as compared to the manufacturing or the retail levels, or difficulties in separating direct sales by manufacturers to the retailers or by the wholesalers to the consumers are regarded by the advocates as capable of solution through clarity in legislation and by administrative guidelines.

The recent international practice has been towards the VAT rather than single stage taxes (OECD, 1988). There appears to be a need to examine the rationale for the wholesale level sales tax in Hong Kong in greater detail, particularly as economic effects appear to have received less than adequate attention.

In addition to the general consumption tax, there has also been some discussion concerning the appropriate design of regulatory taxes in Singapore. These have centered on the need to minimize congestion on the roads and to ration foreign workers. It is argued that in both cases, allowing an unrestricted market to operate would lead to unacceptable economic or social costs. In the case of the motor vehicles the mechanism adopted is as follows: the government decides how many additional motor vehicles can be registered in any given quarter. The individuals (or motor vehicle dealers) are then allowed to bid for a predetermined number of Certificate of Entitlements ("COEs"). An individual purchasing a new car must have a COE. The current debate centers on the terms and conditions governing the transferability of the COE. The government has also announced its intention to progressively move towards electronic road pricing, thus moving annual charges from ownership to usage of vehicles. In the case of foreign workers, a similar mechanism, beyond a predetermined number of workers to be allowed in through the payment of the regular foreign workers levy is under discussion. If this is adopted, then there will be a two-tier levy on foreign workers, a basic fixed levy and a variable one depending on the bid prices.

V. FUTURE DIRECTIONS

Before noting the general factors which may affect tax policies in the 1990s, it may be useful to briefly mention the constitutional framework in which the tax policies will need to operate in Singapore and Hong Kong.

An important and potentially far-reaching constitutional development in Singapore is the Elected Presidency Law ("EPL"). The incumbent President assumed the authority of an elected President in early 1991, but provisions relating to certain fiscal powers of the government are yet to be enacted. Two main fiscal powers under the EPL are the right to veto the annual budgets of the government, statutory boards and key government companies, if they draw on reserves accumulated during the terms of the previous governments, and the power to scrutinize and, if necessary, veto any large item of expenditure by a statutory board or government company. The President also has the right to veto key public service appointments, including those concerned with fiscal aspects.

The EPL does not forbid the use of reserves by the government, but it requires the concurrence of the President before this can be done. Thus a deficit budget is still possible. The EPL leaves the decisions concerning the level of government expenditure and taxation with the cabinet and the Parliament, so the President does not have any direct oversight powers over the level or size of the public sector, although he can exert considerable influence because of his veto powers.

There are still ambiguities. These concern the definition of reserves accumulated by the previous governments. In addition to the definition of "reserves", whether these are on a gross or net basis, and the method of valuation, ambiguities could arise when longer term projects are undertaken during the terms of two governments. There is also a need to distinguish between a country's official reserves and accumulated balances in various funds around which the government budget is organized.[18] It is unclear how income from the reserves as opposed to the stock of reserves is to be treated for budgetary purposes.

The operation of the EPL appears to require much more transparency in the level of the reserves and balances in various

18. For a description of Singapore's budgetary system, see Asher, 1989b, at 131-136.

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government funds, and the linkages between the two. Whenever a new government is formed, it would be useful to make the level of reserves accumulated by the previous government public and explain the basis for arriving at that figure. Only then can an informed public discussion be undertaken. Unlike in the past, fiscal information would need to be treated more as a public good, rather than a resource to be used strategically.

As Hong Kong is to become the HKSAR of the PRC in 1997, it is to the Basic Law that one must turn for the future constitutional framework. The relevant Articles are 106 to 108 (PRC, 1990, at 38-39). Article 106 prescribes that the HKSAR will have independent finances, which will be used exclusively for its own purposes and that the central government will not levy taxes in the HKSAR.

Articles 107 and 108 concern a balanced budget and low tax regime, respectively.[19] Article 107 provides: "The Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product."

In the draft Basic Law of 1988, the balanced budget article referred to balancing the budget and keeping the budget levels in line with the GDP growth rate over a "....number of fiscal years taken as a whole" (Tang, 1988, at 479). This has been dropped from the 1990 version. The three paragraphs of the 1988 version have been merged into one paragraph.

The above changes have increased the ambiguity and at the same time by dropping the reference to a period as a whole over which balance is to be achieved, made the balanced budget requirement more stringent. The ambiguity arises because while in the first part of the paragraph, the word "shall" is used, in the second part, the words "...strive to achieve fiscal balance" are used. The word "shall" refers to the outcome, while the word "strive" refers to the process. It is not clear which is the operative word as "strive" could negate "shall". Ambiguity may also arise in the interpretation of "... keeping the budget commensurate with the growth rate of its gross domestic product". It is not clear whether the budget refers to taxes, total revenue with or without borrowing, recurrent expenditure only, or recurrent and capital expenditure combined. It is also not clear whether the tax or expenditure aggregates can increase only at the same rate as the GDP (and whether this is to be in nominal or real terms), or whether the word "commensurate" allows some increases in revenue and expenditure to GDP ratios.

Tang indicated that the balanced budget article is contrary to Hong Kong's historical experience, as between 1946/47 and 1988/89, there were 21 deficit budgets, 21 surplus budgets and one balanced budget on an estimated surplus or deficit basis (1988, at 482). On an outcome basis, there were eight deficit budgets and the rest were surplus budgets (1988, at 483).

Nevertheless, the balanced budget article will limit expenditure demands. In conjunction with the low tax regime article, this could also prevent any significant departures from the present and proposed tax system and measures[20].

Article 108 provides that "the Hong Kong Special Administrative Region shall practice an independent tax system. The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as a reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation". The low tax policy article in the 1988 draft Basic Law was more forthright. It stated that "the Hong Kong Special Administrative Region shall continue to practice a low tax policy" (Tang, 1988, at 486).

The main criticism of Article 108 is that it presumes that the present expenditure levels which include minimal provision for old age income maintenance, health care and poverty alleviation (i.e. social security) will and indeed should continue in the future. Giving constitutional status to a low tax regime takes too narrow a view of the role of tax policy in an affluent society such as that of Hong Kong.

Tang has argued that ".... before launching an overall review and arriving at a professional judgement on the characteristics of the present tax system, it would be misleading to label it categorically as a low tax system, and it would be even more biased and dangerous to set it as the sole objective of the tax policy for the future HKSAR government" (1988, at 488).

Stopping with the first sentence of Article 108 would have provided greater flexibility to future HKSAR governments. Given the balanced budget and low tax regime articles, even greater ingenuity and innovativeness will be required to respond to the implications of various factors which are likely to have a major impact on the future directions of tax policy.

There are four broad factors which are likely to have a major impact on the future directions of tax policies in Singapore and Hong Kong: affluent status, demographic factors, particularly the aging of the population, increasing linkages among the labour markets of the high income countries, and increased willingness of trading partners to examine all aspects of a country which could have a bearing on commercial opportunities in a globalized economy.

While a detailed analysis of the implications of these factors for future tax policies is beyond the scope of this article, some brief remarks may be made.

Affluence has usually been associated with a desire for wider choice and greater concerns for equity. The 1990s will be the first decade for both Hong Kong and Singapore as affluent societies. This, along with western influences, particularly the desire for participation in public decisions, will form an important backdrop for formulating tax policy changes. The importance of demographic changes lies in the manner of financing social security. If there is an increasing demand for a greater level of economic security than provided for at present, resources and mechanisms will have to be found to sat-

19. For an analysis of the debate on the balanced budget (Art. 105) and low tax policy (Art. 107) articles in the draft Basic Law published in April 1988, see Tang (1988). The discussion in the text is based on the April 1990 decree (PRC, 1990), but draws on Tang's analysis.

20. Tang, however, feels that the future governments of the HKSAR will through the use of various techniques falling within the law, render the constitutional limit concerning the balanced budget ineffective (1988, at 486).

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isfy this demand. Earmarking a part of the budget surplus (in addition to an initial amount coming from present reserves) for education, medical care, and upgrading existing housing is one avenue being attempted in Singapore. As labour markets become increasingly connected factors bearing on labour mobility will receive more attention. In the area of tax policy, this would concern the income tax structure, retirement age and benefits, and other factors which bear on the lifetime real after-tax income of those who have international mobility. Just as capital mobility has constrained tax policy, labour mobility is likely to have similar effects. Of course, labour mobility cannot be as great as capital mobility, so the constraint may not be as stringent. The fourth factor is likely to impact not only on the conventional tax burden on business but on such areas as regulatory charges and levies, and the extent and nature of subsidies and fiscal incentives provided by various jurisdictions. The term "level playing field" is likely to be increasingly applied to fiscal and related areas.

VI. CONCLUDING OBSERVATIONS

The tax policies of Singapore and Hong Kong have been characterized by a clear but narrow focus and by flexibility. While the tax policies in Singapore have been interventionist, Hong Kong has eschewed using tax policy to promote and nurture activities and sectors with potential comparative advantage. Various factors are likely to require broadening the objectives of tax policies. Moreover, the policies need to be more participatory. In both jurisdictions, constitutional provisions will act as a constraint against significant departures from past policies which, given the economic performance of the two jurisdictions, may be regarded as successful. The challenge for policymakers in both jurisdictions will lie in adapting tax policies to the need for broadening the objectives and for greater participation while remaining compatible with relevant constitutional provisions.

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SRI LANKA:

TAXATION COMMISSION REPORT

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I. INTRODUCTION

A comprehensive inquiry into the tax system in Sri Lanka was long overdue since there has not been a comprehensive review of the fiscal system and tax structure for almost a quarter of a century.[1] A Commission of Inquiry (hereinafter "the Commission") was appointed on 20 July 1989 to undertake a broad and comprehensive investigation, including:

- an analysis of the entire tax structure and the overall incidence of tax;
- an examination of the performance of the different taxes in relation to their potential;
- the formulation of recommendations on developing a fair, equitable and simple tax system conducive to promoting economic growth;
- the feasibility of introducing a value added tax system;
- harmonization of indirect taxes; and
- reform of the tax administration.

The Commission's report was presented to the Government in December 1990 and published in July 1991. This article highlights some of the major recommendations.

II. INCOME TAX

A. *Legal framework*

The Inland Revenue Act No. 28 of 1979 (the "Act") is the current law which imposes income tax in Sri Lanka. The Act was amended 14 times up to June 1990. The Commission observed that the series of amendments have resulted in tax legislation that is not easily understood by the taxpayer or the tax administration. The Commission felt that "the tax law should be simple and easily understood and that too frequent changes in the tax law, which lead to uncertainty and undermine public confidence in the tax system, should be avoided".

B. *Residence vs. source principle of taxation*

Sri Lanka uses the residence principle of taxation (subject to certain exemptions), in that income tax is charged in respect of profits and income wherever arising in the case of residents, and in respect of income arising in or derived from Sri Lanka in the case of non-residents. However, at present, foreign employment and professional income are exempt from income tax to the extent that such income is remitted to Sri Lanka. The Commission recommended that the residence principle of taxation be retained without granting further concessions and exemptions to other income sources. The Commission also recommended that the existing exemptions on foreign employment and professional income be reconsidered when the existing foreign exchange restrictions are reviewed.

C. *Foreign tax credit*

Sri Lanka has concluded double taxation agreements with 24 countries.[2] Relief from double taxation by way of tax credit is also provided for in the tax statute for non-treaty Commonwealth countries. The Commission supported the existing unilateral arrangements as well as the policy of entering into double taxation agreements with

1. This long felt need came into sharp focus when the Minister of Finance stated in his 1989 Budget speech: "I believe it is time to re-examine the entire tax system with a view to effecting reforms considered necessary. Therefore I propose to appoint a Taxation Inquiry Commission in keeping with our election manifesto to undertake a complete review of the tax system and to recommend changes necessary to make it both effective and efficient."
2. Treaties with three more countries have been concluded and await ratification.

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potential investor countries and other countries of importance to Sri Lanka. The Commission also felt that to the extent these measures are inadequate to prevent double taxation in cases of legitimate Sri Lankan activities abroad, a general right to a foreign tax credit should be considered.

D. *Self-assessment system*

Self-assessment for income tax was introduced in Sri Lanka in fiscal year 1972/73. The concept of self-assessment was not altogether new since the turnover tax (from its inception in 1964) was organized on the basis of self-assessment. The Commission concluded that the self-assessment system is well established in Sri Lanka and therefore is not in need of any basic changes. However, the Commission recommended that timely action be taken to ensure compliance, to service those taxpayers who comply and those who are in need of assistance to comply.

E. *Net income concept*

As a general rule, all outgoings and expenses incurred in the production of income are deductible in ascertaining profits and income chargeable to tax.[3] Several representations were made to the Commission that a more liberal definition of deductible expenses, which would accord with accepted principles of commercial practice, should be adopted. The Commission recommended that provisions on deductible expenses be extended to include all outgoings and expenses incurred wholly and exclusively for the purpose of the trade.

The other recommendations of the Commission which relate to the determination of net income are as follows:

- Commercial advertising expenditure should be allowed in its entirety. However, payments in the nature of donations and gifts made under the guise of advertising should be disallowed.
- Entertainment expenses should be made deductible in sectors earning foreign exchange, provided that records are maintained and limits are observed, as specified by the Commissioner General of Inland Revenue.
- Foreign travel expenses should be deductible but only reasonable expenses incurred for purposes of earning or saving foreign exchange, and in accordance with guidelines issued by the Commissioner General.
- Duly specified pre-commencement expenses should be allowed to be amortized over a period of five years.
- The ceiling on the repair expenses deduction in the business of letting premises for commercial purposes should be increased to 25 percent.
- As an alternative to contributions to gratuity funds, the option of taking a group life assurance policy by an employer on his employees to cover the payment of gratuity upon the cessation of employment should be allowed, and the payment of premiums on such a policy should be allowed as a deductible expense of the employer, provided they are paid under a general scheme set up under guidelines issued by the Commissioner General.
- The Commissioner General of Inland Revenue should formulate general guidelines for the deductibility of bad and doubtful debts.
- All training expenditure should be allowed in ascertaining profits and income and, if there is any doubt as to its allowability, the law should be amended as necessary.
- The rule of taxing part of the gains realized on disposal of business assets as capital gains should be abandoned and all gains realized on business assets should be fully taxable as business income.
- Depreciation allowances should be granted on buildings purchased.
- Rules should be introduced for the option of valuation of stock-in-trade on the LIFO principle.

F. *Taxation of individuals*

1. Family unit

The aggregation of the income of a husband and wife for individual taxation was abolished from the 1979/80 year of assessment. Currently, husband and wife are treated as separate taxpayers. The Commission concluded that the existing practice of taxing individuals as a single unit accords with the international trend towards separate taxation of husband and wife, and it recommended that joint taxation of husband and wife not be re-introduced.

2. Threshold and tax rates

The present threshold in the individual income tax system is 27,000 Rs., which represents approximately twice the per capita GNP. Because inflationary tendencies in Sri Lanka have pushed incomes above the threshold while real incomes have remained constant, the Commission recommended that the threshold be increased to 42,000 Rs., which represents approximately three times the per capita GNP. The Commission also recommended that the present maximum marginal rate of 40 percent for individuals be reduced to 35 percent with a four-band rate schedule at intervals of 36,000 Rs.[4] The proposed threshold and tax brackets should be reviewed every three years to adjust them for inflation.

3. Qualifying payments

The income tax law currently provides for relief in the form of deductions (subject to certain limits) for certain expenses called "qualifying payments". These deductions include donations to the government, to approved charities and to certain approved institutions; payments of life insurance and

3. The corresponding rule in the United Kingdom is that the expenses be wholly and exclusively incurred for the purpose of the trade. A similar rule prevails in India.

4. The proposed rate schedule is as follows:

Income Rs.		*Rate*
0	to 42,000	0%
42,001	to 78,000	10%
78,001	to 140,000	20%
140,001	to 150,000	30%
150,001	and above	35%

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medical insurance premiums; Provident Fund contributions; cost of the overseas education of a child; and investments in housing and certain approved undertakings. The Commission recommended that all qualifying payment reliefs be abolished as they negatively affect the equity of taxation, they complicate the tax system and are administratively cumbersome.

4. Exemption of public sector emoluments

The official emoluments of persons employed in the public sector are currently exempt from income tax. The rationale advanced for this exemption, when it was first introduced in 1979, was that the salaries of public sector employees were much lower than salaries in the private sector. This exemption was granted as an alternative to increasing public sector salaries, particularly the salaries of persons in professional and managerial grades, to a level comensurate with the private sector. These salary disparities have since been narrowed to a large extent by increasing the salaries of public sector employees. The Commission therefore recommended that the official emoluments of all public sector employees be made liable to tax and compensatory adjustments of salaries and pensions of those employees who would be affected be made to ensure that the net of tax salary or pension would remain unchanged.

G. *Taxation of companies*

For Sri Lankan tax purposes, a company is defined as a company incorporated or registered under any law in force in Sri Lanka or elsewhere and includes a public corporation. Companies in Sri Lanka are broadly classified as resident companies and non-resident companies for purposes of corporate taxation.

A resident company is one which has its registered or principal office in Sri Lanka, or a company of which the control and management of the business are exercised in Sri Lanka. A non-resident company is a company which is registered outside Sri Lanka and does not have a principal office in Sri Lanka. Resident companies are taxed on their worldwide income while non-resident companies are taxed only on profits and income arising in or derived from Sri Lanka.

1. Company tax rates

The corporate sector is subject to a differentiated company tax, together with a withholding tax on dividends.[5] Prior to 1 April 1988, companies in Sri Lanka were taxed under the "classical system" of taxation, i.e. profits earned by a company were first taxed in the hands of the company and the net of tax profits, when distributed, were taxed again in the hands of the shareholder. To mitigate economic double taxation, an "imputation system", by which a shareholder would enjoy a 50 percent imputation tax credit, was introduced in 1988.[6] The Commission observed that the multiplicity of rates in the company tax structure is an unnecessary complication and inhibits the smooth functioning of the company tax system, particularly the imputation system. The Commission therefore recommended that all companies be taxed at a uniform rate of 35 percent regardless of their form and size. The Commission concluded that it did not intend to recommend any changes to the imputation system without giving the system a reasonable trial period.

2. Foreign contractors

In the case of foreign contractors (mainly multinational companies), difficulties arise in computing local profits liable to tax. This may, at times, involve an examination of their worldwide transactions and accounts. In order to overcome such difficulty the Inland Revenue Act provides for income tax to be charged on profits of foreign contractors based on a fair percentage of turnover. A fixed percentage of turnover is not statutorily laid down except in the case of shipping (at the rate of six percent). The Commission observed that a specified and fixed percentage of turnover as a presumptive profit of foreign contractors would serve the interest of both the tax authorities and foreign contractors.

The Commission's other recommendations with regard to company taxation are as follows:

- Dividends declared out of exempt profits should not be exempt in the hands of the shareholders.
- A branch profits tax at eight percent on non-resident companies should replace the current remittance tax.
- The existing 15 percent withholding tax on dividends should be retained.
- The existing partial imputation system should be retained but full integration of corporate tax with individual taxation should be considered in 1995.
- A minimum tax as a general rule for companies is not recommended. However, if experience shows that tax evasion and avoidance are difficult to cope with in a substantial number of cases, a minimum tax may be considered.
- A tax concession to offshore companies is not recommended though there is no objection to retaining the current concessions granted to offshore shipping and banking.

H. *Capital gains*

Taxation of capital gains was introduced in Sri Lanka in 1959 with the implementation of the "Kaldor Reforms". The tax

5. The rate structure applicable to different categories of companies is as follows:

Quoted public company	40%
People's company	40%
Small company	
– Taxable income up to 250,000 Rs.	33⅓%
– Taxable income in excess of 250,000 Rs. but less than 333,333 Rs. If taxable income is more than 333,333 Rs. a company is deemed not a small company.	
– Other resident company (private company and unquoted public company)	50%
Public corporations	50%
Non-resident company	
– On profits	50%
– On remittances during the year, if less than ⅓ of taxable income	33⅓ % of remittances.
If not less than ⅓ of taxable income	11⅓ % of taxable income.

6. For details, see R. de Silva, 42 *Bulletin for International Fiscal Documentation* (December 1988), at 537.

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treatment of capital gains has since undergone substantial changes. Capital gains arising from a change of ownership of property held for more than two years are currently subject to tax at concessionary rates, which vary according to the length of the time the property was held before disposal (from 25 percent for property owned more than two years but less than five to zero percent for property owned more than 25 years). Where the property is held for not more than two years, the capital gain is treated as ordinary income and taxed at normal personal or company rates.

The differential rate structure is intended to distinguish between short-term and long-term nominal gains, the latter presumably reflecting an enhanced appreciation in value due to inflation. However, the present scheme provides greater relief to high income taxpayers as compared to the low income taxpayers. Prior to 1987, tax law attempted to make adjustments for inflation by permitting a deduction of a percentage of the capital gain from taxable income. The Commission felt that the basis of assessment of capital gains which prevailed before 1987 is simpler and more equitable in some aspects. It therefore recommended that a capital gain arising from a change in ownership of any property held by its owner for more than five years be reduced by half and then taxed at normal progressive rates.[7]

III. TAX INCENTIVES

Many developed and virtually all developing countries have at various times used tax incentives to stimulate and sustain economic growth. Since 1951, tax incentives have been granted in selected areas of the economy, such as agriculture, housing, non-traditional exports, tourism, the gem industry, import-substitution industries, etc. After 1977, with the introduction of a liberalized economy based on private enterprise, tax incentives became the major instrument of fiscal policy and they spread to a wider area of economic activity.

In view of the low tax structure formulated and recommended by the Commission, it did not see a need to continue tax holidays and tax exemptions in the future. The Commission therefore recommended that the whole plethora of tax exemptions, tax holidays and half tax holidays be abolished. However, the Commission did not recommend a unilateral withdrawal of incentives granted under existing law.

A summary of other tax incentive recommendations are as follows:

- review of the tax concessions granted to the housing sector;
- no further concessions to the tourist hotel sector;
- continuation of current provisions relating to exemption of interest on Non-Resident Foreign Currency Accounts in bank profits and income from overseas employment and professional services under conditions specified, and export of and sales to tourists in foreign currency of gems and jewellery, for a period of four years;

With respect to Greater Colombo Economic Commission ("GCEC") enterprises:

- Such enterprises should be brought, at the end of the tax holiday period, within the normal tax regime and therefore the option of paying taxes based on a percentage of the turnover be withdrawn, unless such a system is introduced as a general rule for specified areas of activity.
- The tax exemption under the GCEC package should be confined to export profits.
- The tax exemption during the tax holiday period on emoluments earned by expatriate personnel should be withdrawn.
- A withholding tax on domestic sales of GCEC enterprises be introduced.
- No further exemptions should be granted for dividends declared by tax holiday companies.
- The incentive programme contained in the "Strategy for Industrialization in Sri Lanka" is conceived as a short-term measure and the long-term policy should be chosen in line with the Commission's recommendations.
- Only a five-year tax holiday should be made available to unit trusts and venture capital companies. Guidelines should be formulated for venture capital companies and their operations be closely monitored.

IV. CAPITAL TAXES

Taxation of capital has been a feature of the Sri Lankan tax system for several years, and has taken many forms. Estate duty and gift tax which were introduced in 1919 and 1959, respectively, were abolished in November 1985. The Commission's recommendations with respect to the remaining capital taxes are as follows:

- The annual wealth tax should be abolished.
- A tax on all capital transfers, including conveyances by executors, trustees under a will or by administrators, should be charged by extending the normal stamp duty rates to such transfers.
- An attesting Notary should be required to submit an abstract of the particulars of all deeds attested by him to the Valuation Department.
- Stamp duty should be imposed on applications for letters of credit to be retained for the time being but eventually abolished when VAT comes into operation. Such duty should be levied not on the present basis but on the full value of the application for letters of credit and the current rate of stamp duty on applications to be reduced from three to two percent.
- The threshold on the imposition of stamp duty on receipts should be increased from the present 100 Rs. to 500 Rs.
- The existing coverage of stamp duty to ascertain whether the imposition of duty on numerous small items, particularly where the cost of compliance is high, should be abolished.
- A uniform stamp duty rate of four percent should be imposed on transfer of all immovable property.
- The levy of stamp duty on transactions in quoted shares should be withdrawn for a period of two years and reviewed thereafter.

7. This presupposes the existence of a modest tax rate structure as recommended by the Commission.

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V. TURNOVER TAX

The turnover tax was introduced in Sri Lanka in 1964 and was originally known as "business turnover tax". The turnover tax is by and large a multi-stage tax levied on gross receipts, with a broad coverage including manufacturing, wholesale and retail trade, rendering of services and imports. The revenue from turnover tax has significantly increased over the years and in 1989 the total turnover tax collected amounted to 14,658 Rs. million (i.e. 30 percent of tax revenue). Turnover tax is levied quarterly (at three-month intervals) at different rates of tax on different trades, commodities and services with a threshold of 25,000 Rs. per quarter. The multiplicity of rates in the turnover tax structure has become complicated and administratively cumbersome. In view of the complex nature of the turnover tax structure, the Commission recommended that the turnover tax structure be simplified by introduction of a single standard rate for manufactured an imported goods, supplemented by one or two reduced rates for goods considered essential for mass consumption.

Other recommendations include:

- Registration of all businesses and trades, including wholesale and retail trades, with local authorities irrespective of a threshold, and the levy of an annual licence fee of 1,000 Rs. which would constitute a minimum turnover tax under the current law.[8]
- An increase of the threshold should be considered when the VAT is introduced.
- Extension of the credit system to the service sector and commodity-wise to all inputs including capital goods, except, for example, non-commercial vehicles.
- Removal of the turnover tax on financial instruments, including charges on inter-bank transactions and on transactions between financial intermediaries.
- Elimination of ten percent uplift provision in the turnover tax law, used as a base in calculating the turnover tax at the import stage, when VAT is introduced.
- Provision of a statutory limitation of six years for making turnover tax assessments or additional assessment, except in cases of fraud or wilful neglect.
- Review of the turnover tax law and procedures, particularly those applicable at the import stage, in order to eliminate anomalies.

VI. VALUE ADDED TAX ("VAT")

The feasibility of transforming the turnover tax into a VAT was one of the specific mandates given to the Commission. After considering the concept and the different methods of VAT from the standpoints of revenue yield, equity, economic effect and administration, the Commission recommended the following:

- A task force in the form of a "VAT Development Office" should be established in the Inland Revenue Department to plan out the transformation of the turnover tax into a VAT system.
- The VAT system should be introduced by 1 April 1993.
- In view of turnover tax being vested in the Provincial Councils (an autonomous Political Unit within the unitary system of government in Sri Lanka),
  (a) the VAT system should be limited to imports, manufacture and services, or
  (b) a full fledged VAT system, including the wholesale and retail trade should be introduced, in addition to turnover tax imposed by Provincial Councils. (The latter scheme is preferred by the Commission.).
- As an interim measure, the present credit system in the turnover tax should be extended to all areas of manufacture and services.

VII. HARMONIZATION OF TAXES ON GOODS AND SERVICES

A commodity, before it reaches its ultimate consumer, is subject to a multitude of taxes and levies at different levels. These taxes and levies include import duty, excise duty and turnover tax. The Commission was of the view that the existing system of levying these taxes and charges leaves much to be desired and stated that representations to the Commission were directed both against the complicated nature of the system and the alleged injustices of computing tax on tax. The Commission therefore recommended that the ad valorem excise duties should be levied, in the case of imported goods, on the CIF value plus import duties (and cesses); in the case of domestic goods, on the ex-factory price minus excise and turnover tax; and that the turnover tax should be levied, in the case of imported goods on the CIF value plus import duties and excise duty plus (until the VAT is implemented) a ten percent mark-up; and in the case of domestic products, on the ex-factory price minus excise duty and turnover tax, for the harmonization of taxes on goods and services.

VIII. REVENUE ADMINISTRATION

The principal agencies which deal with the administration of taxes are Customs Department, Inland Revenue Department, Excise Department and the Fiscal Policy Division of the Treasury. The lack of coordination among these departments has adversely impacted revenue administration. To eliminate the isolated character in the operations of revenue agencies, the Commission recommended the establishment of a Board of Revenue, comprising the Director General of Customs, the Commissioner General of Inland Revenue and the Commissioner of Excise, with a full-time Chairman who would head the Board and report directly to the Minister of Finance.

The Commission's other major recommendations with respect to revenue administration are as follows:

- A permanent National Taxation Commission should be set up for a continuous review of tax policy and evaluation of its impact on the country.
- An independent Revenue Ombudsman, to whom the public could have direct access for redress of their revenue grievances, should be appointed.

8. This annual licence fee of 1,000 Rs. would, for traders having a turnover in excess of the current threshold of 25,000 Rs., be an advance payment of tax, which could be set off against the turnover tax payable.

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- A Taxpayers' Charter or a Taxpayers' Bill of Rights should be enacted.
- Revenue Courts with jurisdiction to deal with all judicial matters related to the administration of revenue should be established.
- A revenue Training Institute should be established to cater to the training needs of all revenue departments.
- Recruitment of professional staff to the different revenue departments should be made through a combined examination.
- A statutory limitation for collection of tax arrears should be formulated to run over a period of ten years. This limitation should be reviewed in 1993 with a view to reducing it to six years. (At present there is no statute of limitations for recovery of taxes assessed.)

IX. CONCLUSION

The Commission's recommendations have been received with mixed reaction. While the recommendation on the abolition of tax holidays and exemptions are not favoured by industrialists and their trade chambers, the proposal to expand the threshold and reduce the marginal rates of tax is welcomed by all. A taxpayers' Bill of Rights and a Taxpayers' Charter are new concepts in Sri Lanka. The proposal to enact such a Bill of Rights or Charter, if implemented, will undoubtedly improve the attitude both of the tax official and the taxpayer and lead to a better tax official- taxpayer relationship. The Government has announced that the recommendations of the Taxation Commission will be implemented as from fiscal year 1992/93.

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SOUTH ASIA:

TRENDS IN TAXATION

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I. INTRODUCTION

The scope of this article extends to the five major countries of South Asia: Bangladesh, India, Nepal, Pakistan and Sri Lanka. Broadly speaking, these countries comprise the Indian sub-continent, an area which was usually referred to, prior to 1947, as Britain's Indian empire. All five countries are low-income developing economies and together inhabit one-fifth of the world population.

The tax structure of South Asian countries is typical of developing economies, both in terms of level and composition. In addition to being a source of revenue, the tax system is also used to influence resource allocation, to achieve redistributive justice and to achieve a host of other socio-economic objectives. These countries may be said to belong to the twilight zone of the third and fourth stage of the theory of tax structure development propounded by Harley Hinrichs.[1]

Taxes are by far the most important source of finance for development and welfare activities of governments in South Asia. In view of the inadequate voluntary savings, taxes are considered necessary to curtail private actual and potential consumption.

II. TAX VERSUS NON-TAX REVENUE

South Asian countries rely heavily on tax revenues which, except for Pakistan, formed more than 80 percent of total central government revenues in 1988.[2] In India and Nepal, tax revenue as a percentage of total revenue has hovered around 80-85 percent during the period 1980-88. In Pakistan, the share remained between 76-83 percent during the period 1980-86. Significant changes in the share of tax revenue are noticeable in Bangladesh and Sri Lanka. In Bangladesh, tax revenue formed 68.1 percent of total revenues in 1980 while it stood at 83.5 percent in 1988. A reverse trend is discernible in Sri Lanka where tax revenue as a proportion of total revenue declined from 94.7 percent in 1980 to 86.1 percent in 1988.

For all of the countries of the region, non-tax revenue mainly comprises receipts of interest on government loans, profits of public sector companies and cash grants-in-aid received from foreign countries and international organizations. An important source of non-tax revenue in Nepal is the auctioning of import licences.

III. LEVEL OF TAXATION

The level of taxation in a country is traditionally judged in terms of the ratio which taxes bear to some measure of national income aggregate. A change in the ratio is determined by variations in both the numerator (total tax revenue) and the denominator (national income). There are various problems associated with the definitions of the numerator and the denominator of the tax ratio. For example, should social security contributions be included in tax receipts? The denominator suffers from more ambiguities because there are various measures of national income. Among the alternative measures of national income, the more important are gross domestic product ("GDP"), gross national product ("GNP") and net national product ("NNP").[3] Should taxes be related to GDP or NNP, and at market prices or at factor cost? A discussion of these technicalities is beyond the scope of this article. Moreover, the preference for one measure over the other hardly influences tax ratios in practice.

In choosing from the alternative measures of national income, the important considerations are: (a) the measure chosen should be readily available, (b) it should be widely understood and (c) it should be reliable. In view of these considerations, GDP

1. See H. Hinrichs, *General Theory of Tax Structure Change During Economic Development* (Cambridge, Mass: Harvard Law School, 1966). Hinrichs mentioned five stages through which a tax structure evolves as economies develop: *First stage*: Traditional societies rely primarily on "traditional" direct taxes, i.e. taxes on land, livestock, water rights, etc. *Second stage*: Society breaks away from old ways and indirect taxes become more important, particularly taxes on foreign trade, i.e. external indirect taxes. *Third stage*: Traditional direct taxes decline relative to national income and government revenue. *Fourth stage*: Domestic production increases and domestic indirect taxes (excise duties and sales taxes) grow rapidly to replace customs duties. *Fifth stage*: Economy gains maturity and modern direct taxes, e.g. personal income and corporate profit taxes become predominant.

2. The ratio between tax to non-tax revenue in individual countries in 1988 was as follows (in descending order): Sri Lanka (86.1:13.9), Bangladesh (83.5:16.5), Nepal (81:19), India (80.7:19.3) and Pakistan (77.3:22.7 in 1986).

3. GDP includes locally-produced income, including income accruing to non-residents but excluding foreign income of residents. GNP, on the other hand, excludes local income of non-residents but includes foreign income of residents. NNP excludes depreciation (or capital consumption) and signifies a measure of output available for private and government consumption and investment without reducing the capital stock.

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TABLE I

TRENDS IN THE TAX-GDP RATIO IN SOUTH ASIAN COUNTRIES: 1975-1987

(in percent)

Country/Year	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
India	15.1	15.4	14.7	15.6	16.2	14.5	15.0	15.2	15.0	15.3	17.0 1	6.8	17.1
Bangladesh	....	7.2	7.4	7.2	7.3	7.8	8.2	7.5	7.9	6.1	6.1	7.0	7.1
Pakistan	13.5	14.2	13.7	14.3	15.9	13.3	13.5	12.8	12.9	13.3	12.2	....	....
Nepal	....	5.2	6.4	6.3	6.7	6.6	7.5	7.1	7.2	7.2	7.6	7.2	7.6
Sri Lanka	16.5	16.2	15.7	25.1	22.0	19.6	16.5	15.3	16.8	19.9	19.6	17.7	18.6

.... = data not available.
Source: International Monetary Fund, *Government Finance Statistical Yearbook* (Volume XIII), 1989.

at market prices is commonly used as a denominator of the tax ratio. GDP is preferred because it avoids estimates of depreciation which is subject to various statistical and conceptual problems. For example, the OECD uses GDP at market prices as the denominator for comparing tax ratios in its member countries.

Tax/GDP ratio is generally regarded as an index of the relative "tax burden" in a country over a period of time or when countries are compared for the same period. To describe the "tax burden" in terms of tax ratio can be misleading because taxes, though a burden for individuals, are used to finance vital governmental activities and to make transfers to sectors of society requiring assistance. The ratio does not reflect the importance of the government sector as a final purchaser of goods and services because a portion of tax revenue is returned to the private sector in the form of payments such as pensions, etc. If such payments are deducted from the total tax revenue, the ratio of the remaining tax revenue to GDP will evidence the importance of the government as the final purchaser of goods and services. These factors must be taken into account when interpreting the tax ratios.

Table I presents tax/GDP ratios in South Asian countries. For the year 1987, Sri Lanka was the highest-taxed (18.6 percent) while Bangladesh the lowest-taxed (7.1 percent) nation in the region. The ratios for other countries were as follows: India (17.1 percent), Pakistan (12.2 percent for 1985), and Nepal (7.6 percent). The tax/GDP ratio in South Asian countries is very low as compared to developed countries.[4] During the period 1975-87, tax/GDP ratio hovered around 15-17 percent in India and Sri Lanka, 6-7 percent in Bangladesh and Nepal, and 12-13 percent in Pakistan (during 1975-85). Broadly speaking, tax policy, as an instrument of resource mobilization, has fared impressively well in Sri Lanka and India, moderately in Pakistan, and poorly in Bangladesh and Nepal.

IV. DIRECT VERSUS INDIRECT TAXES

A notable and disquieting feature of the overall tax structure of South Asian countries is the limited role of direct taxes (taxes on income and property) in total tax revenue. The percentage shares of direct and indirect taxes in total revenue in different countries in 1988 were as follows: India (14.6 and 64.8), Bangladesh (14.3 and 67.7), Pakistan (10.9 and 66.3 in 1986), Nepal (13.8 and 67.0), and Sri Lanka (15.3 and 70.7). In India, and Pakistan the relative significance of direct taxes decreased during the 1980s while in the other three countries it remained almost the same. The subdued role of direct taxes has made the tax structure of South Asian countries unbalanced and inequitable.

The limited role of direct taxes is due to the large subsistence agricultural sector, small-scale industrial activities, lack of monetization and accounting practices, and low levels of personal income. Even a modest basic exemption for purposes of income tax keeps the vast majority of income earners outside the tax net.[5] Moreover, a host of other factors have contributed to the restricted role of direct taxes, including a plethora of exemptions/concessions in the direct tax law, ineffective tax administration and widespread tax evasion.[6] In Sri Lanka, the wages of all public servants are exempt from taxation. The net result of this and various other concessions is that only about 200,0000 individuals either file tax returns or fall under the pay-as-you-earn system.[7]

The inadequacy of direct taxes has led to heavy reliance on indirect taxes, i.e. domestic commodity taxes (excise duties and sales taxes) and taxes on international trade (customs duties). The preponderance of indirect taxes has serious equi-

4. According to a recent study of OECD countries, the tax/GDP ratio was as high as 53.5 percent in Sweden, followed by Denmark (50.6 percent), Norway (49.8 percent), Netherlands (45.5 percent) and Belgium (45.4 percent). See OECD, *Revenue Statistics of OECD Member Countries, 1965-87* (Paris: OECD, 1988), at 82.
5. For example, the total number of individual income taxpayers in India is seven million, representing 2.5 percent of the country's working population.
6. In India, a government report has estimated the ratio of tax-evaded income to GDP to fall in the range of 4.2 percent to 8.6 percent in 1980-81. See Government of India, Ministry of Finance, *Aspects of the Black Economy in India* (March 1985), at 161. In Pakistan, the Taxation Reforms Commission (1986) estimated in its report that out of 70 billion Rs. of assessable income only 19 billion Rs. was being assessed and 51 billion Rs. was being evaded. The Commission recommended the simplification of procedures and widening of the tax base as much as possible to increase the proportion of direct taxes.
7. Glenn P. Jenkins, "Tax Changes Before Tax Policies: Sri Lanka, 1977-88", in Malcolm Gillis, ed., *Tax Reform in Developing Countries* (Durham, North Carolina: Duke University Press, 1989), at 242.

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ty implications. As is well known, indirect taxes (unlike direct taxes) do not take the personal circumstances of the taxpayer into account. The incidence of indirect taxes depends on the selection of commodities for taxation and the rate of tax on commodities. Equity can be promoted if luxury items are heavily taxed with basic necessities either exempted or moderately taxed. However, in poor countries, the demand for luxury items is limited, apart from being price elastic. Conversely, the demand for necessities is vast and price inelastic, compelling the government to extend the tax net to basic necessities. Therefore, distribution of the indirect tax burden is often, though not always, regressive and even the poorest of the poor are forced to contribute to public exchequer.

V. TAXES ON INCOME AND PROPERTY

Among the direct taxes, the only significant tax from the revenue perspective is the income tax. In 1988, taxes on income (including profits and capital gains) constituted 14.3 percent of total central government revenues in India, 11.7 percent in Bangladesh, 11.1 percent in Sri Lanka, 10.8 percent in Pakistan (in 1986) and 8.4 percent in Nepal.[8] With the exception of Bangladesh, where the share hovered around 10-11 percent, in all other countries the relative significance of income tax declined during the period 1980-88.

Exclusion of agricultural income from the purview of income tax is an important feature of the tax systems of South Asian countries. The governments have generally remained lukewarm in taxing agriculture directly, foregoing a potential source of revenue in the process. The exclusion of agricultural income from the income tax base provides opportunities for tax evasion. It is not uncommon among the urban elite to own agricultural farms on the outskirts of metropolitan cities for the sole purpose of diverting their high non-agricultural income from taxable zones to tax havens. It is, of course, true that there are serious problems in assessing agricultural income, i.e. small-scale holdings, widely dispersed potential taxpayers, fluctuations in production due to uncertain weather conditions and lack of accounting practices on the part of illiterate farmers. It is also true that governments have invested heavily in agriculture in terms of irrigation facilities, availability of better quality seeds, subsidized fertilizers and electricity, credit and marketing facilities and support prices for the main crops.

The benefits of agricultural development have accrued unevenly to rural masses, creating an affluent elite group in rural areas. It is this class which should pay its due to the national exchequer. The resentment of fiscal experts against non-taxation of agricultural income is widespread and is aptly captured in the following remarks of a Pakistani scholar:[9]

> The taxation of agriculture is implicit in the promise of land reforms contained in the PPP (Pakistan's People Party) manifesto. Moreover, during its first government the party had imposed agricultural income tax and should not now surrender to the feudals who do not pay direct taxes while enjoying all types of concessions and subsidies and get prices of their produce raised year after year, thus putting an added burden on the poor. The plea that agricultural income tax should not be levied as "ushr" is being collected mixes a religious levy with a secular tax that must be levied in the overall national interest. Moreover, the collection from "ushr" is only 0.1 percent of the share of GNP contributed by agriculture and thus cannot be a substitute for tax on agricultural incomes.

Barring Nepal, the relative share of taxes on property in the total revenue of governments in South Asian countries is almost negligible.[10] In India and Pakistan, it has remained less than one percent since 1980. In Bangladesh, it has hovered around 1-2 percent. In Sri Lanka, the figure remained around 2 percent up to 1986 when it increased to 3.7 percent in 1987, and further up to 4.2 percent in 1988. In Nepal, a declining trend is noticeable in the share of property taxes, although they still comprised 5.4 percent of total revenues in 1988.

The development process in South Asian countries has bestowed large benefits on select groups such as industrialists, real estate owners, traders, speculators and large land owners. This has generated social tension, requiring urgent corrective measures. Taxes on income and property which could have played an effective role in moderating economic disparities have, by and large, failed to achieve this objective.

VI. TAXES ON DOMESTIC PRODUCTION

Among the indirect taxes, the taxes on domestic production (mainly excise duties and sales taxes) are more important than taxes on international trade in all countries of the region.[11] In 1988, taxes on domestic production constituted 40.8 percent of total revenue in Sri Lanka, 36.0 percent in Nepal, 34.8 percent in India and 33.2 percent in Bangladesh. In Pakistan, the share was 33.4 percent in 1986. The share of taxes on domestic production increased significantly in Sri Lanka from 26.8 percent in 1980 to 40.8 percent in 1988,

8. In contrast, developed countries such as Australia, Denmark, Finland and New Zealand obtain more than 50 percent of tax revenue from taxes on income and profits. See OECD, *supra* note 4, at 86.

9. Muzaffar Hasan, "Possible New Initiatives in Fiscal Policy", 49 *Pakistan and Gulf Economist* (3-9 December 1988), at 14. In the wake of movement toward an Islamic economy launched in 1979, the tax system of Pakistan has some special features. For example, in June 1980, *zakat* (poor tax) was deducted from all deposits and saving accounts in the banks at the rate of 2.5 percent per annum. In 1983, *ushr* (tax on agricultural produce) was implemented at the rate of five percent. These two Islamic levies are administered separately for charitable purposes.

10. The rationale for property taxes (wealth tax, gift tax and estate duty) is advocated on both benefit and ability-to-pay considerations. Protection of life and property has been traditionally a primary function of the government, and a considerable cost is incurred in carrying out this duty, both in terms of law enforcement and judicial administration. The main beneficiaries of these services are the wealthy who, as a rule, should contribute toward the expenses of such services. Another dimension of the benefit argument is that public services, such as roads, street lighting, community centres, public parks, etc., increase the value of real estate, conferring unearned benefits on the owners of such property. It can therefore be argued that property owners should pay for these services. In terms of ability-to-pay, possession of property is a measure of economic well-being, and therefore, of taxable capacity, quite apart from the income earned from that property. Taxation of property is also justified on equity grounds.

11. This was not always the case, however. During the colonial period, customs duties (mainly import duties) dominated public revenue because domestic requirements for manufactured goods were met mostly by imports, chiefly from Britain. The situation has changed significantly. With increasing internal production and diversification of their economies, the former colonies have greater scope for domestic commodity taxation.

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while in India it declined from 42.0 to 34.8 percent over the same period. For the remaining three countries, the trends are insignificant as well as irregular.

In India, excise duties are confined to industrial sector products with the notable exceptions of coffee and tea. The top ten items in terms of excise revenue are as follows: cigarettes, motor fuel, synthetic filament yarn, cement, iron and steel, tyres and tubes, refined diesel oil, aluminum, plastics and motor cars. Under the Indian Constitution, the right to levy sales tax is vested in State Governments. Each of the 25 states is empowered to levy and collect tax on the sale of goods within its territory according to its own rules.

In Bangladesh, a business turnover tax is levied at the rate of two percent of the turnover in respect of goods and services specified by the National Board of Revenue. In Pakistan, sales tax is levied at one stage only and applies to the whole of Pakistan, excluding certain tribal areas. The standard rate of sales tax is 12.5 percent on locally manufactured goods, including urea formaldehyde, asbestos waste, cosmetics, toilet preparations, perfumery, automobile parts, motor cars, machine-made synthetic carpets and cigarettes.

In Nepal, excise duties are levied under the Excise Act, 1958. The main items which attract excise duties are matches, sugar, cigarettes, liquor, jute, artificial yarn, stainless steel utensils, timber, rice and bricks. Sales tax is another important commodity tax levied under the Sales Tax Act, 1966. In Sri Lanka, a domestic commodity tax is levied in the form of a business turnover tax under the Business Turnover Tax Act, 1981. It is levied on sales and other deliveries made by a business carried on in Sri Lanka, including the business of a manufacturer or importer. The rate of business turnover tax ranges from one to two percent.

VII. TAXES ON INTERNATIONAL TRADE

Taxes on international trade (i.e. customs duties) are another important source of indirect tax revenue in South Asian countries. Their relative share in government revenue has registered sharp variations in Sri Lanka and India. In Sri Lanka, the share of taxes on international trade declined from 50.4 percent in 1980 to 29.9 percent in 1988, while in India it increased from 21.7 to 30.0 percent over the same period owing to increased emphasis on fiscal controls in preference to physical controls on the flow of international trade. For the remaining three countries, the share has hovered around 28 to 32 percent since 1980 with some exceptions.

Customs revenue is mainly composed of import duties, levied on a wide range of commodities.[12] Apart from a revenue function, import duties act as policy instrument to protect domestic industry, conserve and ration scarce foreign exchange and frame general international trade policy.

In India, revenue from import duties is concentrated in a select few commodities, including machinery and transport equipment, petroleum oils, chemicals, plastics, and iron and steel. These are the items which form the bulk of India's imports and hence customs revenue. Import duties in India are mostly ad valorem in nature. Essential consumer goods such as foodgrains, edible oils, life-saving drugs and medical equipment bear a nil or low rate of import duty. Conversely, the import of non-essential consumer goods is either banned or subjected to a very high rate of duty ranging from 200 to 300 percent ad valorem. To rationalize and modernize the customs administration, the Parliament passed the Customs Tariff Amendment Act, 1985 to adopt the Harmonized Commodity Description and Coding System. The new commodity classification became operative from 28 February 1986. Similarly, India adopted the GATT Valuation Agreement (Valuation Code) on 16 August 1988. The GATT valuation code lays down broad principles for valuation of goods for levy of customs duty.

Bangladesh relies heavily on foreign aid. Imports, made possible to a large extent by foreign aid, provide the basis for import duties which constitute a significant part of tax revenue. An analysis of the 1988-89 budget manifests the government's intention to encourage private investment. Import duties and sales tax were reduced in a bid to encourage private enterprise in such areas as steel, engineering, chemicals, textiles and electronics. To facilitate the import of industrial raw materials, wide-ranging cuts were announced in customs duties. The duty on steel plates was reduced from 50 to 30 percent; on electrodes from 30 to 20 percent; and on microcomputers from 20 to 10 percent. On the recommendations of the World Bank, the country recently introduced the Harmonized System of Nomenclature for customs tariff.

In Pakistan, essential raw materials and machinery are fully exempted from import duties. Such raw materials and machinery include raw material and components for the manufacture of electronic equipment if imported by a recognized manufacturer, textile machinery, water sprinklers and drip irrigation equipment not manufactured locally for approved agricultural projects, buses and coaches having seating capacity of 100 persons or more, raw material and components for the manufacture of specialized vehicles such as refuse collectors, rescue vehicles, etc. for supplies to local entities. In Nepal, the rates of customs duties are fixed by the Finance Act every year. Full or partial exemption from export tax for a certain period is granted to new or established industries commencing to export their own manufactured goods to foreign countries in order to earn foreign currency. In Sri Lanka, the reversal of roles between domestic commodity taxes and taxes on international trade indicates the strengthening of the domestic production base and import-substitution policies.

VIII. CONCLUSION

The tax systems of the South Asian countries are characteristic of underdeveloped economies. Government revenues are

12. Export duties are avoided to ensure competitiveness of exports in the world market. Exports are encouraged in certain cases through subsidies to narrow the deficit in the balance of payments which is a chronic problem of South Asian countries. Although insignificant from a revenue perspective, export duties have not been completely abolished. Occasions do arise when there is considerable disparity between the domestic and international prices of certain goods (e.g. coffee, mica, black pepper and leather in the case of India) enjoying a relatively strong position in the export market, and the levying of export duties may be justified to limit the profits of the exporters or importers. Export duty on an item is levied after considering such factors as domestic production and likely exportable surpluses, demand for the item in foreign markets, changes in exchange rates and prevailing international market prices.

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dominated by tax receipts which roughly account for four-fifths of total revenues. The level of taxation (i.e. tax/GDP ratio) varies significantly among countries of the region, ranging from 7.1 percent in Bangladesh to 18.6 percent in Sri Lanka. The tax systems of all countries in the group are dominated by indirect taxes, yielding an unbalanced and relatively unjust tax structure. Among the direct taxes, the only notable source of revenue is the income tax which covers a minuscule segment of the working population. The exclusion of agricultural income from the income tax base has deprived the governments of these countries of a potential source of revenue. The revenue from property taxes (wealth tax, gift tax and estate duty) is negligible and such taxes are of decorative value only.

The tax structure of South Asian countries has evolved around indirect taxes: excise duties, sales taxes and customs duties. Generally speaking, excise duties and sales taxes, i.e. taxes on domestic production, are more important than customs duties which are primarily comprised of import duties. An important objective of tax reform in these countries must be to strengthen the direct tax system. This calls for curbing tax evasion and pruning tax concessions which are available under direct tax laws.

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CYPRUS: A GATEWAY TO EASTERN EUROPE

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I. INTRODUCTION

One of the effects of the recent historic political changes taking place in Eastern European countries has been a dramatic rise in the number of Western businesses interested in investing in these countries. This interest was considerably high even before the changes, especially since the U.S.S.R. introduced a law on joint ventures with foreign participation, with a view to attracting foreign investors.

Many international consultants have set up offices in Eastern European countries to advise potential investors, and numerous international conferences on East-West joint ventures have been organized. Investors need to find ways of extracting profits from these countries without having to pay high rates of tax. In most cases Cyprus appears to offer the best solution to the problem. Cyprus has double taxation treaties with Bulgaria, Czechoslovakia, Hungary, Rumania, the U.S.S.R. and Yugoslavia. These treaties are unique in the sense that they are the only treaties these countries have concluded with a country which offers significant tax advantages to non-resident companies. In view of its broad network of tax treaties with both Eastern European and other countries, Cyprus is gradually becoming the best base of operations for doing business with Eastern European countries.

II. TAX ADVANTAGES OF CYPRUS-REGISTERED NON-RESIDENT COMPANIES

A company registered in Cyprus which belongs exclusively to non-residents and which derives its income exclusively from sources outside Cyprus, enjoys significant tax advantages. Such companies (commonly referred to as "offshore" companies) pay tax at a rate of 4.25 percent on their net profits or no tax at all in the case of companies whose profits are derived from the operation of vessels under the Cyprus flag. Other incentives include low or zero rates of tax for the company's employees, complete freedom from exchange control and exemption from customs duty on motor vehicles and equipment (both office and household) for the company and its employees (if the company has a fully operational office in Cyprus). These advantages, combined with the provisions of Cyprus' double tax treaties can produce unique opportunities for reduction of tax. The provisions of the majority of treaties apply fully in the case of offshore companies.

III. TREATIES WITH EASTERN EUROPEAN COUNTRIES

A. *Business profits*

Under the standard article dealing with business profits, which exists in all Cyprus treaties, such profits of an enterprise of a contracting state are not taxable in the other state unless the company carries on business in that other state through a permanent establishment.

B. *Permanent establishment*

The business profits provisions can produce significant benefits for Cyprus offshore companies because the definition of what is *not* a permanent establishment in the Cyprus treaties with Eastern European countries is much broader than the standard

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OECD model definition. In the treaties with Hungary, Rumania, the USSR and Yugoslavia, "a building site or construction or installation project" does not constitute a permanent establishment unless it exists for more than 12 months (six months in the case of Czechoslovakia). This exemption is extended indefinitely in the case of "an assembly project in connection with the delivery of machinery and equipment from one contracting state to the other" (except in the treaty with Yugoslavia). Under the treaty with the USSR the exemption can be extended indefinitely where such works are performed in accordance with programmes of intergovernmental cooperation, by mutual agreement of the competent authorities of the contracting states.

Finally the treaty with Bulgaria provides for an exclusion from what constitutes a permanent establishment in the case of a "construction, installation or assembly activity" which lasts for less than 18 months.

All of the standard exemptions provided in the OECD model apply in all of the treaties, including a fixed place of business which is used only for storing, displaying or delivering goods belonging to the Cyprus company, for purchasing goods or for collecting information on behalf of the Cyprus company, or for advertising, supplying information, scientific research and other activities which have an auxiliary character, on behalf of the Cyprus company.

C. *Profits from international transport*

Under the treaties with Eastern European countries profits of an enterprise from international transport are taxable in the state where the enterprise is resident (treaties with Bulgaria and USSR) or where the effective management of the enterprise is situated (all other treaties).

Except for the treaties with Czechoslovakia and Yugoslavia, which include only shipping and air transport, international transport includes road transport.

It is interesting to note that, although there is no double taxation agreement between Cyprus and Poland, there is an agreement between the two countries on cooperation in the field of merchant shipping. Article 12 of this agreement provides that "any income or profits realized from international operations by shipping or fishing enterprises registered under the laws and regulations of the contracting parties shall be subject to the levy of turnover taxes, income taxes or other direct taxes and dues of any kind only in the state where the respective company has its registered office". Therefore, all of the tax advantages of Cyprus-registered shipping companies and vessels are applicable in this case, without any tax being levied in Poland in this respect.

D. *Dividends, interest and royalties*

The withholding tax rates in respect of dividends, interest and royalties are set forth below. The table refers to a situation where the other contracting state (not Cyprus) is the source country.

Country	*Withholding tax rates*		
	Dividends	Interest	Royalties
Bulgaria	Nil	Nil	Nil
Czechoslovakia	10%	10%	Nil (3)
Hungary	15% or 5% (1)(2)	10%	Nil
Rumania	10%	10%	Nil (3)
USSR	Nil	Nil	Nil
Yugoslavia	10%	10%	10%

(1) The five percent rate applies when the recipient Cyprus company holds directly at least 25 percent of the capital of the paying company.
(2) These are the maximum rates as per the treaty. Under Hungarian legislation there is no withholding tax on dividends payable by joint ventures, which are subject only to the entrepreneurial profits tax on their profits.
(3) Except five percent for patents and other industrial uses.

The withholding tax rates are generally lower than in other treaties. For example, dividends payable to a U.S. resident by a U.S.S.R. joint venture are subject to a 15 percent withholding tax, while the same dividends, if routed through a Cyprus "offshore" company, would suffer no withholding tax and the only tax payable would be 4.25 percent on the profits of the Cyprus company.

E. *Personal services/other income*

The various articles dealing with personal services and other types of income in connection with the low rates of tax for foreign income of temporary residents of Cyprus can also be very beneficial to individuals based in Cyprus and who have activities in Eastern European countries. Under the treaties, an individual resident in Cyprus offering professional services abroad will not be taxed in the other country unless he maintains a fixed base in that country. In the case of salaries, employees working in the other country will not be taxed if present in that other country for less than 183 days in any fiscal year. The treaty with the USSR goes even further in exempting employees from tax on salary earned in respect of a construction or assembly project (of the type that does not constitute a permanent establishment as described above), on salary earned by personnel of transport vehicles used for international traffic and various other types of salaried income. There are other benefits in respect of various other types of income.

IV. APPLICATION OF TREATY BENEFITS TO JOINT VENTURES

In some cases it is not clear from the treaties whether the above benefits, and particularly the provision for reduced rates of withholding tax on dividends, apply in the case of joint ventures, as this may depend on the joint venture legislation in each country and the type of legal entity that the joint venture comprises.

An examination of the joint venture laws in conjunction with the treaties shows that in the case of Bulgaria, Czechoslovakia, Rumania and the U.S.S.R. the ten percent or nil withholding tax applies to joint ventures, while in the case of Hungary, under legislation effective from 1 January 1989, joint ventures are only subject to the entrepreneurial profits

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tax on their profits and no further taxes or withholding taxes on dividends apply. Although the treaty with Yugoslavia specifically excludes from the dividend article any income derived by a resident of Cyprus from investments in a "domestic organization of associated labour", it appears that this term does not apply to joint ventures.

V. CONCLUSION

If the recent trend continues (and there appears no reason why it should not), more and more Western investors will want to do business with Eastern European countries and more tax incentives will be offered by these countries to further stimulate East-West trade. Western investors will want to use a low-tax country, offering incentives and facilities for offshore operations, for their investment. Of all the "offshore" countries, Cyprus appears at present to offer the best possibility. With its strong network of advantageous double tax treaties with Eastern European countries and its tax advantages, geographical position and excellent infrastructure, Cyprus is the ideal place to do business from – it is a true Gateway to Eastern Europe.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

APRIL 1992

The Findings of The Ruding Committee and Their Impact on Belgian Tax Law Affecting Businesses, Brussels (Belgium), 21 April, from 6.00 p.m. until 8.30 p.m. (English, Dutch and French, with simultaneous translation):
VLEKHO (attention: Mrs. D. Claes), Koningsstraat 336, B-1210 Brussels, Belgium, Tel.: (322)221.12.11, Fax: (322)219.78.79.

Tax observatory 1992: the harmonization in the taxation of enterprises, presentation of the Ruding Committee Report, with all the members of the Committee, Milan (Italy), 27 April (English, French and Italian):
Institute of Tax Research for Enterprises (CERTI) Bocconi University, Milan, Italy, Tel.: 0039.2.801085, Fax: 0039.2.804625.

Using Offshore Centres for High Net Worth Financial Planning, London (United Kingdom), 28-29 April (English):
Evandale Publishing Ltd., 38-40 Eastcastle Street, London W1N 7PE, United Kingdom, Tel.: (0)71-4367028, Fax: (0)71-3231382.

MAY 1992

European Cross-Border Life Insurance Conference – 1992 (focusing on regulatory and tax issues), Luxembourg, 7 and 8 May (English):
Ms. Susanne Due, KPMG Management Consulting, 3, rue Thomas Edison, L-1445 Luxembourg, Tel.: +352.45.55.11.830, Fax: +352.45.73.85.

The 5th East-West Tax Conference, St. Petersburg (Russia), 7-8 May (English):
International Tax Academy, Sarphatistraat 124, P.O. Box 2037 , 1000 HE Amsterdam, The Netherlands, Tel.: +3120-6267726, Fax: +3120-6209397.
Joint Ventures in Central and Eastern Europe, London (United Kingdom), 12-14 May (English): Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom, Tel.: 71-7798602, Fax: 71-7798599.

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MAGHREB:

TAXATION OF INVESTMENT INCOME

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I. INTRODUCTION

This article looks at the taxation of income from movable capital distributed by legal entities in the Maghreb countries (Algeria, Morocco and Tunisia) to residents and non-residents.

A brief summary of the tax systems of each country is followed by a comparative analysis of the tax treatment of dividends, interest and royalties. The concluding section offers a comparison of the domestic and treaty provisions for the avoidance of double taxation.

II. GENERAL ASPECTS

Both the Moroccan and the Tunisian tax systems have been completely revised in the last few years. The schedular tax system in both countries has been replaced by a general income tax on individuals.[1] A company tax has been in force in Morocco since 1986, but was only introduced in Tunisia in 1989 along with the general income tax on individuals. Algeria still relies on a schedular tax system, with each category of income being taxable under a different schedule; e.g. industrial and commercial profits, non-commercial profits (including royalties and fees), wages, salaries and pensions. Individuals and companies alike are subject to the schedular taxes as there is no specific company tax in Algeria. A general income tax, called the supplementary tax on income, is charged on the total annual income derived by individual taxpayers in Algeria.[2]

III. TERRITORIAL SCOPE AND CONCEPT OF RESIDENCE

The territorial scope of income tax is different in each of the three countries. The definition of resident and non-resident is also significant in that residents may be taxed on worldwide income and non-residents only on local-source income.

A. *Algeria*

No distinction is made between individuals and legal entities for tax purposes, because in general all industrial and commercial profits realized in Algeria are subject to tax regardless of whether the taxpayer is an individual or a legal entity. Even entities which have no permanent place of business in Algeria but which carry out contract work or perform services in the country are subject to tax.[3] Algeria uses the territorial principle of taxation, according to which only profits realized in Algeria are taxable there, although tax treaty provisions may provide otherwise.

B. *Morocco*

Legal entities and individuals are treated separately for tax purposes because the territorial scope of income tax varies according to the type of taxpayer.

1. Legal entities

Legal entities, both resident and non-resident, are generally taxable on their profits or income realized in Morocco.[4] Legal entities with their registered office in Morocco are not subject to tax in Morocco on income or activities carried on abroad, except in certain limited circumstances.[5]

1. Moroccan Law No. 17-89 of 21 November 1989, published in the Official Gazette of 6 December 1989; Tunisian Law No. 89-114 of 30 December 1989, published in the Official Gazette of 31 December 1989, introducing the Income Tax Code ("ITC").
2. Law No. 76-101 of 9 December 1976, as amended.
3. Law No. 83-19 of 13 December 1988, as amended. There are certain exemptions under this law, but they are not relevant for purposes of this article.
4. Law No. 24-86 of 31 December 1986, as amended, Art. 2, et seq.
5. *Id.*

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2. Individuals

As a general rule, individuals habitually resident in Morocco are subject to taxation on their worldwide income. The law defines a habitual resident as an individual who has his permanent home in Morocco, whose centre of economic interests is in Morocco or who resides in Morocco for any period or periods exceeding 183 days in any period of 365 days.[6] Foreign-source income is subject to income tax in Morocco but tax payable on income from foreign sources may be set off against Moroccan tax payable.[7]

Non-residents are generally subject to tax on their total income from Moroccan sources, regardless of the length of their stay in the country.

C. *Tunisia*

Generally speaking, resident commercial companies and resident individuals are subject to the company tax and the general income tax, respectively, on their worldwide income. Income from foreign sources is only taxable in Tunisia if it has not been subject to tax in the country of origin.[8]

The company tax code does not define resident legal entity but states that a non-resident legal entity is one which is neither established in nor domiciled in Tunisia. A non-resident legal entity is taxable in Tunisia only on its income from Tunisian sources.[9]

The income tax law defines resident individuals as individuals who habitually reside in Tunisia, i.e. persons whose main residence is there and persons whose main residence is not in Tunisia but who are present there for a period of at least 183 days (whether or not a continuous period) in the calendar year concerned. Non-resident individuals are subject to tax only on Tunisian-source income.[10]

IV. TAXATION OF INVESTMENT INCOME

A. *Dividends*

A distinction must be made between the tax treatment of dividends as such and the tax treatment of profits realized by a permanent establishment of a foreign company; such profits are presumed to have been distributed to non-resident shareholders and taxed as dividends.

1. Dividends in general

Dividends are defined in all three countries as amounts distributed to partners or shareholders from profits, after the tax on profits (or company tax, as the case may be) has been paid.

(a) *Algeria*

There is no special tax treatment of dividends which are taxed as ordinary income. In addition to the schedular tax on industrial and commercial profits paid by the distributing entity, dividends received by resident individuals are subject to the progressive rate of the supplementary tax due (which ranges from 5 to 50 percent).

(b) *Morocco*

Dividends distributed by companies with their seat in Morocco, and which are in principle subject to company tax, must be included in the business profits of the company and will be taxed as such, even if the distributing company is exempt from tax. However, 85 percent of the gross amount of the dividends may be deducted so that only 15 percent of the dividends distributed will actually be subject to company tax.[11] As the rate of Moroccan company tax is 40 percent, the tax burden on distributed dividends will be six percent, i.e. 40 percent × 15 percent of the amount of the dividends.

In theory, distributed dividends are also subject to withholding tax on income from shares and similar types of income at the rate of 15 percent. However, such income derived by companies and other legal entities having their seat in Morocco, and by Moroccan establishments of foreign companies, is subject to withholding tax where the companies or establishments provide the distributing company (or bank delegated by such company) with a certificate of ownership of the shares stating that they have been subject to company tax.[12] In such a case, once the shareholders are identified by the tax administration, only the six percent tax will be levied.

The 15 percent withholding tax also applies to dividends distributed to unidentified resident or non-resident shareholders. This tax, however, is final and is payable in place of the company tax (for companies) or the general income tax (for individuals).

(c) *Tunisia*

Dividends and similar income are exempt from the individual income tax and from the company tax, and this exemption is extended to non-resident shareholders.[13]

2. Dividends and profits realized by non-resident entities

(a) *Algeria*

Income realized in Algeria by foreign companies and paid to individuals or legal entities who do not have their fiscal domicile or seat in Algeria are deemed distributed dividends and subject to a withholding tax of 20 percent on the gross amount. This withholding tax is a final tax.[14]

(b) *Morocco*

There is no special treatment of profits realized by non-resident entities in Morocco, which are taxed like dividends distributed by resident entities, and thus the tax burden will be six percent or 15 percent (withheld at source).

6. Law. No. 17-89, Art. 2 II.
7. *Id.* Art. 98.
8. ITC Arts. 9, 36 and 45.
9. ITC Art. 45.
10. ITC Art. 2, Secs. 1 and 2.
11. Law. No. 24-86, Art. 9, as amended.
12. Law No. 18-88 of 21 June 1989, published in the Official Gazette of 6 December 1989.
13. Law No. 89-114, Art. 8 II, Sec. 3.
14. Finance Law 1990, Title II bis, Art. 53 bis, et seq.

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(c) *Tunisia*

Profits realized by Tunisian permanent establishments of foreign companies which are legal entities subject to company tax are presumed to have been distributed to shareholders who are not domiciled in Tunisia.[15] Consequently, such profits fall into the category of distributed income and will escape all taxation on income as a result of the exemption provided for dividends and income of a similar nature.

B. *Interest*

In all three countries interest payments are generally subject to a withholding tax. Special treatment, however, may apply to interest paid to non-residents.

1. Algeria

Interest received by resident individuals or legal entities is subject to a withholding tax of 25 percent on the gross amount of the income after a lump-sum deduction of 5,000 DA from the total amount of interest received by the recipient. This withholding tax is a final tax.

Certain limits are imposed on the application of this tax, however; the withholding tax is only applicable when the creditor is domiciled or habitually resident in Algeria or has an industrial or commercial establishment there which is effectively connected to the debt claim. Interest paid to non-residents is exempt from taxation.[16] Some specific types of interest are also exempted from this withholding tax, e.g. interest on loans issued by credit institutions, interest and other income from loans of banks or other lending institutions by and for their own account, and interest from authorized foreign currency deposits.

2. Morocco

Interest paid to individuals and legal entities habitually resident in Morocco or with their fiscal domicile or a permanent establishment there are subject to a 20 percent withholding tax.[17] This tax can be set off against the general income tax payable by individuals, or the company tax payable by legal entities where such interest is included in the tax base thereof.

A final withholding tax of ten percent applies to interest paid to non-residents on loans and other fixed interest claims.[18] Interest on loans to the State or guaranteed by the State are exempt from this withholding tax.

3. Tunisia

Interest paid to both resident and non-resident individuals and legal entities in Tunisia are subject to a withholding tax of 15 percent; this is a final tax.[19]

C. *Royalties*

Royalties received by residents are taxed as ordinary income in all three countries while royalties received by non-residents are subject to a final withholding tax.

1. Algeria

Royalties received by resident individuals or legal entities are deemed to be non-commercial profits and are subject to a ten percent withholding tax.[20] Royalties received by non-residents are subject to a 25 percent withholding tax but in all cases a lump-sum deduction of 20 percent may be made. The final tax burden will be 20 percent.[21]

2. Morocco

Royalties received by residents, whether individuals or legal entities, are taxed as ordinary income. In the case of individuals, the royalties are subject to a progressive rate ranging from 14 to 52 percent, and in the case of companies, to a flat rate of 40 percent. Royalties received by non-residents, whether individuals or legal entities, are subject to a final ten percent withholding tax.[22]

3. Tunisia

Royalties received by resident individuals are taxed as ordinary income and are subject to the individual income tax at graduated rates ranging from zero to 35 percent. Royalties received by resident companies are subject to the company tax as ordinary income at the rate of 35 percent. Royalties received by non-resident individuals or legal entities are subject to a final 15 percent withholding tax.[23]

V. AVOIDANCE OF DOUBLE TAXATION

A. *Domestic measures*

1. Algeria

Algeria does not apply the worldwide principle of income taxation, so that only profits realized in Algeria are taxable in Algeria; income derived from foreign sources is not subject to income tax in that country.

2. Morocco

In principle, Moroccan legal entities are subject to income tax on their Moroccan profits and on certain remuneration from the rendering of services abroad. Generally speaking, however, foreign profits realized by Moroccan legal entities do not fall within the scope of the Moroccan company tax.

Resident individuals are subject to the general income tax on their worldwide income, and the gross amount of income from foreign sources will be included in their total taxable income. Where foreign-source income has been subject to tax on income in the source country, the foreign tax may be deducted from that part of the general income tax payable

15. ITC Art. 29, I.3 and II.c.
16. Law No. 76-101 of December 1976, Title II, Art. 35, et seq.
17. Finance Law 1987, Art. 2, as amended.
18. Law No. 17-89, Art. 19.
19. ITC Art. 52c.
20. Law. No. 76-101, Art. 54, et seq.
21. Finance Law 1984, as amended, Art. 80-I, et seq.
22. Law No. 17-89, Arts. 19 and 94.
23. ITC Arts. 3-6 and 52.

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which relates to that foreign income (this deduction is available even if such income was exempt from tax in the source country).

3. Tunisia

Legal entities are subject to the Tunisian company tax in respect of activities carried on in Tunisia; income derived from abroad is only taxable in Tunisia if it has not already borne tax in the country of origin.

Individuals are subject to the general income tax on their total income, but income from foreign sources will only be taxable in Tunisia if it has not been subject to tax in the country of origin.

B. *Tax treaties*

The Maghreb countries have been concluding more and more tax treaties. Tunisia has concluded the most treaties, with European and African countries, and the United States. Morocco has entered into fewer treaties than Tunisia, mainly with European countries and the United States, and only one treaty with an African country, i.e. Tunisia. Algeria has only concluded three treaties, i.e. a treaty with France and Tunisia, both of which are in force, and one with Libya which is not yet in force.

Most treaties follow the OECD model; investment income (dividends, interest and royalties) may be taxed in the state of residence of the recipient. The source state, however, has the right to apply a limited withholding tax. It should be noted that the tax treaties concluded between African countries (e.g. Algeria/Libya, Algeria/Tunisia, Morocco/Tunisia, Senegal/Tunisia) apply the principle of source-state taxation. The source-state principle also applies to interest in the treaties between Algeria/Libya and Tunisia/Senegal. Under the tax treaties between Algeria/Libya, Algeria/Tunisia and Morocco/Tunisia, royalties are only taxed in the source state.

Most treaties use the credit method for the elimination of double taxation of investment income (some treaties have special provisions). The treaty between Tunisia and Senegal uses the exemption method and the treaty between Morocco and Sweden provides no particular method.

CHART

	Algeria	*Morocco*	*Tunisia*
Dividends			
to resident	taxed as ordinary income	6%[a] or 15%*	exempted
to non-resident	20%* 15%*	6%[a] or	exempted
Interest			
to resident	25%*	20%*	15%*
to non-resident	exempted	10%*	15%*
Royalties			
to resident	10%* ordinary income	taxed as ordinary income	taxed as
to non-resident	20%*[b]	10%*	15%*

* Rate of withholding tax
(a) Tax burden is 6 percent
(b) Tax burden is 20 percent (withhold at source)

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COLOMBIA:

LATEST TAX REFORM

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I. INTRODUCTION

On 28 December 1990, the Colombian Parliament enacted Law 49 which introduces another tax reform and provides rules for other matters.[1] The tax reform covers income tax, sales tax (VAT), taxation powers and tax administration, and it establishes a tax amnesty.

II. TAXATION OF INCOME

A. *Legal entities*

1. Losses from the transfer of shares

Losses arising from occasional transactions were previously deductible in calculating the taxable base of capital gains.[2] Under the new rules, losses arising from the transfer of shares and participations may no longer be deducted, because profits derived from these transactions are no longer taxed.[3]

2. Exchange gains and losses

Taxpayers reporting income on an accrual basis (basically business enterprises) must treat exchange gains on assets held in foreign currency at the end of the tax year as income.

During the period before the integral adjustment of income for inflation enters into force,[4] financial entities controlled by the Superintendency of Banks must treat exchange gains and losses as receipts, costs or deductions upon actual realization, regardless of when they accrue.

3. Capital gains from immovable property

Capital gains realized from the transfer of immovable property forming part of fixed assets must be computed by deducting the "fiscal cost"[5] from the sale price. However, if the cadastral value was higher than the fiscal cost on 31 December 1990, the taxpayer may opt to deduct the cadastral value instead of the fiscal cost.

B. *Individuals*

Employees need not file an annual income tax return if the following conditions (and conditions set forth in the legislation) are satisfied:
- at least 80 percent of gross income is derived from dependent services;
- gross wealth on the last day of the tax year does not exceed 15 million pesos;[6]
- the employee is not a taxable person for VAT purposes; and
- annual gross turnover does not exceed 12 million pesos.[7]

In such a case, taxes withheld at source are final.

A self-employed individual is subject to the same rule, provided that:
- he is not a taxable person for VAT purposes;
- gross turnover is substantiated by invoices;
- at least 80 percent of gross turnover is derived from independent services which have actually been taxed at source;
- annual gross turnover does not exceed 8 million pesos;[8] and
- gross wealth on the last day of the tax year does not exceed 15 million pesos.[9]

1. Published in the Official Gazette of 31 December 1990, and in general is effective as from the date of publication.
2. Capital gains are generally treated as normal profits and are subject to income tax at ordinary rates.
3. This rule is designed to promote investments in the stock market. See also discussion of capital gains in text.
4. Integral adjustment of income for inflation is applicable as from tax year 1992.
5. Fiscal cost is a percentage of the cadastral value. It has been used to alleviate the impact of the new cadastral values on the calculation of presumed income and net wealth tax.
6. This amount applies to the tax year 1990.
7. *Id.*
8. *Id.*
9. *Id.*

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Individuals and estates who are not taxable persons for VAT purposes, whose annual gross turnover does not exceed 3 million pesos and whose gross wealth on the last day of the tax year is less than 15 million pesos, are not required to file an income tax return.[10]

C. *Non-residents*

1. Dividends

The taxation of dividends paid to foreign companies and non-resident foreign individuals has been alleviated. The 20 percent rate has been reduced to 19 percent (for tax years 1991 and 1992), 15 percent (for tax years 1993, 1994 and 1995) and 12 percent (as from tax year 1996). For the tax year 1990, the rate remains at 20 percent. Dividends derived from investments made as from 1991 are taxed at the reduced rate of 12 percent from the year the investment is made.

2. Foreign capital investment funds

The recently created foreign capital investment funds are subject to a special income tax regime, by which income tax is calculated on business profits realized in Colombia and taxed annually at a rate of 12 percent. This tax is deferred until the remittance of profits abroad. In addition, the repatriation of the capital invested in Colombia is exempt from income taxation.

3. Branch profits

Pursuant to the new rules, the Colombian-source profits of branches of foreign companies are deemed to be automatically remitted abroad, and are therefore subject to the surtax on remittances. However, where these profits are reinvested in Colombia, the surtax is deferred as long as the reinvestment remains in Colombia. No surtax on remittances of profits is levied if the profits are reinvested and remain in Colombia for more than ten years.

The surtax on remittances has been reduced from 30 percent to 19 percent (for tax years 1991 and 1992), 15 percent (for tax years 1993, 1994 and 1995) and 12 percent (as from tax year 1996). Note that, in the case of profits derived from new investments (i.e. investments made as of 1991), the tax on remittances applies at the reduced rate of 12 percent from the year the new investment is made.

4. Debts of permanent establishments and subsidiaries

Interest, financial expenses and exchange gains and losses associated with debts of Colombian permanent establishments or subsidiaries to their foreign head offices or parent companies and other related entities are now non-deductible, except where they are paid by financial institutions controlled by the Superintendency of Banks, or where they arise from the acquisition of raw materials or merchandise whose direct supplier is the foreign-related company and they are paid on a short-term basis.[11]

D. *Investment income*

1. Capital gains from shares

Capital gains[12] derived from the transfer of shares (other than transfers effected through a stock exchange) are exempt from income tax to the same extent as the shareholders' retained profits earned during the period between acquisition and sale of the shares.

Capital gains derived from the transfer of shares through a stock exchange are no longer taxable. However, as an anti-avoidance measure the tax administration is authorized to treat the difference between the sale price and the acquisition price as taxable income in certain instances.

2. Stock dividends and capitalization of profits

Stock dividends and the capitalization of profits are no longer taxable where they result from the capitalization of the "Net Worth Revaluation Account",[13] and/or premiums received upon the placement of shares.

In the case of companies whose shares are quoted on the stock exchange, stock dividends or the capitalization of profits are exempt even to the extent that they exceed the tax-free limit established under ordinary rules.

3. Investment funds

Investment funds, security funds and mutual funds administered by trusts have been included in the list of persons who are non-taxpayers for income tax purposes. The remuneration received by the trust, however, is subject to withholding tax at source.

Receipts of the funds less expenses and remuneration of the managing trust must be distributed among the participants. The distribution is taxed at source under the same conditions as if the receipts were directly received by participants. If the recipient is a non-resident foreigner, tax is withheld at the rates applicable to payments abroad of the same type of income.

The recently created retirement and disability funds and unemployment funds have also been included in the list of non-taxpayers for income tax purposes.

Employer's contributions to the funds qualify as deductible expenses.

Contributions made by the employer to retirement and disability funds are not treated as income to the extent of ten percent of the employee's salary. Contributions to unemployment funds are not treated as income.

Distributions made to participants are not subject to income tax.

10. *Id.*
11. Previous rules on this point were more general: they did not allow the deduction of expenses, fees and royalties associated with debts of Colombian permanent establishments or subsidiaries to their foreign head offices or parent companies.
12. See *supra* note 2.
13. The Net Worth Revaluation Account is a special equity account used to adjust income for inflation.

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III. TAXES ON TRANSACTIONS (VAT)

A. *Tax rates*

As from 1 January 1991, the general rate of VAT has been increased from 10 to 12 percent. Additionally, most special rates have been unified at the 12 percent general rate.

B. *Taxable transactions*

Application of VAT has been extended to cover the following:
- games and videos;
- hotels with less than three stars, motels and other accomodation services;
- restaurants;
- bars, cabarets and discotheques;
- cleaning and temporary services other than security, provided they are rendered by an enterprise; and
- leasing and chartering of airplanes.

C. *Exemptions*

As from 1 January 1991, most services which were exempt from VAT are no longer exempt; these services now "do not give rise" to this tax.[14] However, goods exported or sold to legal entities engaged in international trade, notebooks, and books and magazines having scientific or cultural value remain exempt from VAT.

D. *Taxable base*

Financing granted to a taxpayer by enterprises economically connected to him are no longer part of the taxable base of VAT, if such enterprises are controlled by the Superintendency of Banks.

E. *Simplified regime*

Persons rendering services may no longer opt to be taxed under the simplified regime.

F. *Insurance*

Insurance obtained abroad to cover risks of transportation, and ships, airplanes or vehicles registered in Colombia, as well as goods located in Colombia, is now subject to VAT at a rate of 15 percent, unless it is subject to VAT in the home country. When the home country taxes insurance at a rate below 15 percent, insurance is taxed in Colombia at the difference between the home rate and the Colombian rate.

Insurance covering certain risks (i.e. hull and accident) or liability to third parties is free from VAT regardless of where it was obtained, where the risk or liability covered is associated with ships or airplanes engaged in international transportation of merchandise.

IV. TAXATION POWERS AND TAX ADMINISTRATION

A. *Extraordinary powers*

The President of the Republic has been empowered by the Parliament, inter alia, to:
- amend, phase-in and implement the integral adjustment of income for inflation;
- reduce the presumed income of the taxpayer based on net worth;
- revise the classification of goods for sales tax purposes and specify the services that may be treated as exports;
- reorganize the Ministry of Finance, the tax administration and the customs office; and
- revise the Tax Code.

B. *Tax information*

As from 1 July 1992, Colombia may provide tax information to governments requesting such information. The information may be provided solely for the purposes of fiscal control. Governments requesting information must guarantee the secrecy of the information.

C. *Tax amnesty*

Law 49 also grants a tax amnesty. Taxpayers may declare unreported foreign currency and/or assets located abroad.[15] Declarations must be filed no later than 30 June 1992.[16] The income disclosed under the amnesty is not subject to taxes, fines or assessments if the taxpayer fulfills at least one of the following conditions:[17]
- he acquires in 1991 a special bond for tax amnesty in an amount equivalent to the amount of disclosed income or assets;[18]
- he acquires in 1991 registered bonds of foreign debt in an amount equivalent to the amount of the disclosed income or assets, and renounces his right to remit abroad interest or amortization. The discount received upon acquisition of the bond is exempt from income tax. However, losses incurred upon the transfer of the bond are not deductible from income tax. The net value of the document is subject to a complementary tax of three or five percent.[19] Interest derived from the document is subject to the general rules; or
- he pays a tax of three or five percent on that part of disclosed income or assets not invested as mentioned above.[20]

If the taxpayer invests in special or registered bonds in an amount lower than the disclosed income or assets, he is still entitled to participate in the tax amnesty by paying the tax on that part of the disclosed income or assets not covered by the above-mentioned investments.

The amnesty does not affect current tax disputes.

14. No tax credit for VAT paid is available if services "do not give rise to" VAT. A tax credit is available, however, if the services are exempt from VAT.
15. The tax amnesty covers 1990 and previous tax years.
16. Disclosure is to be made in the 1990 income tax return or amendments thereto.
17. The taxpayer may opt to partially fulfill some of the conditions provided that the aggregate amount thereof is equal to the disclosed income and/or assets.
18. Special Bonds for Tax Amnesty are domestic debt bonds denominated in U.S. dollars or other foreign currency. Taxpayers intending to fulfil this requirement must make the payment in foreign currency.
19. The rate is three percent when the relevant return is filed by the prescribed deadline, and five percent when the return is filed later or when it has been amended. Returns and amendments cannot be filed later than 30 June 1991.
20. *Id.*

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V. CONCLUSION

The main aims of the tax reform are the repatriation of Colombian capital located abroad, the promotion of investments in the stock market and simplification of tax returns. In the Government's opinion, achieving these goals is necessary to alleviate the tax burden. The resulting reduction in tax collection is expected to be counterbalanced primarily by the increase of VAT.

BIBLIOGRAPHY

The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.

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Ghana

INVESTOR'S GUIDE TO GHANA.
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(B. 111.505)

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(B. 111.472)

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The guide will make directors and executives aware of how current tax laws affect their companies, and also the tax implications of carrying out various types of transactions. It outlines areas where tax savings can be achieved. The book is written on the basis of the law and practice in force on 1 September 1991 and incorporates the changes made by the Finance Act 1991. Part I includes the system of corporation tax, profits assessable to corporation tax, advance corporation tax, capital allowances, losses, capital gains, close companies, groups of companies, overseas

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trading, reorganization and venture capital. Part II: VAT. Part III: payroll procedures and taxes. Part IV: the executive, taxation of directors and employees, including benefit in kind, inheritance tax, employee share ownership and share schemes.
(B. 111.418)

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(B. 111.449)

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Practical international tax planning. Revised third edition. Updated annually.
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Up-to-date loose-leaf compression binder, including the 1986, 1987, 1988, 1989, 1991 and 1992 releases. Approx. 1000 pages. Price $155.-. Publication surveying all aspects of international tax planning including the effective use of foreign financial centres and tax havens. Subjects dealt with are: the legal framework of international tax planning; tax planning in the U.S.A. and outside the U.S.A.; offshore basis outside the U.S.A.; fundamentals of international taxation; import practice; how to handle foreign investment in U.S. real property under FIRPTA and the branch profits tax. Coverage reflects the impact of the 1986 Tax Reform Act as well as other changes resulting from new income tax treaties, mutual ass. treaties, and significant changes in the laws of other countries and other revisions.
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Series on International Taxation, No. 13, pp. 610, 290.- Dfl.
Monograph analysing case law dealing with the notion permanent establishment in modern tax treaties between various countries with reference to the OECD Model Tax Treaty and the commentaries thereto, but references are frequently made to bilateral tax treaties and to the Nordic Multilateral Tax Treaty.
(B. 111.570)

PUBLIC FINANCE WITH SEVERAL LEVELS
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NEWS

U.S. BRANCH

Richard L. Goldman of the New York law firm of Goldman & Gladstone, was elected President of the U.S. branch at the annual meeting on 28 February 1992. Mr. Goldman has been on the U.S. National Council since 1978, and Executive Vice President since 1990. He was U.S. National Reporter to the IFA Congress in London in 1975 and again in 1985. He is a graduate of Brooklyn College, New York, and Colombia Law School, where he was a Harlan Fiske Stone Scholar. Mr. Goldman served in the U.S. Army in World War II and in the Berlin Wall crisis of 1961/62, and became a captain in Army intelligence. He was a war crimes investigator in Germany and headed a political intelligence field agency there after World War II.

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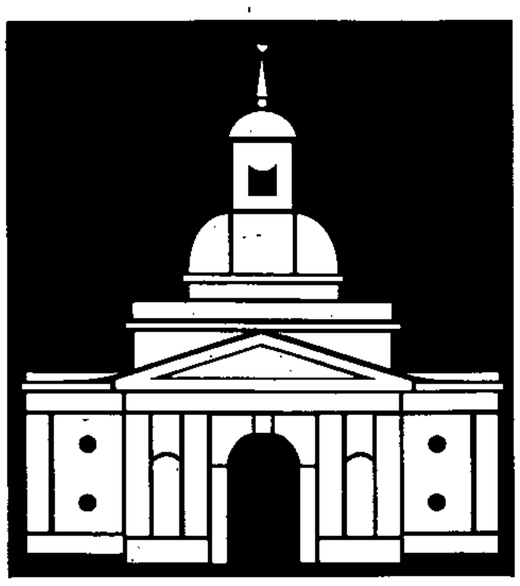

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INTERNATIONAL: TAXING PROFITS IN A GLOBAL ECONOMY — 223 — *John Nørregaard and Jeffrey Owens*

Corporate tax regimes – many of which are undergoing reform – have been criticized for a number of reasons: their adverse effect on domestic investment and saving, they create distortions in the international allocation of capital, they are complex, etc. The coexistence of different corporate tax systems in an increasingly globalized business world has also been singled out as a critical issue. These concerns led the OECD's Committee on Fiscal Affairs to undertake an examination of the different ways in which member countries tax corporate profits and the potential implication of these differences for both domestic and international investment flows. This article summarizes that report.

AUSTRALIA: THE TAXATION OF CAPITAL GAINS — 229 — *Rick Krever*

Legislation implementing the Australian capital gains regime was adopted in 1986, effective from 19 September 1985. While this complicated and unique system has closed many avoidance opportunities and achieved some equity, certain exemptions and rollover provisions have serious equity and efficiency consequences. This article traces the development of the capital gains system in Australia, and points out a number of shortcomings which will need to be addressed.

SOLOMON ISLANDS: AN OVERVIEW OF INCOME AND OTHER TAXES — 244 — *Chris Bowman*

The 140-page Solomon Islands Income Tax Act is a simple yet comprehensive piece of legislation. Tax incentive measures introduced last year aim to attract foreign investors and to encourage residents to invest their savings in productive businesses in the country. Mr. Bowman explains the Solomon Islands system and how it works.

CANADA: 1992 FEDERAL BUDGET: EASING THE BURDEN — 248 — *Ingrid Sapona*

While not promising any quick solution to the country's economic problems, the 1992 Budget was described by the Finance Minister as economically, socially and fiscally responsible, aimed at providing a strong foundation for recovery and sustained growth. Ms. Sapona briefly reviews Canada's fiscal and economic outlook, and outlines the tax matters addressed in the Budget.

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Europees Vennootschapsbelastingrecht (available in the Dutch language only)

SINGAPORE: 1992 BUDGET: A CARRY-ON BUDGET WITH A FEW SURPRISES 254 *Lee Fook Hong*

The 1992 Budget – with a little something for everyone – was generally perceived as a conservative and carry-on budget. Although the corporate tax rate was reduced by one percentage point, certain sectors expressed disappointment at the conspicuous lack of incentives to help tide over the anticipated slow down in the economy or to contain the rising cost of operating a business.

HONG KONG: "RAGS TO RICHES" BUDGET 257 *Ian Harris*

Hong Kong's new Financial Secretary presented his first Budget this year. Emphasizing the need to maintain Hong Kong's simple low rate tax system, continued economic growth and the provision of community services, the Financial Secretary stated there would be no radical changes in this year's Budget. The revenue proposals are aimed to provide a measure of relief to the ordinary taxpayer and they should be effectively neutral on the consumer price index.

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INTERNATIONAL:

TAXING PROFITS IN A GLOBAL ECONOMY

John Nørregaard and Jeffrey Owens
The authors work in the Fiscal Affairs Division of OECD

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B. Reduction of tax-induced distortions in domestic investment patterns
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I. INTRODUCTION

The reform of taxes on corporate profits is currently a major preoccupation in many OECD countries. Corporate tax systems have been criticized in recent years on a number of grounds: their alleged adverse effects on domestic investment and saving; the fact that they may create distortions in the international allocation of capital; complexity; their lack of neutrality between corporate investment and the activities of unincorporated enterprises. Particular concerns have been expressed about the coexistence of different corporate tax regimes in a world where globalization of business activities has increased and where most non-tax barriers to international flows of capital, services and technology have been removed. It is these concerns that led the Committee on Fiscal Affairs to undertake an examination of the different ways in which member countries tax corporate profits and the potential implication of these differences for domestic and international investment flows. A recently published report examines these differences.[1]

II. IMPLICATIONS OF GLOBALIZATION

Capital markets in OECD countries are increasingly integrated as member countries have removed controls on international investment and foreign exchange regulations. At the same time, the proportion of international activities accounted for by large multinational enterprises has increased. One consequence of this gradual liberalization and globalization is that international capital flows may have become more sensitive to differences in the tax regimes as between countries. Differences in the taxation of corporate profits may now be one of the few remaining potential barriers to a better international allocation of capital. With the commitment of the European Communities (whose member states now comprise one half of those of OECD) to establish a single market by 1993, removal of potential obstacles, including tax obstacles, has increased in importance.

Taxation is, however, only one and in many cases not the most important determinant of investment and financing decisions. Among the other determinants of investment behaviour are the short and medium-term economic outlook in different market areas and countries, the cost of capital in relation to that of other productive inputs, the profitability of investments, the availability of finance and government investment grants, the quality of public infrastructure and the existence of an economic infrastructure. The relative importance of these determinants varies between countries and over the business cycle. Nevertheless, the taxation of profits can and often does have an important impact on marginal investments and their financing, as well as on locational decisions both within a country and across frontiers. Other taxes, such as those on payroll and social security contributions, may also affect costs and thus the location of investment, particularly in the short to medium term.

At the national level, OECD governments have a number of common concerns regarding the corporation tax which is the main focus of the report, even if other related taxes on business profits are also covered. Despite their very different reliance on corporate tax as a revenue source (see Chart I), governments have to ensure that these revenues are efficiently and equitably collected. They have to weigh up the various advantages and disadvantages of tax neutrality towards locational and investment decisions and interventionist policies to influence investment

1. "Taxing Profits in a Global Economy: Domestic and International Issues", 1992 OECD.

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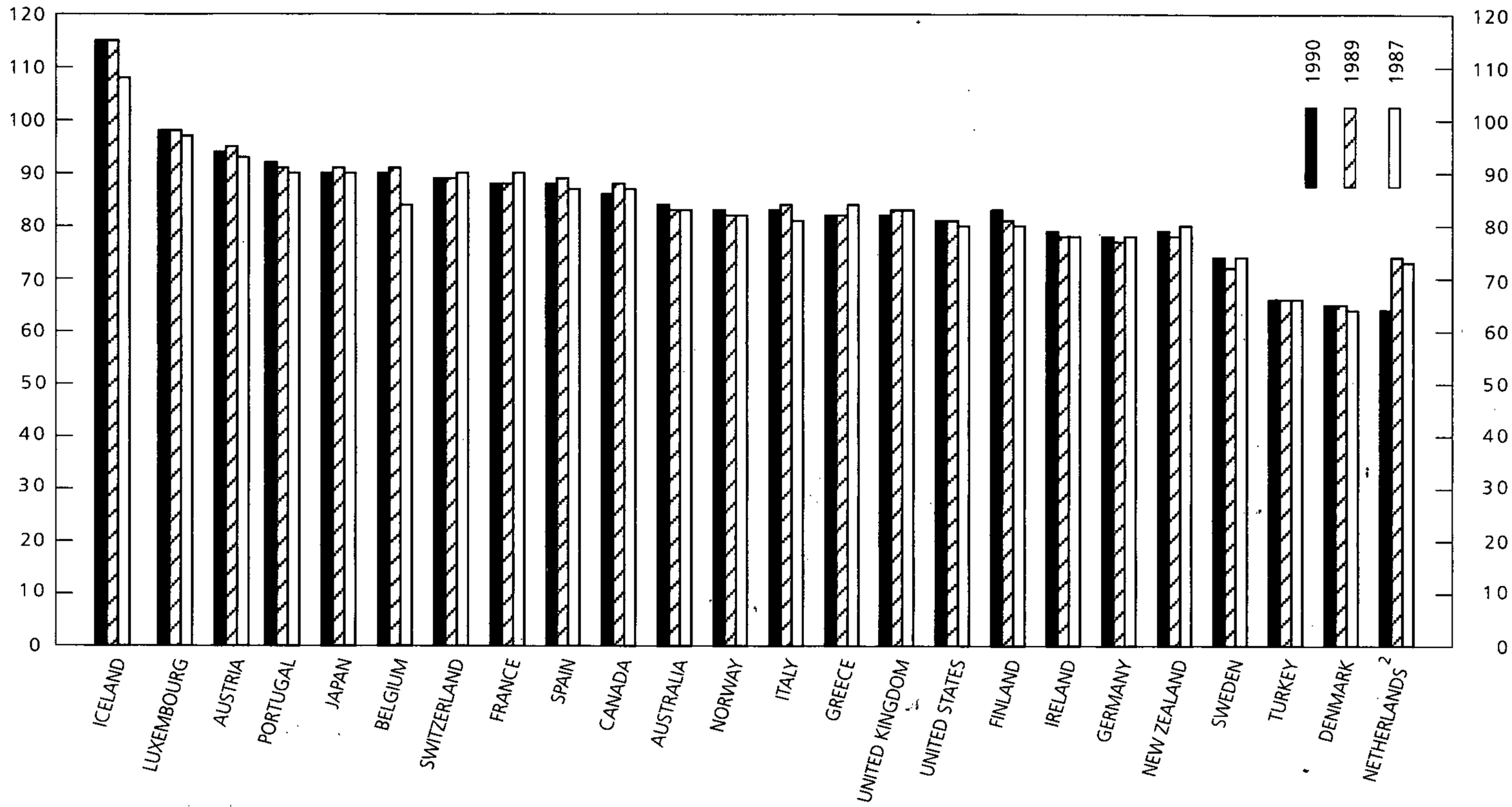
Chart 1

Take-home Pay and Cash Transfers as Percentage of Gross Earnings[1]

One-earner families at APW's wage level

1987-1990



1. Countries are ranked by 1990 figures, except for Greece and Turkey 1989. Take-home pay is equivalent to gross earnings minus income taxes and social security contributions paid by employees.

2. During the 1990 tax reform part of employers' social security contributions was shifted to employees, which was compensated by an allowance of 4316 Dfl. This shift explains in part the fall in take-home pay between 1989 and 1990.

patterns. Recently there has been a shift from interventionism to neutrality, in part reflecting a greater skepticism on the efficacy of governments in "picking the winners", and an increased awareness that the cost of incentives in terms of revenue forgone may exceed the extra investment generated by these subsidies. Nevertheless, governments continue to subsidize particular activities and sectors.

At the international level, the policy issues which arise are more difficult to formulate since they involve not only the design of domestic tax systems, but also the need to take into account how different national systems interact. Each government has to address two broad sets of policy issues. The first is to protect the revenue yield from taxes on profit and to ensure that it gets its fair share of the tax base associated with international transactions. The second goal is to maintain a favourable tax climate for inward investment and to avoid encouraging an outflow of domestic capital which would otherwise not have taken place. For many years it has been realized that countries cannot successfully address these issues on a unilateral basis and that mechanisms for coordination are required. Consequently, over the last 70 years or so international allocation rules have been developed, first in the League of Nations, then in the OECD and the United Nations. These organizations have established "international rules of the game" which help countries arrange their tax relationships with other countries. Rules have been developed, for example, concerning the allocation of taxing rights between source and residence countries and principles have been agreed to govern transfer prices for tax purposes when goods, services, technology and loans are exchanged between affiliates of a multinational enterprise.

III. MAIN ISSUES

The globalization of economies may require that international tax arrangements be reviewed. The importance of international considerations in the determination of national tax policies will increase, especially for small open economies. The broad issue which faces policymakers is how to reconcile these new constraints with the desire to adapt their own tax systems to the social, economic and institutional conditions within their country, whilst at the same time enable all countries to reap the potential efficiency gains from liberalization.

The increased openness of national economies has, in practice, made it more difficult to separate out domestic and international tax issues. When making changes to national tax systems, increased attention has to be paid to the international implications of any proposed modifications. This, in turn, may mean that the traditional criteria used to evaluate tax reforms have to be reconsidered. Policies which may have been appropriate in economies where exchange controls and other limitations on international transactions were prevalent may neither be feasible nor desirable once these non-tax barriers are removed.

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Table 1
Degree of Reduction of Economic Double Taxation
(Central Government)

None or very little reduction	Reduction of economic double taxation				Elimination of economic double taxation	
	Corporate level		Shareholder level		Corporate level	Shareholder level
1	2	3	4	5	6	7
Classical System	*Split rate system*	*Partial dividend deduction system*	*Partial imputation system*	*partial shareholders relief schemes*	*Zero rate system*	*Full imputation system*
	Lower tax rate on distributed income	Partial deduction of dividends paid	Partial credit for corporate tax paid	Partial credit for domestic shareholders	Zero tax rate on distributed income	Full credit for corporate tax paid (imputation system)
Belgium Luxembourg Netherlands Switzerland United States	Germany	Iceland Spain Sweden	France Ireland United Kingdom	Austria Canada Denmark Iceland Japan Portugal Turkey	Greece Norway	Australia Finland Germany Italy New Zealand

Against this background, the main issues which are under discussion by governments are:

A. *Elimination of economic double taxation*

There is no consensus on the desirability of integrating the personal and corporate income tax or on what would be the best method to achieve this integration. Whilst most, but by no means all, public finance experts accept that economic double taxation[2] may be distorting the financing and investing decisions of enterprises, it is difficult to agree on the quantitative significance of these distortions. Also, the introduction of methods of relieving economic double taxation may be costly in revenue terms and can complicate international fiscal arrangements. Table 1 shows the systems operating in OECD in 1991.

B. *Reduction of tax-induced distortions in domestic investment patterns*

Even after the recent wave of tax reform, tax systems continue to distort investment patterns. In the manufacturing sector tax systems tend to favour investment in machinery in relation to buildings and particularly in relation to inventories (see Box I). At the same time, there are wide differences in the effective corporate tax burden on different sectors of the economy and different activities, in part reflecting the continued use of selective tax incentives and in part the often unintended interactions between different parts of the corporate tax system and economic conditions in different sectors. Incentive provisions may also favour capital intensive rather than labour intensive investment projects and inflation accentuates these distortions.

C. *Taxation and corporate finance*

Tax systems are not neutral as between alternative sources of corporate finance. The data in the report indicate that debt finance tends to be favoured over retained earnings and equity (see Box I). How far governments should be concerned about these non-neutralities depends, inter alia, upon the view taken on the efficiency of capital markets in allocating funds and on risks attached to corporations placing a high reliance on debt financing.

D. *Relative tax treatment of domestic and foreign investment*

This is a complex and wide-ranging issue and the OECD study was focused on the tax treatment of cross-border investment flows in the manufacturing sector. Much of the discussion centers upon the question of whether tax systems are neutral as between the choice of investing at home or abroad, what economists refer to as capital import and capital export neutrality.[3] Yet these neutrality benchmarks cannot capture all of the complexity of these arrangements. First, they do not allow for the many-sided nature of international investment decisions. Investors can change their place of residence and the form of

2. "Economic double taxation" is used to refer to the fact that distributed profits are taxed first at the corporate level and then in the hands of the shareholders.

3. Capital export neutrality occurs where the tax system is neutral toward the export of capital since investors face the same marginal effective tax rate on income from similar investments, whether they invest in the domestic economy or abroad. Capital import neutrality prevails when domestic and foreign suppliers of capital to any given market obtain the same after-tax rate of return on similar investments in that market, taking account of the corporate and personal taxes paid in the country of source and of residence.

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Box I
Effective Tax Rates on Domestic Investment in OECD Countries

The tax rates shown in the legislation on corporate profits – the schedule rates – are not a good guide to the tax burden on corporate profits. A better approach to measuring these tax burdens is to look at the effective tax rates on domestic marginal investments. Effective tax rates are tax rates which take into account not only the statutory corporate tax rate, but also other aspects of the tax system which determine the amount of tax paid and profitability of investment, such as capital allowances and stock relief. Effective tax rates may also require a consideration of personal taxes, and the manner (if any) in which the corporate and personal tax systems are integrated. Inflation will also alter effective tax rates in various ways, depending on how the tax system calculates taxable profits in the presence of inflation.

Marginal investments are projects which are expected to earn a rate of return on the initial outlay just sufficient to persuade investors that the project is worthwhile. All investments are expected to yield the supplier of capital with a rate of return at least as high as could have been achieved by putting the same amount of capital to an alternative use (buying government bonds, for example), as otherwise potential investors would choose the more lucrative alternative. Potential investors always have the option of getting the prevailing rate of interest from either banks or the government, so in the absence of corporate taxes and personal taxes, this would imply that the risk-adjusted return on the investment would have to be as high as the risk-adjusted market interest rate.

Taxes on corporate income generally raise the pre-tax rate of return required in order to yield the same (post-tax) return as in the absence of taxes. Hence the company has to earn a higher rate of return in order to be able to match the return which could be achieved by buying a government bond. Taxes on personal income from the corporate sector result in investors receiving less than the gross amount paid to them. The difference between the pre-corporate tax rate of return earned by companies and the post-tax receipts an individual gets is a measure of the total distortion (total tax "wedge") caused by taxes.

Suppose, for example, it is possible to earn a real post-tax rate of return of five percent by depositing money in an interest-bearing account in a bank. For a company to persuade an investor to finance an investment by buying shares in that company, it must expect to be able to provide dividends and/or capital gains of sufficient size so that after tax the investor would get a rate of return of at least five percent. To be able to give shareholders a return of five percent the company may have to pay gross dividends of seven percent, the difference being paid to the authorities as personal tax. In order to be able to pay gross dividends of seven percent, the company may have to earn a pre-corporation tax return of ten percent, the difference being paid as corporation tax. Therefore tax has driven a wedge of five percentage points between the return to investors on the capital they originally invest in companies (five percent), and the return earned before tax by companies (ten percent). This wedge can be calculated if the provisions of the tax code are known.

The importance of this tax wedge is that it gives some indication of whether taxation creates a disincentive to new investment. For example, suppose that investors will only finance investment if they receive a five percent return (after any tax). If the pre-corporate tax rate of return necessary to give potential investors a five percent post-tax return is ten percent, then all those projects which earn a return of between five and ten percent and which would be viable in the absence of tax will not earn a sufficient return when income from capital is taxed, and such projects may therefore not be undertaken.[4]

Apart from the question of whether a project which is profitable in the absence of tax is still profitable when tax is applicable, there is the equally important issue of whether tax distorts the form of the investment. If tax is relatively generous to particular types of finance and assets, then resources may be diverted towards them rather than the sorts of investments which would take place were the tax system neutral. Comparisons of the required pre-tax rate of return or the tax wedge on similar investments financed in different ways (or in investments in different assets financed in the same way) give an indication of the extent to which the tax system achieves this "allocative" efficiency.

The easiest way to understand the methodology used in the OECD study is to assume that a company, which is making some profit on its existing operations, considers obtaining funds in order to invest in a new project. The cost to the company of the project will be reduced by the current value of any capital allowances it receives on physical investment. Both these and the profits it expects to earn will be received in the future, so have to be discounted by some factor in order to obtain their present value. If the investment is a marginal one, then the return on the original investment must be just equal to the cost of the project. Hence, given the value of capital allowances (as given by the tax code), the discount rate which is to be applied to a project and the tax rates, then the pre-tax rate of return necessary to give a present value equal to the cost of the project can be calculated, and this is the rate of return which is considered as "marginal".

Table 2 shows the results of one set of marginal effective tax rate calculations undertaken in the report. The question that the tables address is: what is the pre-tax rate of return (i.e. before paying the corporate and personal income tax on profits) required to give the domestic investor a five percent real rate of return after tax? For example, an investor in the Netherlands undertaking a typical marginal investment financed by debt must earn a pre-tax rate of return of 2.8 percent to give the investor a five percent after-tax rate of return, i.e. in this case the tax system subsidizes the investment in the form of a negative tax wedge.

4. For marginal investments, the required pre-corporate tax rate of return is often called "the cost of capital". The reason is that in order to raise capital for a project, the company must expect to earn at least that rate of return in order to be earning enough to be able to pay the providers of the capital with a sufficient return.

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their investment (whether their investment takes place in a subsidiary or by means of a branch). They have a wide range of choices on how to finance an investment (e.g. finance could be provided by subsidiaries in a third country or locally). Each of these decisions cannot be encompassed in a simple conceptual framework. Second, capital export neutrality is particularly difficult to achieve where domestic systems in the source and residence countries provide for different tax treatments of different sectors and activities. Effective tax rates will then vary widely across assets, industries and sources of finance. Third, even if neutrality were achieved under these circumstances, differences in nominal rates may nevertheless give rise to cross-border arbitrage. Fourth, the analysis is unable to take account of the different possibilities to evade and to avoid tax that are open to domestic and international investors. Finally, these neutrality concepts provide only a starting point for the negotiation of tax treaties, the outcome of which reflects the balance of interest between the parties at a given moment. Nevertheless, the concepts provide a convenient starting point to analyse international tax arrangements and encourage policymakers to take a more global view of the benefits and costs of existing international tax arrangements and proposed changes thereto.

The data presented in Box II, which are calculated under the normal tax regimes applied to corporations operating in the manufacturing sector, show that the potential tax burden is generally higher on direct investment flows from one country to another than on purely domestic investment, i.e. capital export neutrality is not achieved. Whilst this may in part be explained by the methods used to relieve international double taxation, it appears that the operation of withholding taxes on dividends and interest paid to non-resident corporations also tends to result in a less favourable treatment of foreign investment in comparison to domestic direct investment. A general removal or reduction of these taxes could help move countries towards greater capital export neutrality. It is also noteworthy that the existence of tax treaties significantly reduces distortions in international investment flows.

Table 2
The pre-corporate tax required rate of return necessary to give a financer a 5% after tax rate of return[1]

Country	Average for each source of finance			Average for each type of asset			Overall average
	retained earning	new equity	debt	buildings	machinery	inventories	
Australia	9.0	9.0	3.6	7.0	6.4	8.9	7.1
Austria	7.3	7.3	2.3	5.4	4.1	8.9	5.5
Belgium	7.1	7.1	2.4	5.3	4.0	8.9	5.4
Canada	8.1	5.5	3.5	6.3	5.3	8.1	6.2
Denmark	7.5	7.5	2.8	6.0	5.3	7.0	5.9
Finland	8.0	2.8	2.8	5.3	4.9	7.7	5.6
France	7.3	3.1	3.2	5.4	4.5	7.6	5.4
Germany	9.5	1.6	0.6	5.9	5.1	6.2	5.6
Greece	7.3	2.2	2.2	4.9	4.8	5.5	5.0
Iceland	8.0	8.0	4.3	7.7	5.8	7.6	6.7
Ireland	5.5	5.0	4.5	4.8	5.0	5.6	5.1
Italy	9.1	1.9	1.9	6.5	5.5	5.7	5.9
Japan	9.0	9.0	1.6	7.0	5.9	6.7	6.4
Luxembourg	8.1	8.1	3.0	6.8	4.9	8.9	6.3
Netherlands	7.1	7.1	2.8	6.0	5.2	5.9	5.6
New Zealand	8.3	8.3	3.9	6.7	6.3	8.0	6.8
Norway	10.0	4.5	2.4	6.4	5.3	10.6	6.8
Portugal	7.5	7.5	2.3	6.1	5.2	6.1	5.7
Spain	7.8	7.8	3.2	5.7	5.5	8.4	6.2
Sweden	6.6	4.3	2.7	5.0	4.3	6.6	5.0
Switzerland	6.6	6.6	3.1	5.6	5.1	5.8	5.4
Turkey	9.8	9.8	2.5	6.5	6.0	10.9	7.2
United Kingdom	7.7	4.6	3.5	5.7	5.2	7.8	5.9
United States	7.6	7.6	2.6	6.6	5.2	6.1	5.8
Average	7.9	6.1	2.8	6.0	5.2	7.5	5.9

1. No personal taxes, average inflation at 4.5%, average weights. Real interest rate assessed at 5%.

E. *Extending the advantages of integration of the personal and corporate income taxes to non-residents*

This is an area where the data provide no clear guidelines for policymakers. The report identifies the conditions under which either the extension of imputation credits to non-residents by source countries or the granting of imputation credits to residents for foreign taxes paid by residence countries could remove distortions. In practice, either policy could lead to other economic distortions as companies seek to avoid tax, and problems arise as how to share revenue costs. There is no consensus on this issue in the OECD, with countries following divergent practices.

F. *Sharing out the international tax base*

Efficiency and revenue-raising goals can conflict unless there is some coordination of national tax policies. Since different financing schemes encounter different effective tax rates, it can be expected that tax arbitrage will take place, shifting the tax base between countries. This is an issue which encompasses a wide range of policy considerations, including, inter alia, member countries' treaty practices, the approach to the determination of transfer prices, the need to counteract international tax evasion and avoidance. The OECD intends to further examine this issue.

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Table 3
Overall average required transnational pre-tax rates of return[1]

Country	Average required rate of return: Domestic Investment	Residence (investment from named country into all other countries)	Source (investment from all other countries into named country)	Country	Domestic Investment	Residence (investment from named country into all other countries)	Source (investment from all other countries into named country)
Australia	7.1	7.3	8.1	Luxembourg	6.3	7.2	7.4
Austria	5.5	7.2	7.1	Netherlands	5.6	6.9	7.0
Belgium	5.4	7.0	6.8	New Zealand	6.8	7.3	9.7
Canada	6.2	7.5	8.4	Norway	6.8	8.7	6.5
Denmark	5.9	6.4	7.2	Portugal	5.7	9.9	7.9
Finland	5.6	6.6	7.3	Spain	6.2	7.1	8.0
France	5.4	6.6	7.9	Sweden	5.0	6.8	6.3
Germany	5.6	7.7	6.4	Switzerland	5.4	6.8	6.9
Greece	5.0	8.3	7.4	Turkey	7.2	8.3	8.2
Iceland	6.7	7.8	9.2	United Kingdom	5.9	6.7	6.9
Ireland	5.1	8.8	6.6	United States	5.8	7.1	7.4
Italy	5.6	7.4	6.8				
Japan	6.4	8.0	8.1	Average	5.9	7.5	7.5

1. Subsidiary financed by one-third loans from the parent, one-third new equity from the parent and one-third retentions by the subsidiary. Weighted average of three sources of finance by parent. Weighted average of three assets (machinery, buildings and inventories). Inflation of 4.5% everywhere. No personal taxes.

Box II
Effective Tax Rates on International Investment in OECD Countries

Investment across frontiers results in a substantially more complex tax position than investment in one country. The tax treatment of purely domestic investment is determined by one tax system. Transnational investment involves not only dealing with two (or more) tax systems, but also dealing with the interaction of these systems.

A convenient simplification is to consider a parent company which makes an investment in a foreign country through a subsidiary. The parent company could raise funds outside the country in which it is resident. However, to simplify the study, it considers only transnational direct investment.

Under these assumptions, profit made by the subsidiary may be taxed at four levels. First, it is taxed in the country where the subsidiary is located (the source country) under the corporation tax of that country. Second, it may be taxed by the source country when the profits are repatriated to the parent company. Third, the country where the parent is resident (the residence country) may impose a further corporation tax on the foreign source income of the parent. Fourth, personal taxes may be paid by individual investors on their return.

The relevance of each level of taxation in determining the post-tax profitability of a new investment depends on how the investment is financed. Numerous financing arrangements exist. The parent company could provide funds to the subsidiary by an injection of new equity in the subsidiary, or by lending to the subsidiary and charging interest on the funds. In each case, the parent itself also needs to raise the funds, which it could do by issuing new equity, retaining earnings or borrowing on its own account. Finance could also be provided by the parent foregoing the receipt of dividends from the subsidiary (i.e. the subsidiary could retain its profits rather than repatriate them to the parent) in which case it is assumed that the parent also reduces its own dividend payments.

Each of these seven financing possibilities are examined. The tax treatment of the profits made by the subsidiary will be different in each case. The form in which finance is raised by the parent affects the discount rate which must be applied to the return on the project, for the same reasons as when the project takes place entirely in one country. Selected results from the calculations of effective tax rates on international investments are provided in Table 3 with main assumptions provided in the note to the table. The table enables comparisons of effective tax rates on domestic and international investment and thereby also an assessment of whether capital export and capital import neutrality are achieved in practice. As is seen from the table, tax systems tend almost universally to discriminate in favour of domestic investment. For example, a resident of Ireland investing in other countries would on average need a pre-tax rate of return of 8.8 percent against only 5.1 percent on domestic investment to obtain an after-tax rate of return of five percent.

However, it should be kept in mind that there are a number of important limitations to this kind of analysis. In addition to the areas mentioned above in the domestic case, there are several others when the analysis becomes transnational. The assumption that the parent raises finance only in the country in which it is resident is one; others are the assumption that assets are transferred between members of the same group at their true economic values, the absence of any attempt to assess the effects of the taxation of exchange rates gains and losses, and the restriction of the analysis to the simplest form of group relations – parent/subsidiary – rather than looking at more complex group structures and possibilities for treaty shopping. Nevertheless, the estimates provided in the OECD report give some indication of the potential distortion by the tax system of transnational investment. The fact that companies may use more complex financial arrangements and group structures in order to minimize these distortions indicates that the potential inefficiencies can be sufficiently large to alter company financial behaviour from that which would otherwise prevail.

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AUSTRALIA:

THE TAXATION OF CAPITAL GAINS

Rick Krever

In 1985, 70 years after the introduction of federal income taxation in Australia, capital gains entered the tax base. Although there was no shortage of models for the legislative drafters, the peculiarly narrow tax base from which they commenced their base-broadening exercise meant special approaches to the task were needed. The result is a capital gains tax system unique in many respects. The final product has been subject to continual amendment and adjustment since its enactment. Recently revealed shortcomings have yet to be addressed.

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I. INCOME ACCORDING TO JUDICIAL CONCEPTS

The first federal income tax act in Australia was adopted in 1915, primarily as a wartime revenue-raising measure, but also to placate disgruntled rural voters who felt they bore the burden of the nation's excessive reliance on customs duties and excise taxes. At the time, all six Australian States levied income taxes and the federal legislation followed the broad structure of the State precedents.

In form, the Australian legislation resembled that of the U.S. income tax act, adopted two years earlier, imposing tax simply on the undefined generic concept of "income". It was left to the courts to map the limits of the income concept and the resulting scope of the legislation. Notwithstanding the similarity in form between the U.S. and Australian acts and the overt reliance on U.S. precedents in other areas of law (particularly with respect to constitutional issues – parts of the Australian constitution were based on the U.S. model), Australian judges took a dramatically different approach to their American counterparts when interpreting the meaning of income.

The American approach was to read the provisions of the legislation liberally – if the purpose of the law was to tax increases in economic capacity in accordance with fundamental ability-to-pay principles, the U.S. courts concluded, income should be regarded nearly as possible as synonymous with gain, whatever its source or character, be it expected or windfall, earned or unearned. Time and again taxpayers failed to convince American courts that the income concept should be narrow; the only restriction imposed on the reach of the tax act by the U.S. courts was the requirement that gains be realized before they could constitute income.

In contrast to the American courts, the Australian courts read down the term income to seriously restrict the reach of the income tax legislation. Rather than adopt new doctrines for a new body of law, the Australian courts turned to older precedents from other areas of law to help define the term income for tax purposes. The most important doctrinal source was English trust law, which had used the term income for several hundred years. In trust law, income was the type of gain to which a person with a life interest in an estate was entitled. It could be contrasted with a "capital" gain to which a capital beneficiary or remainder person could lay claim.

The Australian courts simply adopted for income tax purposes the income tests developed by the English courts of equity to resolve trust law and property law disputes. For trust law purposes, income was identified by its form (income generally came in periodic payments), the probability of its receipt (income was anticipated, not an unexpected windfall), the use to which it was put (income was used to satisfy ordinary ongoing obligations such as ordinary living expenses) and its nexus with an identifiable source (either labour, property or business activity).

The restrictive judicial concept of income for tax purposes was further narrowed by the "colonial cringe" factor – that is, the tendency of Australian courts to follow

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closely English precedents, including those of relatively low level courts, with insufficient critical analysis of the underlying legislation and its relevance to Australian law. The U.K. tax legislation was based on a schedular system and English judges were often called upon to determine whether or not a gain fell within or outside a particular "schedule" or "case", as the next subdivision was called, not whether it was income. Relying on English tax precedents, Australian courts regularly characterized profits that fell outside a particular case or schedule of the U.K. act as gains that were not encompassed in the Australian judicial concept of income.

A variety of labels were adopted by the judiciary to describe the many types of gain that fell outside the judicial concept of income. All bore a common term – capital; most common were the phrases "realizations of capital", "capital receipts" and "capital gains".

Over time, the legislature gradually chipped away at the boundaries of the judicially-decreed exempt capital gains, pulling particular types of gain into the income tax base. Some of the early base-broadening initiatives frequently backfired as the courts read the provisions narrowly and exempted from tax gains that fell outside the technical limitations the judiciary read into the poorly drafted measures. Often, the result was a tax base narrower than it would have been had no legislation been attempted.

Comprehensive base-broadening remained off the tax reform agenda until the election of a Labour government in December 1972. Tax reform was one of many areas that had been targeted for attention by the new government and important changes were made to many areas of the legislation soon after Labour gained power. The first move in the direction of capital gains taxation was the adoption in 1973 of a provision designed to catch so-called short-term capital gains – gains realized on the sale of assets sold within a year of their acquisition. The amendment was made in response to widespread public anger over the brazen exploitation of the non-taxation of these gains by speculators profiting on a bull market for mining shares, although the provision caught short-term gains on any property.

The 1973 amendment had relatively little practical impact. Some short-term gains would have been caught as judicial concept income anyway and other investors could avoid the provision simply by holding on to property for more than 12 months. Long-term capital gains remained untouched until 1974, when the government announced it would introduce comprehensive capital gains taxation. The unofficial model for the proposed capital gains regime was the Canadian capital gains tax system, which had come into effect at the beginning of 1972.

Before any legislation was released, the Labour government encountered a number of political crises. Reform plans were quietly abandoned as the government focused its attention on political survival. That quest failed in mid-1974 when Liberal-dominated opposition blocked supply in the upper house of Parliament. Seizing the opportunity to intervene, the Governor-General dismissed the Labour government and called upon the opposition to form a government. Not surprisingly, the ensuing debate over the constitutional validity and implications of the Governor-General's action quickly relegated tax reform to the back-burner.

By the mid-1970s the income tax system was in serious trouble. A very conservative High Court (Australia's highest court of appeal), led by a chief justice with an apparent ideological axe to grind, substantially narrowed the judicial concept of income. At the same time, it read down the anti-avoidance provisions in the tax legislation to render them completely impotent. Judicial endorsement of increasingly artificial avoidance schemes encouraged tax planners to step into uncharted waters and the boundaries between tax planning, avoidance and outright evasion gradually blurred. Criminal organizations joined forces with some of the more ambitious tax avoidance marketeers and in some quarters tax planning degenerated into fraudulent conspiracy to defraud the revenue.

The government's initial responses to the contraction of the income tax base were ineffectual to say the least. Labour's short-term capital gains measure, introduced in 1973, was the only significant base-broadening amendment made during the decade of the 1970s. By the early 1980s, the combination of widespread judicially endorsed tax avoidance arrangements and unendorsed evasion schemes that built upon their avoidance counterparts had led to a haemorrhaging of the income tax base that many commentators claimed was unprecedented in international terms. Although the problems were virtually all attributable to the gaps in the income tax base, the government, a Liberal-dominated coalition (its partner was the rural-based National Party), was unable to address the fundamental problem because of its refusal to countenance comprehensive taxation of capital gains. The Liberals' preferred solution, piecemeal stop-gap anti-avoidance measures, attacked the most blatant of the avoidance schemes but left most tax minimization arrangements untouched.

Labour returned to power in 1983, its victory fuelled to a large degree by public outrage over disclosures about the growth of tax avoidance and evasion and the complacency of both the judiciary and legislation in the face of its geometric rise. The Labour government's first important reform initiative was the inclusion in the income tax base (albeit on a preferential rate basis) of one type of so-called "capital gain", lump-sum retirement payments. Further comprehensive reform was promised by the government when it faced the polls in late 1984 and in 1985; soon after Labour's re-election, an agenda for reform was adopted. It culminated in the announcement by the Treasurer in September 1985 of a comprehensive reform package including, among other things, full taxation of capital gains. Legislation implementing the capital gains tax was adopted in 1986, effective from 19 September 1985, the day on which the proposed tax changes were first announced in Parliament.

II. STRUCTURE OF THE LEGISLATION

The objective of the Treasury team responsible for drafting the capital gains provisions was not merely to tax capital gains in the economists' sense of gains derived from the sale

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of assets other than inventory. Rather, it was to bring into the tax net the vast array of so-called capital gains left outside the judicial concept of income. These gains arose in a variety of very different transactions – in addition to gains on the sale of investment assets or business assets, they included such diverse amounts as payments for entering into non-competition agreements, payments for the termination of contractual arrangements, gains realized as premiums or discounts on debt instruments and gains realized upon the cancellation of debt. These amounts shared only one attribute in common – their judicial characterization for income tax purposes. The responsibility of the legislative drafting team was to devise a structure that would bring all gains into the tax base in the simplest form possible.

A. *The realization principle and integration with the income tax system*

Two fundamental tax policy principles guided the design of the reform legislation. First, like all capital gains tax systems in effect, the Australian system was to operate on a realization basis.[1] In other words, there would be no recognition of gain or loss until appreciated or depreciated property was sold or otherwise disposed of.

Second, the capital gains provisions were to operate as an extension of the income tax base, and not implement a new and separate tax base. While there would have been no tax policy rationale for the latter approach, many tax advisers thought the second system would be adopted in Australia because of the U.K. precedent.[2] The judicial distinction between capital gains and income gains in that country was so entrenched that capital gains were brought into the U.K. tax net as a separate tax base, for reasons of political pragmatism. The Australian distinction between income and capital gains was based on the English doctrines and U.K. law remained influential in Australia but given the complete lack of justification for separate taxes from either a theoretical or tax policy perspective, it was not an option ever contemplated seriously by Treasury.

B. *Assets and disposals*

While the so-called capital gains provisions were designed to catch a wide array of gains, it was clear that they would apply most often to gains realized on the sale or other disposal of tangible and intangible property. Accordingly, the capital gains tax designers used as the heart of the new regime a charging provision that is triggered by the disposal of an asset. Where the consideration for disposal of an asset exceeds its cost base, the taxpayer realizes a capital gain; where the cost base of an asset exceeds the consideration for its disposal, the vendor suffers a capital loss.

To bring the many other types of gains labelled capital gains by the courts into this basic capital gains formula, broad definitions of asset and disposal were adopted. Asset, in particular, is widely defined to catch virtually any type of tangible or intangible property, including any type of chose in action and any other "right" belonging to a taxpayer. Commentators and some judges have argued that the apparent breadth of the definition is not as wide as it appears to be on the basis that "right" must be read as a proprietary right, meaning a right that can be transferred from one person to another. However, other authorities have said the definition includes rights to pursue a legal action for damages in contract or tort, a class of right that cannot be traded, so the exact limits of the asset definition remain uncertain.

Much more controversial than the wide definition of asset is the expanded definition of disposal. The basic provision is relatively straightforward – a disposal is defined as a "change in ownership" of property, a term that is subsequently defined to include the various ways in which ownership can be transferred or lost, including the loss or destruction of property. These relatively simple definition measures are supplemented by two complicated deeming provisions, which are designed to bring into the capital gains tax the types of judicially labelled capital gains that are generated in transactions not involving the disposal of an asset.

The two deeming provisions, known to practitioners as the "terrible twins", deem a taxpayer who has derived a gain in a situation not involving the disposal of an asset to have disposed of an asset and to have received consideration for the disposal equal to the gain realized by the taxpayer as a result of the transaction. The gain thus satisfies the statutory definition of a capital gain and enters the income tax base in the same manner as any other capital gain. Gains to which the provisions were intended to apply include payments in respect of a negative covenant (e.g. payment to a taxpayer who has agreed not to compete with the payer) and payments in respect of the cancellation or alteration of a contract.

The two deeming provisions are quite complicated. They have been generously described by some commentators as perversely convoluted, while others have simply labelled them incomprehensible. One section, for example, speaks of the taxpayer receiving consideration for the disposal of an asset that was created upon the disposal. It was inevitable that the deeming sections would give rise to litigation.

In mid-1991 the scope of the sections finally came before the High Court, which is, as mentioned earlier, Australia's final court of appeal. The Court's decision was surely as complicated as the measures themselves. The case, *Hepples v. Federal Commissioner of Taxation*[3] involved a large lump-sum payment made to an employee in return for his promise not to compete with the employer or to exploit knowledge gained from employment for two years following the termination of his employment. A majority of the seven-person court concluded the gains should be taxable. The four members of the majority did not agree on which deeming provision applied, however, so no majority could be found to support the application of one particular section. The Court was at something

1. There have been partial accruals systems used in some special cases – an example is the optional Canadian indexed security investment plan system, which was in effect briefly in the early 1980s, as described in C. Shoup, "Taxation of Capital Gains Abroad", 1 Australian Tax Forum (1984), at 1986.
2. Indeed, in run-up to the reform changes the largest tax publisher in the country, relying on advice from practitioners that any Australian initiative would likely copy the U.K. system, commenced a vigorous advertising campaign to market its proposed "Capital Gains Tax Act" looseleaf service.
3. (1991) 22 ATR 465.

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of a loss as to how to rule, and to resolve its dilemma it invited the parties to appear before it again, in late 1991, to present argument about the nature of the ruling it should issue in light of its split over the appropriate section. The final ruling said the gain was not taxable.

Taxation Office officials now concede the provisions will have to be redrafted to catch gains such as payments for a negative covenant. Officials are unlikely to follow the advice of some tax academics and practitioners and insert inclusion sections in the ordinary income tax part of the legislation, away from the capital gains provisions. Instead, it is expected that there will be another attempt to fit the gains into an arguably alien "disposal of asset" formula.

Since the enactment of the legislation, other limitations of the "disposal of an asset" formula have come to light and it is clear that other types of gains that were formerly exempt from tax will escape the capital gains tax. In particular, it is now conceded that gains realized by a debtor on the cancellation of debt will not be taxed (the borrower is disposing of an obligation, not an asset) nor will leasehold improvements realized by a landlord upon the departure of the tenant responsible for their construction. No remedial legislation is expected for the purpose of bringing either of these types of gain into the tax base.

C. *Indexation, cost and quarantine features*

1. Indexation

In general, the Australian income tax system is based on nominal gains, without regard to the effects of inflation, although there have been some limited inflation adjustment measures available in the past. These include provision for indexation of gains on trading stock or inventory (briefly in effect in the mid-1970s) and more recently 5/3 depreciation, originally adopted as an investment incentive measure and later rationalized as a proxy for depreciation indexation for most of its tenure during the mid-1980s.

Notwithstanding the lack of indexation generally in the income tax system, political advisers to the government believed indexation of capital gains was a prerequisite to the inclusion of capital gains in the income tax base. The concession was thought necessary only to the extent the base was being broadened – thus, for example, there was no pressure to extend indexation to short-term capital gains, which had been subject to taxation since 1973. The government adopted the advice of its political advisers and defined long-term capital gains (realized on assets held for a year or more) as the excess of consideration from the disposal of an asset over the indexed cost base of the asset.

2. Cost bases

Three types of "cost base" are used in the capital gains formulae. As mentioned, long-term gains are calculated as the excess of consideration over the indexed cost base of the asset. Short-term gains, realized on property acquired less than a year prior to disposal, are calculated as the difference between consideration received in respect of the disposal and the cost base of the disposed asset. And finally, a capital loss is measured as the amount by which the reduced cost exceeds consideration in respect of the disposal.

Several elements are included in the calculation of all three cost bases. The most important is the actual cost of acquiring an asset. Also included are a range of expenses that were formerly characterized as "capital outgoings" and hence non-deductible. These include the cost of defending title to an asset and the cost of enhancing or improving an asset.

Another type of expense that was not deductible prior to the introduction of capital gains taxation was interest incurred in respect of non-income-producing property such as speculative land investment that generated no rental income. This expense was non-deductible, not because it was considered to be capital in nature, but rather because it lacked any nexus with the production of taxable income. In the absence of special measures, following the introduction of capital gains tax, interest expenses of this sort could have been added to the cost base (or indexed cost base) of assets since it was, arguably, related to the preservation of the taxpayer's title to the assets, or deductible as a current expense since it was related to the eventual realization of taxable capital gains. However, to ensure there was no tax advantage attached to the acquisition of non-productive, speculative property investments, measures were inserted to specifically deny recognition of interest expenses in these circumstances.

Notwithstanding the rationale behind the denial and international precedents supporting this approach, tax advisers lobbied hard for the recognition of interest expenses related to the acquisition of non-income-producing speculative investments. Surprisingly, in 1991, in the midst of what many commentators claimed was the nation's worst recession since the Great Depression, when the government was desperate to encourage productive investment, Treasury announced a change to the law to include interest and similar holding costs (e.g. local taxes and insurance) in the cost base of assets, thereby encouraging non-productive speculative investments.

The reduced cost base used to calculate capital losses is similar to the bases used to measure gains, but specifically excludes any part of the cost of an asset that has been previously deducted as an ordinary expense. The omission of this condition from the cost and indexed cost formulae appears to have been an oversight, although there will not be many circumstances where part of a cost can be deducted as an ordinary business expense. One situation where this could arise is with the sale of property for a lump sum and ongoing "royalty" payments related to production or profit performance. In this case, the royalties will be deductible to the purchaser but may also constitute part of the purchaser's cost base in the asset, in which event they could be recognized twice by the taxpayer.

3. Quarantining

Like virtually all realization-basis capital gains regimes, the Australian system quarantines capital losses against capital gains. Net capital gains (the excess of capital gains realized during the year over capital losses suffered) are included in gross taxable income. The Australian quarantining rule is

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quite strict. Capital losses can only be offset against capital gains and, to the extent they exceed capital gains, carried forward to be offset against future years' gains. Quarantine systems found in some other jurisdictions are less rigid; for example, both Canada and the United States provide a limited deduction of excess losses against other types of income. The unlimited carryforward of excess losses expires at death and any excess losses not utilized by that point are simply lost.

4. Negative gearing

The taxation of capital gains and the quarantining of losses with gains did not solve one of the more serious problems with the Australian income tax system, its encouragement of negative gearing. Negative gearing refers to the practice of using borrowed funds to invest in an asset that will generate current income while it is held and capital gains when it is sold. If the interest and holding expenses exceed the current income, the property is said to be negatively geared.

Where property is negatively geared, interest expenses are attributable to both the current income and anticipated future capital gains. Under Australian judicial doctrines, no apportionment of the interest expense is needed so long as there is current income generated by the investment. Prior to 1985 there was a complete mismatch between outgoings and gains – the entire interest expense was deductible as incurred while the resulting capital gain was never taxed. Since the introduction of capital gains tax, the mismatch has been mitigated somewhat, but substantial tax minimization opportunities remain for two reasons: first, interest is deductible as incurred while recognition of capital gains may be deferred until property is sold; and second, interest is fully deductible on a nominal cost basis, while long-term gains are inflation-adjusted and hence taxed on a real gain basis.

Although Australia has never used general passive loss quarantining rules, limited matching of interest and resulting capital gains on rental properties was briefly adopted in 1985. Since the repeal of those measures in 1986, there have been no restrictions on the mismatching of current interest expenses and deferred capital gains. Negative gearing has become an important method of tax minimization with serious efficiency repercussions and equity implications.

D. *The pre-20 September 1985 exemption*

The most remarkable feature of the Australian capital gains tax system, and the aspect that has attracted most criticism by foreign commentators, is its exemption for property acquired on or prior to the evening of 19 September 1985, the night on which the Treasurer announced the adoption of capital gains taxation in Australia. It had long been assumed that the Australian system would follow adopt the international norm and use a valuation date procedure, under which all assets held by the taxpayer would be valued at the time from which the tax became operative and gains and losses measured from that value. However, shortly before the capital gains provisions were to be announced, the Prime Minister's political advisers apparently convinced him that the valuation date system could be a long-term political liability. The advisers argued instead for an exemption system under which only assets acquired after the adoption of the tax would be subject to the new provisions. Eventually, the Prime Minister prevailed upon the Treasurer to accept this exemption system despite the vigorous opposition of his Treasury advisers.

The economic and equity implications of the exemption for gains realized on assets that were acquired prior to the introduction of the reform measures were significant. The exemption for gains on pre-assets, as assets acquired prior to 20 September 1985 are sometimes called, introduced an invidious distinction between owners of old wealth and owners of new wealth. The inequity of the distinction was compounded by other tax changes announced at the same time as the capital gains proposals. The most relevant of these was the proposed adoption of a complete imputation system. The Treasurer's imputation announcement led to an enormous unprecedented rise in the value of many types of publicly traded shares, yielding gains that could be realized tax-free for all existing shareholders.

The economic harm of the exemption for pre-assets was caused by its lock-in effect – so long as owners of pre-assets held on to the property, they could realize their gains tax-free, while the switch to another, more economically rational investment, would also involve the move from tax-exempt to taxable gains.

Too late, the government realized the harm the pre-asset exemption system caused. The mistake was not repeated when the income tax system was extended to formerly exempt superannuation (pension) funds in 1988 and to formerly exempt controlled foreign companies in 1990. In both these cases, a simple valuation date system was adopted. No change has been made to the original pre-asset exemption applying to all other taxpayers, however.

From a statutory drafting perspective, the pre-asset exemption has been a direct cause of what may well be the most complicated capital gains legislation in the world. Among other things, complex provisions apply to:

1. The time of acquisition

Special rules were needed to deal with situations where taxpayers commenced work on an asset before the operational date of the capital gains tax but acquired the asset after that date. This might arise, for example, where a taxpayer laid the foundation for a building before 20 September 1985 and the building was completed after that date. It could similarly arise if a taxpayer carried out research and development before 20 September 1985 and the work eventually led to a process or product that was patented after that date. In cases such as these, the transition rules treat the properties acquired after 19 September 1985 as if they had been acquired prior to that time.

2. Carved out assets

In some situations, new assets can be carved out of existing property. This could occur, for example, where on or after 20 September 1985 the owner of real property grants to another person a long-term leasehold interest in property that was acquired before that date. Carve-outs of leasehold interests

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are deemed to be disposals of property interests acquired after 19 September 1985, but other carve-outs from pre-assets are treated as disposals of pre-assets.

3. Composite assets

Composite assets are created when separate properties merge into one as a consequence of property law doctrines. The capital gains provisions contemplate two situations where composite assets relevant to the exemption for pre-assets might arise: the construction or improvement of buildings on real property and the merging of title on adjacent properties. In cases such as these, special dissection provisions distinguish the pre- and post- elements of the composite property for capital gains tax purposes.

4. Assets owned through interposed entities

It was feared that the separation of economic interest and legal title where property is owned through a company or trust could open the door to unwarranted exploitation of the exemption for gains realized on pre-assets. Remedial legislation was drafted to address two particular situations, illustrated in these cases:

(i) A taxpayer who owned a company prior to 20 September 1985 could use the company to acquire property after that date and when the property had appreciated in value sell the exempt shares in the company instead of causing the company to sell the appreciated asset.
(ii) Taxpayers wishing to invest in a particular type of asset after 19 September 1985 could acquire an interest in a company that owned that type of asset prior to that date. When the company sold the asset, the post-19 September 1985 shareholders could indirectly exploit the tax-exemption for the gains in the hands of the company.

Complex (and according to some commentators, unworkable) anti-avoidance provisions are directed at these types of situations.

5. Rollovers

As explained further below, the capital gains tax is subject to a number of rollover provisions which allow taxpayers to defer recognition of gains or transfer tax liability to the new owner of property. In most rollover situations, the cost attributes of property are transferred to new property or a new owner. In the Australian case, however, the pre-20 September 1985 or post-19 September 1985 status of property must be transferred as well, a factor which complicates the rollover provisions.

E. *Integration with the ordinary income tax provisions*

The capital gains provisions operate independently from the rest of the income tax legislation. A taxpayer's net capital gain, that is the excess of capital gains over capital losses, is calculated without reference to other gains and losses measured under the ordinary income tax provisions. The net capital gain is then brought into the taxpayer's gross taxable income.

The same transaction that gives rise to a net capital gain may also generate a profit that will be taxed under the original income tax provisions. A reconciliation provision in the capital gains legislation is supposed to prevent double taxation in these cases. The reconciliation measure lowers net capital gain by the amount, if any, which is included in taxable income as income according to judicial concepts or pursuant to another statutory inclusion provision.

Unfortunately, the structure of the reconciliation provision prevents it from achieving its objective in some situations. The measure only works where it is the disposal of an asset that leads to the realization of a capital gain and income taxed under the ordinary income tax provisions. The provision has no effect where gains are otherwise taxable without the need for a disposal. The problem is well illustrated in the case of zero coupon or deep discount bonds. Gains on zero coupon bonds are taxed on an accrual basis over the life of the bond. By the time the bond is redeemed, virtually the entire gain (the difference between the issue price and redemption price) will have been taxed as interest income under the relevant deep discount bond provisions. However, the redemption will amount to a disposal and the difference between the indexed cost and the redemption price will be taxed again as a capital gain. The reconciliation provision will not operate because the original tax liability was not the result of a disposal.

Thus far, serious reconciliation problems have been avoided only because the Taxation Office has exercised a discretion probably not sanctioned by the legislation and sought to tax the gain only once, ignoring the capital gains provisions that would apply to the transaction. However, tax advisers expect pressure for reform of the reconciliation provision to grow as more cases of potential double taxation become known.

F. *Personal-use assets*

The definition of "asset" is broad and would encompass all personal property owned by a taxpayer. An important tax design issue is the appropriate treatment of losses on personal property. Most personal property declines in value because of use or consumption – a washing machine devalues as it is used, clothes decline in value as they are worn, and so forth. The income tax system is designed to measure changes in economic position, but it is not supposed to recognize taxpayers' individual consumption. Safeguards are therefore needed to ensure that losses on personal property due to consumption are not allowable as "capital losses". At the same time, provision must be made for recognition of losses that are attributable to external changes, that is, the fluctuation of market demand for and supply of various types of assets.

The statutory formula for achieving these goals is modelled very closely on a Canadian precedent. Central to its operation is the concept of a personal-use asset – an asset held primarily for the private use and enjoyment of the owner or owner's family. Personal-use assets are divided into two categories – listed and non-listed assets. Listed assets are sometimes known as collectibles and include paintings, jewellery, antiques, and coin and stamp collections. All other personal-use assets fall into the non-listed camp.

Listed and non-listed personal-use property receive different tax treatment with respect to both losses and gains. Losses on listed personal-use property are recognized for tax purposes

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while losses on non-listed personal-use property are ignored. The rationale for the different treatment of losses has already been noted – losses on listed assets are most likely attributable to market forces while losses on non-listed assets are probably due to consumption and use. Special rules apply to losses on listed personal-use assets. They are quarantined against gains on the same type of property. Thus, net gains on listed personal-use assets enter taxable income, while net losses on listed personal-use assets can only be carried forward, to be offset against future years' listed property gains. There is no limit to the carryforward period.

The different treatment of gains on listed and non-listed personal-use assets is attributable to administrative concerns. There are two aspects to these concerns. First is the administrative cost of applying the capital gains tax to inexpensive personal property on which only minimal capital gains, at most, are likely to accrue. Second, there is legitimate concern that taxpayers are unlikely to retain records of cost, acquisition date, and so on for non-listed assets. This is less likely to be a problem with listed assets, for which taxpayers are more likely to retain records relating to the acquisition price and consideration for disposal and for which other documentary evidence such as invoices, insurance policies, etc., have been generated. Thus, there are no restrictions on the recognition of gains from the disposal of listed personal-use assets.

Not all gains on non-listed personal-use assets are taxable. Special de minimis provisions establish floors to exempt smaller gains on this type of property. The floors bump up the cost of assets to $ 5,000 where they actually cost less than that and establish a consideration of $ 5,000 where assets are sold for lower amounts. As a result, all gains on non-listed property are ignored for tax purposes unless the consideration for their sale is greater than $ 5,000 and even then gains will only be recognized to the extent the consideration exceeds $ 5,000.

The floors exclude from the capital gains regime inexpensive assets that are unlikely to appreciate in value while catching the more expensive ones such as yachts, summer homes, ski chalets, vacation condominiums, and so forth which may appreciate. The floors also establish an arbitrary, but not unreasonable, border between those assets for which the taxpayer is more or less likely to retain documentation and records. Also, transactions involving assets costing and selling for more than the threshold are more likely to generate a paper trail for auditing and enforcement purposes. Transfers of these properties are often recorded for other purposes such as title registration, insurance coverage, etc.

The de minimis provisions are protected by anti-avoidance measures which prevent taxpayers from splitting a more expensive asset into component parts and applying the $ 5,000 floor to each part or from splitting up a group of assets that is normally sold as a set (for example, an expensive chess set) and selling each piece in the set in a separate transaction. The limits of the anti-avoidance provisions are expected to generate some litigation as taxpayers test the concept of a set. The definition of personal-use assets includes non-business loans. This was necessary to prevent taxpayers from making and then cancelling non-arm's length loans to relatives and claiming a capital loss on the cancelled debt.

G. *Rollovers*

It was noted earlier that the capital gains tax provisions contain a number of rollover measures which allow taxpayers to avoid recognition of gains realized and losses suffered on the disposal of assets in certain circumstances. In some cases the tax attributes of the transferred property pass to the new owner of the property and in other cases the tax attributes of the property disposed of transfer to replacement property acquired by the taxpayer.

There are two types of rollovers in the legislation. The first type comprises rollovers that have been adopted to achieve certain tax policy objectives while maintaining the equity and efficiency goals of income taxation generally. The second type comprises a single rollover, known as the testamentary rollover, which was adopted in pursuit of an immediate political objective and which provides concessional treatment in violation of the equity and efficiency tax norms. This latter rollover is examined in a later section of this article.

The rollovers that seek to achieve tax policy objectives fall into three principal categories: the marital dissolution rollover, the involuntary disposal rollovers and the business and corporate reorganization rollovers. There are in addition several relatively unimportant miscellaneous rollovers.

1. The marital dissolution rollover

From its inception, Australia's income tax system has been based on the individual as the taxable unit and generally income tax liability is not affected by marital status or family relationship. The general rule is subject to a few exceptions – there are a limited number of anti-avoidance rules to discourage income splitting and a small tax credit (called a rebate in Australian terminology) is available for taxpayers supporting a spouse or spouse and children. The exceptions prove the rule, however, and arm's length transactions between spouses are treated no differently from their counterparts outside the context of a family.

Family law and the law of marital dissolution in Australia is based upon federal legislation. Like its equivalents overseas (some of which were modelled in part on the Australian law), the Australian legislation is based on trust law principles that recognize the beneficial interests of one spouse in the property belonging to another as a consequence of the first spouse's financial or in-kind contributions to its acquisition. Family law has extended the equitable principles of trust law to recognize as well the rights of one spouse to property owned by the other where the first spouse has not contributed directly to the acquisition of the property, but has contributed indirectly by making financial or in-kind contributions to a family household or by assuming household responsibilities that made it possible for the second spouse to acquire the property.

The capital gains tax provides a rollover for assets transferred pursuant to a court sanctioned marital dissolution (be it a family law court order or an agreement between the parties sanctioned by the court). Under the rollover provision, the disposal is ignored for capital gains tax purposes and the tax attributes of the transferred property, including its cost and time of acquisition, transfer to the recipient. Complementary

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provisions provide for a rollover where property is transferred from a company or trust pursuant to a family court order. This latter legislation contains complicated adjustment formulae which vary the "transferring" spouse's cost base in the company or trust from which the asset was transferred.

The rollover is non-elective; where property is transferred pursuant to a court order under the federal family law legislation, it operates. It also applies to orders made under equivalent laws overseas. Ironically, taxpayers making transfers pursuant to foreign orders may be treated preferentially to taxpayers making transfers as a consequence of Australian legislation. This is because family law legislation in many jurisdictions extends to unmarried persons in a de facto relationship. In Australia, the federal Family Law Act only applies to legally married (or formerly married) persons. State legislation and common law establishes the rights of persons in de facto relationships but any transfers made pursuant to state law will not trigger the marital dissolution rollover.

There is a potentially large loophole in the marital dissolution rollover that can be exploited when a recipient spouse is a non-resident. As explained below, non-residents are liable for capital gains tax only on a small category of assets. If the transferred property falls outside that class, gains attributable to the asset can escape tax completely since the original transfer is ignored for capital gains tax purposes and the non-resident recipient is not liable for tax on any gains she or he eventually realizes when the property is sold to a third party.

2. The involuntary disposal rollover

An implied attribute of a realization basis tax which nets losses against gains is the power of the taxpayer to decide when to recognize gains and losses by choosing the time of disposal. In some circumstances disposals are the result of external forces – government appropriation of property, destruction by natural disaster, etc. When the taxpayer accepts the consequences of involuntary disposal and reinvests any consideration received as a result of the disposal in a dissimilar asset, there is no reason to treat the disposal differently from any disposal initiated by the taxpayer. If consideration is received in the way of compensation or insurance, the taxpayer has realized the value of the property and made a portfolio choice as to where to reinvest the funds.

The situation may be different where the taxpayer uses any consideration received as a result of the disposal to replace the lost asset. In that case the taxpayer is arguably trying to put him or herself in the position he or she would have been in but for the involuntary disposal. To recognize a realization of gain in these circumstances might be unfair, given that the taxpayer did not wish to dispose of the asset and has tried to replicate the pre-disposal situation. Considerations of this sort explain the availability of two involuntary rollovers in the capital gains provisions. The first applies where a taxpayer receives a replacement asset for the one lost or taken and the second applies where the taxpayer receives cash which is invested in a replacement asset.

While the involuntary disposal provisions are very similar to the marital breakdown rollover measures, they differ in two key respects. First, the involuntary disposal rollover is elective, which means a taxpayer can choose to recognize a capital gain (or loss) even if a replacement asset is acquired. Second, the involuntary disposal rollover has special provisions to deal with cases where lost assets are replaced with less valuable property. If the consideration for an involuntary disposal (e.g. compensation, insurance, etc.) exceeds the cost of the replacement asset, the taxpayer is required to recognize any gain realized as a result of the disposal to the extent it is not reinvested in the replacement property.

3. The incorporation and corporate rollovers

The capital gains provisions contain a large number of rollovers that operate when property is transferred in the course of business and investment reorganizations.

The business and investment rollovers are designed to facilitate efficient ownership of productive assets by removing a tax barrier to reorganization where legal title of property changes but the underlying interests of natural persons in the property remains the same. One of the most important of these is the rollover that applies to the incorporation of a business that has previously been operating as a sole proprietorship, partnership or trust. Although the incorporation rollover eliminates any tax penalty from changing business form, it does give rise to some interesting eventual tax consequences.

The incorporation rollover is available only where the taxpayer receives non-redeemable shares exclusively from the company in return for the transfer of assets. In other words, the company cannot provide the transferor with debt, cash or other property except shares. (The company can, however, assume any liability of the taxpayer for debt owing on the transferred property.) The taxpayer's cost rolls over twice – it becomes the transferor's cost for the shares he or she receives and the company's cost for the asset it receives. Thus, there are in theory two potential future tax liabilities created out of one accrued gain.

A related rollover that is becoming of increasing importance is the intercorporate rollover, which applies to asset transfers between companies in the same group (i.e. companies subject to the same ultimate ownership). This particular rollover has probably given rise to more technical problems than any other provision in the capital gains legislation. To avoid the duplication of potential tax liabilities that arises in the incorporation rollover, the intercorporate rollover provides for only one rollover of cost, this being to the recipient company. Thus, while the transferor's cost for an asset rolls over with the asset to the transferee, the transferor's cost for the shares it receives is the market value of the asset it gives up in return for the shares.

Allowing the transferor a cost in its shares equal to the value of transferred property eliminated the potential problem of double tax liability, but it created a serious avoidance opportunity. A company wishing to sell an asset and avoid capital gains tax could simply establish a subsidiary with nominal capital, transfer the appreciated asset to the subsidiary in exchange for shares and sell the subsidiary to a buyer seeking to purchase the underlying asset. Because the cost of the

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shares in the subsidiary equalled their market value following the transfer, the vendor company would realize no gain on the sale of the shares.

The government has explored a range of options in its attempts to solve this problem including, for a short while, adopting the double rollover of cost formula used in the incorporation rollover. Eventually it returned to the original formula but added an interesting twist to discourage transfers motivated by avoidance objectives. Where an intercorporate asset transfer takes place and the transferor and transferee companies cease to be group companies at some time after the transfer has taken place, the transferee company is deemed to have sold the transferred asset for its market value and immediately reacquired the asset for a new cost equal to the market value at the time the two companies ceased to be group companies. The deeming provision insures the gain is subject to tax as soon as the transferee company is sold to a new owner. It is expected that the purchaser will discount the purchase price by the amount of tax it will have to pay and in this way the transferor company indirectly bears the tax burden for the indirect transfer of the appreciated asset.

Limited rollovers are available for corporate capital reorganizations such as where one class of shares is redeemed and replaced with another class of shares. There are no rollovers available where the shareholders' interests fundamentally change such as in the case of a takeover where shares in one company are replaced with shares in another company.

4. Other rollovers

Two other, less important, rollovers are available to taxpayers who dispose of property without changing their fundamental economic position. The first is the "strata title conversion" rollover. Strata title ownership (or condominium ownership, as it is known in North America) of a flat (townhouse) or apartment is a relatively recent legal development in some jurisdictions in Australia. Before individual title to part of a larger building with common facilities was available, taxpayers often secured their interest in a flat or apartment through a cooperative company, which owned the title to the entire building. State property law has now been changed to facilitate individual ownership and as a result, many property owners are changing their interests in property to direct strata title ownership.

The "renewal or extension of statutory licence" rollover is for the benefit of persons with statutory licences such as liquor licences or taxi licences that are issued for a fixed period, but renewed almost automatically in most cases.

H. *Averaging*

One of the arguments used by opponents of capital gains taxation was the so-called "bunching" argument. This argument is based on the fact that capital gains are recognized for tax purposes in one year if the tax is levied on a realization basis, even though the gains may accrue over many years. It was said that the resulting bunching of several years' gains into one tax year might push a taxpayer into a higher bracket and hence lead to higher taxation than would have been the case if the gains were recognized over many years, as they accrued.

Critics have pointed out several flaws with the argument. First, they note that many so-called capital gains assessed under the Australian capital gains rules are generated and derived in a single year, not accrued over many years. Gains for which this would be true include negative covenant payments or damages for tort or breach of contract actions.

Second, critics pointed out that the bunching argument does not take into account the significant deferral advantages enjoyed by taxpayers who recognize capital gains on a realization basis compared to those taxpayers who derive severable income from capital such as interest or rent, which is taxed on an annual basis. In effect, the taxpayer realizing capital gains enjoys an interest-free loan from the Taxation Office from the year in which a gain accrues until the year in which it is actually recognized for tax purposes. Many tax scholars have argued that to offset the deferral advantage available to persons deriving capital gains and thereby achieve both equity and efficiency objectives, capital gains taxed on a realization basis should be subject to higher taxes than other types of income. If bunching does occur, it could be justified to some extent as a compensatory measure. As such, it would be highly discriminatory, however, since it would only apply to lower income taxpayers pushed into a higher bracket; taxpayers who would be in the top bracket anyway would not be subject to any extra tax burden from bunching.

Finally, critics of the bunching argument note that the argument fails to recognize who actually derives capital gains in Australia. Tax statistics in Australia mirror those overseas and show that the vast majority of capital gains are derived by companies that are taxed at a flat rate or high income taxpayers whose incomes would be subjected to the highest marginal tax rates even without considering the capital gains they realize. For most capital gains derived in Australia, there is no question of a bunching problem. Statistics also reveal that the percentage of individuals' income that is derived as capital gains rises with income. Less than one percent of taxpayers earning under $ 35,000 per year derive capital gains and for those who do, it forms a small part of their incomes. Capital gains are an important component of the incomes of top bracket taxpayers who derive this type of gain, however, amounting to between one quarter and one fifth of their incomes.[4] Any concession or exemption for capital gains based on the bunching argument would, therefore, be a tremendous windfall for the many capital gains-deriving taxpayers who never actually suffer from a bunching problem.

The legislature's solution to the alleged problem of bunching was the adoption of a "top slice" averaging formula, designed to provide relief to those for whom bunching is truly a problem, while denying any concession to those for whom it causes no additional tax burden. The formula first calculates the taxpayer's tax liability on all income other than any net capital gain realized by the taxpayer. It then determines the taxpayer's tax liability on all income other than capital gains plus one fifth of the capital gain. The amount determined in the first step is subtracted from the amount determined in the second step. The difference is the extra tax attributable to the

4. All figures are based on Australian Tax Office, Taxation Statistics 1987-1988 (Canberra: AGPS, 1989).

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inclusion of one fifth of the capital gain in the taxpayer's taxable income. This extra tax is multiplied by five to determine how much tax should be levied on the entire capital gain. The taxpayer's final tax liability is the sum of the tax payable on all income other than capital gains plus the tax payable on capital gains (i.e. five times the tax payable on one fifth of the capital gain).

The formula is only effective for taxpayers whose taxable incomes without a capital gain is below the threshold of the next higher income bracket and with the capital gain rises above that threshold. One fifth of the capital gain will attract a lower tax rate, particularly if it does not cause the taxpayer's income to rise into the next higher bracket. Thus, five times that tax will yield a smaller amount than would normally be levied on the capital gain if some of it would be taxed only at the higher rate.

The top slice income averaging system is not restricted to capital gains. It actually applies to a variety of income types, collectively called "abnormal income", which includes capital gains and the fluctuating incomes of persons such as artists, composers, inventors, performers, sportspersons and writers.

I. *Non-residents, immigrants and emigrants*

Australian income tax is levied on the basis of residency. Residents are taxable on their worldwide incomes, wherever the source. Non-residents are taxable only on their Australian-source income.

The capital gains provisions retain the basic distinction between residents taxed on their worldwide incomes and non-residents taxed on the gains they derive from sources in Australia. In the case of the capital gains measures, however, the principle is tempered somewhat by pragmatic considerations concerning the collection of tax.

Non-residents are liable for Australian capital gains tax only on the disposal of certain identified assets known as taxable Australian assets. The most important of these are real property in Australia, property connected with a permanent establishment in Australia, shares in a private company and shares of a resident public company where the taxpayer holds ten percent or more of the shares in the public company. There are no tracing provisions where taxable Australian assets are owned through another entity. Thus, a simple way for a non-resident to avoid Australian tax liability would be to establish a private company outside the country, acquire taxable Australian assets through the private company and sell the private company to any purchaser interested in the underlying Australian assets.

The Taxation Office finds little support in the legislation for its attempts to collect capital gains tax from a non-resident even if the non-resident chooses to own taxable Australian assets directly. There is no provision in the Act making the purchaser of property liable for the non-payment of taxes by a non-resident vendor. Measures of this sort are found in many capital gains tax system and to the extent they apply to the sale of property that can be easily seized by tax authorities (that is, real property), they are very effective in ensuring that purchasers seek evidence of satisfied tax liability from non-resident vendors before turning over the entire purchase price. The only section in the Act that affords any support to the Tax Office is a provision that allows the office to collect tax from a person owing money to a defaulting taxpayer. If the purchase price has been paid, the purchaser has no potential liability.[5]

Because capital gains are taxed on a realization basis, special rules are needed for persons changing residency. In the absence of special provisions, taxpayers could manipulate their capital gains tax liabilities by deferring realization until after they have changed residency status.

The statutory rules that apply to persons changing residency status were largely modelled on Canadian precedents, as were the principles underlying those rules. The first principle is that capital gains which accrue to a resident during the period of his or her residency should be taxable in Australia, whenever the gains may be realized. The second is that Australia has no legitimate right to tax capital gains that accrue to a non-resident during the period he or she is not resident, even if the gains are realized after the person becomes a resident.

These principles are embodied in two rules. The first rule deems departing taxpayers to have disposed of their assets for consideration equal to the market value of the assets at the time the owners cease to be residents. The second rule deems arriving residents to have acquired their assets for consideration equal to the market value of the assets at the time the owners become residents. Further provisions deem similar results for changes in residency of trusts and partnerships, although the latter provisions are probably redundant in light of the procedure now used for tracing each partner's interest in partnership assets separately.

In certain circumstances, taxpayers have the option of electing out of the deemed disposition and acquisition rules. Because non-residents remain taxable on gains realized on the sale of a taxable Australian asset, departing residents may elect not to recognize accrued gains on these assets at the time of departure. Moreover, departing residents may elect to characterize other assets as taxable Australian assets until the assets are disposed of or until the taxpayers become Australian residents again. With respect to departing residents who have no intention of ever re-acquiring Australian residency status, the election appears to be generous, since it allows them to defer tax possibly until long after they have departed from Australia. There is a trade-off, however – the price extracted for the deferral is an obligation to pay tax on all gains that accrue following departure from Australia as well as those which accrued while the taxpayer was resident here.

Temporary residents who acquire Australian residency only for a relatively short period are exempted from the deemed disposal and acquisition rules with respect to property acquired before they became Australian residents provided they were resident for a total period of less than five years during the period of ten years before departure.

5. If the sale proceeds are held by another resident such as a bank, the Commissioner could utilize this provision to demand payment by the bank which "owes" money to the vendor.

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III. CONCESSIONAL FEATURES

A. *Testamentary gifts*

In general, the Australian tax system treats a gift of property such as inventory or trading stock as a disposal for the market value of the gifted property. In other words, donors are deemed to have derived payment equal in value to the property they give away. Comparable rules are found in many jurisdictions, particularly in respect of gifts of inventory, although this policy is less universal in the case of depreciable property or capital assets.

The tax policy rationale for the deemed receipt of payment rule is quite simple. The psychic reward (altruism, emotional gratification or whatever) realized by the taxpayer who gifts property must be worth the value of the property or the taxpayer would not gift it. Moreover, the deemed receipt of payment rule achieves neutrality and equity between three arguably equivalent cases: first, where the taxpayer gifts property; second, where the taxpayer gifts cash equal to the market value of the property and then sells the property to the donee; and third, where the taxpayer sells the property to an outside party and then gifts the proceeds to the donee to enable him or her to purchase the property from the outside party or to purchase a replacement property from someone else.

The arguments underlying the deemed derivation of consideration rule apply equally to inter vivos disposals (gifts made by a living person) and testamentary disposals (gifts directed by a deceased person by means of a will). Just as tax liability should not differ depending on whether a taxpayer sells an asset and gifts the proceeds or simply gifts the asset, tax liability should not differ depending on whether a taxpayer gifts property on his or her deathbed or provides in a will for property to be transferred immediately after his or her death.

For this reason, the original blueprint for capital gains tax treated all gratuitous disposals similarly, deeming receipt of consideration whether property was transferred by way of inter vivos or testamentary gift. Critics of the proposed system argued against the deemed receipt of consideration for testamentary disposals on two grounds. First, they said the deemed receipt on testamentary disposal gave rise to a "death duty", a type of tax that was not appropriate for Australia. Second, they argued the recognition of testamentary transfers as a taxable disposal might cause liquidity problems in some cases.

Although the first argument received some attention in the press and was pursued with vigour by some professional advisers, it made little impact on the government. Australia had once imposed death duties on testamentary transfers at both the federal and state levels, but those taxes had ceased to operate by the time the capital gains provisions were being designed. Death duties are quite different from income taxes that apply to testamentary disposals. Death duties impose a tax on a testator or beneficiary based on the value of the transferred property. Whether that property has risen or fallen in value prior to the transfer is irrelevant. An income tax, by way of contrast, measures gains and losses and where an income tax applies to testamentary disposals, a tax liability will accrue only if property has appreciated in value prior to the transfer. If it has declined in value, the transfer will result in tax savings.

The liquidity argument proved somewhat more successful. It was put forward with particular vigour by the farming sector, which argued that the transfer of family farms from generation to generation would be endangered if taxes were imposed on deceased farmers. The sector claimed many farmers reinvest profits in their farms and consequently have few liquid assets at death. Satisfying a testamentary tax liability could, therefore, require sale of the farm since unlike intangible assets such as shares, farms are not easily divisible for partial sale. To ensure this would not happen, opponents of the government's proposal called for a deferral of tax upon testamentary transfers. The deferral would be accomplished through a testamentary rollover that transferred the testator's cost in an asset to the beneficiary.

Most tax policy analysts dismissed the liquidity argument as a basis for non-recognition of gains and losses upon testamentary disposals. Statistical studies showed that farming properties rarely rose in value by more than the rate of inflation so in most cases recognition of testamentary disposals would lead to no tax liability. The general rule is not true for farms on the edge of expanding urban areas; these properties do appreciate in value and can generate real gains to their owners. However, the increase in value is attributable to their potential for subdivision for housing or commercial purposes, in which case external factors, and not tax considerations, are ultimately more likely to lead to the end of a family farm.

In any case, as several tax experts pointed out, the liquidity problem could be addressed in other ways. The easiest solution is the one that was sometimes used on an informal basis by revenue authorities with respect to the former estate taxes, namely to defer collection of the tax until the taxpayer had sufficient resources but charge interest on the outstanding debt and secure the debt on the appreciated asset.

On the broader tax policy question, supporters of the government's original proposals to treat inter vivos and testamentary gifts similarly voiced concern over the equity and efficiency implications of a testamentary rollover. They conceded a deferral system might provide some relief to a few taxpayers who would be faced with liquidity problems if property transfers at death were treated as a taxable disposal, but argued that this relief would come at a considerable cost. The concession, they pointed out, would provide an enormous windfall for all other taxpayers not facing the liquidity problem. Moreover, supporters of the original proposal argued, for very wealthy taxpayers who are able to pass property from generation to generation, the deferral would amount to virtual exemption. And finally, they noted, from an economic perspective the deferral would open the door to considerable inefficiency by locking taxpayers into existing investments, possible for several generations.

Notwithstanding the views of tax policy analysts, representatives of the primary production sector were able to attract considerable political support outside the government for their testamentary rollover proposal. It became clear that the government would not secure passage of its tax reform package

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unless it compromised on this point and when the draft legislation was finally released, it contained a testamentary rollover.

The rollover transfers only the cost attributes from the deceased taxpayer to his or her beneficiaries. It does not transfer the pre-20 September 1985 and post-19 September 1985 status of property. Where pre-20 September 1985 property is transferred to a beneficiary, gains accruing to the time of the transfer remain exempt from tax but subsequent gains will be taxable.

The rollover of cost for post-19 September 1985 assets is allowed only where the beneficiary is not exempt from taxation – otherwise the deferred taxes will never be collected. Thus, there is a deemed receipt of market value payment when property is gifted to a tax-exempt recipient such as a charity.

B. *Principal residence*

The dream of owner-occupied housing represents a national aspiration in Australia and support for owner-occupied housing holds a high priority for leaders of all political parties. One way in which political support for homeowners manifests itself is through generous income tax exemptions and concessions aimed at owner-occupied homes. One of the most important exemptions is the non-taxation of imputed rental value, which was originally taxed in Australia but then exempted, in part to encourage homeownership.

An equally significant exemption is the exemption from capital gains taxation of gains realized on the disposal of a principal residence. The Labour government which adopted capital gains tax deliberately exempted gains on principal residences to remove a potential focus from the opposition party's expected attack on capital gains. The government foresaw the likelihood of opposition politicians exploiting popular sentiment against a tax on gains realized on the disposal of principal residences to discredit capital gains generally. Labour politicians of the day were well aware of the fact that a little more than a decade earlier they had been defeated in a federal election in part because of the false claims of the then government that Labour would tax principal residence gains if they attained power.

While the capital gains tax exemption for gains realized on the disposal of a principal residence may be appreciated by existing homeowners (or at least homeowners who acquired their properties after 19 September 1985 and who would otherwise be subject to the tax), the concession has been strongly condemned by many groups. And support by homeowners waned when the cost of houses declined and taxpayers who had supported an exemption for gains realized on the disposal of principal residences discovered the flip side of the exemption, namely that they could not recognize the losses they suffered when properties were sold for a loss.

Ironically, some of the strongest criticism of the exemption came from tax scholars who supported the goal of more owner-occupied housing. Relying on overseas experience, they warned that a capital gains tax exemption for owner-occupied houses would be "capitalized" into the price of housing and would quickly push the price of houses into an unaffordable range for ordinary Australians. Although some sort of capital gains tax concession for homes is found in many countries, an unlimited outright exemption of gains is not that common. Scholars interested in the area followed the case of Canada which adopted a capital gains tax and unlimited principal residence exemption in 1972. The exemption was capitalized into the price of homes in less than half a decade. As it turned out, the Australian market proved somewhat more efficient and house prices in this country rose by a corresponding amount even quicker than they had in Canada. Prices have moderated with the advent of the recession, but still remain significantly higher than they were before the adoption of capital gains tax.

The exemption has also been criticized by many organizations concerned with the equity of the income tax system. Critics point out that exemption is of far more value to high income taxpayers than to lower income taxpayers – for every dollar of untaxed gain, a lower bracket taxpayer saves $ 21 in tax, while a highest bracket taxpayer saves $ 47. Moreover, because there is no cap on the exemption, the concession is likely to exempt more income for high bracket taxpayers than for low bracket taxpayers, or at least those low bracket taxpayers able to afford homes. If all homes appreciated in value at the same rate, more valuable homes would generate greater gains than less valuable homes and usually expensive home appreciate at faster rates than inexpensive houses.

Finally, the exemption has come in for its strongest criticism by economic analysts and spokespersons for the business community who advocate the adoption of a free enterprise system in Australia in which investment would be made on the basis of where it could generate the highest return, without government interference or tax-induced distortions. The capital gains tax exemption, these persons point out, has biased investment away from productive commercial and industrial activities and into owner-occupied housing, leading to over-investment in houses relative to the occupants' real needs in many cases. As a result, commercial enterprises have had less investment capital available to them and have had to rely on more expensive debt financing and overseas financing, which has greatly exacerbated Australia's foreign debt problems.

For all these reasons, many tax advisers predict the principal residence exemption system may be modified as part of some future tax reform programme, although the government has consistently denied this.

1. Structure of the exemption

The main operative provision for the principal residence exemption deems a taxpayer not to have derived a capital gain or suffered a capital loss on the disposal of a dwelling that is a sole or principal residence. The exemption is extended to trustees, executors and trust beneficiaries in certain cases such as where a taxpayer dies and his or her will provides for the surviving spouse to use the house for his or her lifetime.

2. Multiple principal residences: family members overlap

While a taxpayer could have more than one residence, clearly it would not be possible to have more than one *sole or*

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principal residence at any given time. It could, however, be possible for different members of an immediate family to have different sole or principal residences, or at least to claim they have different principal residences for purposes of the exemption. For example, one spouse could claim a city residence is his or her principal residence while the other spouse claims a recreational house at the beach or in the country is his or her principal residence.

A number of provisions operate in conjunction with one another to prevent different members of an immediate family from claiming principal residency status for more than one house for any given period. The provisions establish very complicated pro-ratio formulae which are based on the relative percentages of ownership of each person in each dwelling alleged to be a principal residence.

Interestingly, the provisions designed to prevent multiple exploitation of the principal residence capital gains tax exemption are triggered by the taxpayers' legal status at the time the properties are sold. Thus, if spouses are legally separated at the time of the sales, they can each claim separate principal residence exemptions, even though they may have lived together as spouses from the time the properties were first acquired until immediately before their separation and the sale of the properties.

3. Multiple principal residences: temporal overlap

In addition to an overlap where different members of an immediate family nominate different dwellings as principal residences for the same period, a temporal overlap may occur where a taxpayer owns more than one residence at the same time. While it is not literally possible to "reside" in two dwellings at the same time, it is not always possible to arrange for a change in residence to coincide with a change in ownership. For example, where a taxpayer moves from one house to another, the closing date on the new home may occur before the closing date on the old home. A different, but related, problem occurs where a taxpayer acquires a block of land and erects a house on the block. Even if the taxpayer does not own another principal residence during the construction period (for example, where the taxpayer rents accommodation), the new property cannot really be said to be a principal residence before anyone can reside on it. Finally, a third problem arises in cases of temporary absence from a residence. This could occur, for example, where a taxpayer is transferred to another city or country for a limited time and rents his or her home during the period away.

The principal residence exemption sections contain a number of provisions to deal with these situations. As a general rule, capital gains are pro-rated and partially taxed and partially exempted where a property is a principal residence for part of a period of ownership and not a principal residence for another part. The general rule is subject to override by the special subsections designed to overcome the problems described above. Where these sections operate, a property will be deemed to be a taxpayer's principal residence for some or all of the period in which it was not actually a principal residence. The maximum overlap period in the case of persons owning two completed houses at the same time is three months; the maximum overlap period for taxpayers with a first house building a new house on land they own is four years.

Another provision extends the principal residence exemption to gains attributable to a period of temporary absence of up to six years, provided the taxpayer does not own another principal residence during this time.

4. Multiple purposes in respect of a principal residence

A principal residence may serve a number of purposes in both a spatial sense and a functional sense. With regard to the former, a property containing a dwelling may also include land not used primarily for domestic purposes. This would be the case, for example, with a farming property where the homestead or residence occupies only a small part of the total property. In terms of functional aspects of multiple purposes, a residence may be used for purposes other than living purposes. For example, a house may contain professional offices. Similarly, any number of businesses may be conducted from rooms located in a family home. Provisions addressing the spatial issue seek to separate the residence part of a property from the remainder of the property. The provision dealing with the functional question prima facie adopts a pro-ratio approach for determining taxable gains and recognizable losses.

In the case of rural properties, a special carve-out provision extends the principal residence to an area covering two hectares, including the dwelling. Where property can be easily divided into identifiable parts such as a retail store and a private residence above the store, the cost of the building will be prorated between the two properties. Gains on the disposal of the shop will be calculated and subject to taxation without regard to the fact that the shop is attached to an exempt dwelling. Similarly, the Taxation Office can prorate a taxpayer's capital gain where the taxpayer has set aside rooms in a dwelling for professional or business purposes.

C. *Goodwill*

Goodwill, the market attraction enjoyed by a firm that allows it to realize a higher return from its tangible assets than would another firm owing the same assets, can comprise a significant part of the value of many companies.

To establish goodwill, a business will incur costs. In virtually all cases, however, the costs of generating goodwill will be deductible as current expenses incurred in respect of an aspect of ongoing business operations. Goodwill arises from quality service by employees, clean and well maintained premises, ongoing advertising campaigns, and so on. Although they generate long-term benefits, the cost of employee salaries, cleaning and maintenance services and advertising are all deductible expenses. Thus, while the purchaser of a business may have an identifiable cost for the goodwill being acquired, if the vendor is the original owner of the business, he or she will most likely not be able to identify any separate cost for the goodwill that is being sold.

When the government's original design plans for the capital gains tax were first announced, some commentators called for special concessions for sales of small businesses where

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some of the consideration was attributable to goodwill. Lower tax rates or exemptions would, they claimed, put small business investments on a par with other investments because other investments were entitled to indexation of gains, while no indexation was available to the owner of a small business who had no cost base for his or her goodwill.

The case for special treatment of gains on the sale of small businesses gained some support, although there was no tax policy basis for the arguments. Owners of small businesses received no indexation on goodwill because they had no unrecognized capital investment to recover in respect of the goodwill – all costs of generating the goodwill are deductible as incurred.

Faced with the difficulties of sustaining an "indexation equivalent" argument in favour of special treatment for goodwill gains, proponents of concessional rules raised two further arguments in favour of their position:

First, they argued that small businesses play a special role in the development of Australia in terms of entrepreneurial initiatives, risk-taking and employment generation and their growth therefore should be encouraged by means of tax concessions, in particular an exemption for gains attributable to goodwill when a small business is sold.

Critics of the proposed exemption reviewed it in the context of a tax expenditure. They treated the proposal to forgo taxes as the equivalent of a direct expenditure and analysed the concession in terms of the objective of encouraging small business. They concluded tax concessions on the sale of a successful business would amount to an unfair and inefficiency subsidy; more logical, said some, would be assistance when a business is starting up, for example by way of guaranteed loans, export financing, marketing assistance, and so forth.

Second, supporters of the concessional rule argued preferential taxation or an exemption from taxation for goodwill gains was necessary to achieve equity between small businesspersons and employees. The latter, it was pointed out, received government subsidies by way of tax deferral on funds invested in superannuation funds and other retirement income vehicles. Small businesspersons, it was argued, forgo subsidized retirement savings in tax-exempt superannuation funds and instead reinvest their savings in their businesses, in effect treating the goodwill gains they hope to generate eventually as the source of their retirement funds.

Once again, the argument met with some criticism. While the assertion of reinvestment of savings in a business in lieu of superannuation contributions was no doubt true for some businesses, for others it was not. Some small business owners had established personal superannuation plans that provided generous retirement incomes. Furthermore, the superannuation savings concessions were designed to encourage taxpayers to save in pooled investments that minimized risk, which was something investment in the taxpayer's own business did not. Finally, it was pointed out that outright exemption of goodwill gains from taxation would not equalize the treatment of these gains and superannuation benefits, since the latter were only tax-deferred, not tax-exempt.

While the arguments in favour of a goodwill gain concession appeared weak, political developments ultimately favoured the cause when proponents convinced the Democrats, the minority party holding the balance of power in the Senate, of the need for tax relief. The Democrats subsequently indicated to the government they would only support the introduction of the capital gains legislation if the treatment of goodwill gains was altered and, in order to save the bulk of its base-broadening programme, the government eventually backed down and granted the concession sought by the Democrats.

The final legislation contained a partial exemption for goodwill gains. Twenty percent of the goodwill gain realized by a taxpayer selling a business was exempted from taxation, provided the net value of the taxpayer's interest in the business was less than $ 1 million. In early 1992 the government announced it would extend the exemption to 50 percent of the goodwill gain and raise the qualifying threshold to $ 2 million, a figure that will be indexed from mid-1992.

The exemption applies to all taxpayers – that is, a company selling a business can take advantage of the exemption in the same manner as an individual. However, the exemption only applies to the sale of a "business" per se – it would thus not be available if, for example, a taxpayer sold shares in a company that operated a business. Instead, the taxpayer would be advised to retain his or her shares in the company and have the company sell the business.

IV. EXEMPTIONS

The capital gains provisions contain a number of exemptions that are based partly on some tax policy rationale and partly for concessional reasons. The most important of these is the exception for personal injury damages. Although these amounts have no apparent monetary cost, it is arguable they represent no net gain. Unless a damage award includes a punitive element, the payment contains no profit component – it is intended to compensate the taxpayer for a loss equal in value to the payment.

Some critics have claimed the personal injury damages exemption is being used as an avenue for tax avoidance in cases involving contrived injury actions, particularly defamation actions. It has been suggested that there have been instances where departing employees have arranged minimal termination payments and commenced defamation actions against their former employers claiming they suffered injury as a consequence of the circumstances of their termination. The actions are settled and, according to some, the tax-free settlement payment is intended by all parties to substitute for what would have otherwise been a larger (taxable) termination payment.

A politically astute exemption was that accorded gambling and lottery winnings. The exemption maintains the effect of the old English common law characterization which kept most gains of this sort out of the English and later Australian income tax bases.

Finally, the capital gains provisions contain an exemption for gains realized on the disposal of decorations for valour or brave conduct.

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V. FUTURE DIRECTIONS

At the time of its introduction, the capital gains tax was generally supported by a wide cross-section of the community, although it was strongly opposed by the Liberal party (which continues to head the opposition coalition) and by some parts of the business and farming sectors, as well as by many tax professionals. Six and a half years later, overt opposition to the tax per se has largely dissipated. In their tax reform agenda, released in late 1991, the Liberal party indicated that they now believe the taxation of capital gains to be an integral part of the income tax system. Business and farming groups have virtually all accepted the tax, and professional tax advisers now concede the taxation of capital gains is essential to protect the integrity of the income tax base. The long-term future of the tax appears secure.

Less certain is the future design of the tax. There is no question that the tax has closed many avoidance opportunities and achieved some equity while ameliorating the distorting effects of the former exemption. At the same time, the exemption for assets acquired prior to 20 September 1985, the exemption for principal residences and the testamentary rollover all have serious equity and efficiency consequences. The potential political risks that modification of these features would entail will likely deter potential reformers, although change is possible in the context of a broader tax reform package which offsets capital gains reform with a partial shift to greater reliance on consumption taxation. At the same time, however, pressure has been growing from special interest groups for some watering-down of the capital gains tax through the introduction of more business reorganization rollovers and for further small business concessions.

From the technical law perspective, the legislation's apparent shortcomings with respect to integration with the pre-existing income tax system, the flaws in its deeming provisions and the limitations in its application to non-residents will no doubt give rise to ongoing litigation and amendment.

In a world of increasing economic integration and information exchange, Australia's capital gains tax will remain an important field of study for both tax policy theoreticians and technical tax analysts in Australia and abroad.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

MAY 1992

Joint Ventures in Central and Eastern Europe, London (United Kingdom), 12-14 May (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom, Tel.: (0)71-7798601, Fax: (0)71-7798599.

Euromoney's Second International Tax Planning Forum, Amsterdam (the Netherlands), 13-14 May (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, Tel.: 71-7798602, Fax: 71-7798599.

JUNE 1992

The Outlook for Joint-Ventures, Investment and Privatization in the New "Soviet Union", London (United Kingdom), 16-18 June 1992 (English):
Business International. Editorial Office, Eastern Europe, Schwarzenbergerplatz 8/7, A-1030 Vienna, Austria, Tel. : 43171241610, Fax: 431756769.

Understanding and Using Swaps, Southampton, Hampshire (United Kingdom), 19-22 June (English):
Euromoney Training, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom, Tel.: (0)71-7798784, Fax: (0)71-7798799.

Effective International Tax Management, Brussels (Belgium), 22-23 June (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: +3225161911, Fax: 3225137108.

US/Int'l Tax Planning & Compliance under Subpart F and The Foreign Tax Credit Provisions, London (U.K.), 25-26 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom, Tel.: (0)71-9357502, Fax: (0)71-9356951/1308.

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SOLOMON ISLANDS:

AN OVERVIEW OF INCOME AND OTHER TAXES

Chris Bowman

Chris Bowman is a partner in Coopers & Lybrand, Solomon Islands and has been associated with the Australian firm for some 15 years. His specialty has been income tax for the majority of this time in Australia, Papua New Guinea and now the Solomon Islands.

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B. Exchange control
C. Investment restrictions on non-residents

VIII. SELECTION OF BUSINESS ENTITY BY NON-RESIDENTS

IX. CONCLUSION

I. INTRODUCTION

Income tax in the Solomon Islands is based on a simple but comprehensive Act established by the British prior to Independence. The Income Tax Act (ITA) came into being in 1965 and has been amended as the Government of the day has seen the need.

Income tax and sales tax are administered by the National Government via the Inland Revenue Division of the Ministry of Housing and Government Services. While income tax is a major source of revenue, by far the largest source of Revenue is through the collection of customs and excise duties (based on official estimates published by the Minister of Finance in his annual Budget speech to Parliament).

The administration and collection of tax is centred in the capital, Honiara. Based on the above quoted statistics the major source of income tax is from pay-as-you-earn tax collected from individual taxpayers. During the current year this dependence on individual tax may diminish as higher exemption levels and greater reliance on direct withholding taxes take effect.

Tax incentive measures were introduced in January 1991 to attract foreign investors and to encourage residents to invest their savings in productive businesses in the Solomon Islands. The incentives are centered around tax holidays (five to ten years on average) that are approved by the Investment Board and administered under the ITA. It is too early to say whether or not the measures will result in simpler administration under the tax system but suffice to say that the wording of the new provisions will keep tax advisers and the Inland Revenue officers productive.

Following is a broad outline of the method of tax imposed on corporations and individuals – both resident and non-resident – where tax holidays do not apply. I have also included notes on other taxes and on matters to be considered by investors in the Solomon Islands.

II. INCOME TAXES ON CORPORATIONS

A. *General*

Income tax is imposed on the territorial basis, i.e. resident corporations are taxed on income accruing in, deriving from or received in the Solomon Islands. Non-resident corporations are liable to income tax only on income accruing in or derived from the Solomon Islands.

Companies incorporated in the Solomon Islands are subject to tax at the rate of 35 percent and companies incorporated elsewhere are taxed at a rate of 50 percent. Taxable income includes business and professional income, dividends, interest, rents, royalties and technical assistance fees.

B. *Local income taxes*

There are no local income taxes.

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C. *Capital gains tax*

There is no capital gains tax in the Solomon Islands. However, capital gain arising on the sale of any business assets on which depreciation ("wear and tear deduction") has been allowed is subject to tax at normal rates (applies to plant, machinery, vehicles, vessels and business premises).

D. *Branch profits tax*

Non-resident corporations are subject to tax at 50 percent on Solomon Islands-source income, except where withholding tax is deemed to be final as in the case of:

- dividends;
- interest;
- professional services;
- royalties (based broadly on the OECD model treaty royalty definition);
- insurance premiums paid to overseas insurers;
- film rentals;
- payments to overseas contractors, foreign fishermen;
- lease income from plant, machinery, fishing vessels; or
- where a treaty provides for such limitations.

The Minister has the power to amend, by order, the rate of tax to be deducted from non-resident income.

E. *Foreign tax relief*

Income derived by a resident corporation from sources outside the Solomon Islands is taxable on the same basis as if it had a Solomon Islands source only when the funds are received in the Solomon Islands. Foreign income is ascertained according to the income tax legislation of the country in which it was derived.

A foreign tax credit is allowed equal to the lesser of the foreign tax paid or the Solomon Islands tax payable on that income. The foreign tax credit must be utilized in the same fiscal period in respect of which it is paid.

F. *Minimum tax*

The ITA was amended in July 1990 to introduce a "turnover tax" on loss companies and low-profit companies. The tax applies to income derived after 1 January 1991, and has the following features:

- The tax is an income tax and is charged at a rate of 0.5 percent (to a maximum tax of SI$ 10,000 per year) on gross income where gross income less allowable deductions (chargeable income) is less than 0.5 percent of gross income.
- The imposition of tax does not affect the amount of losses carried forward for deduction in future years.
- The tax is final and is not allowed as a setoff against future corporate taxes paid by loss companies.

Note that corporations granted tax holiday relief under the new tax incentives legislation will not be subject to this "tax" during the term of the tax-free period.

G. *Resident withholding tax*

A domestic withholding tax is charged on dividends (see below) and on payments representing:

	Rates
– income from contracting or sub-contracting	7.5%
– royalties (timber and natural resources exploitation)	10%
– income from fishing operations	10%
– income from lease of property (rent)	10%
– income from sale of cocoa and copra	0%
– income from sale of marine products	10%

The withholding tax is final if total annual income (all sources) received by the recipient is $ 10,000 or less. If this does not apply then the tax is allowed as a credit against annual tax assessed on lodgement of the normal income tax return.

Payers are required to produce certificates to the payee and the tax office and account for the tax by the 20th day of the month following payment to the recipient. Penalties for non-compliance are imposed.

The ITA allows for exemption certificates to be issued to remove the withholding where the recipient is a good taxpayer in the eyes of the tax office. The rate of withholding tax may be varied by Ministerial Order.

III. INCOME TAXES ON INDIVIDUALS

A. *Rates*

Resident individuals are subject to tax only on taxable income accruing in, derived from, or received in the Solomon Islands. Income tax rates are the same for residents and non-residents, but residents are entitled to a basic exemption (deduction against gross income received),[1] and to deductions from income for certain medical, education, insurance and superannuation payments.

Most benefits-in-kind are taxable, including the value of free or subsidized housing, and vehicles supplied by employers and education allowances paid by employers. A PAYE system of taxation applies to all income from employment or services rendered.

The tax payable on total income *less* personal exemptions and deductions is as follows:

- *Married person* (spouse not working): 14 cents per dollar for the first $ 2,500, increasing by 4 cents per dollar for each successive $ 2,500 until a maximum rate of 42 cents per dollar is reached (at $ 17,500 chargeable income).
- *Single taxpayer*: 14 cents per dollar for the first $ 2,100, increasing by 4 cents per dollar for each successive $ 2,100 until the maximum of 42 cents per dollar (at $ 14,700 chargeable income).

B. *Local income taxes*

No local income taxes are levied as such. However, Councils are permitted to charge a head tax on individuals known as

1. $ 2,700 from fiscal 1991 for a single taxpayer; $ 5,100 from fiscal 1991 for a married taxpayer whose spouse is not working.

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the basic rate. Employers are required to withhold this tax from employee salary and wages and to account by 30 June to the Council. The rate is generally set in January each year.

C. *Capital gains tax*

See above under taxes on corporations.

D. *Foreign tax relief*

The basis of assessment of foreign income and the calculation of available tax credits is the same as for corporations (see above). The Solomon Islands tax payable is computed as the average rate applicable to total income.

E. *Tax period*

31 December is the standard year-end, but an alternative date may be adopted by business taxpayers.

F. *Estate and gift tax*

There is no estate tax per se in the Solomon Islands, although a fee imposed on a graduated scale is payable when probate or letters of administration are granted on personal property situated in the Solomon Islands. No gift tax is imposed.

IV. INCOME TAX ON NON-RESIDENTS

A. *Liability to tax*

Non-resident corporations are taxed as described in II.D. above.

For non-resident individuals, Solomon Islands-source income, other than income subject to withholding tax, is taxed at the same rates that apply to single residents. Non-resident individuals, however, are not eligible for exemptions (see III.A.).

B. *Withholding tax rates*

Certain gross income payments to non-residents are liable to withholding tax in lieu of individual and corporation taxes. The rates of deductions are:

	Pre 1/7/90	
Interest	15%	15%
Royalties	15%	15%
Income from contracting	6%	7.5%
Outward income from ships and aircraft	2.5%	5%
Insurance premiums	15%	15%
Film rentals	5%	5%
Professional services (excluding travel and accommodation)	15%	7.5%
Pole and line fishermen	Nil	10%
Purse seine fishermen	Nil	15%
Lease of plant, equipment, fishing vessels		15%

The Solomon Islands has tax treaties in force with the United Kingdom and Sweden.

C. *Other matters*

Resident companies are required to deduct withholding tax at the rate of 35 percent on dividends paid to non-residents and 20 percent on dividends paid to residents. The gross dividends are a deductible expense of the paying company when calculating assessable income provided the tax withheld is paid to the tax office within 15 days of the date of payment of the dividend. In some cases, this tax is a final tax (see below).

V. OTHER SIGNIFICANT TAXES

A. *Sales (value added) tax*

A comprehensive Sales Tax Act was introduced with effect from August 1990. The tax is applied to local and overseas telecomunications (2.5 percent), restaurant services (ten percent), tickets purchased for overseas travel ($ 10 per ticket), accounting, legal and security services (five percent) and movie tickets and video hire (schedule of rates). The tax is collected at source by the provider. The Minister has power to add to the schedule of taxable items by Order.

B. *Customs and excise duties*

Customs and excise duties are applied at varying base rates, plus a ten percent additional levy.

VI. COMPUTATION OF TAXABLE INCOME

A. *Capital gains*

The revenue arising upon the sale of any capital asset subject to the wear and tear deduction, which is in excess of its written down value for tax purposes, is subject to tax at normal rates. Capital gains on the sales of shares, private dwellings, etc. are not subject to tax.

B. *Depreciation and depletion*

The ITA provides for a capital allowance deduction in lieu of depreciation (referred to as the "wear and tear deduction"). The allowance is calculated using the reducing method. The current rates are:

– Buildings, buildings fixtures and fittings, bridges, wharves, slipways, boilers and oil storage tanks	5% (written-down value)
– Assets used by timber concessionaire for cutting, extracting and processing timber from a timber concession and low cost housing for employees	35% (written-down value)
– Cost of purchasing and planting coconuts, oil palms and cocoa; provision of yards, fences and water supplies for livestock; prevention of soil erosion; experimentation, scientific or other research expenditure	100%

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– Capital expenditure on mining	20% per annum
– Vehicles, vessels, aircraft and all plant not otherwise specified	25% (written-down value)

In addition, the new tax incentives allow a 40 percent accelerated depreciation for new and extended factory/industrial buildings (five percent per annum thereafter) and a special 50 percent per annum deduction (until fully written off) for the cost of new or improved tourist-oriented building projects. These incentives are not automatic and require Investment Board approval and notification to the tax office.

C. *Treatment of dividends*

All dividends received in or remitted to the Solomon Islands by residents form a part of their assessable income. The withholding tax deducted on local dividends (35 percent non-resident shareholders; 20 percent resident shareholders) is a final tax in the case of all non-residents, including corporations, and resident individuals with income (including gross dividends) of less than $ 10,000.

D. *Loss carryovers*

A deficit for any year may be set off against the profits of a future year if the shareholders are substantially the same (not less than 51 percent shareholder continuity on the last day of the year of loss and year of recoupment). There are no time restrictions.

E. *Transactions between related parties*

Solomon Islands law provides for the review of transactions between related parties on an arm's length basis. A comprehensive anti-avoidance section was introduced from 1 January 1990 to strengthen the powers of the Commissioner to review all arrangements and transactions that impact on the level of revenue collected. The provisions are similar to those enacted by New Zealand.

F. *Consolidation of income*

There is no provision for the filing of consolidated tax returns by related corporations. Provisions do exist to aggregate the income of married individuals (where a spouse earns less than $ 2,700 per year); otherwise each spouse is taxed as single individual taxpayers.

G. *Tax period*

Residents are required to adopt a 31 December year-end. Substituted tax accounting periods are granted to foreign controlled corporations to allow the local company to align with the tax year-end of the parent company. The substituted periods ending 1 January to 30 June are in lieu of the preceding year; all others are in lieu of the succeeding 31 December.

H. *Other matters*

1. Interest received

The first $ 5,000 received from Solomon Island banks is exempt from income tax.

2. Business licence fees

Licence fees paid to a Council under the Local Government Act are treated as a prepayment of income tax. Credits up to the level of income tax due are allowed on lodgement of the annual income tax return. The fees vary as to the type of business carried on and Council involved.

3. Bad debts

Bad debts may be claimed as a deduction only when actually written off. General provisions for anticipated losses are not permitted.

4. Entertainment

Business related entertainment is currently tax deductible.

VII. RELATED CONSIDERATIONS

A. *Incentives and grants*

When the Investment Board approves an investment proposal, the following forms of assistance are available from the government:

- assistance with siting of proposal and security of land;
- tax relief;
- drawback of duty on re-exports;
- import duty-free concessions on capital goods used in the capital construction of new projects;
- assistance with training, employment, counselling and staff selection and a double tax deduction for the training of apprentices and other professional staff at SICHE (Solomon Islands College of Higher Education) and other approved institutions;
- contracts to purchase output.

The new legislation granting tax concessions is targeted at the following investments:

- manufacturing that has local value added ("LVA") of greater than 25 percent of ex-factory sales of approved products – three to six-year tax holiday dependent on percentage of LVA;
- export-oriented manufacture with greater than 25 percent LVA – three to six-year tax holiday;
- investments over $ 10 million attract a five to ten-year holiday;
- tourist-oriented investments may alternatively apply for a five-year holiday plus a two-year write-off of depreciable assets constructed or purchased and a 150 percent deduction for approved overseas promotion costs;
- export businesses involved in agricultural produce, manufactured or processed goods or fresh seafood may alternatively apply for a three to six-year holiday irrespective of LVA and a 150 percent tax deduction for export promotion;
- businesses involved in agricultural or export agricultural produce, diary or goat farming, beef production, reforestation or fisheries or off-shore deep-sea fishing, may apply alternatively for a tax holiday on the profits of such activities for five years out of any ten years from the date of commencing commercial production;

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CANADA:

1992 FEDERAL BUDGET: EASING THE BURDEN

Ingrid Sapona

On 25 February 1992, Canada's Finance Minister, Donald F. Mazankowski, presented his first budget. Admitting times are difficult, Mazankowski's main economic message was that "difficult times are no excuse for governments to live beyond the taxpayer's means".[1] The Minister promised no quick fixes to Canada's economic problems. Instead, he delivered a budget he described as economically, socially and fiscally responsible aimed at providing a strong foundation for recovery and sustained growth. The proposals concentrate on reducing spending, while offering modest tax breaks.

This article briefly reviews Canada's fiscal and economic outlook, and outlines the tax matters addressed in the Budget.

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I. FISCAL AND ECONOMIC OUTLOOK

A. *The deficit*

According to the Minister, the government has held the 1991/92[2] deficit to C$ 31.4 billion (despite the fact that in last year's Budget the government predicted the 1991/92 budget deficit would be $ 30.5 billion). The 1992/93 budget deficit is expected to drop to $ 27.5 billion, with a further drop in 1993/94 to $ 22.5 billion.

The total national debt forecasted for 1991/92 is $ 420 billion, which is about 4.6 percent of Gross Domestic Product (GDP) – down from a high of 8.7 percent in 1984/85. Interestingly, though the debt as a percentage of GDP has decreased since 1984, in absolute terms it has more than doubled because of compound interest, going from $ 206 billion in 1984/85 to $ 420 billion. By comparison, the United States expects its deficit to rise from 4.8 percent of GDP in fiscal 1991[3] to 6.8 percent in fiscal 1992, and then drop to 5.7 percent of GDP in fiscal 1993.[4]

B. *Other economic indicators*

The Department of Finance expects inflation in Canada to be 2.2 percent in 1992 and 1993. This is the lowest inflation Canada has seen since the early 1970s.[5] At the same time, inflation in the United States is expected to be 3.1 percent in 1992, and 3.2 percent in 1993.[6]

Along with lower inflation rates, over the past year Canada has enjoyed a substantial decline in interest rates. Currently, the prime lending rate is 8.25 percent – its lowest in almost 19 years. Since the spring of 1990, the government estimates that interest rates have dropped by about seven percent.[7]

The government's decision last year to limit federal public sector wage settlements to three percent for three years and its call for private sector wage restraint apparently paid off. According to Mazankowski, pubic sector wage settlements fell from 6.4 percent at the start of 1991 to below three percent in the second half of the year. At the same time, private sector wage settlements declined from a high of 6.4 percent in the third quarter of 1990 to 3.3 percent by the end of 1991.[8]

Despite all the good news about lower inflation, interest rates and wage settlements, by the government's own admission, and corporate financial positions deteriorated further in 1991. Profit margins that were "extremely low" by historical

1. Official transcript of the Budget Speech 1992, published by the Department of Finance, Canada, on 25 February 1992 [hereinafter referred to as Budget Speech].
2. Canada's fiscal year begins 1 April.
3. The U.S. fiscal year begins 1 October.
4. The Budget Papers, published by the Department of Finance, Canada, on 25 February 1992, at 40 [hereinafter referred to as Budget Papers].
5. Budget Speech, *supra* note 1, at 7.
6. Apparently the OECD also predicts lower inflation in Canada than in the United States during 1992 and 1993. The OECD's prediction for 1992 is that Canada's inflation rate will be 2.9 percent, while the U.S.'s will be 3.6 percent. For 1993 the OECD expects inflation to fall slightly in both countries, dropping to 2.5 percent in Canada, and to 3.5 percent in the United States. See Budget Papers, *supra* note 4, at 64.
7. Budget Speech, *supra* note 1, at 8.
8. Budget Papers, *supra* note 4, at 36.

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standards in the first quarter of 1991 undermined business confidence for the year.[9] In addition, "stubbornly high unemployment" (government lingo for unemployment of about ten percent for 1991) weakened domestic confidence which, coupled with falling exports, added to the economy's stagnation.[10]

The government anticipates continued weakness in the first quarter of 1992, but is hopeful that for the remainder of 1992 the economy will continue to grow at a modest rate.[11] More robust growth is expected for 1993.

C. *Expenditure control programme*

In 1990 the government launched the Expenditure Control Plan (ECP), which was intended to freeze or reduce government spending over a two-year period. The ECP was extended in the 1991 Budget to apply through 1994/95 and is being further extended and broadened this year. The ECP measures announced in this year's Budget are to yield accumulated savings through 1996/97 of $ 7.3 billion. For 1992/93 a savings of $ 1.1 billion is expected under the programme.

To meet the targeted $ 1.1 billion savings for this year, the government will make cuts in defence spending;[12] in non-wage operating budgets of government departments;[13] in spending on government communications;[14] by eliminating, deferring the creation of, or merging the operations of numerous government entities;[15] by restricting the growth in spending on public housing and on the so-called Green Plan;[16] and by making various other cuts.[17]

II. BUDGET TAX CHANGES

Much to some people's surprise, there were a number of tax changes – none of them earth shaking, but taken together they do add up. There was only one minor excise tax change[18] – all the other changes were in the area of corporate tax and personal tax. (Surprisingly, for the first time in a number of years "sin" taxes, i.e. those on cigarettes, tobacco and liquor, were not increased.)

A. *Corporations*

As far as tax measures affecting corporations, the changes announced focused on two major areas: the manufacturing and processing sector and small businesses. There was also a surprise announcement regarding Canada's treaty negotiation position with respect to direct dividends. In addition, Mazankowski mentioned areas the government will be looking at over the next year, including the taxation of life insurers and the tax rules regarding scientific research and experimental development.

1. Manufacturing and processing sector

According to the government, nearly one fifth of Canada's GDP and employment come from the manufacturing and processing (M&P) sector.[19] The government has proposed tax changes aimed at enhancing the international competitiveness of the M&P sector.

(a) *M&P tax rate reduction*

Corporations engaged in M&P are eligible for a reduced rate of tax on income from such activities carried on in Canada.[20]

9. *Id.* at 30.
10. *Id.* See also Budget Papers, at 49.
11. *Id.*, at 41. According to the government, the expected rate of growth is 2.7 percent for 1992 and 4.5 percent for 1993. Interestingly, these rates of growth are below the 4.7 percent average growth rates experienced in the 1983 and 1984 recovery period.
12. The government's spending on defence will be cut by $ 258 million in 1992/93. Mazankowski confirmed the government's commitment to the defence policy announced last September, and reiterated its intention to pull out from Germany. In addition, the Canadian Forces Station at Bermuda will be closed. Over the next two years, additional savings in the area of defence will come from cuts in capital spending, research and development, public communications and administration. All told, defence spending is to be cut nearly $ 2.2 billion over a five-year period. Budget Papers, *supra* note 4, at 82.
13. Mazankowski announced an across-the-board cut of three percent in planned non-wage operating budgets of federal departments for 1992/93. In addition, the government will continue last year's strategy of limiting wage budgets to growth of no more than three percent. The total savings from these proposals will be $ 150 million for 1992/93.
As part of the across-the-board operating budget cuts of three percent, the government will tighten travel guidelines for public servants. Implementation of the travel restrictions will mean a reduced presence by Canadian officials at international meetings and conferences. Budget Papers, *supra* note 4, at 87.
14. Over the next five years communications budgets for departments are to be cut by $ 75 million per year. These cuts are to be accomplished by adopting a "no frills" publishing policy that will ensure that only publications serving a demonstrated public need are produced. Budget Papers, *supra* note 4, at 87.
15. The Canadian government is made up of more than 400 separate organizations and advisory bodies. In an effort to eliminate overlap and duplication within the government and the private sector, various government entities will be eliminated or merged, and certain other organizations that were to come into being are being deferred.
The Law Reform Commission, the Canadian Institute for International Peace and Security, the International Centre for Ocean Development and the Economic Council of Canada are among the entities that will be wound up. A total of 46 separate government entities will be affected by these plans. When the winding up and consolidation is completed, total savings from the "streamlining" is expected to be $ 22 million per year. Budget Papers, supra note 4, at 85-86.
16. To assist Canadians find affordable housing, the government provides funds through cost-sharing arrangements sponsored by the Canada Mortgage and Housing Corporation (CMHC). From 1984/85 to 1991/92 the CMHC's spending grew by an average annual rate of 6.5 percent. Continuing the trend started in the last two Budgets, the growth in CMHC spending will be restricted to an average of three percent per year through 1996/97. These restrictions will save $ 622 million over the five years it is to be in place.
The Green Plan (the Plan) was announced in December 1990. Originally, $ 3 billion was to be spent on the Plan over five years, through 1995/96. Mazankowski reiterated the government's commitment to the Plan, but announced that the $ 3 billion would be spread over a period through 1996/97. The extension of the time within which the $ 3 billion will be spent will be accomplished by reducing allocations by $ 75 million for both 1992/93 and 1993/94. Budget Papers, *supra* note 4, at 83.
17. In the area of international aid, government funding under the Official Development Assistance (ODA) programme and other international assistance initiatives, particularly in Eastern Europe and the former Soviet Union, now come under the auspices of the International Assistance Envelope (IAE). Under the terms of last year's Budget, the cash disbursements that could be paid by the IAE was limited to an annual growth rate of three percent a year. That limit in the growth of cash disbursements is being continued under this year's Budget. Like other government operating non-wage budgets, however, the IAE's operating budget will also be subject to the across-the-board cuts. Budget Papers, *supra* note 4, at 84.
18. To encourage the development and use of ethanol and methanol fuels which are made from renewable feedstocks, the excise tax on gasoline that is blended with ethanol and methanol is being eliminated, effective 1 April 1992. This is a tax reduction of 8.5 cents per cents per litre. See Budget Papers, *supra* note 4, at 165.
19. *Id.*, at 150-151.
20. Income Tax Act (Canada), R.S.C. 1852, c. 148, as amended by S.C. 1970-71-72, c. 63, as subsequently amended, Sec. 125.1 [hereinafter referred to as the ITA]. A general discussion of what constitutes M&P for purposes of the ITA is beyond the scope of this article.

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The current federal rate on M&P income is 23.84 percent, including the corporate surtax. The rate is to decrease by one percent on 1 January 1993 to 22.84 percent (including surtax), and by a further one percent on 1 January 1994 to 21.84 percent (including surtax). To these must be added provincial income taxes, at rates ranging from 6.5 to 17 percent.

This change will cost the government about $ 150 million in 1993/94,[21] and over $ 1.5 billion over the next five years.[22]

(b) *Capital cost allowance rate increase*

Capital cost allowance (CCA) is the system under which depreciation deductions are determined for Canadian tax purposes.[23] Under the CCA system, assets are pooled (generally by type or function of asset) into "classes", which are depreciated at a rate set by regulation (so-called CCA rates).[24] Most CCA rates are applied on a declining-balance basis. The CCA rate for machinery and equipment used directly or indirectly in the manufacturing or processing of goods for sale or lease (Class 39 property) is to be increased. For such property acquired after 25 February 1992 the CCA rate will increase from 25 to 30 percent. This change will cost about $ 40 million in taxes foregone in 1992/93, and approximately $ 730 million over the next five years.[25]

2. Reduced dividend withholding rate

Some of Canada's treaty partners may be happy to learn that the government is now willing, in its treaty negotiations, to accept a treaty withholding rate of five percent on "direct dividends". Until the Budget announcement, the government was adamant in its position that the lowest rate it was willing to offer was 15 percent on portfolio dividends and ten percent on direct dividends, i.e. dividends paid by a Canadian affiliate to a foreign parent or other corporation with a substantial interest in the affiliate.

This change in policy will enable Canada to adopt the dividend provisions contained in the OECD model treaty, which has been adopted by many of Canada's treaty partners. The government is prepared to negotiate reciprocal reductions in the withholding tax rate on direct dividends beginning 1 January 1993. Any negotiated rate reduction would be phased in over a five-year period.

In announcing this policy change, Mazankowski stressed that this change is intended to help ensure that Canada's M&P sector will remain competitive in world markets.[26] This change, assuming the reduction commences in 1993, is expected to cost the government $ 10 million in 1992/93, and $ 430 million over five years.[27]

3. Small business taxation

Canada's tax system contains various provisions that specifically benefit small businesses. For example, the first $ 200,000 of active business income of Canadian-controlled private corporations is eligible for the small business deduction,[28] which effectively reduces the federal income tax rate to 12.84 percent (including surtax). (The regular federal corporate tax rate, including surtax, is 28.84 percent.)

To further aid small businesses in these tough economic times, the government announced the establishment of the Small Business Financing (SBF) Programme. The SBF is to benefit small businesses (including corporations, sole proprietorships and partnerships) that are otherwise unable to obtain additional financing. Such a business will have access to the SBF programme only when it is experiencing financial difficulty, including default or expected default on an arm's-length debt, or when greater than 90 percent of the borrower's assets are under the control of a receiver or trustee in bankruptcy.

Interest payments on loans under the SBF programme will be treated as dividends by both the borrower and lender. Therefore, qualifying small businesses should be able to borrow at interest rates below those normally charged in the commercial market, since lenders will either qualify for the intercorporate dividend deduction[29] or for the dividend tax credit[30] (depending on whether the lender is a corporation or individual). The interest payments will not be deductible in computing the income of the borrower.

The special tax treatment will be available on debt issued for more than one year, but less than five years, and for a principal amount of at least $ 10,000, but not more than $ 500,000. There will be a cumulative limit of $ 500,000 on such financing. Such debt must be issued before 1 January 1993.[31]

In addition to the SBF programme, small businesses can get financing help in the form of guarantees on loans to finance land, premises, and fixed and movable equipment under the under the Small Business Loan Act (SBLA). The maximum amount of loans outstanding to any individual firm under the SBLA is currently $ 100,000. The government plans to increase this limit to $ 200,000. In addition, the government noted that it is considering other modifications to this programme. Further announcements are expected this fall.

The SBF and the changes in the SBLA are expected to cost the government a total of $ 20 million for 1992/93, and $ 70 million over five years.[32]

4. Other matters under consideration

(a) *Research and development*

Reaffirming the government's commitment to encouraging research and development (R&D), the government is considering making the rules applicable to R&D less restrictive in

21. It will be revenue neutral for 1992/93 since the reduced rate does not apply until 1 January 1993.
22. Budget Papers, *supra* note 4, at 151.
23. ITA, Sec. 20(1) permits the deduction as prescribed by regulations. ITA Sec. 13(21)(b) defines depreciable property.
24. ITA Regulations, Consolidated Regulations of Canada, c. 945, as subsequently amended, Sec. 1100 *et seq*. See also Schedule II in the Regulations.
25. Budget Papers, *supra* note 4, at 150.
26. *Id.*, at 151.
27. *Id.*, at 152.
28. ITA, Sec. 125.
29. ITA, Sec. 112.
30. ITA, Secs. 82(1) and 121. These two sections set out the dividend gross-up and credit mechanism applicable to individuals.
31. Budget Papers, supra note 4, at 160.
32. *Id.*, at 161.

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the areas of the treatment of capital equipment that is used for both research and production purposes; and the allocation of certain overhead and administration costs between R&D and other activities.

No specific proposals regarding R&D were announced in the Budget, but changes are expected to be announced this summer.

(b) *Taxation of life insurers*

Noting that the tax revenues from this industry remain low, the Minister announced that over the next few months, the government will outline specific proposals to ensure that life insurance companies pay additional tax.

Specific attention will be directed to rules relating to the computation of policy reserves of life insurance companies; and the computation of investment revenue of resident multinational and non-resident life insurance companies.

B. *Individuals*

Several proposals in the Budget will affect the taxation of individuals. Two proposals are particularly noteworthy: the reduction of the surtax and the changes affecting the capital gains exemption. In addition, the government announced a temporary measure permitting people to withdraw money from their Registered Retirement Savings Plans to make a downpayment on the purchase of a home. A new child tax benefit was also announced, which will combine various types of assistance currently available with regard to children. Various other changes affecting individuals were also announced.

1. Surtax decrease

Currently, the federal government levies a general surtax of five percent of basic federal tax on individuals, plus a further five percent surtax on high income earners.[33] The general surtax is to be reduced to four percent effective 1 July 1992, and to three percent effective 1 January 1993. The additional surtax of five percent on high income earners will not be affected.

A couple with two children and an annual income of $ 75,000 will enjoy a tax reduction of $ 74 in 1992 and $ 297 in 1993 from this measure. This measure will cost the government $ 500 million in lost revenue in 1992/93, and more than $ 6.6 billion over five years.[34]

2. Capital gains exemption

In Canada, three quarters of an individual's realized capital gains must be included in income as "taxable capital gains".[35] A lifetime capital gains exemption of $ 100,000 ($ 75,000 of taxable capital gains) is available to Canadian residents on most capital gains, net of certain losses.[36]

The government is restricting the type of gains eligible for the $ 100,000 lifetime capital gains exemption. The exemption is no longer available on capital gains accrued on real estate after 29 February 1992. Gains accrued through that date will continue to qualify. A gain realized after 29 February 1992 will be prorated (based on the total number of months the property was held) and the portion of the gain representing the number of months the individual held the property before March 1992 will be eligible for the capital gains exemption.[37] The proration formula will ignore any period of ownership prior to 1972 (when capital gains were first made subject to tax in Canada).

This change will not apply to real estate used in an active business, nor does it affect the enhanced capital gains exemption for qualified small business corporation shares and qualified farm property.[38] Furthermore, gains on the disposition of a principal residence will continue to be generally tax-free.[39]

3. Registered Retirement Savings Plan (RRSP) for homes

To encourage saving for retirement, individuals are permitted to deduct contributions to RRSPs. There are limits on the amounts that may be contributed annually, and severe penalties can be levied for over-contributions. Amounts properly contributed, however, earn investment income free of tax. Funds in an RRSP are ultimately taxed when they are withdrawn.[40]

To stimulate the economy, and give a break to potential home buyers, the government announced that, effective immediately, individuals can withdraw up to $ 20,000 of existing funds from an RRSP to buy or build a home without paying tax on the withdrawal. A couple who both own RRSPs will therefore be able to withdraw a total of $ 40,000 to acquire a house. Money withdrawn must be used toward the purchase of a home that will be occupied as the buyer's principal residence. Such withdrawals must be repaid to the RRSP in instalments over 15 years, beginning no later than 31 December 1994. Amounts that are not repaid as scheduled will be included in the individual's income.[41]

This measure is temporary, however, and will end on 1 March 1993.

4. RRSP and RPP contributions

Pension tax reform begun in Canada in the late 1980s is still continuing. Among the many changes in this complicated area are the contribution limits to RRSP and Registered Pension Plans (RPPs). When pension reform legislation was first passed in 1990, the maximum contribution to RRSPs was to increase by $ 1,000 per year from $ 11,500 for 1991 to $ 15,500 for 1995, with increases thereafter to be indexed to

33. ITA, Sec. 180.1.
34. Budget Papers, *supra* note 4, at 135.
35. ITA, Sec. 38.
36. *Id.*, Sec. 110.6(3).
37. Budget Papers, *supra* note 4, at 157.
38. ITA, Sec. 110.6(2.1) and (2) provide for an additional $ 400,000 exemption for gains realized from the disposition of shares of a qualifying small business corporation, or on gains realized on the disposition of a qualified family farm operation, respectively. A detailed discussion of the enhanced capital gains exemption is beyond the scope of this article.
39. ITA, Sec. 40(2) relates to the exemption for principal residences. There are certain conditions that must be met to ensure that the entire gain is tax free.
40. ITA, Sec. 146 *et seq.* and Sec. 60(i).
41. Budget Papers, *supra* note 4, at 142-143. See also, The Home Buyer's Plan – Draft Legislation, issued by the Minister of Finance, Canada, on 25 February 1992.

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the average industrial wage. Contributions to money purchase RPPs were to increase in a similar fashion.

Mazankowski announced that the phase-in of the higher RRSP and RPP contribution limits will be deferred by one year. Therefore, the $ 12,500 limit for contributions to RRSPs for 1992 will also be applied to RRSP contributions for 1993. The previously scheduled increases in the limit will then resume, reaching the maximum of $ 15,500 in 1996, with indexed increases thereafter.

There will be a similar deferral in the phase-in of higher contribution limits applicable to money purchase registered pension plans (RPPs).

5. Child tax benefit

The Minister announced a new child benefit programme, which is to combine the benefits that are currently available under the family allowance programme, the child credit and the refundable child tax credit. This new programme will unify allowances, credits and refunds currently available into a single monthly benefit, as well as incorporate additional support for lower-income working families with children.[42] The monthly amounts are to be based on income reported the previous year and will be updated annually. Child tax benefit payments will not be taxed.

Beginning 1 January 1993, the new child tax benefit will be $ 1,020 per child. This basic benefit will be augmented by $ 75 for the third and each subsequent child, plus a further $ 213 per child under seven where no claim is made for child care expenses. In addition, the new programme will also include an earned income supplement of up to $ 500 for low income families.

On a separate, but related topic, the government announced that beginning in 1993 the deduction allowed for child care expenses will be increased by $ 1,000. This increase will bring the maximum deduction to $ 5,000 for each child under age seven and to $ 3,000 for each child between seven and 15. Special rules apply to disabled or infirm children.[43]

6. Other changes affecting individuals

(a) *Education credits*

Currently, students are entitled to an education credit of 17 percent of $ 60 for each month of fulltime study.[44] This credit is to be raised to 17 percent of $ 80 per month.[45]

To the extent that the student does not have sufficient income to take advantage of education and tuition credits, these credits may be transferred to a supporting person to a maximum of $ 600.[46] This maximum is to be raised to $ 680.[47]

These changes are to take effect in 1992.

(b) *Labour-sponsored venture capital funds*

Labour-sponsored venture capital corporations (LSVCC) are investment funds established by labour organizations in which individuals pool their money to purchase shares in small businesses. A tax credit is available to individuals who invest in LSVCCs.[48] Currently, the credit is equal to 20 percent of the first $ 3,500 invested. The credit is to be increased to 20 percent of the first $ 5,000, i.e. a maximum credit of $ 1,000.[49]

In addition to the federal credit, some provinces have LSVCC programmes and provide similar tax credits to LSVCC contributors. Currently, the federal government matches credits provided by the province up to a maximum of $ 700.[50] This maximum will be increased to $ 1,000 per year.[51]

These proposal are to be effective for the 1992 and subsequent taxation years.

(c) *Disabled persons*

A number of changes are proposed to assist taxpayers with disabilities:[52]

- The range of expenditures eligible for the medical tax credit will be expanded beginning in 1992. For example, visual signalling devices for the hearing impaired and payments for therapies related to speech or hearing loss will now be covered.
- For 1992 and subsequent years, the education tax credit will also be extended to part-time students who are eligible for the disability tax credit.
- Disability pensions paid under the Canada Pension Plan and the Quebec Pension Plan will now be considered to be earned income for RRSP contribution limit purposes. This will enable individuals who receive such pensions to make larger RRSP contributions in 1992 and subsequent years.
- Certain devices used by business to help disabled employees and customers are eligible for immediate write-off. This list will be extended to include a number of additional devices acquired after 25 February 1992 for assisting those with visual or hearing impairments.

(e) *Common law couples*

According to the government, the number of common-law couples in Canada more than doubled in the 1980s.[53] Beginning in 1993, for tax purposes, common law couples will be treated the same way as married couples. This will entitle them to the related tax benefits, such as the married credit. It will also expose them to the related restrictions, such as the attribution rules, which are aimed at discouraging income splitting between spouses.

This change will be accomplished by changing the definition of "spouse" for purposes of the Act. Under the broadened definition, a common law spouse will be a person of the opposite sex with whom the person is cohabiting in a conju-

42. See the government publication, "The Child Benefit: A White Paper on Canada's New Integrated Child Tax Benefit", distributed by the Minister of National Health and Welfare, Canada, on 25 February 1992.
43. Budget Papers, *supra* note 4, at 136.
44. ITA, Sec. 118.6(2).
45. Budget Papers, *supra* note 4, at 140.
46. ITA, Sec. 118.9(1).
47. *Id.*
48. ITA, Sec. 127.4.
49. Budget Papers, *supra* note 4, at 157-158.
50. ITA, Sec. 127.4.
51. *Id.*
52. Budget Papers, *supra* note 4, at 140-142.
53. *Id.*, at 138.

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gal relationship that has subsisted through the immediately preceding 12 months. As well, the natural or adoptive parents of the same child will be considered spouses under the expanded definition.[54]

(f) *Interest-free processing period*

Currently, individuals earn interest on tax refunds as of the later of the filing deadline (30 April of the following year) or the date on which a late return is filed.[55] For tax returns filed after 1992 the government will not start accruing interest on refunds to individuals until the later of 45 days after the filing deadline or the date on which the return was actually filed.[56]

54. *Id.*, at 139.
55. ITA Secs. 150(1)(d) and 164(3)(a).
56. Budget Papers, *supra* note 4, at 145.

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- any business approved by the Investment Board can claim special additional incentives for write-off of new or expanded factories and training expenses; and a 150 percent deduction for the inter-province transport of raw materials and qualifying products.

B. *Exchange control*

There are comprehensive controls on foreign currency transactions both to and from the Solomon Islands. In most cases, approval must be obtained prior to making the commitment.

C. *Investment restrictions on non-residents*

Any investment by a non-Solomon Islands citizen which acquires equity or ownership in a company or organization or substantial capital asset investment in the Solomon Islands (e.g. via a branch) requires the approval of the Investment Board.

VII. SELECTION OF BUSINESS ENTITY BY NON-RESIDENTS

While some overseas investors conduct operations in the Solomon Islands through branches, the current trend is to establish a Solomon Islands registered subsidiary corporation. This preference is generally based on tax considerations. The following compares the tax payable by a branch with that payable by a local subsidiary remitting all profits as a dividend.

	Local Subsidiary ($)	*Branch* ($)
Operating profit	100	100
Dividend	100	
Profit before tax	100	
Tax payable		50
Profit after tax		50
35% dividend withholding tax	35	
Total tax payable	35	50

NOTE: Thin capitalization rules are not formalized in the ITA although the Commissioner of Inland Revenue has power to review non-arm's length interest charges, and imposes a 15 percent withholding tax on interest paid or credited to non-residents.

IX. CONCLUSION

The above is designed to give the reader a broad overview of the tax system of the Solomon Islands in a non-technical way. For those in the "first world" it may be interesting to note that there has not been a tax case via the courts in Solomon Islands since Independence and that the Income Tax Act is some 140 pages in length.

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SINGAPORE:

1992 BUDGET: A CARRY-ON BUDGET WITH A FEW SURPRISES

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I. INTRODUCTION

On Friday 28 February 1992, the Minister of Finance, Dr. Richard Hu, presented Singapore's 1992 Budget to Parliament. Although this is the first Budget that requires the assent of President Wee Kim Wee under the selected presidency laws enshrined in the Constitution of the Rèpublic of Singapore, the Budget speech follows the customary pattern and is divided into three parts: review of the economy, the financial year 1992 Budget, and revenue and tax changes.

In his review of the economy, the Minister highlighted the economic performance in 1991, sketched the economic outlook for 1992 and outlined the strategies for Singapore's medium-term sustainable growth. The Minister reported that the 1992 economic growth forecast for Singapore had been revised downwards by the Ministry of Trade and Industry (MTI) from five to seven percent to four to six percent. He was, however, confident that the medium-term target of five to seven percent would be achieved if Singapore could adhere to the following strategies:

- to enhance Singapore's links with the world, with a greater focus on ASEAN and the wider Asia-Pacific region;
- to continue restructuring and upgrading, but not lowering rentals or allowing an unlimited supply of foreign workers;
- to adhere to free market principles so that resources are used more efficiently and individuals are motivated to perform better.

On the Government's fiscal policy, the Minister said that fiscal prudence had served the country well. If the economy performs as well as the Government expects, Singapore should run a budget surplus over the next few years. The Government will allocate money from the next year's surplus for the Medisave Scheme and will launch the new Education Endowment Fund. In concluding the first part of his Budget Speech, the Minister said that while 1992 might be a more difficult year, he was confident that economic growth would continue.

Moving on to the Budget estimates for the financial year 1992, the Minister emphasized that the Government's expenditure policy was to continue to support the private sector as the engine of growth. On the Government's revenue position, the Minister said that slower growth and an aging population would lead to higher expenditure and slower increase.

The Minister then announced that the long-awaited White Paper on proposals for a comprehensive goods and services tax (GST) would be introduced in Parliament in the second half of 1992. He also proposed the pending changes to the Central Provident Fund (CPF) contribution rates. With effect from 1 July 1992, the employer's CPF contribution rate will be raised from 17.5 to 18 percent, and the employee's CPF contribution rate will be reduced from 22.5 to 22 percent. The Government is committed to achieving before 1996 the ultimate target of a 40 percent CPF contribution rate with equal contributions by employers and employees.

In the final part of his Budget Statement, the Minister announced the following tax changes:

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II. TAX CHANGES[1]

A. *Tax on companies*

1. Corporate income tax

The Minister announced a reduction in the corporate tax rate by one percentage point from 31 to 30 percent to help maintain Singapore as an attractive location for investments and offset some of the business cost increases of the past year. Most businessmen welcomed the one percent point cut in corporate tax and described the reduction as a "welcome respite" from rising business costs.

2. Tax incentive for commodity futures market

To develop Singapore as an international trading hub, it is necessary to provide traders with a vehicle to manage their risk in commodity trading. To help the new commodity futures exchange, called the RAS Commodity Exchange, get off to a successful start, it will be granted a five-year tax exemption on its income from future activities.

To promote the new RSS3 contract targeted at large foreign participants in the United States, Europe and Japan, the income of corporate members of the exchange arising from future transactions in this contract will be taxed at a concessionary rate of ten percent. These transactions must be with non-residents, Asian Currency Units and other members of the exchange. Income derived from transactions with residents will continue to be taxed at the prevailing corporate rate. The current tax treatment will continue to apply for income arising from transactions in the two existing contracts, RSS 1 and TSR 20.

3. Tax incentive for spot transactions undertaken by corporate members of SIMEX

Currently, corporate members of SIMEX are taxed at a concessionary ten percent rate on profits derived from trading in currency futures. However, profits derived from spot currency transactions are taxed at the prevailing corporate rate. To facilitate corporate members of SIMEX to hedge effectively in spot currency transactions, the ten percent tax concession is extended to profits derived from spot transactions in designated currencies. The transaction must be with a non-resident, another member of SIMEX or an Asian Currency Unit.

Whilst this incentive is intended by the Government to improve hedging facilities for members of the Singapore International Exchange (SIMEX) in the spot market for their customers and for their own account, some SIMEX members feel it might not boost the volume of currency futures on SIMEX significantly, because trading in Deutschmark, yen and sterling futures in 1991 accounted for 1.8 percent of average daily volume. Currency traders find it more efficient to trade in the liquid interbank forex market.

4. Double deduction for skill and knowledge-intensive financial activities

Singapore is now a regional centre for financial services. To stay ahead, Singapore cannot rely on providing traditional financial services, but must move on to new and more sophisticated financial services, which would include knowledge-intensive services such as financial engineering and financial research and development. To encourage the development of such services, a double tax deduction will be granted to financial institutions for expenses relating to the establishment and development of approved financial activities in Singapore. The incentive will be given for a period of five years, and may be extended thereafter. Further details of the scheme will be announced by the Monetary Authority of Singapore. While those in financial circles welcome this incentive, they hope that details of what activities will qualify for the double deduction will be clearly defined to avoid uncertainty.

5. Basis of taxation for life insurance companies

Currently, life insurance companies are taxed on the excess of investment income over management expenses and agency commissions. Investment income includes gains from the sale of investments. The investment income of companies with overseas operations is determined by apportioning their worldwide investment income in the ratio of Singapore premiums over worldwide premiums.

Tax to be paid by life insurance companies will be based on their total income from Singapore business, i.e. premiums and investment income less a composite of expenses, commissions, claims and increased provision for future claims.

Income due to policy holders will be effectively taxed at ten percent instead of the prevailing corporate tax rate. Tax on income due to shareholders remains unchanged at the corporate tax rate (currently 31 percent), and is to be reduced to 30 percent.

According to some managers in the insurance business, the proposed changes in the formula for assessing life insurance companies will make life insurance more attractive as a form of savings. The new basis of assessment will be more equitable to policy holders and consequently, life insurance companies will be able to offer more innovative or attractive products. Thus the ten percent instead of 30 percent tax on the resultant surplus attributable to the policy holders will enable the life insurance companies to offer better benefits to policy holders by way of higher yield on the policies.

6. Stamp duty on financial derivatives

Singapore has been developing as a centre for trading in regional securities. To cater to the increased sophistication of regional investors and the growing interest in financial derivatives, the Stock Exchange of Singapore (SES) will soon launch trading of stock options on securities traded on the exchange. To encourage such trading, stamp duty will not be levied with effect from 1 April 1992 on options, contract notes and instruments of transfers relating to share warrants, rights in shares and units in unit trusts. Only contract notes and transfer instruments for transactions in stocks and shares will be subject to the existing stamp duty.

1. Unless otherwise noted all tax changes will take effect as from year of assessment 1993.

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C. *Tax on individuals*

1. Personal income tax

No change was proposed by the Minister, as he felt that Singapore's personal income tax rates were lower than those in many other countries. To encourage continued individual efforts, however, the Minister announced that an across-the-board and one-off rebate of five percent for personal income tax would be granted for year of assessment 1992.

2. Rebate of service and conservancy charges

For Singapore citizen householders staying in rented and owner-occupied one, two and three-room Housing Development Board (HDB) flats who pay little or no income tax, the Government will pay to Town Councils, on their behalf, the service and conservancy charges payable in the month of December 1992. This is a one-off payment for Singapore citizens only. It is the equivalent of the five percent income tax rebate.

3. Tax relief for reservists

Reservists play a crucial role in preserving Singapore's prosperity. Their contributions therefore deserve special recognition and the following tax reliefs will be granted:
$ 1,000 for all active reservists, that is, those who are called up annually for in-camp training and other activities to maintain their operational proficiency; and $ 500 for all who have done national service but are not in active reserve service. The tax reliefs will also apply to those who have done national service in other services such as the police force and the Singapore Joint Civil Defence Force.

C. *Other tax changes*

1. Tourism cess

In 1991, the tourism cess rate was temporarily reduced from four to three percent for a period of one year to help hotels and restaurants tide over the poor conditions in the wake of the Gulf War. As the tourism sector has recovered from the sharp decline in tourist arrivals, the tourism cess rate is restored to four percent with effect from 1 April 1992.

2. Duties on alcoholic beverages

Duties on alcoholic beverages are imposed by the Government to constrain the growth in liquor consumption, and the import and excise duties have been increased with effect from 28 February 1992.

3. Restriction on duty-free privilege on alcoholic beverages

Presently, travellers arriving in Singapore other than from Malaysia are allowed to bring in duty-free limited quantities of alcoholic beverages for their personal consumption. This privilege is intended for international travellers. With effect from 1 June 1992 eligibility for the duty-free privilege will be restricted to travellers who are outside of Singapore for at least 48 hours before their arrival to ensure that only bona fide travellers benefit from the concession. The restriction is not unique to Singapore. Hong Kong and Malaysia have imposed similar restrictions on the granting of duty-free privileges. The existing practice of disallowing the duty-free concession in respect of travel between Singapore and Malaysia will continue.

4. Water conservation tax

Singapore imports a large part of its water. Water is a scarce resource, far more valuable than its production costs alone; thus there is a need to continually encourage water conservation.

In order to curb the growth in water consumption, the water conservation tax on domestic customers who consume more than 20 cubic metres of water per month will be increased from five to ten percent. The tax change takes effect from 1 April 1992.

III. CONCLUSION

In conclusion, the Minister said Singapore would be affected by uncertainties of the world economy in 1992. Although 1992 might be a more difficult year he was certain that Singapore would continue on the path of economic growth and could face the future with confidence. The 1992 Budget was generally welcomed by the community. For many, it was, as predicted, a conservative carry-on Budget with a little something for every one, and a few surprises. There are six changes affecting tax for companies, three affecting tax for individuals, four other tax changes and an increase in the rate of contribution to the CPF.

The tax relief for Singapore's reservists was a surprise. Whilst such relief was welcomed, the amount was felt to be too little to have any impact. According to the Government, the new tax relief for reservists is not a payment for services rendered but rather a symbolic expression of appreciation.

Most businessmen welcomed the reduction in the corporate tax rate to 30 percent, the double tax deduction for financial R&D, the tax break for the RAS Exchange and the tax concession for life insurers and SIMEX spot trading. But some, particularly those in the manufacturing sector, were disappointed that there were no incentives to help tide over the expected slow-down in the economy or to contain the rising cost of operating a business. Hoteliers expect to be the hardest hit by restoration of the tourism cess from three to four percent, the higher taxes on alcoholic beverages and the increase in the water consumption tax. To sum up, the 1992 Budget was widely regarded as a conservative, non-event and carry-on budget.

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HONG KONG: "RAGS TO RICHES" BUDGET

Ian Harris
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Hong Kong's new Financial Secretary, Mr. Hamish Mcleod, presented his first budget to the Legislative Council on 4 March 1992. Mr. Mcleod laid great stress on the need to maintain Hong Kong's simple low rate tax system and to assure the business community of his intention of ensuring Hong Kong's continued economic growth while not forgetting the need to materially improve social services. He said that radical changes played no part in this philosophy and that there was a broad consensus about the need to preserve the key elements of Hong Kong's success – the commitment to the market economy, to competition and to providing community services from the wealth created by that economy. These community services ensure that everyone receives proper education and health care, and can rise as far as their talents enable them. We are, he said, an open, meritocratic society, where success inspires effort to emulate that success, not jealousy. Rags to riches stories are commonplace in Hong Kong. Long may that continue to be so, he concluded.

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1991/92

In reviewing the expected outcome of the 1991/92 Budget, which provided for a surplus of HK$ 1.3 billion (US$ 167 million), the Financial Secretary said that Hong Kong is in the process of transformation and that the economy has undergone a profound structural change in recent years mainly due to the fact that a large part of Hong Kong's manufacturing base has been transferred to the lower cost environment of the Pearl River Delta in Southern China. Hong Kong's trading patterns have also changed from 20 years ago when the main markets were in North America and Europe; while in recent years although the traditional markets are still very important, the new markets in Asia are growing dynamically. Hong Kong and China are each other's single largest customer. The transformation in Hong Kong, the Financial Secretary continued, is not only related to trade and industry but also to the priorities and aspirations of the community, and he said it was the responsibility of the Government to take into account the community's desire for better public services, particularly in relation to the elderly who are becoming an increasingly large proportion of the total population.

In 1991 GDP growth was about four percent which represented a one percent increase over the previous year. The increase in economic activity stemmed from a number of factors, the most significant of which was the agreement with China on the development of the new airport. This led to a surge in optimism throughout the business community in Hong Kong which is expected to continue into 1992/93.

As a result of the better than expected performance of the economy, the latest estimate of the surplus for 1991/92 is HK$ 14.1 billion. Of the total surplus some HK$ 8 billion was the result of under-spending which in turn was mainly due to a slippage in various public works but chiefly as a result of the delays arising from the negotiations relating to the new airport with the result that planned expenditure was deferred. On the income side, revenue was also buoyant, accounting for some HK$ 4.7 billion of the surplus which in turn was due to the better than forecast revenue from stamp duty and land sales, the latter being substantially above original forecasts. Both of these items provide direct evidence of increased economic activity in the stock and property markets. As a result of the surplus, fiscal reserves at 31 March 1992 are estimated to be some HK$ 92 billion.

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1992/93

As indicated above, Mr. McLeod said that the outlook for 1992/93 was optimistic in view of the expected continuing buoyant economy with GDP growth reaching five percent which in turn would mean that GDP per head would reach HK$ 125,000 which is amongst the highest in Asia and better than many developed economies. However, he conceded that inflation was still a major worry and the anticipated decrease last year had not materialized to the extent expected. The latest forecast is 9.5 percent which is a downward trend from the peak reached in April 1991 of 14 percent. Commenting on the rate of inflation, the Financial Secretary once again confirmed the Government's commitment to the pegging of the Hong Kong dollar to the U.S. dollar. He said that critics of the linked exchange rate were of the view that this meant that Hong Kong was importing inflation but he said that import prices had only risen two percent in 1991. Furthermore, he said since the peg had been introduced in 1983 the Hong Kong dollar had actually increased in value by nearly ten percent over the period. The Financial Secretary also refuted the suggestion that Government expenditure itself had an impact on inflation as he said that the public sector accounts for only a relatively modest share of GDP.

In framing his Budget strategy, he said that he had been determined to ensure that public spending remained in line with economic growth, to raise sufficient revenue to cover the spending commitments, to ensure that at least half the cost of the capital expenditure is financed by recurrent revenue and to maintain reserves at the level adequate to meet known commitments and to provide a cushion against future uncertainties.

In respect of the fiscal reserves the Financial Secretary said that in the agreement with China over the airport, the fiscal reserves by mid-1997 should be at least HK$ 25 billion. While concern has been raised over the cost of the airport, the Financial Secretary said that Government's share of the costs of its capital works on the airport project would not exceed 25 percent of the total capital expenditure in the period to 1997.

Mr. McLeod said that the draft estimates of expenditure for 1992/93 provided for an increase of some 16 percent over 1991/92 to HK$ 115.1 billion. He stressed that the increase in expenditure represented a real increase particularly in respect of social services. He said that Government's plans over the next four years should be able to meet 80 percent of the demand from the elderly for places in care and attention homes and 60 percent of the demand for hostel places for the mentally handicapped. A 25 percent increase in the number of hospital beds is expected over the next four-year period and the housing programme will continue with a further 400,000 new flats being planned over the next decade. A further HK$ 18 billion will be spent on tertiary education alone in the next three academic years. Additional expenditure is scheduled in respect of law and order, particularly the police. Total Government expenditure in 1992/93 is expected to amount to 18.8 percent of estimated GDP representing a small increase over the figure for 1991/92 which was 17.8 percent. On a national income accounts basis, the ratio of Government expenditure amounts to 11.5 percent which is very similar to that of the previous year.

In forecasting the revenue for 1992/93 before new measures, the increase is expected to be 20.3 percent over that for 1991/92, most of which is expected to come from both earnings and profits tax and land sales which were expected to continue at a high level.

As a result of the estimates of revenue and expenditure a final out-turn for 1992/93 is expected to produce a surplus of HK$ 6.4 billion, 30 percent of which will result from the Government's bond programme. This will bring Government's fiscal reserves at the end of March 1993 to HK$ 98.2 billion.

REVENUE PROPOSALS

In introducing his revenue proposals, the Financial Secretary said that he had not focused exclusively on the need to raise more revenue but that he had also taken into account the need to reduce the dependence on relatively volatile sources of revenue while at the same time not adding to inflation. By some carefully selected tax concessions, he aimed to provide a measure of relief to the ordinary taxpayer and he said that his proposals would be effectively neutral on the consumer price index.

He said that he had very much in mind the need to plug tax loopholes whenever they appear. Mr. Mcleod said that Hong Kong's low, simple and predictable tax regime is crucial to its successful business environment. However, this commitment to a generous tax climate should not be misunderstood. Extensive tax avoidance is a clear breach of the spirit of Hong Kong's liberal tax arrangements and is not acceptable. Nor of course is tax evasion. The Financial Secretary said that those who profit from their operations or residence in Hong Kong must accept their obligation to make a contribution to the community through Hong Kong's far-from-onerous taxes and duties.

REVENUE MEASURES

The Financial Secretary's new revenue measures are estimated to produce HK$ 2.9 billion in 1992/93 and about HK$ 3.8 billion in a full year. The five concessions that he proposed are estimated to cost some HK$ 1.8 billion for 1992/93 and about HK$ 2.1 billion in a full year. The revenue proposals are as follows:

Profits tax

A one percent increase in the standard rate of corporation profits tax from 16.5 to 17.5 percent; the Financial Secretary said that the new rate was still below the historical high of 18.5 percent reached in 1984/85 and that it would have no impact on either local or international enthusiasm for investment in Hong Kong.

Rates

An increase in rates from 5.5 to 6 percent of assessments for 1992/93; the Financial Secretary said that this would represent an increase for the average private flat of some HK$ 43

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per month whereas the average increase in respect of Housing Authority flats would be some one third lower. Business premises will experience a higher percentage increase but as a percentage to rents and over other overheads the new rates will merely add 80 cents or 2.4 percent to the cost per square foot per month of office space. Rates in Hong Kong will still remain low by international standards.

Stamp duty

Stamp duty will be extended to include the sale or transfer of covered warrants.

Betting tax

Betting tax on standard bets will be increased from 10.5 to 11.5 percent while for exotic bets the rates will go from 17 to 17.5 percent. The Jockey Club has agreed to absorb a significant proportion of the increase.

Pleasure craft

Duty will be required on light diesel oil as supplied to locally registered pleasure craft.

Indirect taxes and charges

The Financial Secretary did not propose any other increases in real terms in indirect taxation but duties which are assessed on a specific base as opposed to ad valorem will be adjusted by ten percent to maintain real yields.

In respect of other Government charges for water, postal, tunnel, airport and toll fees, these will be considered during the course of the next financial year and any necessary increases will be phased-in in an orderly fashion so that the impact on taxpayers can be minimized.

Tax concessions

In terms of tax concessions, the Financial Secretary's main proposal related to salaries tax where the personal allowances for single and married persons have increased from HK$ 41,000 and HK$ 82,000, respectively, to HK$ 46,000 and HK$ 92,000. Increase in children and other allowances were also announced. In proposing these measures, the Financial Secretary said that well over half of the working population of Hong Kong does not pay any tax at all and of those that do only some 100,000 pay tax at the standard rate of 15 percent. The measure proposed in the Budget will mean that some 120,000 taxpayers or eight percent of the total will be freed completely from paying any salaries tax.

The Financial Secretary also announced that the duty on soft drinks would be totally abolished as would the entertainment tax on cinema tickets. The duty on diesel oil for franchised bus companies will be eliminated; the final measure was a further reduction in stamp duty on stock transfers from 0.5 to 0.4 percent with an indication that further reductions will be considered in the future.

Mr. McLeod said that two further measures that had been debated were the introduction of a sales tax and an increase in salaries tax. In respect of the former, he reiterated his previous view that he does not regard a sales tax as attractive at a time of relatively high inflation and therefore he said it is not currently under serious consideration. In respect of salaries tax he said that he was happy to be able to assist taxpayers by not raising rates but at the same time increasing profits tax. He warned, however, that the resulting differential between salaries tax and profits tax of 2.5 percent is probably about the maximum beyond which avoidance was likely to be a problem.

CONCLUSION

In concluding his Budget statement, the Financial Secretary said the "we must have confidence in ourselves and in our ability to create economic success and to enjoy its rewards". He said that he had sought to maintain the necessary balance between investing in areas which will keep the economy growing, such as education and infrastructure, and spending in other areas which make life in Hong Kong relatively safe and rewarding. In conclusion, he paid tribute to his predecessor, Sir Piers Jacobs, who he said had steered Hong Kong safely through some testing times and in the process carried Hong Kong's monetary management and regulatory framework a long way forward. Above all Mr. McLeod said in relation to this Budget, Sir Piers had left Hong Kong's finances in a healthy state, a state which Mr. McLeod said he had every determination to continue.

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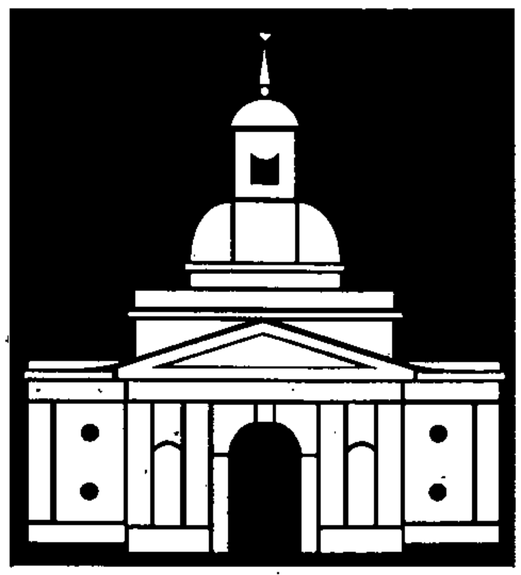

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UNITED STATES: ANALYSIS OF THE RECENTLY PROPOSED SECTION 482 REGULATIONS — 271 — *Alan W. Granwell*

The proposed Section 482 regulations contain detailed new rules for applying the commensurate with income standard to the transfer of tangible and intangible property between controlled parties, and to cost sharing arrangements, and additionally they modify certain of the general rules of application of the existing regulations. Mr. Granwell examines the proposed regulations in detail and addresses a number of issues which the regulations would create.

UNITED STATES: A COMMENTARY ON HOW THE PROPOSED REGULATIONS AFFECT THE GENERAL PRINCIPLES OF SECTION 482 AS DESCRIBED IN THE EXISTING REGULATIONS AND IN CASE LAW — 281 — *Michael Quigley*

There is little doubt that the proposed Section 482 regulations will have profound implications for multinational companies. This article takes a look at the background of Section 482, and addresses several key issues raised by the new regulations, including whether the regulations, by extending the comparable profit method and the commensurate with income standard to tangible property, comply with the legislative history and purpose of the section, and how the regulations address significant lines of case law concerning the IRS' discretion in several areas.

UNITED STATES: PROPOSED SECTION 482 REGULATIONS: COMPATIBILITY OF USE OF THE COMPARABLE PROFIT INTERVAL WITH INTERNATIONAL NORMS — 287 — *Alan W. Granwell, May Anne Mayo, Todd Helvie, Matthew Blum*

Altough the IRS and U.S. Treasury officials claim that the methods for applying the commensurate with income standard in the regulations are compatible with international standards, it appears that in some respects the regulations are not compatible with international norms, i.e. use of the CPI in determining prices for tangible property is a departure from international practice at least where use of the fourth methods is not required. This article compares the methods used to determine arm's length prices by major U.S. trading partners in respect of both tangible and intangible property

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UNITED STATES: PROPOSED TRANSFER PRICING REGULATIONS UNDER SECTION 482 OF THE INTERNAL REVENUE CODE — 292 *Robert T. Cole and Gilbert W. Rubloff*

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INTERNATIONAL: TRANSFER PRICING IN THE 1990s: DO THE LATEST U.S. DEVELOPMENTS RELATE TO A GLOBAL ECONOMY? — 299 *Jill C. Pagan and J. Scott Wilkie*

The proposed Section 482 regulations on transfer pricing may not be a blueprint for a new or improved methodology which would gain worldwide support, but it is suggested that they indicate a welcome, if slight, movement towards a national tax policy accepting the challenges of a tax system relating to a global economy.

UNITED STATES: PFIC AND SUBPART F SIMPLIFICATION PROPOSALS OF THE TAX SIMPLIFICATION ACT OF 1991 — 307 *John G. Mott*

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UNITED STATES:

ANALYSIS OF THE RECENTLY PROPOSED SECTION 482 REGULATIONS

Alan W. Granwell

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I. INTRODUCTION

Recently, the Internal Revenue Service (the "IRS") released the long-awaited regulations under Section 482 (the "regulations"). The regulations are intended to provide guidance in implementing the commensurate with income standard, which was added to Section 482 by the Tax Reform Act of 1986. Under that standard, the income with respect to a transfer of an intangible is required to be commensurate with the income attributable to that intangible.

The regulations contain detailed new rules for applying the commensurate with income standard to the transfer of intangible and tangible property between controlled parties, and to cost sharing arrangements. The regulations also modify certain of the general rules of application of the current Section 482 regulations. Finally, the regulations solicit comments on a broad range of issues. The regulations are proposed to be effective generally for taxable years beginning after 31 December 1992, although the commensurate with income standard with respect to the transfer of intangibles is generally effective for taxable years beginning after 31 December 1986.

II. GENERAL RULES OF APPLICATION

The current regulations under Section 482 provide that the purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. The regulations clarify how the foregoing determination should be made.

First, the general principle to be followed in making this determination is whether uncontrolled taxpayers would have agreed to the same terms, given the actual circumstances under which the controlled taxpayers dealt. For this purpose, uncontrolled taxpayers are deemed to exercise sound business judgment on the basis of reasonable levels of experience (or, if greater, the actual level of experience of the controlled taxpayer) within the relevant industry and with full knowledge of the relevant facts.

Second, in applying the general principle, the IRS is given discretion in two specific areas to look to the substance, rather than the form, of the transaction.

The IRS may consider the combined effect of all transactions of a controlled taxpayer with other members of the group, as well as with uncontrolled taxpayers, before, during and after the taxable year under review. Thus, rather than analyzing each transfer independently, the IRS has discretion to integrate closely related transfers. For example, the IRS could integrate the licence of an intangible to a related party and the sale of tangible property (produced by using the technology of the transferred intangible) by the related party to the licensor. In this situation, the IRS could consider the price charged for the tangible property as one of the circumstances that should be taken into account in determining whether an uncontrolled taxpayer would have agreed to the same consideration for the licence of the intangible property.

The IRS also may disregard the absence or presence of contractual arrangements between controlled taxpayers and instead consider the actual conduct of the parties.

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These principles set forth above will most likely make it more difficult for a taxpayer to rebut a Section 482 allocation proposed by the IRS[1] and could lead to international double taxation for three reasons: first, the taxpayer now will have to show that uncontrolled taxpayers would have agreed to the same terms given the actual circumstances and knowledge under which the controlled taxpayers dealt. This showing establishes a stricter standard than that required in the past and could perhaps be interpreted as forestalling a taxpayer from claiming "ignorance", and it may permit the IRS to substitute its business judgment for that of the taxpayer, a position that courts have rejected in the past. Second, though Section 482 historically has been concerned with matters of substance over form, the explicit discretion now given to the IRS to integrate closely related transfers, and to respect or disregard the presence or absence of contractual agreements, as the case may be, may make it much more difficult for a taxpayer to attempt to equate a controlled transaction to an uncontrolled transaction and also is a reversal of prior judicial precedent adverse to the IRS. Third, the general principles may not be in conformance with international standards, as is discussed in more detail below.

III. TRANSFERS OF PROPERTY

The regulations contain detailed new rules for determining whether the transfer of intangible or tangible property is arm's length. The regulations adopt a results-oriented comparable profit analysis, rather than focusing on whether there is transactional comparability. Under this analysis, unless a controlled taxpayer can establish that there is an exact comparable uncontrolled transaction, i.e. a "matching" transaction in the case of the transfer of intangible property, or a "comparable uncontrolled price" in the case of the transfer of tangible property, the transfer will be treated as arm's length generally only if the controlled taxpayer's operating income falls within a range of profitability determined by reference to what similarly situated uncontrolled taxpayers earned from comparable uncontrolled transfers. This important new concept is known as the "comparable profit interval" (the "CPI").

The CPI will be utilized (a) to validate the arm's length consideration in most transfers of intangible or tangible property, and (b) to determine transfer prices for intangible or tangible property if the operating income of the controlled taxpayer falls outside of the CPI.

A. *Comparable profit interval*

1. General

The CPI is a range of profits that a controlled taxpayer (the "tested party") would have earned from a "controlled transfer" of intangible or tangible property if such taxpayer had determined its profitability by using objective measures of profitability ("profit level indicators") derived from similarly situated uncontrolled taxpayers engaging in comparable uncontrolled transfers. To determine the CPI, profit level indicators derived from similarly situated uncontrolled taxpayers are applied to the financial data of the tested party to recalculate its operating income ("constructive operating income"). The CPI is then constructed by selecting amounts of constructive operating incomes that converge to form an interval that is reasonably restricted in size.

2. Operating rules

The CPI should be constructed based on actual, rather than projected, results for the three-year period that includes the taxable year under review, the preceding year and the following year, unless circumstances indicate that a different period is more appropriate.

There are six steps in developing and applying the CPI:

Step 1: Select the party to a controlled transaction to be tested. The tested party is the party to the controlled transaction whose "operating income"[2] is to be tested. Which controlled taxpayer is selected as the tested party depends on whose operating income can be verified using the most reliable data and by making the fewest and most accurately quantifiable adjustments. This, in turn, depends on the nature of the transaction and the transfer pricing method to be validated by the CPI. For example, in the case of a transfer of an intangible, the tested party ordinarily would be the transferee. In the case of a transfer of tangible property, the tested party ordinarily would be the buyer if the resale price method is being used and the seller if the cost plus method is being used.

Step 2: Determine the applicable business classification of the tested party. The term "applicable business classification" is the broadest category of operations of the tested party that relates to the controlled transaction under review. Its determination involves (a) identifying the operations of the tested party that relate to the controlled transaction under review (the "tested operations"), and (b) matching as closely as possible the tested operations to similar operations of uncontrolled taxpayers, based on the most reliable data available.

If possible, operations of uncontrolled taxpayers are selected that closely correspond to the tested operations, i.e. by reference to products and functions. (The regulations do not refer to corresponding type risks.) If that is not possible, then the scope of the applicable business classification may be broadened if there is sufficient reliable data relating to the broader classification, or the tested party's operations may be divided into separate categories to permit proper matching of the tested party's results to those of similarly situated uncontrolled taxpayers engaging in uncontrolled transactions. The regulations do not contemplate the possibility that an applicable business classification cannot be found.

Step 3: Compute constructive operating incomes. The "constructive operating income" is the tested party's operating income recalculated by applying profit level indicators obtained from a selection of uncontrolled taxpayers in the

1. A Section 482 allocation is presumed to be correct unless the taxpayer can show that it was arbitrary, capricious or unreasonable. In addition, even if the taxpayer can prove the foregoing, it is necessary for the taxpayer to prove that its transfer pricing was arm's length.

2. The term "operating income" means "gross income" less "operating expenses". The term "gross income" means sales less cost of goods sold. The term "operating expenses" includes expenses associated with advertising, sales, marketing, administration, research and development and a reasonable allowance for depreciation and amortization, but does not include interest expense or foreign or domestic income taxes.

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applicable business classification to the financial data of the tested party.

The selection of profit level indicators depends upon two interdependent factors: (a) the extent to which reliable data is available concerning similar uncontrolled taxpayers, and (b) the extent to which a particular profit level indicator provides a reliable basis for comparing profits of controlled and uncontrolled taxpayers under the specific facts.

A variety of different profit level indicators can be calculated in any given case. Profit level indicators include a rate of return on assets (the ratio of operating income to total assets), margins that divide income and costs in different ways (such as the ratio of operating income to sales or the ratio of gross income to operating expenses) or, in limited cases, comparable profits splits, based either on total operating profits or residual operating profits.

Prior to applying profit level indicators to the relevant financial data of the tested party, the data must be adjusted to reflect (a) allocations under Section 482 (other than adjustments made under the intangibles or tangible goods sections of the regulations), and (b) any significant differences between the assets of the tested party and the assets of the uncontrolled taxpayers, such as differences in the relative amount of financial assets or inventory held.

Step 4: Determine the CPI. The CPI is constructed by selecting those amounts of constructive operating income (determined in step three above) that converge to form an interval that is reasonably restricted in size. Data that diverges significantly from other data is excluded from the interval.

If there is a small number of uncontrolled taxpayers whose operations correspond closely to the applicable business classification, two types of convergence should be considered in constructing the CPI. The first is convergence of constructive operating incomes of the tested party derived from several profit level indicators of a single uncontrolled taxpayer. The second is convergence of constructive operating incomes derived from one or more profit level indicators obtained from multiple uncontrolled taxpayers. In determining both types of convergence, the reliability of the data must be considered and greater weight accorded to data that is more reliable.

If the number of uncontrolled taxpayers whose operations correspond to the applicable business classification is large enough to permit the use of valid statistical techniques, then convergence must be determined by using those techniques to identify a reasonably narrow area of concentration among all of the constructive operating incomes computed. The regulations do not elaborate further on the statistical techniques to employ.

Step 5: Determine the most appropriate point in the CPI. Where the results reported by a controlled taxpayer are outside the CPI, it generally will be necessary to identify the most appropriate point within the CPI. If statistical techniques are not used to construct the CPI, the most appropriate point is determined by considering a number of factors relating to the comparability and reliability of the underlying data. If statistical techniques are used to construct the CPI, then the most appropriate point is determined using statistical measures of central tendency,[3] though the regulations do not provide further guidance as to how to determine such point.

Step 6: Determine the transfer price for the controlled transaction. The transfer price is determined by adjusting the actual charge in the controlled transaction to produce an operating income for the tested party that equals the constructive operating income corresponding to the most appropriate point in the interval.

3. Comment

The CPI is the benchmark against which controlled transfers of intangible and tangible property are tested in an effort to produce an objective measure to validate the arm's length nature of controlled transactions. The drafters of the regulations also have sought to provide a more structured framework for performing the necessary economic and financial analyses. The CPI is computed by reference to financial data, though ultimately it is used to validate tax data.

The following discussion considers a number of the more technical issues related to the derivation of the CPI.

(a) *Data*

Generally, data must be obtained for a three-year period that includes the taxable year under review, the preceding year, and the following year. While data for this span of years possibly may be available in an audit situation, it would not be fully available in a planning situation, thus necessitating the use of projections, rather than actual results, for some of the years. Query how the IRS will view the CPI in this case, especially where material differences may exist between the projected and the actual data.

(b) *Subjectivity*

While on its face the derivation of the CPI appears to be objective, in practice numerous decisions will require subjective judgments. For example, with respect to the selection of the tested party, how is that determination made in a transfer pricing situation involving the sale of goods if each controlled party owns valuable intangibles? The determination of an applicable business classification is another example, especially where it is not possible to show similarity to a tested party on a reasonably narrow level and thus a broader applicable business classification has to be found, or the functions of the tested party have to be divided and compared on a functional basis. Also, under this portion of the regulations, it is not clear whether the benefits of locations savings can be lost. The regulations allow the utilization of comparable third-party data from a jurisdiction other than the one in which the controlled taxpayer conducts business if reliable data does not exist for the jurisdiction in which the controlled taxpayer operates. Thus, if comparable third-party data only can be obtained from a high cost jurisdiction, but is applied to compute the CPI for the tested party in a low cost jurisdiction, how does one deal with location savings?

3. The mean or average is the most often cited measure of central tendency, though it is only one of several such measures and may sometimes be misleading because it is sensitive to extreme values in a group.

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The selection of profit level indicators and the required adjustments to the financial data provided for in the regulations may not practically result in sufficient comparability. Query how adjustments will be made to reflect differences in foreign data to U.S. GAAP, and how adjustments for data in non-functional currencies will be reflected. The regulations do not provide guidance as to how a convergence of constructive operating incomes is determined or how one determines the "most appropriate point", though the IRS has sought comments in these areas.

While the IRS has sought to construct more objective tests for validating (or determining) transfer prices (and has sought comments on the use of a "safe harbour" in this area), at this point in time it is not clear whether the new methodology will achieve that objective, or will have only the effect of creating or shifting, rather than resolving, areas of controversy.

B. *Transfers of intangible property*

1. General

The regulations propose entirely new rules to deal with transfers of intangible property. Intangibles are broadly defined to include both manufacturing and marketing intangibles. A transfer of an intangible occurs if it is licensed, sold, assigned, loaned, contributed or otherwise made available in any manner.

The intangible portion of the regulations also applies to any transaction that in substance is a transfer of an intangible, regardless of the form of the transaction. Thus, the transfer of tangible property or the provision of services is within the scope of this portion of the regulations if the income attributable to the intangible is material in relation to the income attributable to the tangible property or services to which it relates.

2. Methods

The regulations prescribe three methods for determining the amount of an arm's length consideration for the transfer of an intangible, i.e. the matching transaction method, the comparable adjustable transaction method and the comparable profit method.

(a) *Procedural rules*

These three methods must be applied in the order of priority listed above, though the inapplicability of a higher priority method need not be specifically established before applying a method of lower priority. However, a higher priority method must be used if it is established that the standards for its application are met.

In applying these methods, the IRS may consider all relevant facts and circumstances throughout the period the intangible is used, including information from before, during and after the taxable year under review. The IRS is not limited to considering projections and forecasts and may consider the actual income derived from the use of an intangible.

(b) *Matching transaction method*

A matching transaction is an uncontrolled transfer of the same intangible under the same or substantially similar economic conditions and contractual terms. An intangible involved in an uncontrolled transfer is the same as the intangible in the controlled transfer only if the property, protected interest or body of knowledge that is subject to exploitation through the use of each intangible is identical. However, adjustments are permitted to be made for a limited number of minor differences in economic conditions and contractual terms that alone, and in combination with all of the adjustments, have a definite and precisely determinable effect on the consideration for the intangible. The consideration charged in the uncontrolled transfer then must be adjusted to compensate for those differences, if any.

(c) *Comparable adjustable transaction method*

A comparable adjustable transaction is an uncontrolled transfer of the same or a similar intangible under adjustable economic conditions and contractual terms. This method can be utilized even if there are material differences in the intangibles or in the economic conditions and contractual terms, provided such differences can be determined with reasonable accuracy. The consideration charged in the uncontrolled transfer then must be adjusted to compensate for those differences. However, this method cannot be utilized if the operating income for the tested party from the controlled transaction determined under this method is outside of the CPI.

(d) *Comparable profit method*

This method applies the CPI to determine an arm's length consideration when the matching and comparable adjustable transaction methods are inapplicable. It requires a comparison of the operating income that results from the consideration actually charged (and directly or indirectly reported on a U.S. tax return) in a controlled transfer ("reported operating income") with the operating incomes of similar taxpayers that are uncontrolled.[4] The consideration charged in the controlled transfer ordinarily will be considered an arm's length amount when the reported operating income falls within the CPI, but will not be considered arm's length and may be adjusted when the reported operating income falls outside the CPI. Where this occurs, the transfer price generally may be adjusted to produce operating income that is at the most appropriate point in the CPI.[5] However, a smaller adjustment is permitted to be made when reporting operating income is outside of, but corresponds closely to, the CPI. This special rule is limited in its application to the comparable profit method.

4. Here, the tested party's operating income as reported on a U.S. tax return must fall within the CPI as determined from financial data of uncontrolled taxpayers. In contrast, in other cases where the CPI is used, the regulations generally refer to operating income, determined from financial data.

5. In cases where the transferee paid no consideration in connection with the controlled transfer, or the consideration paid by the transferee was substantially disproportionate to the value of the intangible, if an adjustment is made by the IRS, it must be made by reference to the most appropriate point.

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3. Transfers for more than one taxable year

If an intangible is transferred under an agreement for a term covering more than one taxable year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. The determination in an earlier year that the amount charged for an intangible is arm's length will not preclude the IRS from making an adjustment for a subsequent year for the intangible except in three narrowly circumscribed situations.[6]

4. Developer/assister rules

The regulations provide rules to determine which member of a controlled group will be the "developer", i.e. the owner of an intangible in a situation when two or more members of a controlled group undertake the development of an intangible. The other participating members will be regarded as "assisters". Which controlled taxpayer is the developer and which other controlled taxpayers are assisters is a factual determination, with greatest weight given to which member (a) bears the direct and indirect costs and corresponding risks of developing the intangible, and (b) makes available without adequate compensation property or services likely to contribute substantially to developing the intangible. Other factors that may be relevant in determining which controlled taxpayer is the developer include the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer controls the project and the actual conduct of the controlled taxpayers.[7]

The regulations contain examples illustrating the developer/assister rules. One example takes the position that where a U.S. subsidiary of a foreign parent expends funds to enhance the trade name of the foreign parent which is widely known and is valuable outside of, but not within, the United States, the U.S. subsidiary will be treated as the developer of the U.S. tradename and thus is entitled to the return unless the foreign parent reimburses the U.S. subsidiary's expenses. (Query, whether the IRS would apply this same approach in an "outbound" situation.)

5. Comment

In replacement of the general rules of the current regulations, the IRS has proposed very specific and exclusive rules (in the form of three methods) to determine an arm's length price for the transfer of an intangible. Use of the matching transaction method likely will be limited. Though use of the comparable adjustable transaction method (as validated by the CPI) is intended by the IRS to be of somewhat broader application, arm's length determinations most likely will have to be made under the comparable profit method which requires using the CPI. Moreover, all multi-year transfers will require validation of a tested party's profits, generally by reference to the CPI. Thus, the methodology proposed by the IRS for determining the transfer price of intangibles will basically have to be made by reference to a profits-based analysis through use of the CPI.

Whether the methodology proposed to deal with transfer pricing of intangibles comports with international standards is discussed below in the General Comment section.

C. *Transfers of tangible property*

Significant revisions have been proposed to the current rules for determining the transfer price of tangible property.

1. Methods

The regulations retain the comparable uncontrolled price method and require that it be used prior to any other method. However, they clarify the circumstances when such method can be used. If such method cannot be used, second priority is given either to the resale price method or the cost plus method, depending on which of these two methods more accurately results in an arm's length price in the particular factual situation, provided that the transfer price determined under such methods results in a level of operating income for the tested party that is within the CPI. Third priority is given to the so-called "fourth methods". A fourth method, for example, may include an analysis based on profit level indicators used to construct a CPI. However, in order to utilize a fourth method, the transfer price determined under such method generally must result in a level of operating income for the tested party that is at the most appropriate point within the CPI.[8]

Thus, when the comparable uncontrolled price method is inapplicable,[9] if the result produced by use of resale price or cost plus methods does not fall within the CPI, and generally, if the result produced by a fourth method does not result in operating income to the tested party at the most appropriate point in the CPI, then the results are disregarded for purposes of determining an arm's length price. When the foregoing occurs, a method will be required to be used that results in the tested party deriving operating income at the most appropriate point in the CPI.

(a) *Procedural rules*

For purposes of applying the priority of methods, the regulations do not require the IRS or the taxpayer to demonstrate the inapplicability of a higher priority method before applying a lower priority method. However, either the IRS or the taxpayer may establish the applicability of a higher priority method.

6. Very briefly, these three circumstances are as follows: (1) where the reported operating income of the tested party remains within the CPI; (2) where for at least ten years since the date of the initial transfer a royalty for the use of intangibles in commercial production has been arm's length under one of the three methods of the regulations; and (3) where due to unanticipated events the transferee's operating income moves outside of the CPI and the use of the intangible was limited in a commercially reasonable way. To use this latter exception, it also is required that a comparable agreement between uncontrolled taxpayers contained no provision that would have permitted adjustment or termination, and no adjustment in fact was made.

7. The regulations also provide that the IRS may make allocations to reflect an arm's length consideration for assistance in the form of loans, services or the use of property provided to the developer by another controlled taxpayer in connection with the development of an intangible. Moreover, in unusual circumstances where application of the developer/assister rules would not clearly reflect the income of a member of a group of controlled taxpayers, the IRS may apply the cost sharing provisions to any arrangement that in substance constitutes a cost sharing arrangement notwithstanding a failure to comply with any requirement of the cost sharing provisions.

8. The way the rule is expressed in the test reflects our understanding of the intent of the drafters of the regulations, though the wording of the regulations meant to effectuate this intent is not expressed as clearly as it might have been.

9. Which would generally seem to be the case given the limitations in identifying a comparable uncontrolled sale.

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(b) *Grouping rules*

The regulations continue to apply the grouping rules of the current regulations. Under these rules, even though the methods for determining arm's length prices for tangible goods are by reference to individual sales of property, because a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyse every sale for the purpose of determining the arm's length price. Thus, an arm's length price may be determined or verified by applying the pricing method to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the IRS may determine or verify the arm's length price of all sales to a controlled taxpayer by employing reasonable statistical sampling techniques.

2. Comment

The changes proposed in this portion of the regulations also significantly alter current rules. Although the regulations retain the primacy of the comparable uncontrolled price method, the "clarification" of when a comparable exists most likely will make it more difficult to establish a comparable in practice.

The elimination of the priority of application of the resale price method over the cost plus method is favourable. However, the requirement that methods other than the comparable uncontrolled price method be validated by reference to the CPI will cause problems. As an initial matter, this rule causes major portions of the rules crafted for intangibles to apply to the transfer pricing of tangible property.[10] This rule most likely will limit the practical viability of the resale price and cost plus methods and, as a result, may cause severe problems with our trading partners, since currently they do not have similar validation rules.

The regulations also provide additional guidance with respect to fourth methods. However, to use a fourth method, the transfer pricing generally must result in operating income for the tested party that is at the most appropriate point within the CPI.

Inexplicably, the regulations have more rigid rules for the transfer pricing of tangible property than apply to the transfer pricing of intangible property, a surprising result in view of the fact that the commensurate with income standard applies to intangible, and not tangible, property. This point is discussed in more detail below in the General Comments section.

IV. COST SHARING

Cost sharing is an arrangement used, generally by members of a controlled group, to share the costs and benefits of research and development. It is an alternative to licensing intangibles and can obviate many of the issues which arise in defending arm's length transfer prices. In a cost sharing arrangement, the participants share in the costs of the research and development and can utilize the intangibles developed therefrom, without the payment of any additional consideration.

The regulations provide detailed rules for purposes of determining whether an arrangement for the development of intangibles will be considered a "qualified cost sharing arrangement".

A. *General requirements*

A cost sharing arrangement must satisfy five conditions to constitute a qualified cost sharing arrangement, as follows:

(1) it must include two or more "eligible participants" (described below);
(2) it must be recorded in writing contemporaneously with the formation of the cost sharing arrangement;
(3) it must provide for the sharing among eligible participants of the costs and risks borne by any participant of developing one or more intangibles[11] in return for a "specified interest in any intangible"[12] that may be produced;
(4) it must reflect a reasonable effort by each eligible participant to share all of the costs and risks of intangible development, including the costs and risks of unsuccessful or less successful related development, such that each eligible participant's share of the cost and risks is proportionate to the benefits that each eligible participant reasonably anticipates it will receive from the exploitation of intangibles developed under the arrangement; and
(5) it must meet certain administrative requirements: (a) the "material provisions"[13] of the arrangement must be recorded as required in condition two above, and (b) any change to a material provision must be recorded in writing and reported by the eligible participants.

B. *Eligible participant rules*

An eligible participant is a member of a group of controlled taxpayers that agrees to participate in the qualified cost sharing arrangement (a) if intangibles developed under the arrangement are, or will be used in the active conduct of the participant's trade or business,[14] and (b) the participant meets certain administrative requirements.

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10. In the view of the IRS, the purpose of applying the CPI to verify transfer prices for tangible property is to avoid artificial and unwarranted distinctions between the treatment of intangible and tangible property by eliminating the need to make allocations between the tangible and intangible components of tangible property which incorporate intangibles and to determine the profits attributable to each component.

11. For this purpose, costs include all of the direct and indirect costs related to the intangible development area. The intangible development area is a classification of products or services with respect to which intangible development is conducted under a qualified cost sharing agreement.

12. The term "a specified interest in any intangible" means a legally enforceable interest the benefits of which are susceptible of valuation and which would ordinarily be transferred between uncontrolled taxpayers acting at arm's length under an arrangement to share the costs of developing intangibles.

13. The material provisions of a cost sharing arrangement are as follows:
(1) identification of the arrangement's participants;
(2) the duration of the arrangement;
(3) the intangible development areas covered by the arrangement;
(4) the arrangement's method for dividing costs of developing intangibles;
(5) the extent to which a tangible or intangible property not developed under the arrangement is made available to the participants for use in the arrangement;
(6) the extent to which any entity other than an eligible participant is permitted to use intangibles developed under the arrangement;
(7) whether any participant has received an exclusive right to use developed intangibles (such as an exclusive right to manufacture particular products or an exclusive right to sell products in a particular geographic area) and, if so, the nature of that right;
(8) the conditions under which the arrangement may be modified or terminated; and
(9) the general administrative provisions of the arrangement.

14. For purposes of this requirement, activities may be carried out on behalf of the participant by independent contractors, provided that the participant bears the economic risks and receives the benefits of those activities. Also, one mem-

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A participant meets the administrative requirements if the participant substantially complies with each of the following rules: (a) the material provisions of the arrangement are made available to the IRS; (b) the participant maintains records sufficient to verify the material provisions of the arrangement, the amount of the costs borne under the arrangement, and the computation of the participant's operating income resulting from the arrangement; and (c) the records are timely produced by the participant if requested by the IRS.

C. *Costs proportionate to benefits rules*

A key portion of this section of the regulations relates to guidance in determining whether the cost sharing arrangement is arm's length, whether cost shares are proportionate to benefits received and the type of adjustments the IRS can make.

1. Overview

A cost sharing arrangement must establish a method that under all the facts and circumstances reflects a reasonable effort to share the cost of developing intangibles in proportion to the benefits that each eligible participant anticipates it will receive from the exploitation of intangibles developed under the arrangement. Anticipated benefits may be measured in several different ways, so long as the measure reasonably predicts the benefits to be shared. Methods include units of production, sales, and gross or net profits.

A cost sharing method must provide a mechanism to adjust shared costs to account for changes in economic conditions, the business operations and practices of the participants and the ongoing development of intangibles under the arrangement. Such adjustments must ensure that the method continues to reflect a reasonable effort to share costs in proportion to benefits over time and generally should be made on an annual basis.

2. Allocation rules – in general

The IRS may make two basic types of allocations with respect to a qualified cost sharing arrangement to reflect each participant's arm's length share of an arrangement's costs. The first relates to the intangible development area encompassed by the arrangement. The second relates to the consequences to the participants if there is a variation between the share of the benefits that each participant expects to receive and the share that is actually received.

3. Intangible development area adjustments

If the intangible development area encompassed by the arrangement is too broad or too narrow, then an adjustment in the participant's cost share may be necessary to place the arrangement on an arm's length basis. An intangible development area is too broad if any participant will not be able to use developed intangibles in its active business and is too narrow if it does not encompass all related intangible development.[15] In this case, an allocation made by the IRS must be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year, and an appropriate charge for interest also may be made.

4. Cost/benefits variation adjustments

To the extent that a qualified cost sharing arrangement fails to divide cost share in proportion to benefits, the regulations provide for three different types of adjustments. The type of adjustment to be applied is determined generally by a comparison of the U.S. participant's cost/income ratio and the cost/income ratio of the other participants.

(a) *Cost/income ratio*

The "cost/income ratio" is generally the participant's three-year average (i.e. the current year and the prior two years) cost share, divided by its three-year average of operating income attributable to developed intangibles. For purposes of computing this ratio, different periods for costs, income or both may be used if amounts from such periods more clearly reflect the relationship between the cost of developing intangibles and operating income attributable to intangibles developed under the arrangement.

(b) *Grossly disproportionate cost/income ratio*

If the cost/income ratio of a U.S. participant is "grossly disproportionate" to the cost/income ratio of the other participants, the method for dividing cost shares will be presumed not to reflect a reasonable effort to share costs in proportion to benefits and the cost sharing arrangement will not be considered a qualified cost sharing arrangement. In this case, the regulation's rules for the transfer of intangibles (discussed above) apply.

(c) *Substantially disproportionate cost/income ratio*

If the costs/income ratio of a U.S. participant is "substantially disproportionate" to the cost/income ratio of the other participants, the cost sharing arrangement will be considered a qualified arrangement, but a partial transfer of an intangible property may be deemed to have occurred outside of the scope of the arrangement. In such case, a "buy-in" (or "buy-out") payment may be required to reflect an arm's length consideration for that portion of the intangible deemed to have been transferred. The portion of the intangible deemed to have been transferred will be measured by the difference between the U.S. participant's cost/income ratio and the cost/income ratio of the other eligible participants, unless another method is more reliable.

A U.S. participant's cost/income ratio will not be considered substantially disproportionate if it is less than twice the cost/income ratio of the other eligible participants.

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ber of a group of controlled taxpayers may participate in cost sharing arrangements on behalf of one or more members of the group (the "cost sharing subgroup"). However, any intangible acquired pursuant to a qualified cost sharing arrangement in which a cost sharing subgroup is treated as a single eligible participant will be considered acquired solely by the member participating in the arrangement on behalf of the cost sharing subgroup. An intangible is not used in the active conduct of a participant's trade or business if a substantial purpose for participating in the arrangement is to obtain an intangible to transfer to an uncontrolled taxpayer.

15. Related intangible development consists of all intangible development of any product or service in the stated intangible development area without regard to whether such products or services are ever successfully developed or sold. It includes basic research and activity relating to similar products or services.

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(d) *Cost/income ratio is not substantially disproportionate*

If the cost/income ratio of a U.S. participant is not substantially disproportionate to the cost/income ratio of the other participants, an adjustment will be limited to an adjustment of the participant's cost shares.

In this case, an allocation made by the IRS must be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year, and an appropriate charge for interest also may be made.

D. *Buy-ins and buy-outs*

1. Buy-in

If an eligible participant in a qualified cost sharing arrangement transfers an intangible that it owns to another member of the group of controlled taxpayers, an arm's length consideration for the transfer must be determined. Such a transfer may occur, for example, if the intangible is developed outside of the arrangement, if the intangible is developed inside the arrangement but transferred to a new participant in the arrangement, or if the intangible is developed inside the arrangement but additional rights are transferred to existing participants upon the departure of a participant. In addition, the IRS may make an allocation to reflect compensation that should have been paid to a member for assistance rendered in the development of the intangible.

2. Buy-out

An eligible participant may be deemed to have acquired rights in an intangible if another participant (called a "departing participant") transfers, abandons or otherwise relinquishes some or all of its rights under the agreement to the benefit of one or more of the remaining participants. Once a relinquishment occurs, a departing member may not subsequently exploit the rights to any intangible deemed relinquished unless it pays the remaining participants an arm's length consideration.

3. Form of payment

The payment in a buy-in or a buy-out may take the form of a lump sum payment, instalment payment or royalty.

E. *Character of payments*

Payments made pursuant to a qualified cost sharing arrangement will be characterized as costs of developing intangibles of the payor and reimbursements of such costs to the payee. Any payment made or received by a taxpayer pursuant to an arrangement that the IRS determines not to be a qualified cost sharing agreement or a payment made or received pursuant to a buy-in or a buy-out will be considered a payment in consideration for the transfer of an interest in intangible property subject to the provisions of the regulations dealing with intangible transfers.

1. Comment

The regulations significantly liberalize the cost sharing rules in comparison to how those rules were described in the White Paper.[16] Cost sharing now applies to both manufacturing and marketing intangibles, non-manufacturers can be participants in cost sharing arrangements, a cost sharer's interest in the resulting intangibles has been broadened, a buy-in for goodwill is no longer required, and existing bona fide cost sharing agreements can more easily qualify. However, tax exposures may still arise in these types of arrangements, particularly with respect to the scope of the research and development to be conducted by the arrangement, cost-to-benefit computations and buy-ins and buy-outs. Query, whether our trading partners will accept the rules as to qualified cost sharing arrangements in general, and whether they will be amenable to proposed adjustments made by the IRS under the specific operating rules.

V. EFFECTIVE DATES

The regulations are effective for taxable years beginning after 31 December 1992, although the commensurate with income standard with respect to the transfers of intangibles is generally effective for taxable years beginning after 31 December 1986. The regulations do not apply to transfers of intangibles granted to foreign persons before 17 November 1985, or before 17 August 1986 for transfers or licensing to others unless the intangible property was not in existence or owned by the taxpayer on such date. The regulations provide that for the period prior to the proposed effective date, the commensurate with income standard of Section 482 shall be applied using any reasonable method not inconsistent with the statute. The IRS considers a method that applies the general principles of the regulations to be a reasonable method.

With respect to cost sharing arrangements, a transitional rule is provided that cost sharing arrangements will be considered qualified if the arrangement was considered bona fide under the current Section 482 regulations, provided that the arrangement is amended, if necessary, to conform with the new rules of the cost sharing provisions by the date that is one year after publication of the final regulations in the Federal Register.

VI. GENERAL COMMENTS

In considering the broad policy implications of the regulations, it may be helpful to review the general operating rule of Section 482. Section 482 authorizes the IRS to make allocations in order to prevent the avoidance of taxes or to clearly reflect income if the IRS determines that a controlled transaction is not arm's length and, in the case of any transfer of intangible property, to make an allocation if the income is not commensurate with the income attributable to the intangible. In establishing transfer prices, controlled taxpayers are required to price controlled transfers on an arm's length basis, but are not required to follow the regulatory guidance under Section 482.

In the past, taxpayers were not as concerned as today with exposures under Section 482. Regulations under Section 482

16. Department of Treasury, "Section 482 White Paper on Intercompany Pricing" (18 October 1988).

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were viewed principally as a compliance tool of the IRS rather than as a planning tool for taxpayers. Times have changed. Transfer pricing has moved to the forefront of concern for multinationals for many reasons. A primary reason is the heavy emphasis on, and enormous resources the IRS has allocated to, transfer pricing issues and examinations. Today, if the IRS is able to sustain a proposed allocation, the resulting exposure not only includes the tax and interest attributable to the allocation, but also can include significant penalties. The new regulations (even while they are in proposed form and certainly if and when they are finalized) will assume a much more prominent position in planning. Generally, controlled taxpayers, in structuring their transactions, will now attempt to conform their transfer pricing to methodologies sanctioned under the regulations so as to be in the best position possible to defend their pricing in the event the IRS were to question the transaction.

The regulations, which generally are stricter than the current regulations, attempt to formulate a more objective and workable framework for determining transfer prices for intangible and tangible property. From a broad policy perspective and on a positive note, the regulations continue to affirm the primacy of the arm's length standard. Also, they acknowledge that there is not a single arm's length price; rather, arm's length prices can be within a range and, in establishing that range, it is appropriate to use a multi-year analysis to deal with business cycles. However, these positive positions are balanced by the regulations' emphasis on a retrospective view of transfer pricing and the emphasis on the use of actual (rather than projected) results; consistent with this type of approach, the regulations also generally require annual reviews to determine whether a multi-year transfer of an intangible continues to be arm's length.

Though the regulations in principle continue to affirm the primacy of exact comparables, they do not easily accommodate establishing the existence of an exact comparable, either with respect to the transfer of intangible or tangible property. Moreover, even though the regulations seek to permit the utilization of inexact comparables (i.e. a comparable adjustable transaction in the case of a transfer of intangible property and a resale price or cost plus method in the case of tangible property), such methods can only be used if the operating income of the controlled taxpayer resulting from the transfer price is validated by satisfying yet another test, namely, the CPI.

The use of the CPI reduces the importance of a transactional approach to pricing, while emphasizing a profits analysis, determined by reference to the profits that uncontrolled taxpayers derived from engaging in comparable arm's length transactions. Under the CPI methodology, the arm's length nature of a controlled transfer is validated by reference to one of the controlled parties to the transaction, i.e. the tested party, and the transfer is treated as arm's length if the tested party's operating income, or reported operating income, as the case may be, falls within the CPI. This approach implicitly assumes that if the tested party's profits are validated by the CPI, the other controlled taxpayer necessarily will also derive an arm's length amount. A question arises whether the CPI will in most cases clearly reflect the incomes of both of the controlled parties to the transaction where no inquiry is made as to whether the transfer pricing results in a reasonable allocation to the other controlled taxpayer participating in the controlled transaction. Under current rules and practices, it is common to verify the reasonableness of a transfer pricing method by determining whether there is a fair division of the profits between the two controlled parties.

The use of CPI is innovative. If a controlled taxpayer's profits fall within the interval, the IRS generally will not adjust the transfer pricing under review. On the other hand, if a controlled taxpayer's profits do not fall within the interval, then the controlled taxpayer knows generally what the resultant consequences will be. The foregoing assumes that the taxpayer and the IRS will be able to agree on the construction of the CPI.

The way the CPI is constructed has the effect of standardizing a controlled taxpayer's rates of return by reference to those of uncontrolled parties. The fact that a controlled taxpayer's profits may vary from those of uncontrolled parties should not necessarily be treated as due to deficiencies in the controlled taxpayer's transfer pricing.[17] As is obvious, a company's financial performance is due to a variety of external and internal factors and may be better or worse, depending on these factors. The regulations as currently drafted do not seem to take this into account in arriving at the CPI.

The regulations also do not fully rationalize the use of financial data to validate tax data. The CPI is constructed by reference to financial data obtained from uncontrolled taxpayers which data is then applied to the financial data of controlled taxpayers. However, the sole purpose of the CPI under the regulations is to validate (or determine) transfer prices for tax purposes. In the context of that objective, the regulations do not appear to fully take into account the fact that financial data and tax data may not necessarily be computed in a similar manner or conform in result, absent making certain adjustments. For example, in computing operating income, how should one reflect differences in the derivation of financial and tax income? Why is the concept of reported operating income used for purposes of the comparable profit method and in two of the three tests excepting multi-year transfers from annual re-examination, but not used in the comparable adjustable transaction method or in validating the resale price, cost plus or fourth methods applicable to the transfer pricing of tangible property? It would be useful for the IRS to explain in more detail how financial data should be used in validating (or determining) tax data.

In the case of a property sale the regulations, on their face, appear to require a bifurcation of the income attributable to the tangible and the intangible. If the income attributable to the intangible component is "material" (the regulations provide no standards in this regard) the intangible (rather than the tangible) property rules would apply. This priority of application rule will have wide application because virtually all types of tangible property are likely to involve some type of intangible, whether a manufacturing intangible (e.g. a

17. In its discretion, the IRS may decide not to propose an adjustment even if a controlled taxpayer's profits do not fall within a CPI.

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patent or a manufacturing process) or marketing intangible (e.g. a trade mark or trade name). The practical effect of this rule may be somewhat less significant (except in a transaction in which the comparable uncontrolled price method would otherwise apply), since the other tangible property pricing rules require validation by the CPI and the intangible property rules are less harsh than the tangible property rules.

The application of the CPI to validate the transfer price of intangibles follows from the adoption of the commensurate with income standard; however, its wholesale application to transfers of tangible property significantly alters the prior rules of the game and vitiates the use of resale price and cost plus methods. The source of the IRS's authority to apply the commensurate with income standards to tangibles is not entirely clear. Though a profits-based comparability rather than a transactional comparability has been determined by Congress to be more appropriate for determining the transfer price of intangibles, a profit-based approach is not necessarily more appropriate for the transfer of tangible property. Further, Congress has not demonstrated an intention that a profits-based approach should apply to transfers of tangible property. In public remarks subsequent to the issuance of the regulations, the IRS has indicated that this aspect of the regulations is undergoing further consideration.

The regulations provide for inconsistent results in the treatment of transfers of intangible and tangible property that are difficult to rationalize. Basically, an adjustment with respect to the transfer of tangible property causes a harsher result to the controlled tested party than an adjustment for intangible property.

With respect to intangible property, if a controlled party's operating income or reported operating income falls within the CPI, then generally the IRS will not make an adjustment. If a controlled taxpayer's reported operating income falls just outside of the CPI, under the comparable profit method, the IRS has the discretion to make a small adjustment and not require that an adjustment be made to the most appropriate point in the CPI. On the other hand, if the controlled taxpayer's operating income does not fall within the CPI, then the IRS may adjust the controlled taxpayer's transfer pricing to result in operating income at the most appropriate point in the CPI.

For transfers of tangible property, the IRS generally will not make an adjustment if under the resale price or cost plus methods the controlled taxpayer's operating income falls within the CPI. However, if under such methods the controlled taxpayer's income is outside of the CPI, and if the IRS decides to make an adjustment, and irrespective of how closely the controlled taxpayer's operating income corresponds to the CPI, an adjustment must result in the level of operating income of the tested party to the most appropriate point within the CPI. The most appropriate point also must be used if a fourth method is used.

A major issue in connection with the overall operation of the regulations is how a taxpayer will obtain the necessary information to apply the CPI analysis to transfers of intangible and tangible property. The IRS is aware of this problem and it is anticipated that a portion of its report to Congress on the operation of Section 482 (which is expected to be released in the near future) will be devoted to explaining how it proposes that third-party information can be obtained (and protected from unauthorized disclosure) for purposes of performing the necessary analyses required by the regulations. Even if a proposed legislative solution is workable for U.S.-based documentation, it is not clear at this time how foreign third-party information will be obtained, or how our trading partners will react to this development.

Finally, it is necessary to closely examine whether the regulations are compatible with arm's length standards internationally. Will our trading partners accept the emphasis of the regulations on a profits-based analysis and the de-emphasis of a transactional comparability? Will they accept the emphasis of the regulations on actual results (rather than projections), and the required annual re-examination and validation of the arm's length nature of multi-year transfers of intangibles? The concept of annually re-evaluating multi-year transfers generally is inconsistent with general business practices and international standards that focus on the facts and circumstances existing at the time an agreement is entered into to transfer an intangible. What will their reaction be to validating a transfer price determined by the resale price or cost plus method through the CPI?

How will our trading partners react to the general principle enunciated in the regulations as to how the arm's length standard should be applied? Will they be in agreement that it is appropriate to "second-guess" the business judgments of controlled taxpayers? What will their reaction be to the power of the IRS to integrate transactions and disregard either the existence or non-existence of contractual arrangements, especially when many countries are more formalistic in their approaches? The IRS's unilateral application of new approaches that may cause differences in heretofore internationally accepted standards will most likely lead to international double taxation in the absence of competent authority relief. Competent authority relief may not be available if contracting states apply different standards. These important issues must be examined closely to determine whether the regulations will provide a useful, practical and internationally acceptable framework for determining arm's length pricing.

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UNITED STATES:

A COMMENTARY ON HOW THE PROPOSED REGULATIONS AFFECT THE GENERAL PRINCIPLES OF SECTION 482 AS DESCRIBED IN THE EXISTING REGULATIONS AND IN CASE LAW

Michael B. Quigley

I. INTRODUCTION

On 24 January 1992 the Internal Revenue Service ("IRS") published new, proposed regulations under Section 482, primarily concerning rules for the determination of transfer prices for tangible and intangible property transferred between related parties, and cost sharing arrangements.[1]

The proposed Section 482 regulations, seen in the context of the language of the statute, its historical purpose, and recent legislative, administrative and political developments, have profound implications for multinationals.

The regulations propose a comparable profit analysis which is described in minute detail. The basic premise, however, is somewhat simple. If exact comparables (either a comparable uncontrolled price ("CUP") for tangibles or a matching transaction for intangibles) are not available, then any other method of determining transfer prices must be tested against a constructive income computed using profit level indicators derived from other companies. In short, measures of the profitability of unrelated third parties will be applied to the operating income of the taxpayer to determine a range of comparable profits in which the taxpayer's actual profit must fall. If the taxpayer's profit does not fall within the range then an allocation under Section 482 may be made.

While many questions remain to be raised about the details and application of the regulations, several questions, addressed to the broad structure and the policy of the regulations, can be raised immediately.

First, do the regulations, by extending the comparable profit method and, consequently, the commensurate with income standard, to tangible property (and implying that it will be applied to services) comply with the legislative history and purpose of Section 482? Second, how do the proposed regulations address significant lines of case law concerning the IRS's discretion (i) to second-guess taxpayer's business judgement, (ii) to disregard the independent significance of the sale of goods and the license of intangibles, (iii) to ignore the existence or absence of contractual arrangements, and (iv) regarding the burden of proof in Section 482 cases?

II. BACKGROUND OF SECTION 482 AND THE ADMINISTRATIVE AND LEGISLATIVE CLIMATE

Section 482 authorizes the IRS to make allocations between related parties to prevent the avoidance of tax or to reflect clearly a taxpayer's income. Section 482 or its predecessors have been a part of the tax law for over 70 years. In this time only one change of significance has been made to the language of the statute – the addition in 1986 of the requirement that income from the transfer or license of intangible property be commensurate with the income attributable to the intangible.

Since the earliest formulations of the federal tax law, the basic purpose of Section 482 has been to prevent artificial shifting of income from one related entity to another for the purpose of avoiding U.S. tax. In the words of one of the principal

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1. 57 Fed. Reg. 3,571 (1992).

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architects of the tax code which contained the predecessor to Section 482, its purpose was described as follows:

> I am afraid the device is being used increasingly – to incorporate a subsidiary and throw the profits one way or the other. If that subsidiary is a foreign corporation you can throw the profits to it; in other words, by selling products . . . at artificially high prices . . . you have got to know that they are not milking the subsidiary.[2]

The abuse to which Dr. Adams referred arises when one entity engages in transactions with a related entity that is subject to lower tax rates. Through the years the IRS has used its power to reallocate in many situations – where income has been shifted either among many domestic corporations to avoid the corporate surtax, or to foreign corporations located in tax havens or to domestic corporations with substantial tax preferences (e.g. possessions corporations). The celebrated cases involving pharmaceutical companies with outbound transfers of intangibles are noteworthy examples of the last category.[3]

In recent years the IRS has demonstrated a different and more aggressive use of Section 482. In cases the IRS is now investigating, the U.S. taxpayer is "favoured" with lower tax rates than its parent corporation (or other related parties to the scrutinized transaction). The focus on such cases represents a departure from the typical case in which the IRS has used its power under Section 482. Because foreign-controlled corporations no doubt prefer to pay lower overall taxes evenly distributed worldwide rather than higher taxes at home, it is hard to understand why such a situation would provoke a manipulation of transfer pricing to the detriment of the U.S. fisc.

Political concerns, exacerbated by the U.S. budget problem and trade deficits, also bear heavily on the administration of transfer pricing. Much public debate and congressional inquiry has focused on whether U.S. corporations controlled or wholly-owned by foreign corporations pay the required U.S. tax. In these times of budget short-falls and economic recession this inquiry has become acute.

Studies have analyzed industrywide and macroeconomic data to prove or disprove the contention that foreign-controlled corporations pay insufficient U.S. tax. Do foreign-controlled corporations report less taxable income and pay less tax than other U.S. corporations? The answer is not clear, and the explanations for any such disparity are even more elusive, although many are offered. Higher debt loads with concomitantly greater interest burdens, a willingness to charge lower retail prices and earn lower profit margins to gain market share, access to subsidized capital markets, and foreign currency fluctuations are among the many rationales offered. Of course, the IRS's concern and the focus of Section 482 is on the role, if any, of the manipulation of transfer prices.

The IRS has marshalled impressive resources to investigate possible transfer pricing abuses by foreign- controlled corporations. "International" examiners, "international" special trial attorneys and IRS economists are now widely deployed. Congress, sometimes at the IRS's behest and sometimes not, has greatly expanded both the IRS's power to collect information and foreign-controlled corporations' recordkeeping obligations. Designated summonses, formal document requests, Section 6038A and jumbo case Tax Court litigation have all recently become part of the Section 482 lexicon.

III. IS THE PROPOSED REGULATIONS' APPLICATION OF THE COMMENSURATE WITH INCOME STANDARD TO TANGIBLE PROPERTY JUSTIFIED?

With these considerations in mind, the first step in examining the scope of the proposed regulations is to look to the language of the 1986 amendment to Section 482 which justifies the promulgation of new regulations. The additional sentence added to Section 482 reads as follows:

> In the case of any transfer (or license) of intangible property (within the meaning of [S]ection 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

The first thing that is clear from the plain language of the statute is that its scope is limited; the commensurate with income standard applies only to transfers of *intangible* property. It is, of course, well known that the IRS's power under Section 482 is not limited to intangibles, and the existing Section 482 regulations have specific provisions addressing loans and advances (§ 1.482-2(a)), performance of services (§ 1.482-2(b)), use of tangible property (§ 1.482-2(c)) and sales of tangible property (§ 1.482-2(e)). However, the 1986 amendment to Section 482 did not directly affect these other provisions.

The purpose of the commensurate with income standard demonstrates its limited scope. Congress, mindful of the experience of U.S. taxpayers transferring high-profit intangibles to foreign corporations and possessions corporations, wanted to curtail the tax advantages available from such outbound transfers.

> There was a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers could result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.
>
> Congress was concerned that the provisions of [S]ections 482, 367(d), and 936 that allocate income to a U.S. transferor of intangibles may not have been operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations.[4]

The initial legislative proposal applied the commensurate with income standard only to outbound transfers; however, subsequently in conference, the standard was applied to inbound transfers of intangible property. It was not, however,

2. Statement of Dr. T.S. Adams, Tax Advisor, U.S. Treasury Department, before the Committee on Finance on 2 September 1921, at the Hearings on H.R. 8245, which became the Revenue Act of 1921.
3. *Eli Lily Co. v. United States*, 84 T.C. 996 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Commissioner*, 88 T.C. No. 16 (1987).
4. General Explanation of the Tax Reform Act of 1986 ("Blue Book"), at 1013-1014.

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extended to tangible property. The legislative history on this point is explicit:

> The conference agreement follows the House bill. The concerns addressed in the House bill originated in connection with transfers of intangibles from U.S. parties to foreign affiliates, particularly those operating in low-tax foreign countries. Consequently, the provisions of the House bill only were applied to transfers of intangibles from U.S. persons to their foreign affiliates. In view of the fact that the objective of these provisions – that the division of income between related parties reasonably reflect the relative economic activity undertaken by each – applies equally to inbound transfers, the conferees concluded that it would be appropriate for these principles to apply to transfers between related parties generally if income must otherwise be taken into account.[5]

Whether the tax avoidance problem that Congress perceived with high-profit intangibles in outbound transfers was also present with other intangibles and with inbound transfers is not subject to meaningful debate today. The 1986 amendment clearly covers all intangibles (not merely high-profit intangibles) and it is intended to apply with equal force to outbound and inbound transfers. It does not, however, extend beyond intangible property.

The proposed regulations utilize the comparable profit interval ("CPI") as a test of transfer prices of tangible property established under the resale price, cost plus or other "fourth" methods. In so doing the regulations extend the commensurate with income standard to tangible property. The justification offered for this is twofold.

First, the legislative history to the 1986 modification to Section 482 asked the IRS to give careful consideration to whether the existing regulations could be modified in any respect.[6]

Second, the application of the CPI to certain tangible property transfers is said to be necessary:

> because applying the comparable profit interval solely to transfers of intangibles would create an artificial and unwarranted distinction between the treatment of tangible and intangible property, and would lead to disputes in cases involving tangible property incorporating an intangible. Adoption of similar transfer pricing rules for the tangible and intangible components of the transferred property will eliminate or reduce the need to allocate the property's value between its tangible and intangible components and then to determine the profits attributable to each component.[7]

While it is quite correct that the legislative history of the 1986 Act asked IRS to comprehensively study whether the Section 482 regulations should be modified in any respect other than as to intangibles, neither of the justifications offered support the application of the commensurate with income standard to tangible property.

A study was, of course, undertaken and matured into the publication of the "White Paper",[8] in which IRS thoughtfully discusses the history of Section 482, the 1986 amendment, the economic theory underlying Section 482 and cost sharing arrangements. While the White Paper focuses primarily on intangible property, it does make some observations about tangible property.

The White Paper questions the sense of the regulations' preference of the resale price method over the cost plus method.[9] The resale price method has widest application to distributors, whereas the cost plus method most often applies to manufacturers. Consequently, a built inpreference for one method over the other is not practical. In the proposed regulations this preference is eliminated. This is a sensible change.

The White Paper also observes that a functional analysis is not described in the existing regulations, even though such an analysis is commonly employed by examining agents as part of a Section 482 examination, if not as a "fourth" method of pricing, at least as corroboration of the comparability of prices or transactions. Neither do the proposed regulations mention functional analysis explicitly, although elements of such an analysis are part of the computation of the CPI. However, one would expect from the wide use of a functional analysis by examining agents, its emphasis in the Internal Revenue Manual,[10] and the White Paper reference to it, that the proposed regulations would have given functional analysis greater weight.

Finally, the White Paper notes that intangibles are often transferred by incorporation into tangible property that is sold and that, consequently, setting a transfer price in such a case presents the same difficult issues as setting a royalty rate for a licensed intangible.[11] However, the White Paper does not propose, even in such cases, to apply the commensurate with income standard to tangibles.[12]

Congress did not extend the commensurate with income standard to tangibles, no doubt, because the standard was initially designed to address the outbound transfer of high- profit intangibles and the valuation issues presented in their license or sale. Congress did expand the scope of the standard to other transfers of intangibles. It did not, however, extend the standard to tangibles.

Further evidence of the limited scope of the amendment is the legislative history's specific rejection of the view that any inquiry into the appropriate payment for an intangible must be confined to facts in existence at the time of the transfer.[13] The legislative history endorses the use of periodic adjustments to payments made for intangibles in light of the actual profit experience of the transfer.[14] The legislative history cau-

5. H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986), at II 637.
6. Preamble, Proposed Regulations, Fed. Reg., at 3574, quoting H.R. Rep. 99-841, 99th Cong., 22 Sess. (1986), at II 637-38.
7. Preamble, Proposed Regulations, Fed. Reg., at 3574.
8. A Study of Intercompany Pricing Under Section 482 of the Code, Notice 88-123, I.R.B. 1988-49 (5 December 1988).
9. White Paper, Chap. 3, at 13.
10. I.R.M. 4233-27, Ex. 500-1, Economic Principles Involved in IRC 482 cases.
11. White Paper, Chapter 3, at 12-13.
12. The White Paper goes so far as to observe that, where intangibles have been incorporated into tangible property that is sold or rented, taxpayers have not been required to isolate the value of the intangible, citing Revenue Ruling 75-254, 1975-1 C.B. 243.
13. This legislative history and the enactment of the commensurate with income standard represents a rejection of the holding in *R.T. French v. Commissioner*, 60 T.C. 836 (1973), where the Tax Court held that the royalty established in a long-term license could not be challenged with data from subsequent taxable years.
14. Blue Book, at 1016.

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tions that annual adjustments are not required, and that minor variations in revenues do not warrant a Section 482 reallocation. The primary reason for the periodic adjustments (and the commensurate with income standard itself) was capsuled in these words:

> The problems have been particularly acute in the case of transfers of high-profit intangibles. Taxpayers may have transferred such intangibles . . . at an early stage, for a relatively low royalty, and taken the position that it was not possible at the time of the transfers to predict the subsequent success of the product.[15]

Such risks are not present in (i) the sale of tangible property which is not closely intertwined with intangible property, (ii) the sale of tangible property the price of which is determined by the resale price method,[16] or (iii) the sale of tangible property the price of which is determined by the cost plus method.

The proposed regulations' extension of the CPI to each of these situations is unwarranted. Arguably, the only case in which the CPI should be applied to tangible property is where the sale is closely intertwined with a high-profit intangible and neither the CUP, resale price or cost plus methods are applicable.

Moreover, the Preamble to the proposed regulations foreshadows the application of the CPI and commensurate with income standard to services.

> A similar allocation and valuation problem may arise in cases in which the transfer of services i[s] indistinguishable from the transfer of intangible property. See *Hospital Corporation of America v. Commissioner*, 81 T.C. 520 (1983). The Service solicits comments on how the services regulations (§ 1.482-2(b)) should incorporate the commensurate with income standard.[17]

For the same reasons that the commensurate with income standard should not extend to tangible property it should also not apply to services. Certainly, except in rare cases, the problems associated with the transfer of a high-profit intangible are not present where services are rendered. The contention that the commensurate with income standard is inapplicable has even more force in the context of services, which rarely can be the cause of a material distortion of income. This point is recognized by the safe haven which, for services that are not an integral part of the taxpayer's trade or business, requires that any reallocation under Section 482 for services be limited to the costs (not the value) of rendering such services.[18]

The dominant role of the comparable profit analysis over intangibles, as well as its aggressive application to tangible property (and possibly services), reflects too great an orientation towards the commensurate with income standard. This emphasis could have the effect of diminishing the importance of many factors which have historically been an integral part of both the arm's length standard and Section 482 analysis. The proposed regulations show the strain of attempting both to achieve the certainty of result that a true formulary method of apportionment could provide, and to remain faithful to the arm's length standard which intrinsically requires a fact specific analysis. While the proposed regulations contain general statements that maintain allegiance to the arm's length standard, the primary emphasis of the CPI and its apparent across-the-board application casts doubt on the primacy of the arm's length standard.

IV. OTHER PRINCIPLES WHICH THE PROPOSED REGULATIONS WOULD MODIFY

The proposed regulations, in addition to providing new rules for intangible and tangible property, alter some basic principles applicable to transfer pricing analysis. These rules are set forth in proposed regulation § 1.482-1(b).

Two important proposals can be considered together. First, the IRS may "consider the combined effect of all transactions of a controlled taxpayer with other members of the controlled group, as well as with uncontrolled taxpayers, before, during and after the taxable year under review. . . ." Second, the IRS may "disregard contractual arrangements, or the absence of contractual arrangements, between controlled taxpayers and instead give appropriate consideration to the taxpayers' actual conduct".

These provisions are clearly a regulatory override of two parts of the court's analysis in *Bausch & Lomb v. Commissioner*.[19] In *Bausch & Lomb*, the IRS argued that the sale price of contact lenses manufactured by an Irish subsidiary and the royalty paid by the Irish subsidiary should be analyzed together. The court rejected this approach and held that the price for the lenses (tangible property) and the royalty paid for theintangibles had independent significance.[20] Contrary to the court's ruling, the proposed regulations would permit the IRS to combine such transactions. Moreover, the *Bausch & Lomb* court rejected the IRS's argument that the Irish subsidiary was a contract manufacturer entitled only to its costs of production plus a reasonable mark-up. Vital to the court's holding was the absence of an output or requirements contract which would have obligated Bausch & Lomb to purchase the Irish subsidiary's product. The proposed regulations are drafted to enhance the IRS's ability to ignore the form of transactions selected by taxpayers, even when the form has independent economic significance, such as was the case in *Bausch & Lomb*.

The proposed regulations also, for the first time, permit the IRS to "second-guess" the business judgement exercised by a taxpayer. Under the proposed regulations, the general principle to be followed is:

> whether uncontrolled taxpayers, exercising sound business judgment on the basis of reasonable levels of experience (or, if greater, the actual level of experience of the controlled taxpayer) within the relevant industry and with full knowledge of the relevant facts, would have agreed to the same contractual terms under the same economic conditions and circumstances.[21]

15. *Id.*, at 1014.
16. Importantly, under the existing regulations, the resale price method is not applied in cases where more than insubstantial value is added by the use of intangible property. Reg. § 1.482-2(e)(3)(ii).
17. Preamble, at 3574.
18. Reg. § 1.482-2(b)(3). Moreover, services are not considered property (intangible or otherwise) and consequently do not give rise to an income stream susceptible to the commensurate with income standard.
19. 91-1 USTC 87,674 (2d Cir. 1991) aff'd 92 T.C. 525 (1989).
20. The same analysis was used in *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991).
21. Proposed Reg. § 1.482-1(b)(1).

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How this standard, which is fraught with issues over which reasonable people could differ, will be applied by IRS in specific cases is unknown. However, the "sound business judgement" standard seems directed at the argument which the IRS was unsuccessful in pursuing in *Eli Lily & Co. v. Commissioner*.[22] The IRS argued, and the Tax Court held, that it was "inconceivable" that a corporation would have transferred the valuable intangibles involved in the case to an unrelated party without compensation (e.g. lump sum payment, royalty or other agreement) sufficient to enable continuing research and development.[23] On appeal, this position was rejected. Essentially, the issue involved one of the role of business judgment in Section 482 analysis. The proposed regulations articulate a new and more stringent standard, under which the IRS will likely renew and continue the type of argument it pressed in *Lily* and *Searle*.

V. THE COMPARABLE PROFIT METHOD'S POSSIBLE IMPACT ON THE BURDEN OF PROOF

It is well known that a taxpayer challenging an assessment or deficiency made by the IRS bears the burden of proving the IRS action is incorrect. In a normal case the taxpayer will prevail if it is shown by a preponderance of the evidence that the IRS erred. In a Section 482 case, where the statute explicitly grants the IRS discretion to make allocations, a taxpayer can prevail only if it is shown that the Commissioner's action was arbitrary, capricious or unreasonable. Taxpayers properly bear the burden because, in the normal case, taxpayers possess the books, records and other information needed to establish the correctness of the return. Whether this is true in Section 482 cases has always been subject to some debate. However, the proposed regulations' heavy reliance on the CPI – which requires extensive third-party information – raises the question again. Perhaps the drafters of the regulations were sensitive to this point, because the preamble to the proposed regulations carefully reiterates the rules on the burden of proof. It is fair to ask whether, because the IRS has the best access to the detailed financial information (at least as to other U.S. taxpayers) required to determine and apply the CPI analysis, the burden of proof in such cases should be placed on the IRS rather than the taxpayer.

VI. SUGGESTED MODIFICATIONS

The difficulty of valuing intangible property is formidable. Such property is almost by definition unique property for which exact comparables cannot exist. However, reliance on comparisons of the profit of other companies that also possess intangibles as the primary method of determining transfer prices is unsatisfactory. Since intangibles themselves are fundamentally incomparable, it cannot be reasonably expected that a fuzzy approach of comparing company-by-company profit will achieve reliable results. The profitability of companies varies for an infinite variety of reasons and, in all but a few abusive cases, improper transfer pricing is not the likely or exclusive cause.

The arm's length standard, which has been the bedrock of Section 482 for many years and is fundamental to U.S. double taxation treaties and worldwide standards, should be respected not merely in form but also in substance. The CPI (and particularly its promulgation as a standard for tangibles and possibly services) does not satisfy this standard.

In response to such commentaries, the reaction from Treasury and IRS will likely be – don't criticize the proposed regulations unless you are prepared to offer an alternative. Indeed, if the comment process over the Section 6038A regulations offers any guidance, Treasury and IRS may be somewhat defensive. Interested taxpayers should take up this call and offer balanced suggestions and constructive criticism. The Treasury and IRS cannot seriously consider the wholesale rejection of the proposed regulations, and such recommendations will likely result in little change to the regulations when they are issued in final form. In this spirit a few suggestions are offered here.

The CPI should be limited to intangible property. The existing rules for tangible property transfers (and for services) should remain relatively unchanged. To prevent abusive situations where a substantial part of the value of tangible property is attributable to an intangible, a general rule for intertwined property should be included. However, there is no reason to apply the CPI (and with it the commensurate with income standard) to sales of tangible property where the value of any intertwined intangible property is not substantial. Surely Congress had in mind "blockbuster" or "breakthrough" pharmaceuticals and similar products when Section 482 was amended in 1986. The same standard should not apply to the sales of stereos, televisions, automobiles and motorcycles.

For the same reasons, a safe harbour in the form of more lenient rules for other than high-profit intangibles should be included. There is no reason that transfers of routine intangibles should be treated the same as high-profit intangibles, since the risk of an abuse is so much less. Nor is there any reason to scrutinize transfers between related parties where the non-U.S. party is subject to effective tax rates equal to or higher than the U.S. taxpayer with the same intensity as transfers to tax-favoured related parties. The regulations could so provide and such rules would give regulatory authority to the practical horse-sense many revenue agents already employ.

Rather than using the CPI as the absolute test, why not use it as one factor, perhaps an important one, among others? Under such a rule, if a taxpayer's transfer price yields a profit level within the interval the transfer prices will be respected. However, if the transfer price produces a profit level outside the interval the taxpayer would still be permitted to offer proof that such transfer prices are nonetheless arm's length. In other words, why not utilize the CPI in the same fashion as is contemplated in the OECD reports[24] and leave room for

22. 856 F.2d 855 (7th Cir. 1988).
23. Eli Lily, 84 T.C., at 1130. See also *G.C. Searle & Co. v. Commissioner*, 88 T.C. 252, 370 (1987) ("In an arm's length situation, it would be the height of corporate mismanagement to transfer the lion's share of the corporation's income-producing assets to another corporation solely for non-income producing stock and the right to perform compensated services for the transferee corporation").
24. "Transfer Pricing and Multinational Enterprises", Report of the OECD Committee on Fiscal Affairs (Paris: OECD, 1979); "Transfer Pricing and Multinational Enterprises – Three Taxation Issues", Report of the OECD Committee on Fiscal Affairs (Paris: OECD, 1984).

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alternative analyses. While with such a modification to the proposed regulations the IRS would lose the ability to argue that all transfer prices outside the comparable profit interval are per se non-arm's length, the IRS would gain by lending to the proposed regulations the flexibility to deal with the highly complex factual situations with which IRS is already faced (and untold complexities in the future) and foreign tax authorities and treaty partners would have much less to criticize.

Finally, the process of formulating legislation and regulations in the transfer pricing area could be improved. Too much emphasis is placed on the advice of those schooled in the adversarial arts. Litigators, and also examining agents, and those convinced that foreign-controlled corporations manipulate transfer prices seem to determine the transfer pricing legislation and regulations agenda. Consequently, a blizzard of onerous compliance measures have bombarded taxpayers in recent years.[25] The rules are developing in a haphazard way to the detriment of both taxpayers and the voluntary compliance system. One need go no further than to observe that the Section 6038A regulations, which require detailed product line financial statements (the utility of which is dependent on a profit split methodology) have little relevance to the CPI analysis the Section 482 proposed regulations require. Some hopeful signs are present. Notably, the flexibility and diligent effort demonstrated by IRS in the advance pricing agreement procedure. However, in the development of legislation and regulations in this intricate area a better job could be done of encouraging industry input. The best way this can be done is by involving industry groups in the process from the earliest stages and by IRS demonstrating that helpful, constructive suggestions will result in meaningful change and workable rules. Such a collaborative process is essential to the resolution of the tough issues presented by transfer pricing compliance and disputes.

VII. CONCLUSION

The words of Stanley S. Surrey in a commentary made after the final Section 482 regulations were promulgated in 1968 apply equally well today:

> This matter of allocation is thus not to be viewed as a typical skirmish between taxpayers and the IRS, involving only the typical parochial interests that normally color such skirmishes. On the contrary, its proper resolution is a challenge to the vision and statesmanship of those who speak of the present and coming stature of the "multinational corporation."[26]

As the complexity of multinational operations increases the challenge for both taxpayers and tax authorities will be to build upon the foundation established by the farsighted tax policy of Mr. Surrey, Dr. Adams, and others to establish rules that will serve well in the long term and not merely to address the "parochial interests" of one skirmish or another.

25. Section 982 formal document requests; Section 6038A recordkeeping requirements; designated summonses to suspend the statute of limitations; Section 482 valuation penalties.

26. Stanley S. Surrey, "Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482", *Journal of Taxation* (February 1968), at 75. This quote is also cited in James P. Fuller, "Section 482: Revisited Again", 119 *Tax Review* (1990), at 63.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

JUNE 1992

Effective International Tax Management, Brussels (Belgium), 22-23 June (English):
Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: +3225161911, Fax: 3225137108.

US/Int'l Tax Planning & Compliance under Subpart F and The Foreign Tax Credit Provisions, London (U.K.), 25-26 June (English):
The American Tax Institute in Europe, 8-10 Bulstrode Street, London W1M 5FT, United Kingdom, Tel.: (0)71-9357502, Fax: (0)71-9356951/1308.

Planning for Euro-Trust and Euro-Estates, Geneva (Switzerland), 29-30 June (English):
IBC Legal Studies and Services International Ltd., 57-61 Mortimer Street, London W1N 7TD, United Kingdom, Tel.: (0)71-6374383, Fax: (0)71-6313214.

JULY 1992

Offshore Tax Planning for Business, London (U.K.), 3 July (Engllish):
IBC Legal Studies and Services Ltd., 57-71 Mortimer Street, London W1N 7TD, United Kingdom, Tel.: (0)71-6374383, Fax: (0)71-6313214.

Tax Planning for International Treasury Operations in Europe, Old Windsor, Berkshire (United Kingdom), 7-10 July (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard London EC4V 5EX, Tel.: (0)71-7798601, Fax: (0)71-7798599.

International Taxation and Asset Financing, London (United Kingdom), 8-10 July (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard London EC4V 5EX, Tel.: (0)71-7798793, Fax: (0)71-7798795.

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UNITED STATES:

PROPOSED SECTION 482 REGULATIONS: COMPATIBILITY OF USE OF THE COMPARABLE PROFIT INTERVAL WITH INTERNATIONAL NORMS

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In announcing the proposed regulations under Section 482, representatives of the Internal Revenue Service and the Treasury Department stated that the methods for applying the commensurate with income standard contained in the regulations are compatible with international standards. Accepted international practice is to apply an "arm's length" standard that looks to whether uncontrolled parties dealing at arm's length would enter into a similar transaction on similar terms. It appears that in some respects the regulations are not compatible with international norms. Use of the comparable profit interval ("CPI") in determining prices for transfers of *tangible* property is a departure from accepted international practice, at least where the use of so-called "fourth methods" is not required. However, use of the CPI in determining prices for transfers of intangible property appears generally compatible with such international norms as exist.

I. TANGIBLE PROPERTY

The regulations prescribe the use of three primary methods in determining transfer prices for tangible property – the comparable uncontrolled price method, the resale price method and the cost plus method. Use of these methods is consistent with international practice. Where the regulations depart from international practice is in requiring that tangible property transfer prices determined using the resale price and cost plus methods be validated using the CPI.

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A. *The 1979 OECD Report*

The leading statement of international practice on transfer pricing is the 1979 report of the Organization for Economic Cooperation and Development ("OECD") on Transfer Pricing and Multinational Enterprises (the "1979 OECD Report").[1]

The 1979 OECD Report envisages using four possible methods for determining a transfer price for tangible personal property: the first three methods (which are similar to the three primary methods described in the regulations) and any other method (the so-called "fourth methods").[2] Fourth methods are to be used when the first three methods cannot be used.[3] However, the Report does suggest that fourth methods might be used to verify transfer prices derived by one of the first three methods.[4]

The fourth methods discussed in the 1979 OECD Report involve analysis of profits, but they are all suggested with diffidence, and the implication is that they should not be used as primary methods, at least unless no other approach is available. Nevertheless, the 1979 OECD Report states that:

> Tax authorities may find some help in a comparison of an enterprise's overall performance with that of other similar enterprises in the same or similar circumstances. Levels of a profit in an industry may for example conform to a pattern and an exception to the pattern might indicate that profits were being shifted by artificial transfer prices.[5]

However, the Report immediately goes on to say that: "But comparisons of this sort would need to be made with care. It does not necessarily follow that exceptional profits or losses are artificial."[6] Furthermore, the Report suggests that a profit analysis might best be used to determine whether to initiate a transfer price inquiry, not to validate the results of such an inquiry. It states that:

> It may be profitable nevertheless to make comparison of this sort [ratio of profits to sales or operating expenses] in relation to the gross profits from sales of particular products or groups of products but even so the results of the comparison could normally be regarded only as pointers to further investigation.[7]

The Report takes the same view of comparisons of yield or return on capital:

> But this too is an arbitrary assumption: the profit made by a comparable independent concern would not necessarily bear any particular relationship to the return on investment in other ways. Although therefore such an approach might have some value in indicating a reasonable range of possible profit margins the concept of a "normal" return on capital invested is too imprecise to be likely to be useful in isolation.[8]

Thus, the Report does not envisage use of fourth methods as a primary method when one of the other three methods can be reasonably used. It also implies that while fourth methods based on profits may be useful in asking transfer pricing questions, they ordinarily should not be used alone in answering them.

B. *Major U.S. trading partners*

Transfer Pricing contains some material about the practices of other countries with regard to transfers of tangible property. This material suggests that using a profits analysis in determining prices for transfers of tangible property, at least when one of the first three methods is available, would be viewed as contrary to accepted practice.[9]

1. Canada

Revenue Canada has published guidance on its transfer pricing policies in Information Circular 87-2, "International Transfer Pricing and Other International Transactions" (27 February 1987).[10] This Circular states that it is "not to be construed as a formal interpretation of the law but rather an explanation of the basis on which the Department considers that the 'arm's length principle' is reflected in the Act".[11]

The Circular sets out the first three methods, and then goes on to state that "[o]ther methods may be employed in support of one of the three aforementioned methods or in circumstances where none of these methods is appropriate".[12] The examples which it cites for this purpose involve consideration of cost of direct materials, full cost, value as a replacement part and value as a fraction of the value of a larger unit.[13] Profits-based fourth methods are not mentioned. Indeed, while the Circular states that these other methods may be employed in support of one of the first three methods, it provides that "[t]he method utilized should reflect an attempt to present the particular transaction in terms of what would have transpired in an arm's length relationship".[14] Accordingly, the Canadian view appears to emphasize the use of comparables with little emphasis, and no indicated requirement, for profits-based methods.

Canada has one reported case of which we are aware, in which a court appeared to use a profits analysis as part of a fourth method.[15] This case involved invoicing aluminum billets through an offshore company, and the Court apparently accepted evidence from the Canadian tax authorities based on a functional analysis of the companies involved, and referred to the *Du Pont* case as an example of such an analysis.[16]

2. France

A commentator has stated that France will use profit indicators as a sign of whether transfer prices are or are not acceptable.[17]

1. Reprinted in International Bureau of Fiscal Documentation, *The Tax Treatment of Transfer Pricing* (IBFD: Amsterdam, 1987 & Supp. 1991)(hereinafter, "Transfer Pricing").
2. *Transfer Pricing*, at 1979 OECD Report – 24.
3. *Transfer Pricing*, at 1979 OECD Report – 31.
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Transfer Pricing*, at 1979 OECD Report – 32.
9. Note, the chapter for Japan has not yet been released.
10. Reprinted in *Transfer Pricing*, at Canada – 65-76.
11. *Transfer Pricing*, at Canada – 65.
12. *Id.*, at 70.
13. *Id.*
14. *Id.*
15. *Indalex v. The Queen*, 86 *Dominion Tax Cases* 6039 (Canada Fed. Ct. Trial Div. 1986), rev'd on other grounds; 86 *Dominion Tax Cases* 6053 (Canada Fed. Ct. App. 1986). This case is summarized in Boidman, "Transfer Pricing in Canada", *Transfer Pricing*, at Canada 1-88, 26-29.
16. *E.I. Du Pont de Nemours & Co. v. U.S.*, 608 F.2d 445 (Ct. Cl. 1979), cert. denied, 445 U.S. 962 (1990).
17. Goldsmith, "Transfer Pricing in France", in *Transfer Pricing*, at France 1-84, 22.

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3. Germany

The former Fiscal Counselor in the German Embassy to the United States states that fourth methods are not to be used as a replacement for the first three methods when one of such methods is available:

> Under the German TPG[18] these [fourth methods] are not considered to be standard methods for deriving the arm's length price for an individual transaction. Rather, they are considered as additional or auxiliary tools for the examination of the international income allocation.[19]

The German TPG provides that the first three methods are standard methods.[20] As to fourth methods, the German TPG states that:

> In applying the principles mentioned thus far, the business results which the taxpayer, a related person or unrelated parties have achieved under comparable business conditions from comparable transactions with unrelated parties can be used as a basis to identify areas which warrant special examination, to verify transfer prices or to obtain supplementary criteria for the income allocation. The combined results of connected business operations and their apportionment to the individual business operations within a group of enterprises can also be used for this purpose. The income allocation can be based on the results within the meaning of the 1st and 2nd sentences alone if, because of special circumstances (e.g. where merchandise or a category of merchandise is acquired or produced, processed and marketed in a substantial quantity solely within vertically structured groups of enterprises) the standard methods would not lead to appropriate results; the same applies in the cases mentioned in [the next paragraph] . . . .
>
> In special cases it is not possible to compare the actual circumstances with a similar situation involving unrelated parties, above all where, applying the criteria of [arm's-length dealing], business dealings of the kind in question would not have come about between unrelated parties or would only have come about with an essentially different commercial content. In these cases the allocation is to be based on the appropriate apportionment of the income arising from the series of transactions overall which sound business managers would have determined.[21]

Thus, the German view appears to be that where the first three methods can be used, fourth methods may be appropriate as investigative tools or checks, but are not to be primarily used.

4. Italy

Italy also appears to view fourth methods as inappropriate for primary use when the first three methods are available. A Circular Letter from the Ministry of Finance has the following to say about fourth methods:

> The "alternative" method will prove useful:
>
> (a) subsidiarily, when (i) in the check for the correct application of the three basic methods, some uncertainties should arise; (ii) the necessity arises of singling out the differential factor between two transactions susceptible of comparison for the purpose of the application of one of the three principal methods;
>
> (b) alternatively, where no possibility absolutely exists of applying the three basic methods.[22]

5. United Kingdom

An Inland Revenue release indicates that, in setting transfer prices, the United Kingdom generally would look to the first three methods and follow the OECD Report, but "will in practice use any method which seems likely to produce a satisfactory result".[23] One commentator has stated that Inland Revenue might use profits-based methods if nothing else appeared likely to work.[24]

C. *Summary for tangible property transfers*

While international practice appears to admit of using some form of profits analysis to determine whether tangible property transfer prices need investigating, or whether a transfer price derived by another method makes sense, it does not appear to be the general view that tangible property transfer prices must produce an "acceptable" profit to satisfy the arm's length standard. In particular, the general view appears to be that if the first three methods[25] can be used, transfer prices so determined will not be required also to pass a profits test. The White Paper[26] correctly states that the 1979 OECD Report authorizes inquiries into profits. But even the White Paper does not attempt to argue that use of profits-based methods with respect to tangible property is compatible with international norms when the first three methods can reasonably be used.[27] Accordingly, in the case of tangible property, it appears that using the CPI in determining transfer prices is incompatible with international norms in situations where the first three methods can be reasonably used.

If the first three methods cannot be reasonably used, then, as will be discussed in more detail below, it would appear that looking to profits is not per se objectionable, and there is no specific feature of the CPI which appears to clearly violate international norms. However, neither the 1979 OECD Report nor any of the materials available to us concerning the major U.S. trading partners' practices suggests relying on an analysis of profits as strongly as do the regulations.

18. This is the letter of the Federal Minister of Finance of 23 February 1983, concerning principles for the examination of income allocation in the case of internationally related enterprises (IV C 5 – S1341 – 4/83) (hereinafter, "German TPG"), official translation reprinted in *Transfer Pricing*, at Germany (Fed. Rep.) – 53-87 [footnote added].
19. Jacob, "Transfer Pricing in the Federal Republic of Germany", in *Transfer Pricing*, at Germany (Fed. Rep.) – 1-93, 17.
20. German TPG §2.2, in *Transfer Pricing*, at Germany (Fed. Rep.) – 63.
21. German TPG §§2.4.5 – 2.4.6, in *Transfer Pricing*, at Germany (Fed. Rep.) – 65.
22. Circular Letter No. 9.2267, issued by the Italian Ministry of Finance on 22 September 1980; the transfer prices in the computation of taxable income of enterprises subject to foreign control (hereinafter, the "Italian Circular"), unofficial translation reprinted in *Transfer Pricing*, at Italy – 57-92, 76.
23. Revenue Note on the transfer pricing of multinatonal enterprises, reprinted in *Transfer Pricing*, at United Kingdom – 58-61, 60.
24. Collins, "Transfer Pricing in the United Kingdom", in *Transfer Pricing*, at United Kingdom – 1-61, 27.
25. Comparable uncontrolled price, resale price and cost plus methods.
26. Treasury Department, Office of International Tax Counsel, Office of Tax Analysis and Internal Revenue Service, Office of Assistant Commissioner (International), Office of Associate Chief Counsel (International), "A Study of Intercompany Pricing" (Discussion Draft 18 October 1988) (hereinafter, the "White Paper"), reprinted as Notice 88-123, 1988-2 C.B. 458, 476.
27. The discussion on the compatibility of profitability-based transfer pricing with international norms, at White Paper 59-61, 1988-2 C.B., at 475-77, is explicitly about transfers of intangible property.

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II. INTANGIBLE PROPERTY

In the case of intangible property, the "internationally accepted" methods for determining transfer prices are not well developed. Methods most often used appear to include an analysis of profits. This generally accords with the proposed regulations' methods for intangibles, which are profits-based in that they require CPI validation.[28] Nevertheless, it is not clear that the weight of international practice norms rely solely on an analysis of profits, although there is precedent for doing so in particular cases.

A. *The 1979 OECD Report*

The 1979 OECD Report recognizes that the determination of an arm's length consideration based on similar unrelated transactions frequently will be unusable in the case of intangible property, because there will be nothing comparable on which to base an analysis.

> In many cases, it will be difficult to find satisfactory comparable open market transactions since the owner of intangible property (and particularly the owner of a patent) is essentially the owner of a monopoly right which he may not make available to unrelated enterprises. It is considered that it is unlikely to be possible to construct any standard rates, such as a certain percentage of sales, as even within a given sector of industry it is extremely difficult to discern any typical rate or range of rates.[29]

The report states that no one particular method is appropriate in such a situation.[30] It does suggest that a profits-based method might be appropriate, although not without difficulties, and might be more useful to indicate the need for further investigation than as a final answer:

> It appears that one of the common approaches employed in practice is to make a pragmatic appraisal of the trend of an enterprise's profits over a long period in comparison with those of other unrelated parties engaged in the same or similar activities and operating in the same area. There could, of course, be many reasons for an unusual profit situation and it may be possible for the taxpayers to give satisfactory explanations for particular cases. The profit comparison approach thus remains more in the nature of an indication that the consideration charged for the use of intangible property may or may not be reasonable. Recourse to a comparison of the proportionate profits of the licensor and the licensee achieved thanks to the development and the use of the intangible property would not be a promising method. It would be very difficult to isolate the respective profits of the licensor and the licensee since a number of rights may be under license at the same time for the manufacturing of different products .... In addition there is the difficulty of knowing how to apportion the overall profit between the licensor and the licensee.[31]

Thus, while using profits analysis as a tool in analyzing transfer prices for intangibles is not incompatible with the OECD view, relying solely on a profits analysis would appear to be incompatible with the OECD view.

B. *Major U.S. trading partners*

1. Australia

A commentator has suggested that the Australian tax authorities might use an allocation of overall profits, or a comparison of profits earned by similar enterprises, in a case that could not be analyzed under one of the first three methods.[32] He also states that when the Australian tax authorities are auditing a transfer price for intangible property, some of the questions are aimed at determining profits, and whether a third party would be willing to pay such a royalty to achieve such profits.[33]

2. Canada

Information Circular 87-2 states that in determining a transfer price for intangible property, if no good comparable exists:

> The best that can be expected is to draw comparisons with royalty rates in the same industry or a similar industry involving relatively similar products, similar market conditions, and similar licensing arrangements.
>
> The following items might be expected to have a bearing on the determination of a royalty rate: (a) prevailing rates in the industry; (b) terms of the license, including geographic limitations and exclusivity rights; (c) singularity of the invention and the period for which it is likely to remain unique, (d) technical assistance, trade marks, and "know-how" provided along with access to the patent; (e) profits anticipated by the licensee; and (f) benefits to the licensor arising from sharing information on the experience of the licensee.[34]

Thus, although there appears to be precedent in Canada for using an analysis based in whole or in part on profits, it would seem that the Canadian approach to transfer prices of intangible property would not be based exclusively on profits.

3. Germany

In respect of German practices for determining transfer prices for intangibles, it is said that the Federal Tax Office maintains a royalty file for use in determining an acceptable royalty rate.[35] If this is not helpful and the cost plus method cannot be applied, it appears that profits might be examined on the theory that no one dealing at arm's length would agree to pay a royalty which would not allow an acceptable commercial profit.[36] Indeed, as discussed above, the German TPG apparently explicitly envisages using profits-based methods if the first three methods cannot be applied. Thus, it appears that Germany often has regard to profits analysis in determining transfer prices for intangibles, and might even make a determination based entirely on profits analysis.

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28. Of course, under the regulations the primary method is the matching transaction method, which does not require validation under the CPI. However, the matching transaction method is available only in such narrowly defined circumstances that there is little likelihood of its applicability in practice. Therefore the other two methods presumably will be predominant.
29. *Transfer Pricing*, at 1979 OECD Report – 38.
30. *Id.*, at 39.
31. *Id.*
32. Dominic, "Transfer Pricing in Australia", in *Transfer Pricing*, at Australia – 1-102, 35. Mr. Dominic also refers to Case 53, 11 *Commonwealth Taxation Board of Review Decisions* (new series), a tangible property case, which we have not seen, but which is summarized in *Transfer Pricing*, at Australia – 42-49, and appears to be primarily a CUP case.
33. *Transfer Pricing*, at Australia – 50.
34. *Transfer Pricing*, at Canada – 74.
35. *Transfer Pricing*, at Germany (Fed. Rep.) – 33.
36. *Id.*; German TPG §5.2.3, in *Transfer Pricing*, at Germany (Fed. Rep.) – 75.

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4. Italy

The Italian Circular acknowledges that, in transfers of intangibles, good comparables will rarely exist.[37] When comparables are not available, the Italian Circular appears to take an eclectic approach, looking at both the profits of the licensor and licensee, and an analysis of the nature and value of the rights transferred.[38] The Italian tax authorities have set forth certain safe harbours.[39]

5. Netherlands

The information we have been able to find concerning the practices of the Netherlands suggests that in the case of licensing companies (as opposed to original licensors or end users), the Netherlands tax authorities have an extensive file and they have set safe harbours for acceptable royalties.[40]

6. Switzerland

One commentator has suggested that in the case of goods and services that are exclusive property of a company, presumably including most intangible property, the tax authorities will look at overall profits and profit splits. This would only be done if there were no good comparables available to demonstrate the price paid by people dealing at arm's length.[41]

C. *Summary for intangible property transfers*

International practice with respect to intangible property, as in other situations where a fourth method must be used, is not completely settled. Germany and the Netherlands admit to using a file of royalties; presumably they are not unique. It appears that setting transfer prices from a profits analysis is explicitly permitted in Canada and Germany, and is not necessarily unacceptable elsewhere. Accordingly, the principal difference between the proposed regulations' use of the CPI in the case of intangible property and the norms of international practice would seem not to be the use of a profits analysis, but the regulations' elevation of profits analysis to the status of a preferred method. The White Paper correctly states that the international view appears to be that when there is no comparable (which is generally the case with intangibles), the methods used often look to profits analysis.[42] Nevertheless, it would seem there is no accepted international norm requiring that such methods be based solely, or even primarily, on a profits analysis.

37. *Transfer Pricing*, at Italy – 82.
38. *Id.*, at 82-84.
39. *Id.*, at 84-85.
40. Ellis, "Transfer Pricing in the Netherlands", in *Transfer Pricing*, at Netherlands – 1-50, 21-22.
41. Luethi & Digeronimo, "Transfer Pricing in Switzerland", in *Transfer Pricing*, at Switzerland – 1-30, 8-10. Mr. Luethi is a vice director of the Swiss Federal Tax Administration.
42. White Paper, at 60, 1988-2 C.B., at 476.

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UNITED STATES:

PROPOSED TRANSFER PRICING REGULATIONS UNDER SECTION 482 OF THE INTERNAL REVENUE CODE*

Robert T. Cole and Gilbert W. Rubloff

The Internal Revenue Service ("IRS") released its proposed revisions to the U.S. transfer pricing regulations on 24 January 1992.[1] This action follows the 1986 amendment to Section 482 of the Internal Revenue Code which added the requirement that the payment for transfers (or licences) of intangibles be commensurate with the income attributable to such property,[2] as well as the Treasury Department's issuance in 1988 of a White Paper dealing with the new statutory provision and related topics.[3] The next steps will be for the IRS to receive comments on the proposed regulations, to hold public hearings and to then promulgate final regulations. The deadline for comments and requests for public hearings was 29 May 1992.

Although the IRS' proposals are subject to modification and generally would not go into effect until 1993, as discussed below they can and should be taken into account now in resolving any existing transfer pricing disputes and for planning purposes.

The proposed regulations replace with a new regime the provisions of the current regulations that deal with transfers of intangibles, including licences and sales of intangibles. These new intangibles rules also would apply to sales of goods in which intangibles are a material factor and where services are provided involving intangibles that are a material factor. The regulations for transfers of other tangible property would continue in effect, but they have been substantially modified to reflect some of the concepts applied to intangibles.

Set forth below are the key features and implications of the proposed regulations. A more detailed description of the new regulatory rules follows.

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I. KEY FEATURES AND IMPLICATIONS

– *The proposed regulations significantly alter the manner in which transfer prices for both intangible and tangible property will be reviewed by the IRS, by reference to a range of operating profit.* The centrepiece of the proposed regulations is a bottom-line operating profit analysis that will apply except in all but those rare instances where near-perfect comparables are available. This analysis effectively attributes to taxpayers engaged in related-party transactions an amount of operating income somewhere within a range, referred to in the regulations as the comparable profit interval ("CPI"), that the taxpayers would have earned had their performance been equivalent to comparable businesses operating at arm's length. The CPI concept represents important progress, providing a measure of flexibility to taxpayers, since, until recently, the IRS still thought in terms of only a single correct transfer price. It is also intended to narrow the magnitude of disputes by discouraging both the IRS and the taxpayer from taking extreme positions.

– *The proposed regulations are extremely technical and complex and introduce new areas for dispute.* The computation of the CPI involves a host of new concepts and terms (e.g. the "tested party", "applicable business classification", "profit level indicators", "constructive operating income", and "convergence"). Also, in order to construct a CPI, one needs detailed financial information regarding similar businesses. At the time needed, such data often may be either inaccessible (for example, the comparables are privately-owned) or non-existent (for example, the comparables are divisions or segments of integrated companies). Moreover, the selection of businesses whose data are to be used and the actual use of the available data requires a series of subjective judgements, each of which presents a potential source for disagreement.

* This article also appears in the March/April 1992 issue of *The Tax Executive*.

1. *Intercompany Transfer Pricing and Cost Sharing Regulations under Section 482*, Prop. Treas. Reg. § 1.482, 57 Fed. Reg. 3571 (1992). As the name indicates, the proposed regulations also include new regulatory provisions relating to cost sharing arrangements. This subject is not discussed in this article.
2. Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, 2561-63 (1986).
3. *A Study of Intercompany Pricing*, IRS Notice 88-123, 1988-2 C.B. 458 (commonly referred to as the "White Paper"). For a discussion of the White Paper, see Cole, "Working with the Section 482 White Paper" 41 *Tax Executive* (Winter 1989), at 137.

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– *The proposed regulations are not structured to facilitate the prospective setting of complying transfer prices.* The proposed regulations generally require a comparison of a related party's operating profit ratios with those of comparables for the tax year at issue, as well as the first preceding year and the first succeeding year. Thus, by definition, most of such information will not be available in advance. An advance pricing agreement ("APA") may be helpful in this respect.[4]

– *The proposed regulations adopt various positions the IRS has taken in audits and, without success, before the courts.* The proposed regulations contain provisions addressing the significance of the presence or absence of related-party contracts, the ability to consider together related transfers of tangible property and intangibles, the comparison of data from different years, and the need to consider the effects of sales volumes and other factors in assessing whether arm's length transactions may be used to establish a comparable uncontrolled price. All such issues have been the subject of dispute in recent court decisions.[5]

– *Foreign acceptance of the U.S. concepts may be necessary to avoid double taxation.* Certain of the transfer pricing methodologies and principles embodied in the proposed regulations are somewhat novel and, accordingly, may not be fully understood by, or acceptable to, the tax authorities of other countries. Obviously, if two different sets of rules are applied in a cross-border transfer pricing dispute, any competent authority proceedings designed to avoid double taxation may be severely inhibited unless the results of the differing approaches happen to coincide. In this connection, the Treasury Department has undertaken a programme to obtain international acceptance of the new U.S. concepts.

– *An APA may become the best way for a taxpayer to ensure that its transfer pricing practices will not be challenged by the IRS.* The uncertainties and other problems resulting from the new regulations make it all the more advantageous for a taxpayer to consider an APA. At the present time, it is the only way to effectively resolve, in advance, the myriad of transfer pricing issues that will invariably arise under the proposed regulations. An APA would be especially useful, for example, in making such difficult determinations (required by the proposed regulations) as identifying the tested party, choosing the applicable business classification, determining the relevant comparables and profit level indicators, making appropriate adjustments, and establishing convergence. In addition, the competent authority procedure, which is an integral part of the APA process, offers the opportunity to confront and resolve differences with our treaty partners before they materialize, rather than after the fact.[6] This process requires agreement of each treaty partner, and to date a significant number of U.S. treaty partners have agreed to the process on a general or experimental basis.

– *Comments can be presented to the IRS and constructive changes suggested.* Interested taxpayers and organizations may provide the IRS with their written comments on the proposed rules. There will also be a public hearing which should serve as a useful forum to provide input to the IRS. While it might be tempting to dwell on the defects and shortcomings of the new rules, it should be recognized that many of the IRS' proposals will undoubtedly survive. Thus, taxpayers may eventually find themselves in the position of having to convince foreign tax authorities to accept, not reject, the new U.S. regulatory provisions. The ultimate goal should be for IRS (and foreign tax authorities) to adopt rules that will serve as a basis for uniform international standards and procedures.

– *Treasury's imminent report to Congress on transfer pricing may produce legislation.* In addition to the regulatory process, it is important to note that the Treasury Department has prepared a report to Congress on transfer pricing which was due 2 April 1992. This report could result in legislative changes, including procedural refinements and, possibly, major substantive changes (although Treasury is on record as opposing substantive changes).

– *Taxpayer reporting and recordkeeping obligations continue.* The proposed regulations do not address reporting and recordkeeping in the Section 482 context, although the preamble to the proposed regulations suggests that new requirements may be issued in the future.[7] For foreign-owned taxpayers, Section 6038A and the regulations thereunder also remain in effect.[8] The application of the recordkeeping obligations under Section 6038A, however, should be heavily influenced by the new Section 482 regulations, since the Section 6038A regulations contain an overriding relevancy limitation. In addition, the Section 6038A regulations include a procedure for obtaining District Director agreements on recordkeeping and record production both in connection with an APA and otherwise.[9] Again, such agreements should be heavily influenced by the proposed regulations.

– *Measures should be taken now to reduce exposure to substantial Section 482 adjustments and penalties.* A 1990 amendment to the Code established severe penalties for net transfer pricing adjustments which exceed $ 10 million, unless the taxpayer can establish that it acted in good faith and with reasonable cause.[10] While the new regulations do not address the penalty provisions, they do accord better treatment to those taxpayers whose transfer prices produce profits that are within or are only slightly outside the CPI. *The clear message to taxpayers, therefore, is that they should be prepared to establish that they have made a reasonable effort to comply with the statutory and regulatory requirements regarding transfer pricing.* As previously indicated, this can

4. Guidelines on securing advance pricing agreements were issued by the IRS in Rev. Proc. 91-22, 1991-11 I.R.B. 11.

5. See, e.g. *U.S. Steel Corp. v. Commissioner*, 617 F.2d 942 (2nd Cir. 1980); *Sundstrand v. Commissioner*, 96 T.C. 226 (1991); *Bausch & Lomb v. Commissioner*, 92 T.C. 525 (1989), *aff'd* 933 F.2d 1004 (2nd Cir. 1991).

6. On the same date the IRS issued Rev. Proc. 91-22, it also issued Rev. Proc. 91-23, which updates the procedures for requesting competent authority resolution of disputes under U.S. tax treaties.

7. 57 Fed. Reg. 3571, 3577 (1992). The Preamble states: "[Q]uestions regarding documentation and penalties will be addressed in [S]ections 6001, 6038, 6038A, 6038C, and 662(e) rather than under [S]ection 482."

8. Treas. Reg. § 1.6038A, adopted by T.N. 8353, 14 June 1991.

9. Treas Reg. § 1.6038A-3(e); see also Rev. Proc. 91-38. Agreements may establish the records that must be maintained, how the records must be maintained, the retention period, by whom the records are to be maintained, which industry segment profit and loss statements are material and a variety of other matters. In most instances the requirements will be reduced as compared to the safe harbour of the regulations.

10. IRC Sec. 6662(e) and (h). Where the net transfer pricing adjustment exceeds $ 10 million, the penalty is equal to 20 percent of the adjustment, and where the amount exceeds $ 20 million, the penalty becomes 40 percent.

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be achieved with certainty by securing an APA. For those taxpayers who do not wish to proceed with an APA, they may be required to show that their transfer prices were set with due consideration given to the statute as revised in 1986 and to the proposed regulations as an official (although preliminary) expression of what the statute means. At a minimum, therefore, every affected taxpayer should consider a review and a revision, as necessary, of its current transfer pricing policies and practices and be in a position to demonstrate the good faith and reasonableness of such policies and practices.

II. DESCRIPTION

A. *Transfers of intangibles*

The proposed regulations prescribe, in order of priority, three methods for ascertaining an arm's length consideration for transfers of intangibles:

(1) the matching transaction method ("MATCH");[11]
(2) the comparable adjustable transaction method ("CAT");[12] and
(3) the comparable profit method ("COMP-PROFIT").[13]

Neither the IRS nor the taxpayer is required to establish the inapplicability of a higher priority method before applying a lower priority method.[14] In the absence of an agreement, however, either party has the option of establishing the applicability of a higher priority method.

It is important to note that these three methods will govern any transfer of an intangible in a controlled transaction, including transfers of intangibles occurring through a sale of goods or the rendition of services – as long as the income attributable to the intangible is "material" in relation to the income attributable to the tangible property or services to which it relates.[15] In applying these methods, the realm of comparables has been expanded by eliminating the rigid geographical and temporal restrictions of prior law. On the other hand, neither the CAT method nor the COMP-PROFIT method will be regarded as applicable unless they produce results that are within the CPI.[16]

1. MATCH method

The MATCH method entails matching controlled and uncontrolled transactions to one another to determine an arm's length consideration for the controlled transaction. Transactions are considered a match (or comparable) if the *same* intangible is transferred in both the controlled and uncontrolled situations and the contractual terms and surrounding economic conditions are either the same or substantially similar. The requirements for application of the MATCH method are quite strict. The intangible involved must be essentially identical in the two sets of transactions. Furthermore, although adjustments can (and must) be made for differences in economic conditions and/or contractual terms (including geographic and use restrictions), adjustments are permissible only if they are few in number and, taken together, they have only a "minor effect" on the consideration charged. Since the MATCH method relies on the most complete and accurate data and requires the fewest adjustments, it has the highest priority where it is applicable.

2. CAT method

The CAT method also involves recourse to comparable arm's length transactions, but its application is considerably broader than that of the MATCH method. The CAT method may be used where the intangibles in the controlled and uncontrolled transactions are not exactly the same. The intangibles and their stages of development must still be sufficiently similar, however, so that the differences can be accounted for through adjustment and with reasonable accuracy in fixing the terms of an appropriate consideration for the controlled transaction. Adjustments for differences in economic conditions and/or contractual terms must also be made, but are permissible even if they are not few in number or minor in effect. The only requirement is that the adjustment for each material difference must be based on reliable and accurate data and be reasonably susceptible of quantification. Although the proposed regulations provide a series of examples to illustrate the circumstances in which the CAT method may or may not be applied,[17] they contain very limited guidance as to how to make appropriate adjustments or, for that matter, how to locate and select transactions that will be deemed suitable CAT comparables. As discussed below, the result of the CAT method must be validated by the CPI.

3. COMP-PROFIT method

The COMP-PROFIT method must be used whenever both the MATCH and CAT methods are inapplicable. The COMP-PROFIT method utilizes the CPI to determine a transfer price, rather than simply for verification. Since the COMP-PROFIT method focuses primarily on profits, its application requires the least transactional comparability between the controlled and uncontrolled transactions. The COMP-PROFIT method involves attribution of the operating profit levels actually realized by those independent businesses that are *most similar* to the controlled parties, based on the best available information. It is the method of last resort. It appears, therefore, that the COMP-PROFIT method is intended to be usable in virtually any situation. (The proposed regulations do not indicate whether there are any circumstances in which the COMP-PROFIT method would be inapplicable or how an arm's length consideration is to be determined if there is a total absence or unavailability of data reflecting the financial performance of relevant comparables.) Again, the proposed regulations do not provide sufficient guidance for finding or choosing COMP-PROFIT method comparables and, consequently, these matters still remain a fertile field for disputes between the IRS and taxpayers.

4. Effect of CPIs

As stated, both the CAT method and the COMP-PROFIT method require construction of a CPI.[18] For the CAT method

11. Prop. Treas. Reg. § 1.482-2(d)(3).
12. Prop. Treas. Reg. § 1.482-2(d)(4).
13. Prop. Treas. Reg. § 1.482-2(d)(5).
14. Prop. Treas. Reg. § 1.482-2(d)(2)(iii).
15. Prop. Treas. Reg. § 1.482-2(d)(1)(iii).
16. Prop. Treas. Reg. § 1.482-2(f)(1).
17. Prop. Treas. Reg. § 1.482-2(d)(4)(vi).
18. Prop. Treas. Reg. § 1.482-2(f)(1).

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to be valid its results must fall within the CPI; if not, the CAT method cannot be used. A CPI also is used to determine the extent to which the IRS can make an adjustment of the transfer prices reported by the U.S. taxpayer where the COMP-PROFIT method is used. If the reported results are such that the operating profit of the tested party is within the CPI, the IRS cannot make an adjustment.[19] If, however, the operating income of the tested party falls outside the CPI, the IRS adjustment is to take into account how far outside the interval the tested party's operating income falls (unless either no consideration was paid for the transferred intangibles or the consideration paid was substantially disproportionate to the value of the intangibles, in which case the adjustment will be based on the "most appropriate point" in the CPI).[20] Accordingly, taxpayers falling well outside the CPI will find their adjustments made based on the "most appropriate point" in the interval, whereas the adjustments for taxpayers close to the interval may be smaller than necessary to reach the "most appropriate point" in the interval. An example in the proposed regulations and statements made by Treasury officials suggest that this procedure will result in a dollar-for-dollar adjustment. That is, for each dollar outside of the CPI, there is an adjustment of the same number of dollars within the CPI, but not beyond the "most appropriate point". However, the dollar-for-dollar concept has not been expressed as a specific rule because the Treasury recognizes that there might be disagreement on the parameters of the CPI. This adjustment rule is designed to encourage taxpayer efforts to comply with the proposed regulations. When considered in combination with the reasonable cause exception to the transfer pricing penalties, taxpayers have a strong incentive to take the proposed regulations into account in formulating their transfer pricing programmes.

B. *Sales of tangible property*

The proposed regulations retain the same methods of pricing for tangible property as those set forth in the original regulations: the comparable uncontrolled price ("CUP"), resale price and cost plus methods.[21] The CUP method continues to have first priority if CUP comparables are available. In applying CUP, the proposed regulations include a list of additional factors that must be evaluated for price effects: sales volume, inventory turnover rates, and advertising and warranty practices.[22]

Where the CUP method is inapplicable, the decision as to whether to use the resale price or cost plus approaches depends upon which method relies on the most complete and accurate data and requires the fewest and most readily quantifiable adjustments. (This rule contrasts with the priority of the resale price method over the cost plus method under the current regulations.)[23] The proposed regulations note that ordinarily recourse to the resale price method is more appropriate where a manufacturer sells products to an affiliated distributor that resells the articles without further processing or the use of significant intangibles. If, however, the affiliated buyer further processes the products or uses significant intangibles, the cost plus method will normally be more appropriate.[24] As in the case of the existing regulations, recourse to a so-called "fourth" method is authorized, but only if the CUP, resale price and cost plus methods have not been applied.[25] (As in the case of the provisions dealing with intangibles, the inapplicability of a higher priority method can be assumed until its applicability is established.) The new regulations specifically confirm that "fourth" methods may include analyses based on profit level indicators, such as operating margins, rates of return on assets and Berry ratios.[26]

The proposed regulations' most significant change to the rules relating to the sale of tangible property is the requirement that a transfer price determined under the resale price, cost plus or any "fourth" method must produce a level of operating income for the controlled party that is within the CPI.[27] As in the case of CAT, if the results produced by the resale price method or the cost plus method do not fall within the CPI, the method is deemed inapplicable. Apparently, other methods must then be tested until one produces results within the CPI. In assessing the reliability and applicability of "fourth" methods for pricing tangible property, the method that produces a result that is at or closest to the "most appropriate point" within the CPI will be regarded as the best approach.

The new regulations permit the IRS to apply each of the pricing methods to product lines or other groupings where there are a large number of transactions and it is impractical to ascertain an arm's length price for each transaction. The IRS is further allowed to employ "reasonable statistical sampling techniques" for this purpose.[28]

The scope of the tangible property pricing methods are significantly reduced because of the rule that requires application of the intangible pricing methods to transfers of property (or the rendition of services) if the income attributable to associated intangibles is material. The tangible property pricing methods would continue to apply, however, where the relevant intangibles are developed by the transferee of the tangible property, since, in such circumstance, no controlled transfer of an intangible is involved. In this situation, the proposed regulations generally would apply the cost plus method, reversing the priority of the resale price method under the existing regulations.

C. *The comparable profit interval ("CPI")*

As indicated above, the construction of a CPI – a range of profitability – is the most meaningful innovation included in the new regulations. Conceptually, it constitutes a potential "safe harbour" zone for transfers of intangibles in transactions that do not lend themselves to the MATCH or CUP methods. The problem, of course, is that in the absence of an APA, a

19. Prop. Treas. Reg. § 1.482-2(d)(5)(ii).
20. Prop. Treas. Reg. § 1.482-2(d)(5)(iii).
21. Prop. Treas. Reg. § 1.482-2(e)(1)(ii).
22. Prop. Treas. Reg. § 1.482-2(e)(2)(ii).
23. *Compare* Prop. Treas. Reg. § 1.482-2(e)(1)(ii) with Treas. Reg. § 1.482-2(e)(1)(ii).
24. Prop. Treas. Reg. § 1.482-2(e)(1)(ii).
25. Treas. Reg. § 1.482-2(e)(1)(iii); Prop. Treas. Reg. § 1.482-2(e)(1)(iv).
26. Prop. Treas. Reg. § 1.482-2(e)(1)(iv).
27. Prop. Treas. Reg. § 1.482-2(e)(1)(iii), (iv).
28. Prop. Treas. Reg. § 1.482-2(e)(1)(v).

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taxpayer can have no assurance that the range it believes is justified is one that the IRS will accept. Nonetheless, the mere recognition by the IRS that there is an acceptable range of profits offers an element of flexibility lacking in the old regulations and affords taxpayers significant opportunity to minimize exposure to Section 482 adjustments and penalties.

There are six steps involved in constructing the CPI.[29] Several of these steps entail essentially mechanical or arithmetic procedures. At least three of the steps, however, will require considerable skill and knowledge, as they involve locating, assembling, interpreting, adjusting, and applying commercial and financial data and information. The six steps are as follows:

Step One: Select the controlled party whose profits are to be tested.[30] The tested party can be any one of the affiliated businesses that is a party to the controlled transaction, including an entity that is not under examination by the IRS. This may thus include a foreign party not subject to U.S. taxation. Since the tested party should be the one whose operating income can be verified using the most reliable data and with the fewest adjustments, the tested party normally will be the transferee in the case of a transfer of an intangible.[31] Where there is a transfer of tangible property, if the resale price method is being applied, the tested party ordinarily will be the related buyer (reseller) of the products; where the cost plus method is used, the tested party ordinarily will be the seller in the controlled transaction.

Step Two: Find the comparables whose profitability will be used to establish the CPI.[32] Comparable businesses whose functions and circumstances are most similar to the relevant operations of the tested party must be identified. To identify relevant comparables, it will ordinarily become necessary to define and isolate (or segment) the particular controlled operations to be tested and then correlate them to those of businesses dealing with one another at arm's length. The delineation of the tested operations by function, product, market or the like, should be as broad as possible to encompass all potential comparables, yet sufficiently narrow so as to include only relevant data and information. Needless to say, the selection (and appropriate segmentation) of proper comparables is critical, since, if there is any serious error at this point, the succeeding steps in the analysis are rendered academic.

Step Three: Compute the "constructive operating income" of the tested party based on the financial performance of the comparables.[33] The "constructive operating income" of the tested party is computed by applying the profit level indicators ("PLIs") derived from the comparables to the tested party. The ability to perform this exercise depends on the extent to which reliable data is available for the comparables and the extent to which the PLIs provide a reliable basis for comparing the profits of the uncontrolled parties to those of the tested party. Once again, the new regulations leave the taxpayer to its own devices. However, the revised rules do specify which PLIs the IRS may regard as probative. They are:

- rate of return on assets (ROA)
- ratio of operating income to sales (operating margin)
- ratio of gross income to operating expenses (Berry ratio)
- other margins (such as the ratio of operating income to labour costs or the ratio of operating income to all expenses other than those included in cost of goods sold)
- comparable profits splits (residual and overall).[34]

The proposed regulations indicate that the IRS will also consider any other indicator that reflects a perceptible relationship between "various factors" and income if the taxpayer can demonstrate that the indicator can be, and is in fact, reliably applied.

The actual computation of the tested party's constructive operating income involves imputing to the tested party a dollar amount of income equal to that which it would have realized had it experienced the same PLI results as the potential comparables. This can be done by using several different PLIs derived from a single potential comparable or by using one or more PLIs derived from multiple potential comparables. Before these calculations are made, however, it is necessary to adjust the financial data for the tested party in two ways: (i) to reflect any Section 482 allocations other than those made for transfer pricing purposes but that affect the tested party's income, and (ii) to reconcile material differences between the accounting treatment employed by the potential comparables and the tested party. In this latter regard, it is particularly important to restate assets and income where, for example, the tested party's financial assets or inventory are inordinately high (or low) in relation to the potential comparables.

To illustrate the application of Step Three, assume that a potential comparable's ROA for the tested period was 28.4 percent, its operating margin was 12.5 percent and its Berry ratio was 138.5 percent. After adjustment of the tested party's financial statement to conform it to that of the potential comparable, the amount of the tested party's income is recalculated by imputing to it the same ROA, operating margin and Berry ratio as that of the potential comparable. To the extent other potential comparables can be found, the process is repeated, forming a data base as comprehensive as the available and reliable information will permit.

Step Four: Determine the Comparable Profit Interval ("CPI").[35] The CPI is determined by selecting those amounts of constructive operating income derived from the potential comparables for the tested party which converge to form a range that "is reasonably restricted in size". The economic theory underlying this procedure is that where there is a convergence of the constructive operating incomes (i.e. the com-

29. Prop. Treas. Reg. § 1.482-2(f)(3).
30. Prop. Treas. Reg. § 1.482-2(f)(4).
31. This assumes that the transferee will not have its own self-developed intangibles. If it does, it is far from clear who the tested party should be. Is it the party with the least valuable intangibles, or does one test both parties? In the latter case there would be two CPIs to deal with. The proposed regulations do not provide guidance on how to proceed in such circumstances.
32. Prop. Treas. Reg. § 1.482-2(f)(5).
33. Prop. Treas. Reg. § 1.482-2(f)(6).
34. Definitions of various accounting terms relevant to all the PLIs, such as "sales", "gross income", "operating expenses", "operating income" and "assets", are provided at Prop. Treas. Reg. § 1.482-2(f)(6)(iii)(B). The computational methods for the various PLIs are provided at Prop. Treas. Reg. § 1.482-2(f)(6)(iii)(C).
35. Prop. Treas. Reg. § 1.482-2(f)(7).

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parables' PLIs produce similar amounts of imputed profits for the tested party), such results indicate that the potential comparables and the tested party are similar. Proceeding from this premise, the converging constructive operating incomes can be used to set the boundaries of the CPI. Where there is divergence, the disparate PLI data will be excluded unless further adjustments can be made to reduce the differences to acceptable levels.

The proposed regulations include a number of examples that demonstrate how the CPI is formed and how the data is to be construed and applied. One of the most informative examples involves a situation where the tested party is an exclusive U.S. distributor of its foreign parent's products.[36] Eight potential comparables are identified and their ROAs, operating margins, and Berry ratios are used as PLIs. Since their individual PLIs vary considerably from company-to-company, they produce a rather broad range of constructive operating incomes, some of which are well above or well below the tested party's actual reported income. However, the constructive operating incomes derived from four of the potential comparables are clustered together. According to the proposed regulations, this "convergence" provides persuasive evidence that these four independent distributors are not only similar to one another, but that the tested party, had it been operating at arm's length, should have registered operating income within the range of operating incomes derived from these particular comparables. Accordingly, the CPI for the controlled U.S. distributor was fixed by the constructive operating incomes of these four closest comparables. The data for the other potential comparables was disregarded.

Step Five: Determine the "most appropriate point" within the CPI to set the tested party's arm's length income.[37] In cases where the CPI is not being employed merely to validate the results under a priority method, the "most appropriate point" in the range may have to be determined. This would be required where the COMP-PROFIT method is used and the reported results of the tested party are not within the CPI or close to it. It would also be needed to test a "fourth" method under the rules relating to tangibles. The proposed regulations provide that if statistical techniques were used to construct the CPI, the most appropriate point should be determined using statistical measures of central tendency. If statistical techniques were not used, various qualitative factors are to be considered, with special weight being accorded to those particular comparables and PLIs that appear to be most relevant.

Step Six: Determine the transfer price for each controlled transaction.[38] This final step, applicable only when Step Five becomes operative, simply involves the conversion of the "most appropriate point" within the CPI to a transfer price for the controlled transactions.

D. *Other noteworthy provisions*

Other provisions in the proposed regulations that should be noted include the following:

1. Despite the 1986 amendment to Section 482, the proposed regulations state unequivocally that the arm's length standard will continue to apply in all instances. The language of the general regulatory provisions has been amended, however, to provide that the test to be applied in all intercompany dealings is whether uncontrolled taxpayers "exercising sound business judgement" would have agreed to the same terms given the actual circumstances under which the controlled taxpayers dealt.[39]

2. Under the proposed regulations, the IRS will be authorized to consider the combined effect of all transactions between members of an affiliated group to determine their respective "true taxable income" and to make allocations of income on the basis of the realities, rather than the legalistic formalities, of the controlled transactions.[40] Thus, for example, the new regulations specifically permit the IRS to treat a party that sells its entire output to an affiliate as a contract manufacturer even if there is no contract requiring the latter to purchase all the seller's output.

3. The proposed regulations attempt to clarify ownership of an intangible for Section 482 purposes:

- In the absence of a qualified cost sharing arrangement (whether actual or as constructed by the IRS), there is a single tax owner depending on who qualifies as the "developer". Other participants in the process are referred to as "assister".
- In determining who is the developer of the intangible, greatest weight will be given to who bore the costs and risk of developing the intangible and who made available (without adequate compensation) property and services contributing to its development. Other relevant factors include the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer controls the project and the actual conduct of the controlled taxpayers. Any assister must be compensated for its services or for a deemed loan, and the developer alone is entitled to the income from the intangible.
- In an apparent attempt to augment U.S. tax revenues, the proposed regulations illustrate the developer-assister rule with an example in which a U.S. subsidiary which distributes its foreign parent's products is treated as the developer of the "enhanced U.S. rights to the trade name" that is legally owned by its foreign parent. This determination is predicated on the fact that the U.S. subsidiary has paid the promotional and advertising expenditures that have popularized the trade name in the U.S.[41]

36. Prop. Treas. Reg. § 1.482-2(f)(ii)(Example 3).
37. Prop. Treas. Reg. § 1.482-2(f)(8).
38. Prop. Treas. Reg. § 1.482-2(f)(9).
39. Prop. Treas. Reg. § 1.482-1(b)(1).
40. Prop. Treas. Reg. § 1.482-1(b)(1).
41. See Prop. Treas. Reg. §1.482-2(d)(8)(iv)(Example 4). A careful examination of this example suggests that its appropriate scope may be relatively narrow. In the example, the U.S. subsidiary incurred $5 million of expenses promoting the trade name for which it was not reimbursed by its foreign parent. It would appear, however, that assuming the U.S. distributor earned normal levels of operating income in each year, it would be incorrect to conclude that the U.S. distributor had not been effectively reimbursed for the expenses of promoting the trade name in the U.S. The very fact that the distributor realized a normal amount of income would indicate that it had either been directly reimbursed for its promotional expenditures or that reimbursement had been reflected in the transfer prices it was charged.

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4. The IRS will be expressly empowered to make periodic adjustments (normally on an annual basis) to long-term arrangements involving intangibles, with limited exceptions.[42]

5. While the proposed regulations include overall profit splits and residual profit splits as PLIs, as a practical matter their use will be quite limited because these methods cannot be applied except where comparable (arm's length) splits between uncontrolled parties can be found.

6. Because the IRS is normally obligated to consider a controlled party's performance in the year before and the year after the one under examination, it may very well become possible for a taxpayer to avoid a Section 482 allocation in a single aberrant year (e.g. a year in which its actual results are outside the range of normal profitability for that one period).

E. *Effective date and related matters*

It is proposed that the new regulatory rules will become effective for taxable years beginning after 31 December 1992.[43] Nevertheless, the 1986 commensurate-with-the-income amendment to the statute is generally effective for taxable years beginning after 31 December 1986. The amendment does not apply, however, to existing intangibles transferred (or licensed) to foreign persons before 17 November 1985, or to others before 17 August 1986. While it appears that the grandfather provisions are not applicable to Puerto Rico and other U.S. possessions, a contrary argument can be made.

According to the preamble to the proposed regulations, until 1993 the statutory amendment is to be applied using any "reasonable method" not inconsistent with the statute. The IRS further states that it will consider a method that applies the proposed regulations or their general principles to be a "reasonable method". Thus, the proposed regulations are clearly relevant to any taxable year and transfer covered by the 1986 amendment. For earlier transactions, the proposed regulations set forth methods that may well make business and economic sense in particular circumstances, and, therefore, can properly be considered both by the taxpayer and the IRS as "fourth" methods under the existing regulations.

Since the new regulations were issued in proposed form and comments have been solicited, it is quite possible that some of its provisions may undergo further revision. In this regard, the IRS has specifically requested comments with respect to (i) the possibility of creating "safe harbour" profit ranges constructed by reference to pre-established benchmark standards such as published rates of return on assets, (ii) the recognition of PLIs other than those identified in the proposed rules and (iii) the treatment of lump-sum payments.

Finally, it should be observed that the IRS seems to recognize the problems involving availability and access to appropriately refined comparable data needed for purposes of selecting the most appropriate pricing method and developing CPIs. In this connection, while the IRS believes it currently has the authority to summons third party comparable information, it is sensitive to the dual concerns that the business upon which the summons is served is entitled to confidentiality for its trade secrets, while the taxpayer under audit is entitled to review and "cross-examine" the data sources. Possible legislative approaches are being explored.

III. CONCLUSION

The proposed Section 482 regulations deal with one of the most important and perplexing international tax issues now being addressed by taxpayers and governments alike. The IRS' acceptance of an income range concept, its adoption of a "sound business judgement" standard and its focus upon operating income are all positive developments. But there are still a great many problems that must be solved.

If the final regulations are to advance the interpretations and administration of the statute, they must be workable. In addition, they must be acceptable in principle (if not application) to the international tax community, so that probably the threat of double taxation will be materially reduced. At a minimum, this will probably require simplification of the CPI concept and/or additional elements of regulatory flexibility, such as the introduction of predetermined safe harbours. Transfer pricing administration must also be made more consistent and predictable.

The IRS also needs to seriously consider the fundamental question of which taxpayers ought to be subjected to intensive transfer pricing scrutiny. For all practical purposes the multinational businesses that operate in high tax-rate countries are tax stakeholders and are essentially neutral as to how the respective taxing authority share the revenues.

42. Prop. Treas. Reg. § 1.482-2(d)(6).
43. 57 Fed. Reg. 3601 (1992) (to be codified at 26 C.F.R. pt. 1, par. 4).

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INTERNATIONAL:

TRANSFER PRICING IN THE 1990s: DO THE LATEST U.S. DEVELOPMENTS RELATE TO A GLOBAL ECONOMY?

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I. INTRODUCTION

The release by the United States of proposed new regulations governing transfer pricing in the United States will force other countries to consider just where the transfer pricing issue is heading. Since 1986 the United States has consistently sought to tighten up its rules in this area and the draft regulations provide the latest focus for assessing the extent to which the United States has broadened its tax base looking towards a larger share of the total tax take on cross-border investment. More importantly, the question also needs to be asked whether there is anything in the U.S. approach that relates to the changed needs of transfer pricing provisions in a global economy.

The initiative against foreign-owned U.S. businesses was seemingly motivated, in important part, by the success of Japanese products in the U.S. market on the one hand, and on the other, by the scant success of U.S. products in the Japanese market, and the remote likelihood that Japanese-owned U.S. subsidiaries would contribute taxes to the U.S. Treasury. However, the U.S.'s concern about its eroding national tax base, reflected in its reaction to foreign investment, is not confined to the Japanese. A number of the U.S.'s longstanding trading partners who have traditionally shown no particular hostility or aversion to U.S. investment in their countries are now finding themselves considering whether the United States has tilted the playing field unacceptably against foreign investment in the United States or, more generally, has sought to impose through its transfer pricing rules a systematic bias in favour of allocating multinational income to the United States.

Most of the developed nations are potentially affected by the U.S. developments, but the two main cross-border investor/trader countries with the United States are the United Kingdom and Canada.

A. *U.K. AND U.S. cross-border investment*

It is the United Kingdom which is the largest foreign investor in the United States with 31.5 percent of foreign investment, way ahead of Japan which is in second place with only 16.9 percent.[1] Unlike Japan, there is considerable reciprocity. SOI figures[2] quoted by Ways and Means Oversight SubCommittee Chairman, J.J. Pickle at the hearing in Washington on 10 and 12 July 1990 ("the Pickle Hearings") show that U.S. companies reported $ 102 billion sales in the United Kingdom, just behind Canada with $ 108 billion, and way ahead of Germany with $ 72 billion and Japan with $ 28 billion. Figures[3] show that in 1990 the United Kingdom accounted for 25 percent of all U.S. exports to the European Community (EC), which is the largest export market for the United States. The United States is also a major investor in the United Kingdom which is, in addition, the main gateway for U.S. investment into the EC which now forms a larger market than the United States.[4]

B. *The special Canadian/U.S. relationship*

Canada, with its border with the United States, has longstanding special links. These are, and have for some time, been reflected in two ways. First, between Canada and the United States there is substantial bilateral trade generally and intra-

1. 1989 figures for international trade, released by the Association for International Investment.
2. Statistics of Income data produced by the U.S. Internal Revenue Service.
3. U.S. Department of Commerce.
4. Figures for 1990 show GDP: United States $ 5,423.4 billion, EC $ 5,925.2 billion, Japan $ 2,812.48 billion, Canada $ 649.4 billion.

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firm trade in particular.[5] Second, there are strong structural links such as the recently entered Canada-U.S. Free Trade Agreement, which contemplates the reduction and ultimate elimination of tariff barriers and other impediments of trade. There is also the longstanding (since 1965) Automotive Products Trade Agreement (the "Auto Pact").

The economies of Canada and the United States are connected functionally and structurally in important ways. In some respects, proposals in the recent Canadian budget (25 February 1992)[6] which are designed to protect and stimulate the Canadian manufacturing sector are evidence of this. The budget proposes certain domestic corporate income tax rate reductions and a phased-in reduction in treaty withholding tax rates on direct (substantial investment) dividends which, interestingly, will result in a tax rate bias in favour of carrying on manufacturing in Canada. At present, to the extent that tax rate structures are material to locations decisions, there is a tax bias away from Canada of some four percentage points of tax.

C. *Resolution of transfer pricing disputes*

Both Canada and the United Kingdom have a history of amicably resolving transfer pricing issues with the United States under competent authority procedures and there are established communication channels, together with an amount of goodwill. However, it would be unrealistic to expect that this system could, or indeed should, cope with the explosion of transfer pricing disputes that will arise with the emerging global economy. The way forward has to be by recognizing that transfer pricing is due for a substantial change of emphasis and analysis and that any workable solution has to be based on an internationally acceptable system.

II. THE EMERGENCE OF TRANSFER PRICING

A. *Initial purpose*

Transfer pricing provisions were first introduced at the time of World War I, the United Kingdom enacting legislation in 1915, closely followed by the United States in 1917. The Canadian transfer pricing provisions originated in the Income War Tax Act (which applied before 1949) and continue in modified form in the present law. The aim of the legislation was simple. War had meant higher taxes and businesses were to be discouraged from tax avoidance by pricing goods and services too cheaply to foreign associates or purchasing goods and services from those associates at high rates in order to deplete taxable profit in the high tax country and accumulate profit overseas in a foreign associate which was subject to a lower rate of tax overseas.

Thus the initial role was as much preventative as operational, for once provisions were on the Statute book, an obvious tax deficiency had been remedied. It did not matter that if a dispute did arise, it could be difficult, time consuming and costly to resolve.

The period of economic recovery after World War I was swiftly followed by the world depression of the 1930s, and then by World War II, so transfer pricing did not really become an issue of much concern until the late 1960s when international trade and investment began to reach new heights.

B. *Expansion of international trade and investment*

By the mid 1970s, increased communication and technological advances had meant that the developed nations, which were inevitably high tax countries, had a problem on their hands preserving their tax base. Governments and fiscal authorities responded on two fronts.

First, expertise was developed in transfer pricing matters. There was particular emphasis on transactions where research and development were conducted (tax deductible) in high tax areas, but the larger share of profits from the fruits of that research were held and exploited by an offshore company. Industry statistics were often used as a guide when adjusting prices. The major developed nations worked together through the OECD and produced two reports on transfer pricing: "Transfer Pricing and Multinational Enterprises" in 1979, and a second report "Transfer Pricing and Multinational Enterprises, Three Taxation Issues", in 1984. The three issues were corresponding adjustments and mutual agreement procedures, multinational banking enterprises and allocation of central management and service costs. The second report was more sophisticated than the first, indicating then how fast transfer pricing was moving on.

Second, the aggressive use of tax havens by domestic corporations was dealt with by introducing a new type of anti-avoidance legislation – the controlled foreign corporation ("CFC") provisions which attribute back to the country of the parent company profits accumulated in offshore subsidiaries. Examples include the U.S. Subpart F legislation, Canadian foreign affiliate (and in particular the "foreign accrual property income" ("FAPI") rules), the German Aussensteuergesetz and the U.K. controlled foreign company provisions. This legislation provided a simpler solution to catching transactions with special pricing which allocated profits to subsidiaries in low tax areas. The CFC legislation does not, of course, provide a solution for offshore parent companies who extract higher than arm's length payments from their subsidiaries, although withholding taxes on interest and royalties can have a part to play here; likewise limitation of benefit provisions in tax treaties. Thin capitalization provisions may also hit aggressive use of debt financing.

The 1980s ended with the fiscal authorities, albeit some reluctantly, demonstrating an awareness that the complex issue of how to adapt transfer pricing to the emerging global economy was not something that could be avoided in anything other than the very short term.

5. A study, "International Investment: Canadian Developments in a Global Context", by Investment Canada (January 1991) describes the significance of U.S.-Canada bilateral trade. For example, in 1985 almost one-half of all exports from the United States to Canada and one-third of exports from Canada to the United States were accounted for by intra-corporate trade.

6. For a discussion of the Budget, see Sapona, "1992 Budget: Easing the Burden", 46 *Bulletin for International Fiscal Documentation* (March 1992), at 248.

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III. TRANSFER PRICING IN A GLOBAL ECONOMY

A. *Nature of multinational operations*

The 1980s saw the development towards a global economy. As the 1990s arrived so, without doubt, did a global economy become a fact. Its existence can no longer be denied.

The operational blueprint of a multinational enterprise ("MNE") has changed. To continue to operate successfully in a fast moving world, an MNE often centralizes technical research, financial management and marketing and has to be ready to switch manufacturing or assembly to where cost efficient or trained labour is available to cope with a new product. Management must communicate across three eight-hour time zones and do so almost instantaneously by fax or telephone. The "brain" of an MNE is no longer all in one place at any one time, or, unlike tax regimes, necessarily associated with any particular national jurisdiction.

The less sophisticated transactions which transfer pricing was originally devised to deal with are now largely obsolete.

Transfer pricing *was* about tax avoidance in a background of relatively straightforward international trade and investment. It applied only to a small percentage of international transactions. Tax avoidance was often at the centre.

Transfer pricing *is now* about allocation of income of an MNE between nations. It applies to virtually all international transactions of an MNE and, because of technological advancements and split functions, an MNE has more international transactions than ever before. Tax avoidance, if present, is at the margins, not at the centre.

B. *Decline of the national product*

Perhaps the most indicative as well as disturbing aspect of the global economy is the decline of the national product and this could well be at the forefront of the reluctance of governments to address some of the problems. Robert B. Reich writing in the *Harvard International Review*[7] made the point that "[t]he notion that products have national origins is so deeply ingrained that governments and the publics they represent are unable to adjust to emerging reality"; and he identified the decline of the national product as meaning that:

- international trade is not in finished products but in components which are then combined to create value;
- trade no longer occurs in arm's length transactions between buyers in one nation and sellers in another;
- trade occurs between people within the same global web who are likely to deal repeatedly with each other across borders.

Relating this economic distinction to transfer pricing, the fact is that many persons within a given global web may be related parties to which transfer pricing provisions will apply.

C. *Commercial v. fiscal authority approaches*

The two main difficulties in allocating the income and expenditure between all parties within a global web for tax purposes are:

- there is a massive gap between commercial thinking and fiscal authority thinking;
- each global web has its own specialities and approaches and there are few if any reliable directly comparable transactions outside that global web.

It does not seem that the gap between commercial thinking and fiscal authority thinking will lessen in time. On the contrary, it may only broaden. Fiscal authority thinking is national not global, and works solely (or at least principally) on methodology for establishing individual transaction profit. By contrast, commercial thinking of an MNE is global not national, the emphasis is on consolidated accounts or results; individual transaction profit may not be a yardstick. For example, centralization may be the most important factor as in Japanese business methods, unit location may be important and is a traditional U.S. business approach, cash flow may be a leading factor in financial trades, and total world sales may be the yardstick for a few specialist products, such as automobiles.

The fiscal authorities who themselves have access, albeit on a confidential basis, to detailed information on various competitors within an industry often seem unable to comprehend that the competitors do not have that same detailed information about each other. Even if they did, two competitors in the same market may have important differences in commercial approach. Though a successful business will always monitor some aspects of what competitors are doing, the commercial thrust comes from internal technological and product developments or a response to customer requirements.

D. *International system v. protection of domestic tax base*

It follows that in the global economy of the 1990s transfer pricing poses problems that can only be solved by an internationally acceptable system for the allocation of income of an MNE. In many instances profit split, by design or by effect if not by name, will be the answer. To be avoided at all costs is a situation where high tax countries ("HTCs") expand their domestic tax bases by transfer pricing methodology; this would be a race to the bottom in which there would be no winners, only losers. The global economy would be stifled by economic double taxation and important economic activity would be directed away from HTCs.

Though theoretically the mutual agreement procedure ("MAP") under the tax treaty network might be said to be of assistance in alleviating problems of double taxation, in practice it is a lengthy process, and always potentially unsatisfactory in that the competent authorities are only bound to attempt to reach agreement; failure to agree is always a possibility. MAP is no more than an unsatisfactory fall-back provision when things go wrong, and that is the crux of the issue. MAP equals failure. It applies when the domestic tax systems of countries do not agree on what is an arm's length price on a cross-border transaction; the solution is to find a workable international system. MAP is also unhelpful in a planning context, operating as it does in relation to past events put in issue by tax authorities.

7. Robert R. Reich, "Multinational Corporations and the Myth of National Origin", *Harvard International Review* (Summer 1991).

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IV. THE U.S. SECTION 482 PROPOSED REGULATIONS

A. *Relaxation of White Paper approach*

The encouraging aspect of the proposed regulations is that their introduction clearly demonstrates an understanding and perhaps sensitivity that the central problem is international allocation of income of an MNE. However, this advance in thinking is then undermined somewhat because the perceived solution is expressed in conventional methodology, e.g. the prominence of matching transaction and exactly comparable transaction tests. More importantly, perhaps, any approach that draws its strength or significance from the conventional methodologies ignores the fundamental international concern, i.e. the interjurisdictional allocation of income that, increasingly, has no national home. In many instances the regulations may have the effect of enlarging the U.S. tax base and so leaving MAP to deal with the problem of economic double taxation.

Certainly the proposed regulations, with the main emphasis on intangibles (including patents, know-how, copyrights, trade marks, franchises, methods, technical data, etc.) contain some welcome relaxation from what was foreshadowed in the 1988 White Paper.[8] There are implied suggestions that the U.S. tax policymakers recognize that transfer pricing analysis is unlikely to yield an arithmetically correct or precise determination. Furthermore, there is a thread of a philosophical or tax policy shift which realizes that, fundamentally, what is at issue is international income allocation according to a method which is as likely to be as imperfect as it is imprecise. There is also a willingness to consider safe harbour rules. These are indications that U.S. thinking is moving forward.

Another example is that the "comparable adjustable transaction" method ("CATS") for intangibles is a useful liberalization of the White Paper's "inexact comparable method". CATS allows the taxpayer to make a fair number of adjustments to take into account different circumstances and contractual terms. But the vital question is whether it will work in practice. The answer, alas, may be not that often, simply because taxpayers will have difficulty in demonstrating that they meet the additional requirement of the "comparable profit interval test".

B. *Comparable profit interval test*

The comparable profit interval test ("CPI") is in fact the key to the new regulations which specify six stages in developing and applying a CPI. This test is applicable not only to intangibles to which the CATS and comparable profit method ("CPM") applies, but also to tangibles where the resale price, cost plus and "fourth" methods are used. In one sense, the concept is an attractive one which accepts that there may be more than one arm's length price. A taxpayer's profit from the transfer of tangible or intangible property will be accepted as arm's length if it falls within a range of profitability (taken over a three- year period) in relation to what a similarly situated uncontrolled third party taxpayer earned from comparable business transactions.

Internationally, there are three potential areas of difficulty with the CPI. First, the word "profit" as opposed to "price" indicates a belief that there will always be profits, determinable by internationally common or acceptable standards, when in truth there may be genuine commercial losses, as well as different notions or conceptions of "profit". International practice is not that only transfer prices which produce an acceptable profit meet the arm's length test. Second, where tangibles are concerned, there is an argument that international practice does not require that if the resale price or cost plus method is used, it must be validated by another further test. Whether these difficulties are more apparent than real will depend upon how difficult the CPI requirement proves to be in practice and what compromises are made. Third, the three-year CPI period specifies the use, for transfers of intangibles, of third party data for present and future taxable years, so there is no certainty of tax treatment at transaction date.

The real difficulty arises in finding reliable information on financial margins on competitors' activities on which to compute the CPI. It is simply envisaged that this information may be culled from available financial data. This means mainly published accounts, which may not be a reliable indicator. Not only do methods of accounting treatment vary, but the accounts rarely contain sufficient detail to be sure that one is comparing like with like. Industry statistics, if available, are often based on accounts or on responses to questionnaires which are not looking for profit margins on an arm's length basis.

The very fact that the CPI test is being applied means that there is no matching or exactly comparable third party transaction, so the taxpayer has to identify an uncontrolled entity carrying on a roughly similar trade and then get what little published financial and trading data there is on that competitor and, without any facilities for verification or further information, apply a series of tests to try and arrive at an appropriate CPI. Infuriatingly, this is one instance where the IRS will have considerably more information than the taxpayer on that taxpayer's competitors, but the confidentiality requirement will, quite rightly, prevent that information being disclosed when a CPI test is required. Moreover, if taxpayers' competitors were to actually cooperate with each other to find a solution to allocation of profit on transactions, they could find themselves in breach of the U.S. anti-trust laws.

C. *Priority of methodology*

Naturally the draft regulations put as first priority the matching transaction basis for intangibles and the exact comparable basis for tangibles. However, in practice these methods will rarely, if ever, be used for there are few instances when matching or exactly comparable transactions exist.

Indirectly the proposed regulations recognize this because they eliminate, for licences of intangibles and sales of tangible goods, the restriction in the existing regulations whereby a lower-priority method cannot be used without first estab-

8. "A Study of Intercompany Pricing", a consultative document released in 1988 by the U.S. Internal Revenue Service albeit representing the combined efforts of experts in the IRS and the U.S. Treasury.

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lishing that no higher-priority method applies. Therefore a taxpayer can go straight to the method that is applicable, although it remains open to the IRS to contend that a higher priority method applies.

This raises the interesting question of whether the proposed regulations switch the burden of proof from the taxpayer to the IRS. The answer would appear to be that formally they do not, but in practice whoever contends for the higher priority method will have the burden of proof initially, though this may switch once that a party makes an initial case for the higher priority method, for the other party will then have to show why that method is inappropriate. Obviously there will be a few cases where the IRS and the taxpayer cannot agree on the appropriate method, but in most cases they will be in broad agreement. It will be an advantage for both parties not to have to go to the time and expense of proving a negative in relation to the higher priority methods.

V. U.S. TRANSFER PRICING DEVELOPMENTS 1986-1992

In the sense that they contain a move towards greater flexibility, the proposed regulations may be welcomed. However, they are no less than the seventh U.S. development in this area in seven years and it is dangerous and inappropriate to evaluate these proposed regulations in isolation.

A. *Tax Reform Act of 1986*

The U.S. concentration on transfer pricing resulted first in the widening of Section 482 of the Internal Revenue Code in the Tax Reform Act of 1986. This Act amended Section 482 to require that payments to a related party for a transferred or licensed intangible be "commensurate with the income" attributable to the intangible involved and is commonly called the "super royalty" provision. Essentially it looks to the future actual profit to determine the price for the contract at contract date. The international question is whether the commensurate with income standard is compatible with the arm's length standard. The answer will depend upon what unrelated third parties would do in similar circumstances; if they would have regard to actual profit experience and make periodic adjustments to the contract, then a commensurate with income standard would be said to be an arm's length standard. In cases where there would not be periodic adjustments over the life of the contract then it would run contrary to the arm's length standard. This amendment to Section 482 was further considered in the Section 482 White Paper in 1988 which attempted to address the U.S. Treasury/IRS concerns on licensing of intangibles and has now been superseded by the proposed regulations.

B. *Omnibus Budget Reconciliation Acts of 1989 and 1990*

The period of activity continued, and in 1989 and 1990 three more proposals were enacted, relating to recordkeeping, penalties and earnings stripping via interest payments. Recordkeeping and compliance requirements for foreign-owned businesses were greatly increased and final regulations have recently been issued on the reporting, recordkeeping and related requirements under Section 6038A and C of the Internal Revenue Code.

The stringent penalties provided for in cases of significant understatement of profit posed a particular problem for MNEs. The safe harbours (i.e. what was regarded as insignificant) to avoid penalties were too small to encompass most MNE transactions, with the result that many foreign-based parent companies were forced to spend large fees on professional analysis of their pricing policies to their U.S. subsidiaries or branches in order to be able to defend their filing position on the grounds of "reasonable cause and good faith". The problem is exacerbated in that regulations on the scope of "reasonable cause and good faith" are still awaited, so an element of uncertainty still exists.

The earnings stripping provisions were aimed at thin capitalization and, inter alia, denied the benefit of an interest deduction for interest paid to a foreign related party who claimed the nil or a lower rate of withholding tax under a treaty with the United States. The safe harbours for the earnings stripping provisions of a debt/equity ratio of 1.5/1 or profits of two times interest cover may be said to be outside the arm's length basis implicit in the many tax treaties that the United States has negotiated.

There is no doubt that these three developments placed burdens on foreign investors in the United States that U.S. based MNEs do not face when in the reciprocal position of being the foreign investors in the other investors' own countries.

C. *The Pickle Hearings*

The assault against foreign investors in the United States was continued and aired in public in July 1990 at the Pickle Hearings.[9] Obviously politically inspired (foreign observers were well aware that some two thirds of Congress were up for re-election that autumn), much of the rhetoric is best forgotten. However, the testimony of the IRS in response to questioning as to why some 36 major foreign investors (25 of them Pacific Rim (Japanese)) had not paid "one thin dime" in U.S. corporate taxes remains of interest. If the IRS had failed so far to collect any tax that may be due, the reason was a combination of insufficient powers to get at information (only just remedied) and understaffing, with IRS being heavily outgunned by practitioners. The lack of funding to attract the numbers and quality of staff has not been wholly remedied, but transfer pricing now has higher priority within the IRS and the IRS is under pressure to actually deliver the tax take for foreign investment in the United States.

While the integrity of individual members of the IRS is not in question, it is going to be difficult for them to accept that certain foreign-owned operations are currently running at a tax loss situation, or are less profitable, financially, than the tax laws of a jurisdiction may be prepared to concede. It may

9. Ways and Means Oversight Sub-Committee investigation of 36 foreign-owned U.S. distributors of automobiles, motorcycles and electronic equipment, chaired by J.J. Pickle, D-Texas.

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prove unfortunate that the move forward to enforce transfer pricing provisions has coincided with both an economic recession in the United States and other fundamental structural economic changes.

This is perhaps the nub of concern over the U.S. developments in the transfer pricing area. The U.S. approach is all geared to increasing its share of the tax take and the introduction of the CPI is simply the latest indication of this attitude. There is an underlying assumption that transfer pricing is only about taxing profits. In reality transfer pricing is not confined to allocation of profit of an MNE between HTCs; at times there will be losses to be allocated or different notions of "profits" to be considered.

If the expectation of the United States is that efficient activity on the transfer pricing front will always result in increased tax take, then it follows that there will be an increasing number of instances of potential double taxation referred to the competent authorities for the mutual agreement procedure under tax treaties to be activated.

D. *Advance pricing agreements*

Having said that, the introduction of the sixth development, that of advance pricing agreements ("APAs") in 1991 and the flexibility showed in the proposed new regulations may indicate the beginning of a retreat from the aggressive stance in 1988, 1989 and 1990.

Many countries have operated APAs on an informal basis for a number of years. It is a useful facility, albeit limited to instances where the facts and circumstances are such that an agreement with a fiscal authority should be able to be reached. It is good news that the United States has joined the club; it encourages MNEs to consider the transfer pricing implications of cross-border transactions in advance rather than firefight a problem years later.

It is too early to evaluate the U.S. experience with APAs, but first reports are encouraging with signs of a practical and relatively speedy response from the IRS. The 1992 proposed Section 482 regulations do, however, pose an interesting question in relation to APAs. Namely, if methodology insists on a CPI which takes into account actual future profit, then how can an APA be reached?

E. *Section 482 proposed regulations*

While the relaxation of ideas contained in the White Paper are welcomed (see above), concern must remain about the continued use of, or reliance on, tests that both reflect conventional (and in many respects unworkable) transfer pricing analytic methodology and a concentration on "arm's length" comparisons. For an internationally acceptable system, the aim should not be to reconstruct intrafirm transactions as if they had characteristics that, because of the nature of the taxpayer, would never apply. Rather it should be recognized that MNEs behave and are formed to avoid strictures of third party dealing and that the real issue is how to apportion their income among jurisdictions able to lay some claim to it based upon a defined commercial or economic nexus.

VI. THE U.S. TAX SYSTEM AND INTERNATIONAL INVESTMENT

Interestingly, the U.S. tax system has a rather different policy approach to foreign investment, both inward and outward, to other developed nations. Also, by world standards, the United States came very late to introducing a modern style federal tax system. Due to a "slight problem" under the U.S. Constitution, it was not until after the famous Sixteenth Amendment to the Constitution that the first federal income tax was enacted in 1913.

However, where taxation of international trade and investment was concerned, the early advantage of not being tied to a system over 100 years old, was counteracted in that the system was really only developed after World War II when the United States was in a position of unusually great economic dominance. This resulted in the tax policymakers of the time not analyzing how the U.S. corporate tax system affected the competitiveness of U.S. based multinationals in world markets. Even as late as the 1970s, there was a widely supported movement to introduce tax and other barriers against international investment by U.S. companies.[10]

The inevitable happened, in that Europe and the Pacific Rim countries recovered from the devastation of World War II and moved forward in technological development, international trade and investment, with particular success in the U.S. market, and the U.S. influence on world markets declined. By the mid-1980s the United States was a net capital importer. The global economy was fast developing, together with signs of the polarization of three main economic blocs: North America, Europe and the Pacific Rim.

U.S.-based multinationals pleaded the case for a less restrictive federal tax system to enable them to compete on equal terms with foreign-based investors from countries with tax systems more responsive to international investment. Rather than level the playing field by removing restrictions in the U.S. tax system, the U.S. tax policy reaction was to try and level the playing field by bringing in more onerous provisions for inward foreign investors!

By 1991 Congress at last began to listen to the U.S.-based multinationals.[11] A coalition of U.S.-based multinationals under the auspices of the National Chamber Foundation sponsored a major report on U.S. International Tax Policy for a Global Economy. The report is interesting reading and makes the point that global investment strategies are critical to the competitiveness of the U.S. economy. Most importantly it stresses that the United States must seek greater harmonization of its tax rules with those of its major competitors.

January 1992 saw the emergence of the U.S. Treasury Report on Integration of the Individual and Corporate Tax Systems.[12] The footnotes to this lengthy report are noteworthy in that they indicate that the authors have read more widely on non-U.S. ideas and experience than in the past.

10. Burke Hartke Bill 1972, HR 14052.
11. International Competitiveness Hearings 1991.
12. "Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once", 7 January 1992.

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There are thus a number of encouraging signs that the isolationist U.S. approach to taxation of foreign trade and investment is being abandoned. It may be that 1990 will be identified in retrospect as the high watermark of U.S. anti-foreign investment tax policy.

VII. DIFFERENCES IN GENERAL APPROACHES TO TAXATION

Quite apart from approach to international investment, the United States has two cornerstone approaches to taxation in compliance and administration which are not in general shared by other developed nations.

First, it attempts to collect "every last dime" of tax. Many other countries, particularly European countries, have a more businesslike approach to corporate taxation for the simple reason that the "last dime" of tax is expensive to collect; there is an insistence on a balance between total tax take and compliance and other costs to taxpayer and tax gatherer.

Second, the United States looks for a very high degree of certainty and clarity as to how any particular transaction may be taxed. This is sought to be achieved by lengthy and complex regulations supplementing the Internal Revenue Code. Often the regulations are years behind the enactment of a provision in the Code. It is also a continual question as to whether a set of regulations are legislative or interpretive.

Few countries have back-up regulations for technical as opposed to administrative aspects of taxation and none to quite to the same degree as the United States. This divide is well illustrated by other countries' approach to transfer pricing.

A. *U.K. transfer pricing*

The United Kingdom has no regulations. This is quite deliberate, for the view has consistently been expressed that the United Kingdom should not be a prisoner of a prescribed methodology. The absence of detailed regulations or provisions is seen as a plus, enabling a suitable arm's length price to be arrived at by the most appropriate method for the particular commercial transaction involved.

The law is contained in Sections 770-773 Income and Corporation Taxes Act 1988 and takes up just four pages. There is half a page denoting the arm's length requirement between associated persons (Section 770), one and a half pages covering transactions by petroleum companies (Section 771), one page on information requirements and appeal procedure (Section 772) and half a page on interpretation (Section 773). That is it. There is no case law, for no actual transfer pricing cases have reached the courts or, indeed, are in the pipeline to so do. Settlement is always reached between the Inland Revenue and the taxpayer. In 1980 the Inland Revenue issued four pages of general notes for guidance, but they are very basic.

Equally there is no formal procedure for advance rulings, but in practice these are given. The U.K. tax system does not have an automatic audit procedure, nor a special compliance form in respect of transactions with related foreign parties. There is a small specialist team at the Head Office of the Inland Revenue, who are trained in all four methods of arriving at the arm's length price outlined in the OECD report.[13] In addition, selected staff in every District Office of the Inland Revenue are trained in transfer pricing to ensure that all potential transfer pricing transactions undertaken by companies are noted, the small or uncomplicated cases dealt with at District level, with efficient filtering of major or difficult cases to the expert team. It is the expert team who deal with any issues arising under the mutual agreement procedure under tax treaties. Oil taxation is dealt with by a separate specialist division and there are some specially formulated rules.

C. *Canadian transfer pricing*

The Canadian approach to transfer pricing shares a number of similarities with that of the United Kingdom. There are no detailed rules in regulations to supplement the basic provision in Section 69 Canadian Income Tax Act. Advance rulings are not available generally, although it is understood that the Canadian authorities and their U.S. counterparts are experimenting in test cases with the APA procedure to evaluate, presumably, the workability of such an approach. There is tendency for most pricing cases to settle with virtually no judicial decisions of any particular assistance in resolving transfer pricing disputes.

Like the United States, Canada does have an automatic tax audit procedure for MNEs and a special form on which Canadian businesses must declare transactions with foreign associates (parties not at arm's length). However, there are important differences in emphasis and formal approach. The principal statement on the Canadian transfer pricing rules and their functional content are merely administrative and contained mainly in Revenue Canada, Taxation Information Circular 87-2[14] and various public commentaries by Revenue Canada officials. Though these borrow from the U.S. existing Section 482 regulations and reflect the conventional transfer pricing methodologies in the 1979 and 1984 OECD reports, there is some suggestion that a more functional approach is taken, notwithstanding the general reluctance of taxation authorities internationally (including Canada) to give such an approach analytical prominence.

VIII. AN INTERNATIONAL SYSTEM FOR TRANSFER PRICING

Achieving a greater degree of harmonization in world tax systems is obviously a way towards an easing of the path to a solution to effective income allocation of an MNE between countries. But realistically this is some way off. In the meantime, all countries will be looking to each other's experience in the transfer pricing area.

Because the United States has more cases on transfer pricing either before or waiting to come before the courts, together with new developments on compliance and methodology,

13. "Transfer Pricing and Multinational Enterprises", Report of the OECD Committee on Fiscal Affairs (Paris: OECD, 1979).
14. "International Transfer Pricing and Other International Transactions" (27 February 1987).

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than the rest of the world put together, the U.S. experience over the next few years will be closely watched. There is an opportunity to learn from experience, both what ideas to adopt and what pitfalls to avoid.

An anticipated major pitfall with the U.S. developments is that the cost, both in financial terms and time commitment, in meeting compliance requirements and obtaining subsequent resolution of disputes on a methodology that in many instances does not relate to commercial reality, will escalate beyond both taxpayers' and tax gatherers' capacity to absorb. A leading U.S. practitioner and former International Tax Counsel to the U.S. Treasury[15] has questioned whether even a strong U.S. economy could cope with the sheer cost and effort now required under the U.S. provisions on transfer pricing.

Paradoxically, it is a combination of this potential U.S. pitfall, together with the United States having at last followed other countries and adopted an advance ruling procedure, which may show the way for the future. Multinationals now have a positive incentive to address the problem in advance. They can obtain certainty and avoid unacceptable costs and delays.

However, there is still an important missing piece to the puzzle. The fundamental issue still remains, and needs to be recognized as such, the international allocation of income of an MNE. Until there is something in the nature of a legally binding arbitration process between developed nations which, among other things, provides the taxpayer with a right of appeal and contemplates a certain and final resolution of disputes to which affected jurisdictions would be bound, MNEs can be subject to economic double taxation. A binding arbitration process would not only eliminate economic double taxation but, and perhaps more importantly, the fiscal authorities would be encouraged to formulate and operate a workable methodology, and MNEs to comply with it.

It is true that the new U.S./Germany tax treaty contains an arbitration clause, but this may not be invoked by the taxpayer, only the two fiscal authorities if they agree. The European Community Convention on Arbitration was signed by all 12 member states on 23 July 1990, but it will not come into force until three months after the last member state has enacted the appropriate domestic legislation. Progress has been disappointingly slow so far.

IX. CONCLUSION

The proposed U.S. new regulations on transfer pricing may not be a blueprint for a new or improved methodology which would gain worldwide support, but it is suggested that they indicate a welcome, if slight, movement towards a national tax policy accepting the challenges of a tax system relating to a global economy. If the United States is now abandoning the tax policy constraints of the 1950s to the 1980s in not considering the need for tax competitiveness in international investment, and is beginning to address the difficult question of national tax systems recognizing the implications of a global economy, this is good news indeed.

As governments and fiscal authorities seek an answer to the difficult question of how to allocate income of an MNE, there is a window of opportunity for the MNEs themselves to markedly influence developments.

If multinationals rise to the challenge by recognizing potential transfer pricing problem transactions in advance and evaluating their own commercial and economic evidence for their pricing structure (whether or not an advance ruling is sought), then the fiscal authorities will not be under such pressure to tighten up the system and useful flexibility may be maintained. Even more to the point, the transfer pricing practices of MNEs should be materially easier to defend.

There is some truth in the assertion that MNEs do not have to have serious transfer pricing problems.

15. David Rosenbloom, Co-chair, First Annual International Tax Law Institute conference, "Transfer Pricing, the International Tax Concern of the '90s", New York, 14-15 March 1991.

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UNITED STATES:

PFIC AND SUBPART F SIMPLIFICATION PROPOSALS OF THE TAX SIMPLIFICATION ACT OF 1991

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I. SURVEY OF PFIC PROVISIONS UNDER CURRENT LAW

The Tax Reform Act of 1986 introduced the passive foreign investment company ("PFIC") into the Internal Revenue Code. The existence of a PFIC in an international corporate structure will often create havoc from a tax planning perspective.[1]

The PFIC provisions originally targeted the investment by U.S. individuals in widely-held mutual funds organized as foreign corporations. Because these investments were widely held (i.e. the foreign corporation was not a controlled foreign corporation ("CFC") since not more than 50 percent of its stock was held by U.S. shareholders), the investor was not subject to either the Subpart F or the foreign personal holding company provisions of the Code.

In general, a foreign corporation will be subject to tax as a PFIC to the extent that 50 percent or more of its assets (by value) are passive assets or 75 percent of its gross income is passive income.[2]

Passive assets are characterized according to the income they produce or are reasonably likely to produce in the future. The asset test provides complexity since the test is based on the average value of assets computed on a quarterly basis. Also, the test requires the valuation and characterization of intangibles owned by a foreign company.

Passive income means income that qualifies as foreign personal holding company income under Section 954(c), subject to certain exceptions for banking and insurance income and look-through rules for dividends, rents and royalties.[3]

If a corporation is a PFIC, it will be subject to a separate tax computation that imposes an interest charge on the tax liability attributed to prior years' earnings. This interest charge is imposed either on an excess distribution (as defined in Section 1291(b)) or on any gain recognized from the disposition of the PFIC stock. The amount subject to the interest charge or to tax under the PFIC rules includes not only a PFIC's passive income but also any active income it generates which would normally be allowed deferral under the Subpart F rules.

The income subject to Section 1291 is spread pro rata over the shareholder's holding period in the stock.

A taxpayer cannot use current year losses or net operating loss carryforwards to offset the income inclusion under Section 1291. In contrast, where a qualified electing fund ("QEF") election has been made, an inclusion can be offset by net operating loss carryforwards.

Earnings attributable to the current taxable year are taxed as ordinary income under Sections 1 or 11. Earnings attributable to prior taxable years are subjected to an interest charge which is imposed on the U.S. tax attributable to such years' earnings.[4]

A. *Non-recognition transactions*

Non-recognition treatment is allowed with respect to a disposition of PFIC stock to the extent provided in regulations.[5] To date, no regulations have been issued. Subsequent legislative history recommends that non-recognition treatment should be

1. IRC Secs. 1291-1297(i). Unless otherwise provided, the Code section references contained herein refer to the Internal Revenue Code of 1986.
2. Sec. 1296(a)(1) and (2).
3. Sec. 1296(b)(2) and Notice 88-22, 1988-1 C.B. 489.
4. Sec. 1291(c).
5. Sec. 1291(f).

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allowed if the PFIC status is retained following the exchange. This provision may limit non-recognition treatment in a Section 368(a)(1)(D) reorganization.[6]

B. *Exemptions*

The following entities are exempt from PFIC status:
- a foreign corporation actively engaged in the U.S. banking business;[7]
- a foreign corporation engaged in the insurance business that would be subject to tax under Subchapter L, if it were a U.S. corporation;[8]
- start-up ventures (i.e. for first and second taxable years);[9]
- a foreign corporation that has disposed of its trade or business.[10]

C. *Qualified electing fund*

Shareholders may avoid Section 1291 treatment in exchange for current inclusion of their pro rata share of PFIC earnings. The corporation must make a QEF election to avoid Section 1291 and include in income the PFIC's earnings subject to a special election (described below). Losses may not be included under a QEF election. An advantage of making a QEF election is that a current year inclusion of income can be avoided if the earnings satisfy a high income tax exception similar to that contained in the Subpart F rules.

D. *Once a PFIC always a PFIC*

If a corporation is a PFIC in 1987 or later taxable years, it retains the PFIC taint unless the PFIC is a QEF for all taxable years after 1987, unless the PFIC elects to recognize gain and pay tax under Section 1291 with respect to a deemed sale of the PFIC stock, or unless the PFIC is a CFC and elects to make a deemed distribution of its post-1986 earnings.[11]

Taxpayers that receive no repatriation of the PFIC's earnings may avoid current taxation by electing to defer payment of the marginal increase in tax resulting from the QEF inclusion. This deferral is subject to an interest charge and the election is not available if there is an inclusion under Sections 551 or 951 with respect to the QEF.[12]

E. *Examples where PFICs arise*

- foreign holding companies that retain significant passive assets; however, see Section 1296(c) that allows look-through treatment for 25 percent or greater owned subsidiaries. The advantage of the look-through rule is that holding companies can obtain the benefit of using the active assets and income of a subsidiary engaged in an active trade or business in applying the PFIC definition;
- loss companies with only passive gross income;
- personal services companies that own few active income generating intangibles and few tangible assets;
- international finance affiliates that do not qualify for the banking exception. The use of Section 904(d) look-through rules for characterization of assets and income must be considered in this context;[13]
- companies which accumulate earnings by manufacturing products in low tax countries (e.g. Irish manufacturing subsidiaries).

F. *Foreign tax credit pitfalls of Section 1291*

While foreign tax credits are available to reduce the tax imposed under Section 1291, such credits may not match up with the foreign-source income subject to tax under that Section. Section 1291 is also unclear regarding the carryback and carryforward of the foreign tax credits.

II. TAX SIMPLIFICATION BILL: TAXATION OF FOREIGN CORPORATIONS

A. *Purpose and current provisions affected*

Section 301 of the Tax Simplification Bill is intended to consolidate the many different anti-deferral provisions that are currently spread throughout the Code.[14]

The following anti-deferral provisions currently exist:
- CFC (Subpart F) provisions: Sections 951-964.
- Foreign personal holding company provisions: Sections 551-558.
- Passive foreign investment company rules: Sections 1291-1297.
- Personal holding company rules: Sections 541-547.
- Accumulated earnings tax: Sections 531-537.
- Foreign investment companies: Section 1246.
- Electing foreign investment companies: Section 1247.

The bill adopts a two-prong approach to anti-deferral. Subpart F continues to apply to foreign corporations controlled by U.S. shareholders while the new passive foreign company ("PFC") replaces the PFIC, FIC and majority of the FPHC rules. The remainder of the FPHC provisions are incorporated into the existing Subpart F regime. The AET and PHC taxes are eliminated in their entirety (at least as they apply to foreign corporations).

B. *Passive foreign corporation rules*

1. Additions

The PFIC provisions are significantly modified and the PFIC is re-labelled as a PFC. A PFC is any foreign corporation where 60 percent or more of its gross income is passive income, or 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or the foreign cor-

6. See Technical and Miscellaneous Revenue Act of 1988, Conf. Rep. 1104, 100th Cong. 2d. Sess. 10-11 (1988).
7. See Notice 89-91, 1982-2 C.B. 408.
8. Sec. 1296(b)(2)(B).
9. Sec. 1297(b)(2).
10. Sec. 1297(b)(3).
11. See Sec. 1291(d).
12. Sec. 1294.
13. See Notice 88-22, 1988-1 C.B. 489.
14. References to "TSB 91" herein refer to the Tax Simplification Bill of 1991, S. 1394/H.R. 2777, 26 June 1991.

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As under present law, passive income for this purpose is defined in the bill generally as any income of a kind which would be foreign personal holding company income as defined in Section 954(c), subject to the current law exceptions for banking and insurance income and the current look-through rules for certain payments from related persons.[15] Excluded from the definition of passive income for purposes of the definition of a PFC is any income derived from assets that are treated as active assets for purposes of the definition of a PFC.

As under the PFIC rules, the foreign corporation is permitted to elect to measure its assets based on their adjusted basis rather than their value.

In addition, the bill provides two clarifications to present law:
(1) the bill clarifies that, as indicated in the legislative history of the 1988 Act, the same-country exceptions from the definition of FPHC income in Section 954(c) are disregarded;[16] and
(2) any foreign trade income of a foreign sales corporation does not constitute passive income for purposes of the PFIC definition.[17]

The bill expands the present law application of the asset test by treating certain leased property as assets held by the foreign corporation for purposes of the PFC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months.[18]

The bill expands the present law rules that provide an exception from the definition of a PFIC in the case of a company changing business. Under the bill, if a foreign corporation holds 25 percent or more of the stock of a second corporation that qualifies for the change-of-business exception (Section 1297(b)(3)), then in applying the look-through rules (Section 1296(c)), the first corporation may treat otherwise passive assets or income of the second corporation as active.[19]

The bill generally retains those provisions of current law, the application of which depends upon whether a foreign corporation was a PFIC for years after 1986 (e.g. Section 1291(d)), but modifies these provisions to test whether the foreign corporation was a PFC for years after 1986. As a transitional definition, the bill provides that a foreign corporation that was treated as a PFIC for any taxable year beginning before the introduction of the bill is treated as having been a PFC for each such year.

2. Tax treatment of PFCs

The benefits of deferral are eliminated with respect to the income of a PFC under four alternative methods: election to be taxed as a domestic corporation, current inclusion, mark-to-market or interest charge on excess distributions.

(a) *Limited election to be taxed as a domestic corporation*

The bill provides a new election that will allow certain passive foreign corporations to be treated as domestic corporations.[20] A foreign corporation is eligible to make this election if (1) it would qualify for treatment as a regulated investment company ("RIC") under the relevant provisions of the Code if it actually were a domestic corporation; (2) it meets such requirements as the secretary may prescribe to ensure the collection of taxes imposed by the Code on the PFC; and (3) the electing PFC waives all treaty benefits (including treaties other than tax treaties) secured by reason of being resident of another country.

(b) *Current inclusion method*

Mandatory current inclusion – If a PFC is U.S. controlled, the bill will subject every U.S. person owning (directly or indirectly) stock in the PFC to income inclusions under a modified version of the CFC rules.[21] A PFC is treated as U.S. controlled if it would be treated as a CFC under the Subpart F rules or if at any time during the tax year more than 50 percent of the vote or value of the corporation's stock is owned, directly, indirectly or constructively by five or fewer U.S. persons. If a PFC is not U.S. controlled, every U.S. person owning (directly or indirectly) 25 percent or more of the vote or value of the stock of the PFC will be subject to the same rules.[22] If the PFC is U.S. controlled, all U.S. shareholders include in income their pro rata share of the PFC's income. If the PFC is not U.S. controlled, only 25 percent or greater U.S. shareholders are subject to the mandatory inclusion rule.

Under the bill, the entire gross income of the PFC (subject to applicable deductions) is treated as FPHC income, and thus is included (net of appropriate deductions) on a pro rata basis in the income of each U.S. person directly or indirectly owning stock in the PFC, under a modified application of the rules of Sections 951 and 961. Actual distributions of earnings by such a PFC are treated similarly to distribution of previously taxed income under Sections 959 and 961. These rules supersede all application of the present law rules applicable to FPHCs, under which earnings are deemed distributed and then contributed to the capital of the FPHC.

In applying the Subpart F inclusion rules to PFC inclusions, the bill departs from Subpart F in that FPHC income is included in the income of U.S. persons without regard to otherwise applicable reductions pursuant to the export trade corporation rules.[23] However, the high-tax exception from current inclusion of PFC income is available to shareholders who are otherwise treated as "U.S. shareholders" of a CFC under Subpart F.

In addition, as under present law, the characterization of capital gains realized by the PFC is passed through to those shareholders who are subject to the current-inclusion method and who are not otherwise treated as "U.S. shareholders" of a CFC under Subpart F. Unlike present law, these two latter

15. Sec. 1296(b)(2).
16. Proposed Sec. 1296(b)(2).
17. Sec. 951(e) and proposed Sec. 1296(b)(2)(d).
18. Proposed Sec. 1297(e).
19. Proposed Sec. 1297(d)(2).
20. Proposed Sec. 1297(f).
21. Proposed Sec. 1292(a).
22. Proposed Sec. 1292(b).
23. Secs. 970 and 971 and proposed Sec. 1292(a)(1)(D).

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rules are also available to qualifying shareholders of corporations that would also be FPHCs under present law.

In conformity with present law, PFC income included under Subpart F is treated as base company income rather than FPHC income, and is eligible for look-through treatment for foreign tax credit limitation purposes, assuming the look-through rules would otherwise apply under present law.

Elective current inclusion – A U.S. person owning less than 25 percent of the stock in a PFC that is not U.S. controlled may elect application of the current inclusion rules. This election is similar to a QEF election under the PFIC rules. In the application of the elective current-inclusion rules, the PFC is treated as a CFC with respect to the taxpayer, and the taxpayer is treated as a U.S. shareholder of the corporation. For foreign tax credit purposes, amounts included in the taxpayer's gross income under this modified application of the CFC rules are treated as dividends received from a foreign corporation which is not a CFC (i.e. 10/50 basket).[24]

(c) *Mark-to-market method*

Less-than-25 percent shareholders of PFCs that are not U.S.-controlled, and who do not elect current inclusion ("non-electing shareholders"), are subject under the bill to one of two methods for taxing the economic equivalent of the PFC's current income, the mark-to-market method or the interest-charge method.

Under the bill, non-electing shareholders of a PFC with marketable stock are required to mark their PFC shares to market annually. Under the mark-to-market method, the U.S. person is required to include in gross income each taxable year an amount equal to the excess (if any) of the fair market value of the PFC stock as of the close of the taxable year over the adjusted basis of the stock.[25]

All amounts of mark-to-market gain on PFC stock, as well as gain on the actual sale or distribution of PFC stock, are treated as ordinary income. Similarly, ordinary loss treatment applies to the deductible portion of any mark-to-market loss on PFC stock, as well as to any loss realized on the actual sale or other disposition of PFC stock, but only to the extent of prior mark-to-market gains.

The mark-to-market method under the bill only applies to PFC the stock of which is "marketable". PFC stock is treated as marketable if it is regularly traded on a qualified exchange, whether inside or outside the United States. An exchange qualifies for this treatment if it is a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to Section 11A of the Securities and Exchange Act of 1934, or if the secretary is satisfied that the requirements for trading on that exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock.[26]

In the case of a CFC (including a PFC that is treated under the bill as a CFC) that owns or is treated as owning stock in a PFC, the mark-to-market method generally is applied as if the CFC were a U.S. person. For purposes of the application of Subpart F to the CFC, mark-to-market gains are treated as if they were FPHC income of the character of dividends, interest, royalties, rents or annuities, and allowable deductions for mark-to-market losses are treated as deductions allocable to that category of FPHC income. The source of such income or loss, however, is determined by reference to the actual (foreign) residence of the CFC.

Under proposed transition rules, mark-to-market gain representing appreciation in the value of PFC stock prior to the effective date of the bill is subject to tax under the interest-charge method, and each shareholder may elect to defer the payment of the tax. Subsequent mark-to-market losses may be deducted to the extent of the pre-effective-date appreciation, and an election to defer the payment of tax is terminated to the extent of such deductions taken and to the extent of excess distributions received. In the case of a RIC, in place of applying the interest-charge method to pre-effective-date gain, a separate non-deductible interest charge is added to the company's tax. The mark-to-market method does not apply to appreciation in the value of the PFC stock prior to the time that a shareholder becomes subject to tax in the United States.

(d) *Interest-charge method*

Non-electing less-than-25 percent shareholders of a non-controlled PFC with stock that is not marketable are subject to the interest-charge method on an excess distribution with respect to such stock or on the gain recognized from a disposition of such stock.[27] As a result, the interest-charge method is not available to U.S. shareholders of CFCs. The interest-charge computation is similar to that currently imposed under Section 1291 with certain modifications. It is worth noting that although allowable foreign tax credits may reduce a U.S. person's net U.S. tax liability on an excess distribution, the interest charge computed on that excess distribution is computed, under the bill, without regard to reductions in net U.S. tax liability on account of direct foreign tax credits. In addition, the bill clarifies that an income inclusion resulting from a disposition under the interest-charge method takes precedence over an income inclusion under Subpart F. This clarification ensures that the interest charge is imposed without regard to the structure of the transaction.

Under the bill, the interest-charge method applies to any stock in a PFC unless either the stock is marketable (and therefore the mark-to-market method applies) as of the time of the distribution or disposition involved, or the stock in the PFC was subject to the current inclusion method (under the bill or under prior law) for each taxable year beginning after 31 December 1986, which includes any portion of the taxpayer's holding period in the PFC stock.

(e) *Once an interest-charge PFC, always a PFC*

Under the bill, as under the present law PFIC rules, stock in a foreign corporation generally is treated as PFC stock if, at any time during the taxpayer's holding period of that stock, the foreign corporation (or any predecessor) is a PFC subject

24. Proposed Sec. 1292(b).
25. Proposed Sec. 1291(a).
26. Proposed Sec. 1297(c).
27. Proposed Sec. 1293(a).

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to the interest-charge method.[28] This rule is sometimes referred to as the "once-a-PFIC-always-a-PFIC" rule.[29] Under present law, this rule generally does not affect a taxpayer holding stock in a foreign corporation if at all times during the holding period of the taxpayer with respect to the stock when the foreign corporation (or any predecessor) is a PFIC, qualified electing fund treatment applies with respect to the taxpayer. Under the bill, the similar once-a-PFC-always-a-PFC rule does not apply if during the taxpayer's entire holding period with respect to the stock when the foreign corporation (or any predecessor) is a PFC, either (a) mark-to-market treatment applies, (b) mandatory current inclusion of income applies (either because the corporation is U.S. controlled or because the taxpayer is a 25 percent shareholder), or (c) elective current inclusion of income applies. Thus, for example, a shareholder of a CFC is subject to current inclusion with respect to all the corporation's income in any year for which the corporation is a PFC, but is subject to current inclusion only to the extent provided under Subpart F in any year for which the CFC is not a PFC.

Special basis rules apply to stock in interest-charge PFCs acquired from decedents. The rules that deny step-up at death apply to interest-charge PFCs and corporations that would also be FPHCs under present law. The determination of the basis of stock that was acquired from a decedent in a taxable year beginning before 1 January 1992, is not affected. Current law is preserved under the bill to the extent that the rules that override non-recognition transactions still apply to interest-charge PFCs.

(f) *Denial of instalment sales treatment*

In addition, the bill denies instalment sales treatment for any instalment obligation arising out of a sale of stock in an interest-charge PFC.[30] This will prevent shareholders from avoiding the interest charge by means of an instalment sale of their PFC stock. The denial of instalment sales treatment is effective for sales or dispositions after 31 December 1992.

(g) *Broad grant of regulatory authority*

The bill grants the IRS broad regulatory authority. In addition, the bill suggests certain areas that might deserve regulatory attention. A barely noticeable provision at the end of the PFC rules grants the IRS regulatory authority to require recognition of gain on PFC stock if a resident alien shareholder ceases to be a resident.

(h) *Effective date*

The bill generally is effective for taxable years of U.S. persons beginning after 31 December 1992, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

C. *Modifications to Subpart F rules*

First, the bill modifies Subpart F to include a present law provision of the FPHC rules.[31] The bill treats as FPHC income for Subpart F purposes an amount received under a personal service contract if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The bill similarly treats as FPHC income for Subpart F purposes any amount received from the sale or distribution or disposition of such a contract. The effect is to treat income as Subpart F income of a CFC, even though the CFC may not meet the FPHC five or fewer individuals ownership test. For foreign tax credit purposes, the income is considered active business income.

Second, under existing law, when the stock of lower-tier CFCs is sold, the income is treated as passive, Subpart F income to the U.S. shareholders of the upper-tier CFC seller. Under the bill, such lower-tier sales would be taxed to the CFC seller in the same manner as if a U.S. shareholder sold Section 1248 stock. Thus, to the extent of the lower-tier's earnings and profits earned while the stock was held by the upper-tier, the gain is recharacterized as a dividend with only the excess treated as gain from the sale of stock. However, the same-country dividend exclusion of Section 954(c)(3)(A) does not apply to the portion of the sale recharacterized as a dividend. The bill provides for adjustments to the basis of lower-tier CFC stock in the hands of its upper-tier CFC parent for Subpart F inclusions and distributions.

The provision of the bill treating gains on dispositions of stock in lower-tier CFCs as dividends under Section 1248 principles applies to gains recognized on transactions occurring after the date of enactment of the bill. The provision providing for regulatory adjustments in U.S. shareholder inclusions, with respect to gains of CFCs from stock in lower-tier CFCs that previously had Subpart F income, is effective for U.S. shareholder inclusions in taxable years of U.S. shareholders beginning after 31 December 1991.

Third, the bill provides a number of rules to assure that on the sale of CFCs certain earnings previously taxed are properly excluded. The Treasury is given the authority to exclude deemed Section 304 dividends (which typically arise on cross-chain sales of CFC stock) to the extent of the previously taxed earnings and profits out of which the stock is deemed to be distributed. The bill also provides a reduction to the Subpart F income of a U.S. shareholder for the year the shareholder acquires the stock of a CFC from another U.S. shareholder by the shareholder's portion of the seller's Section 1248 dividend attributable to current-year earnings and profits. Under existing law, the Subpart F income of a CFC is taxed only to the U.S. shareholders that hold stock on the last day of the taxable year. To account for this year-end holder rule, the Code provides an adjustment for dividends that are paid out of current-year earnings and profits prior to the acquisition. No such adjustment is currently provided, however, for the portion of the deemed dividend under Section 1248 to the seller that is composed of current-year earnings and profits. The provision of the bill permitting dispositions of stock to be taken into consideration in determining a U.S. shareholder's Subpart F inclusion for a taxable

28. Sec. 1297(b)(1).
29. Proposed Sec. 1294(a).
30. Proposed Sec. 1297(h).
31. Sec. 553(a)(5).

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year is effective with respect to dispositions occurring after the date of enactment of the bill. The provision of the bill allowing the Secretary to make regulatory adjustments to avoid double inclusions in cases such as those to which Section 304 applies takes effect on the date the bill is enacted.

Fourth, the bill addresses the foreign tax credit rules for previously taxed income ("PTI"). Under current law, Section 960(a)(3) allows an indirect credit for foreign taxes paid by the distributing or lower-tier CFC on PTI, and Section 960(b) allows any excess foreign tax limitation free from the year in which the PTI was originally taxed to be recaptured for use in the year of distribution. A proposed modification to the bill would retain the present law provision that permits an indirect foreign tax credit to be claimed with respect to a distribution of previously taxed earnings and profits. However, it would provide authority for Treasury regulations to establish a simplified method for computing the increase in foreign tax credit limitation that results from the application of that provision.

Finally, the bill provides that an exemption or reduction by treaty of the branch profits tax that would be imposed under Section 884 on a CFC does not affect the general statutory exemption from Subpart F income that is granted for U.S.-source effectively connected income. For example, assume a CFC earns income of a type that generally would be Subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The bill provides that notwithstanding the treaty's effect on the branch tax, the income is not treated as Subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

The provision of the bill concerning the effect of treaty exemptions from or reductions of the branch profits tax on the determination of Subpart F income is effective for taxable years ending after the date of enactment.[32]

D. *Additional provisions*

The bill grants the Secretary of the Treasury authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period.[33] It is anticipated that the applicable average exchange rate would be the rate as published by a qualified source of exchange rates for the period during which the tax payments were made. The provisions of the bill applicable to translation of foreign taxes are effective for the years beginning after the date of enactment.

The bill permits taxpayer to make a binding election to use as their alternative minimum tax foreign tax credit limitation fraction the ratio of foreign-source *regular* taxable income to entire alternative minimum taxable income, rather than the ratio of foreign-source *alternative minimum* taxable income to entire alternative minimum taxable income.[34] The provisions applicable to computation of the foreign tax credit for purposes of alternative minimum tax apply to tax years beginning after 31 December 1992.

A proposed modification, effective on the date of enactment, generally would permit accrual-basis taxpayers to accrue foreign taxes at the average exchange rate for the taxable year to which such taxes relate. If at the close of the second taxable year after the close of the accrual year any tax so accrued has not yet been paid, a re-determination of foreign tax under Section 905(c) would be required for the amount of such unpaid tax. That is, the accrual of any tax that is unpaid as of that date would be retroactively denied. In the case of a direct foreign tax credit under Section 901, a Section 905(c) adjustment for the year of accrual would be required – generally resulting in the requirement to file an amended tax return for that year. In the case of an indirect foreign tax credit under Section 902, an adjustment to the taxpayer's pool of foreign taxes generally would be required.

If tax in excess of the accrued amount (or in excess of the net accrual amount following a Section 905(c) adjustment) is actually paid, such excess amount would be translated at the average exchange rate in effect for the year of payment.

Rules similar to those set forth in the bill would apply (1) to tax payments in inflationary currencies; (2) to taxpayers that are not on the accrual basis for determining creditable foreign taxes; or (3) with respect to taxes of an accrual-basis taxpayer that are actually paid in a year prior to the year to which they relate.

A proposed modification to the bill would repeal the provision added to Section 904(d)(2)(E) by the 1988 Act which, except as provided by regulations, requires a recipient of a distribution from a CFC to have been a U.S. shareholder in that CFC for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a non-controlled Section 902 corporation. This rule would be effective for distributions after the date of enactment.

Effective for foreign taxes paid by a foreign corporation in taxable years beginning after the date of enactment, indirect foreign tax credits would be allowed for certain taxes paid by CFCs at the fourth, fifth and sixth tiers. For taxable years beginning after the date of enactment, credits are not allowed for foreign taxes paid by a corporation which, when the taxes were paid, was below the lowest tier qualifying for indirect credits. No inference is intended regarding the creditability or non-creditability of such taxes under present law.

Outbound transfers now subject to Section 1491 would continue to be subject to tax, but the tax would be an income tax, rather than an excise tax, and recognized gain would result in a step-up of basis of the property transferred.

In inbound cases where non-recognition treatment must be based on the status of a foreign corporation as a corporation, a proposed modification to the bill would permit the Secretary to require certain income inclusions without regard to a gain limitation, in cases where anti-abuse rules would otherwise apply. It would also permit better coordination between inbound and outbound reorganization provisions.

32. Proposed Sec. 952(b).
33. Proposed Sec. 986(a).
34. Proposed Sec. 59(a).

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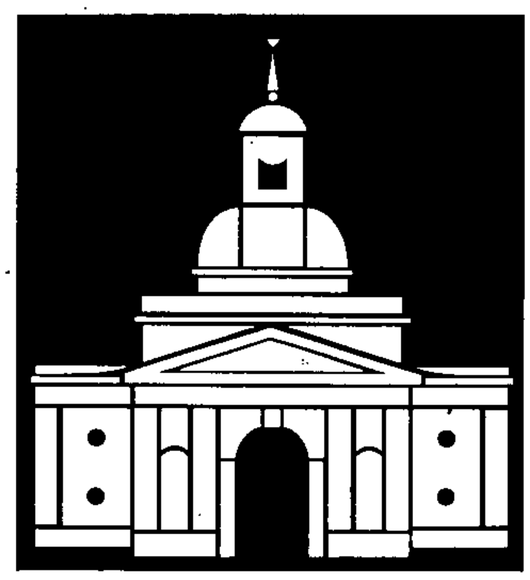

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AUSTRALIA:

CAPITAL ALLOWANCES IN AUSTRALIA

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I. INTRODUCTION

Yet another change was announced on 26 February 1992 to Australia's tax depreciation system by the Prime Minister, the Hon. P.J. Keating MP. This proposal will modify the reforms announced barely less than 12 months ago, on 12 March 1991, by the then Prime Minister, Mr R.J. Hawke and ministerial colleagues under the title of "Building a Competitive Australia".

The 26 February 1992 changes announced as part of the Prime Minister's "One Nation" Statement are designed to help economic recovery and to improve Australia's international competitiveness. The new round of changes has been welcomed to varying degrees by business leaders and commentators.

What has occurred in this area in recent years reflects the outcome of struggles for supremacy in policy making, by the Treasury on the one hand as proponents of economic rationalism and zealous guardians of the tax revenue base and, on the other hand, by the Department of Industry, Commerce and Technology which promotes itself as an interventionist force in the economy on behalf of the manufacturing sector. Overlaid on the inter-departmental process is the lobbying of business organizations, the success of which depends on the political and economic climate at the time the representations are made.

Readers who are familiar with Australia's tax changes will recall the following legislative events of recent years:

- The "standard" depreciation rates for plant were increased by a 20 percent loading[1] for assets acquired in the period from 20 August 1980 to 30 April 1981. As from the latter date the loading was reduced to 18 percent until 26 May 1988 when it increased once again to 20 percent.
- From 19 July 1982 accelerated rates became operative, subject to certain exceptions. This was the optional "3/5" system which granted a three or five-year life for all depreciable assets. The 3/5 system was terminated for acquisitions after 25 May 1988 and plant which qualified had to be in use by 30 June 1991.
- From 1 July 1991 but extending to acquisitions after 12 March 1991 a new system was introduced, part of which was to restore the loading on standard rates to 20 percent but with "broadbanded" asset classes and "pooling". This system is to be further modified as from 27 February 1992 to reduce asset classes and increase rates.
- An investment allowance was granted at the rate of 40 percent of cost during the period 1 January 1976 to 1 July 1978 but this rate was reduced to 20 percent until 1 May 1981 when it was further reduced to 18 percent. The investment allowance was phased out for plant which was not in use by 1 January 1988. But an investment allowance under a new name, "Development Allowance", will become operative for plant, generally from 27 February 1992, at the rate of ten percent, on large-scale projects which satisfy a number of criteria related to world competitiveness. In the Australian context investment allowances offer an immediate deduction in addition to normal depreciation.
- Capital expenditures on construction of buildings and structural improvements were generally excluded altogether from depreciation until 22 August 1979. In respect of construction from that date a separate write-off regime was introduced for short-term traveller (tourist) accommodation at the rate of 2.5 percent per annum. This rate was increased for a short period of time to four percent. Income-

1. Denotes an additional percentage of the standard rate of depreciation; thus a 20 percent loading on a standard rate of ten percent increases that rate to 12 percent.

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producing buildings generally were then added to the building depreciation system at four percent but this rate was later reduced to 2.5 percent. For construction commenced after 15 September 1987 the rate is 2.5 percent and has remained unaltered since. (Buildings used for research and development are dealt with separately and are commented on below.) But for tourist accommodation and industrial buildings the rate will once again be four percent from 27 February 1992.

In the discussion below the references to plant or to plant and equipment exclude buildings. The paper does not extend to intellectual property which can be amortized.

II. IDEAL SYSTEM OF TAX DEPRECIATION

At the risk of over-simplification, the following features should be incorporated in a tax system for depreciation for wasting assets which satisfies the generally accepted criteria for a good tax system, namely equity, neutrality and simplicity. By these criteria Australia has not performed well but the most recent of new measures commented on at the end of this article go a long way to rectify anomalies.

A. *Economic depreciation*

Ideally, the system should permit tax deductions over a period which reflect, as closely as possible, the economic depreciation of wasting assets. The charge against economic income should represent the decline in real value of the asset. If the regime for capital allowances is deficient in this respect taxable profits will be over-stated in real terms.

The loss in value may arise from any one or a combination of the following:
- wear and tear;
- obsolescence;
- changes in monetary value.

Ideally, the depreciation allowance over the life of an asset should be spread so that it reflects each year's movement but this is universally impractical. Therefore an arbitrary rate is normally applied on acquisition and then applied consistently until the asset is sold or its life otherwise terminated.

B. *Neutrality in investment decisions*

Economists would argue that the tax depreciation system should not distort investment decisions. In practice it is frequently Government policy to foster new investment in capital equipment-intensive industries by the granting of special allowances which have the effect of reducing the cost of capital to the taxable entity. This is achieved by investment allowances and/or initial allowances and accelerated depreciation. Accelerated rates are, in effect, interest-free loans from Government provided the depreciation deductions are effectively utilized. But it is questionable whether overly generous capital allowances actually work and, if so, whether they produce long-term economic benefits.

At least five main types of deviation from neutrality can be readily identified:

(1) Allowances in addition to depreciation on historic cost, e.g. investment allowance, development allowance, investment tax credit[2] – these are explicit tax incentives which favour certain capital equipment-intensive industries (e.g. manufacturing) over industries such as retailing.

(2) Compressing asset types into too few classes (e.g. the Australian system of three and five-year asset lives during the period 1982 to 1988) – this favours investment in long-life assets when compared to short-life assets.

(3) Accelerated rates which allow write-off over periods considerably less than the useful life of the assets.

(4) Rates fixed for specified types of assets by reference to the particular industry in which the assets are used rather than by reference to universal use. Such "industry specific" rates favour some industries at the expense of others and vice versa.

(5) Overly generous or flexible rules for repairs and maintenance – this induces plant life extension programmes and delays the scrapping of assets and investment in new equipment.

C. *Simplicity*

To reduce administrative and compliance costs the reduction of asset classes and ease of arithmetic calculation should be considered as desirable objectives. In addition, the type of assets which qualify for depreciation and the applicable rate should be easily determinable. The tax law should not be complex or uncertain so that it prevents investment decisions from being made quickly and with tax certainty.

D. *Internationally competitive*

In an era of global trade and deregulation of financial markets, notwithstanding barriers by trade blocs, the issue of international competitiveness has become even more the focus of public debate. This is certainly so in Australia.

The argument is that in countries with relatively high tax rates and restrictive depreciation systems, the effective tax rate payable by capital-intensive industries will compare unfavourably with overseas competitors. This discourages domestic and inward investment in the home country and, correspondingly, encourages the outward migration of the manufacturing sector to jurisdictions where there are tax incentives on a comparative basis.[3]

E. *Transfer of benefit of capital allowances*

Generally, the acquisition by the business enterprise of depreciable property is funded by borrowings to some degree, frequently to the extent of 100 percent.

It is in the nature of capital allowances and a mature financial/banking sector that a market will develop for the transfer of the tax benefit of capital allowances by the entity entitled to the allowance to a financier for consideration of a reduc-

2. For example, Secs. 38 and 46 of the U.S. Internal Revenue Code.
3. Statistical data on these issues can be found in *Taxing Profits in a Global Economy* (Paris: OECD, 1991).

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tion in finance charges. The penchant of governments to stimulate investment by generous capital allowances has seen the development of large-volume equipment leasing businesses which result in capital allowances being actually claimed by banks and other financial institutions. This has also occurred in Australia where a high degree of sophistication underpins the market in tax benefit transfers.

This feature of concessional capital allowances can be justified on the ground that it treats all entities equally. If a company is not able to maximize the present value of allowances why should it not exchange the tax benefit for commercial gain in the form of a reduction of financing costs?

The extent of the market in tax-based financing of investment in capital equipment is limited by the tax capacity of the banking sector and its capability to absorb the allowances as they fall due. Tax capacity exhaustion was apparent in the United Kingdom in the late 1970s and early 1980s. Australia is in this position in 1992, to some extent because of the recession, but mainly because of large loan losses suffered by banks. It is worth noting that in such circumstances accelerated capital allowances and other investment concessions may not be effective.

Tax benefit transfers have also been widespread in cross-border leasing transactions, especially for aircraft and ships. Such schemes may involve "double dipping" or even "triple dipping".

F. *Inflation*

The effect of inflation on capital allowances has troubled policy-makers in Government – but not as much as business! The issue was well debated in the post World War II era of reconstruction (see for example, the Report of the 1955 UK Royal Commission).[4]

High corporate tax rates coupled with high rates of inflation strongly erode the value of annual depreciation deductions. This effect limits the financial capacity of industry to invest in new technology and to replace worn plant. The 'real' value of the deduction is less than economic depreciation.

The response of tax economists would be to devise some form of indexation of historic cost of plant but such proposals inevitably fail to be acceptable for a host of reasons. Instead, compensation is offered by way of an initial allowance or accelerated rates of write-off. Alternatively, declining balance methods may offer some compensation.

Australia introduced a two-rate "5/3" lives system on 19 July 1982 which survived until 25 May 1988 in respect of acquisitions or construction contracted or commenced by that date, provided the plant was in use by 30 June 1991. Australia's inflation rate as measured by the Consumer Price Index was 11.5 percent during 1982/83. But the accelerated system was introduced principally to make Australia more competitive and to improve the climate for investment and so aid economic recovery.

III. THEORETICAL FRAMEWORK OF TAX DEPRECIATION UNDER THE AUSTRALIAN INCOME TAX ASSESSMENT ACT (ITAA)

A. *Scope*

The ITAA[5] provides for a deduction for depreciation on the cost of property which qualifies as "plant or articles". Unfortunately, the expression "plant or articles" is not defined.

Australia has retained its colonial heritage by interpreting the word "plant" from judicial precedents originating in England and developed by Australian courts. The usual starting point is the UK decision in *Yarmouth v France*,[6] as expanded by subsequent court decisions.

The concept is justifiably regarded as anachronistic by today's business people. It has led to the development of a functional test which requires, simply expressed, the distinction to be drawn between assets which actively perform a function in the business and those which do not. The latter includes items of property which merely provide the setting or environment in which income-producing activities are conducted (e.g. an office building).[7] Structural improvements to land which are fixtures are, as a general rule, also outside the conception of plant, but not always, depending on the function performed.[8]

By a quirk of logic but as a long-standing concession, the Commissioner of Taxation did allow tax depreciation on buildings to the extent that they form integral parts of or take on the nature of plant. He states that buildings form integral parts of plant, wholly or in part, where:[9]

(a) some part of the structure of the building has been erected for the specific purpose of supporting plant installed in that part of the building; and
(b) the erection of that part of the structure involves the use of building materials additional to, or of greater strength than, those used in the general building structure.

However, the rate allowed on such qualifying structures is only one or three percent per annum, depending on the materials used.

4. *1955 Royal Commission on Taxation of Profits and Income Final Report* (June 1955), at paras. 329-373.
5. ITAA 1936; unless otherwise stated all references are to the ITAA.
6. (1887) 19 QBD 647, at 658. The much quoted statement of Lindley J is as follows: "..... in its ordinary sense it (plant) includes whatever apparatus is used by a businessman for carrying on his business – not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or moveable, live or dead, which he keeps for permanent employment in his business".
7. See, for example in Australia: *Moreton Central Sugar Mill Company Limited v. FCT* (1967) 116 CLR 151; *Broken Hill Pty Co v. FCT* 15 ATD 43; *Wangaratta Woollen Mills Ltd v. FCT* 69 ATC 4095; *Imperial Chemical Industries of Australia & New Zealand v. FCT* 70 ATC 4024. More recent references in the United Kingdom are: *IRC v. Scottish and Newcastle Breweries Limited* (1982) 2 All ER 230; *Cole Bros Ltd v. Phillips* (1982) 2 All ER 247; *Benson v. Yard Arm Club Ltd* (1979) 2 All ER 336; *Wimpy International Ltd v. Warland* (1989) STC 273.
8. *IRC v. Barclay, Curle & Co Limited* (1969) 1 All ER 732, which deals with a dry dock at a shipping yard.
9. Depreciation – Income Tax Order No. 1217 (1974 Revision) and Income Tax Ruling IT 31.

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B. *Ownership*

The law requires[10] that depreciable property be "owned" by the taxpayer who is making the claim for the depreciation allowance. The meaning of ownership in this context is unclear. Generally, legal ownership is looked for rather than economic ownership. However, the generally accepted view now held is that the word "owned" should be interpreted reasonably broadly and not requiring all of the bundle of legal rights which may be conceivably looked for by lawyers in relation to ownership. The Commissioner of Taxation has conceded the word should not be interpreted in a strict technical sense and a popular, ordinary meaning may be acceptable.[11]

The question of ownership has most frequently given rise to difficulties where otherwise depreciable property is erected on land which is not owned by the taxpayer. Therefore, such attributes as tenant rights or compensation at the end of a lease term may be regarded as adequate to demonstrate the test of ownership unless tax avoidance is perceived.

The "One Nation" proposals of 26 February 1992 will relax the ownership test in respect of assets installed on land leased from the Crown. The amendments to the law will impose the criteria of incurrence of capital cost, proprietary rights (presumably to remove the assets) and control over use of the asset, as sufficient for depreciation.

Another exception to strict interpretation of ownership is the long-established practice of treating the "hirer" (i.e. user) of an asset under a hire purchase or instalment purchase agreement to be the owner rather than the legal owner.[12]

C. *Used to produce assessable income*

The taxpayer claiming tax depreciation must use the plant item to produce assessable (i.e. taxable) income. This can be contrasted with the use of plant for private purposes when assessable income is not produced or, in some circumstances, where exempt income may be produced.

Australia has also adopted anti-avoidance rules where financing schemes result in assets being used and controlled by tax-exempt authorities (e.g. Government instrumentalities, government-owned utilities), but financiers qualifying for capital allowances on the ground these taxpayer entities are the legal owners.

These restrictions apply to leveraged leases funded with non-recourse debt if the end-user is a tax-exempt body.[13] Where an equity lease to a tax-exempt body can be classified as a finance lease (in distinction to an operating lease), the transaction will be reconstructed into a loan with notional principal and interest components.[14]

D. *Historic cost*

The tax depreciation allowance is based on the historic cost of the item to be subject to depreciation. For these purposes, cost is not statutorily defined but is taken to mean all amounts paid in consideration for the acquisition of the asset or expenditure in constructing it, including overhead expenses, installation and transportation.[15]

As a general rule, financing costs such as interest are not regarded as forming part of the cost of the asset since they do not add any value to it and merely reflect the method whereby the taxpayer has chosen to finance its acquisition or construction.[16] However, if the capitalization of borrowing costs (including interest) does not disadvantage tax collections, it will be permitted.[17]

E. *Depreciation methods*

Up to 26 February 1992, the Australian regime allowed, on election, a straight-line method of depreciation or, a "reducing balance" (otherwise known as "diminishing value") system for which the rates are 150 percent of the straight-line rates. The sum-of-the-digits or double declining balance methods are not permitted.

A reducing balance system is implied acceptance that the value of plant falls more rapidly in its effective life immediately after first use and thereafter at a lesser rate. This is likely for new equipment but is a doubtful proposition on acquisition of used or second-hand plant. Nevertheless, Australia makes no distinction between new and used plant. The rules apply equally to both, including rates of depreciation.

F. *Rates of depreciation*

In respect of assets acquired up to 12 March 1991 the rates of depreciation were set by an arbitrary but convenient regime. The ITAA required[18] the Commissioner of Taxation to make an estimate of the effective life of a unit of property assuming it is maintained in reasonably good order and condition and to fix the annual rate of depreciation accordingly. It should be observed that in the absence of a definition of "effective life" the Commissioner interpreted his obligation as requiring the determination of physical life without allowance for technological or other obsolescence.

Since it is impractical for the Commissioner to make such determinations for each of the circumstances which exists in business, he publishes "standard" or "advisory" rates which reflect his estimate for specified items.[19] The schedule quotes 18 different rate classes before adjustments for loading and reduction in asset classes proposed by the Prime Minister's announcement of 26 February 1992 as implemented in new legislation presented to Parliament on 2 April 1992.[20]

It was after much lobbying that the Government decided in its 12 March 1991 statement, "Building a Competitive Australia", to relax the restrictive approach to effective life. This is to be expressed in a new provision.[21] Students of drafting

10. Sec. 54.
11. Income Tax Ruling IT 2398.
12. Income Tax Ruling IT 2236.
13. Sec. 51AD.
14. Division 16D.
15. Income Tax Rulings IT 2197 and 2618.
16. *Robe River Mining Co Ltd v. FCT*, 89 ATC 4606.
17. Income Tax Ruling IT 2236 in respect of hire purchase charges.
18. Sec. 55(1).
19. "Depreciation" booklet issued March 1991.
20. Taxation Laws Amendment Bill (No. 2) 1992.
21. Sec. 54A(1).

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styles may like to read the proposed section reproduced as an Appendix. In essence the "effective life" is to be a useful life determined by regard to such factors as:

- expected circumstances of use by the taxpayer;
- whether the expected life is restricted by the duration of a particular project; and
- predictable obsolescence.

However, owners of used or "second-hand" plant are required to treat such plant as new in estimating its effective life.

The new concept of effective life can be contrasted with the lack of foresight of the Commonwealth Government's 1955 Review Committee on depreciation. Having conceded the existence of obsolescence as a relevant factor, the Committee observed that: "The evidence we received failed to establish any definable cycle of obsolescence in any industry. It is largely an unpredictable contingency. Moreover, the incidence of obsolescence varies from time to time and is not present in all industries at the same time".[22]

The 1975 Report of the Asprey Committee was no more prescient.[23]

It has taken about 37 years for the effects of technological change to translate itself into economic reality.

G. *Terminal adjustments*

The ITAA provides[24] a "balancing charge" or terminal deduction on disposal of depreciable assets.

These provisions interact with the Capital Gains Tax (CGT) provisions to the effect that any excess of sales consideration over the indexed historic cost base of the depreciable property will be liable to CGT. It is unlikely that this CGT effect will be much evident in practice except in relation to appreciating assets such as works of art which, in any event, attract a low rate of tax depreciation.

The ITAA permits a form of rollover in respect of depreciation recapture by allowing such surplus or balancing charge to be spread over the cost of new acquisitions of plant or the tax depreciated value of existing assets.[25] Rollover will also be permitted where assets are transferred between companies under 100 percent common ownership.[26]

H. *Accounting standards*

The tax law operates independently from accounting standards. Whatever the amount of accounting depreciation or amortization might be, such amount is not an allowable deduction and tax depreciation is to be substituted for it in arriving at the entity's taxable income.

Approved Accounting Standard ASRB 1021, broadly speaking, adopts a useful life approach which accommodates obsolescence as well as exhaustion by effluxion of time and rate of output.

I. *Exceptions to general rules*

There are a number of exceptions to the general principles described above. They are:

- There is a depreciation limit on the cost of motor vehicles. This limit is indexed each year in line with movements in the motor vehicle purchase sub-group of the Consumer Price Index. For the 1991/1992 year the amount is A$ 45,462. In other words, no tax depreciation whatsoever is allowed on the excess over the limit. This measure can be seen to provide an incentive to buy locally manufactured motor vehicles instead of imported "luxury" vehicles.[27]
- The cost of small items of capital expenditure can be deducted outright in the year of acquisition up to the amount of A$ 300 or if the estimated effective life of the item is less than three years. It is expected the threshold of A$ 300 will be reviewed periodically to move it in line with inflation.[28]
- Depreciation is not allowable on the cost of plant and other items which are used in entertaining or in providing leisure facilities (e.g. yachts) under certain circumstances. This is in line with recent years' reforms to eliminate tax deductions for personal use assets and to protect against the erosion of the tax base by disguising private expenditure as a business cost.[29]

IV. TAX-PREFERRED SECTORS OF THE ECONOMY

Notwithstanding the anachronistic approach to manufacturing plant and equipment, Australian economic history shows that successive Governments have preserved favoured treatment for two industries in particular. These are the extractive industries (general mining and petroleum) and the primary industries (e.g. agriculture). Of more recent vintage is Government policy to encourage research and development. The position regarding depreciation in respect of the above is as follows:

A. *Mining*

General mining, petroleum, mineral transport and quarrying benefit from a simple and comprehensive system of depletion allowances based on cost.[30] The capital expenditures which qualify cover mine development generally and extend to infra-structure and treatment plant.

The write-off method is the "life of mine" concept with a maximum life of ten years except for quarries where 20 years is the statutory maximum.

22. Hulme Committee's Report (June 1955), at para. 47.
23. Taxation Review Committee, *Final Report* (January 1975), at paras. 8.75-8.81.
24. Sec. 59.
25. Sec. 59(2A).
26. Proposed Sec. 58.
27. Sec. 57AF.
28. The A$ 300 threshold is an anomaly since Income Tax Ruling IT2264 allows mining companies to expense items costing up to A$ 500 per unit.
29. Secs. 54(3) and 51AE(14).
30. The provisions are found in Division 10 – General Mining, Division 10AA – Petroleum, Division 10AAA – Transport. Quarrying is a subdivision of Division 10.

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The cost of mining plant and equipment was includable in such allowances as an alternative to ordinary tax depreciation until 25 May 1988. As from that operative date, plant and articles used in the relevant industries, other than for exploration, are eligible only for normal tax depreciation and no other method of write-off is available.

B. *Primary industries*

There have been long-standing tax concessions in Australia for capital expenditures in relation to primary industries. This manifests itself in two forms, namely concessionary write-off rates for plant and write-off allowances for capital expenditure which would not otherwise qualify because it is not in respect of plant and equipment. In respect of the latter, the definition of plant is statutorily extended to fences, dams and other structural improvements used in agriculture, farming, etc.[31]

Capital expenditure on soil conservation and land degradation measures is deductible immediately. Certain other capital expenditures on water conservation and water conveyance are deductible over three years in equal instalments or 100 percent on incurrence.

C. *Research and development (R&D)*

Australia introduced a complex incentive scheme for R&D expenditure operative from 1 July 1985. In essence, the scheme allows an immediate deduction of 150 percent for eligible expenditure but this will be reduced to 125 percent from 1 July 1993.[32] Expenditure in acquiring "core technology" is limited to a 100 percent deduction but this is an immediate write-off. The concession is limited to companies which have been incorporated in Australia.

To the extent relevant for capital expenditure on plant and buildings:

- The 150 percent cost of research plant and equipment can be written off over three years in equal instalments (i.e. 50 percent in each of the three years but this will reduce after 1 July 1993).
- Buildings qualify for the 2.5 percent amortization rate from 21 November 1987 (three-year write-off applied from 1 July 1985 to 20 November 1987).

In addition, under a previous scheme being phased out[33] the capital cost of buildings which are solely used by a business for scientific research are deductible over three years in equal instalments. The three-year write-off rate (or 50 percent on the reducing balance method) also applies to plant used solely for research as defined.[34] A "sunset" clause provides that these deductions will not apply to expenditure incurred after 30 June 1995.

D. *Other*

Plant used for basic iron and steel products was eligible for accelerated rates for a short period (acquisition/construction commencement from 18 August 1981 to 20 July 1982) for the benefit of Australia's sole producer at that time. Australian trading ships are granted a 20 percent per annum write-off but the application is of limited interest. Certain employee amenities qualify for a rate of 33 1/3 percent under the straight-line method.

V. NEW ARRANGEMENTS EFFECTIVE AFTER 26 FEBRUARY 1992

The policy announcement made by the Prime Minister applies to plant and equipment including second-hand plant acquired or commenced to be constructed after 26 February 1992. The new measures have not yet been translated into law. Therefore the following details should be treated with caution until they can be checked against enabling legislation which has become law.

A. *Plant and equipment*

Under the concept introduced in the March 1991 Economic Statement[35] there were to be seven classes of depreciable assets each covering a band of effective lives. As a result of the "One Nation" Statement of 26 February 1992 the seven classes were reduced to six. The new bands are skewed to significantly increase rates for plant with an effective life of five or more years.

The cost of an asset with an effective life of less than three years is to be deductible as to 100 percent in the year of first use.[36]

The method of depreciation was announced as the declining balance (i.e. diminishing value) method and the straight-line method was not to be permitted. But on 23 March 1992 it was announced by the Treasurer that taxpayers will be able to continue to depreciate plant on the straight-line method by making an election to this effect. The straight-line rates will be 2/3 of the reducing balance rates of the six effective life asset classes. Where this calculation produces a fraction it will be rounded to the nearest whole number.

The new rate schedules will be as follows:

Years in effective life	*Prime cost*	*Diminishing value*
3 to less than 5	40%	60%
5 to less than 6 2/3	27%	40%
6 2/3 to less than 10	20%	30%
10 to less than 13	17%	25%
13 to less than 30	13%	20%
More than 30	7%	10%

The new regime as proposed in the "One Nation" Statement and Taxation Laws Amendment Bill 1992 and Taxation Laws Amendment Bill (No. 2) 1992 introduced into the House of Representatives on 2 April 1992 adds the following qualifications:

31. Sec. 54(2).
32. Sec. 73B.
33. Sec. 73A.
34. Secs. 73A(2) and (6).
35. Sec. 54A(1).
36. Sec. 55(2) in Clause 7 of Taxation Laws Amendment Bill (No. 2) 1992.

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(1) The existing 20 percent loading on depreciation rates is subsumed into the new accelerated rate scales.
(2) Lower rates than the new (maximum) rates are permitted on election.
(3) The following exceptions are to apply to the new rate schedule:
- passenger motor vehicles and derivatives designed to carry less than nine people will continue to be depreciable under the regime effective from 1 July 1991 which is less generous than the six effective life asset classes;
- paintings and certain other art works will also continue to be depreciable under the regime effective from 1 July 1991. This provides for a rate of one percent per annum (straight line) or 1.8 percent per annum reducing balance;
- the special five-year straight-line write-off for trading ships will remain unaltered;
- the special depreciation rate for employee amenities will be retained;
- plant and equipment used in eligible R&D will continue to be deductible at 50 percent over each of three years.

(4) The rate of depreciation for each asset can be determined either with reference to the depreciation schedules published by the Commissioner of Taxation, or be self assessed as to its effective life by the taxpayer.
(5) Asset items which are subject to the same depreciation rate can be "pooled". This simplifies administration by dispensing with the need to keep records of individual assets. If pooling is elected the straight-line method of calculating depreciation is not allowed and the declining balance method must be used.

B. *Structural improvements*

In respect of the cost of structural improvements to land other than buildings which were previously not deductible, these expenditures will now be deductible at the fixed rate of 2.5 percent per annum. Structural improvements for this purpose will include earth works. Typical examples of beneficiaries of the allowance will be private operators of roads (tollways), airport runways and large industrial projects requiring substantial civil works.

Land improvements which constitute changes to the landscape and do not typically depreciate will be excluded from the new regime. Examples of such exclusions were given as golf courses, landscaping and sports playing fields.

There will be no balancing adjustments on the sale of structural improvements or termination of their use. This follows the regime for writing off the costs of qualifying buildings.

C. *Industrial buildings and tourist accommodation*

Under the existing rules the cost of construction of buildings including tourist accommodation (referred to as "short-term traveller accommodation"), is subject to amortization at the rate of 2.5 percent per annum straight line.[37]

In respect of buildings, alterations or improvements to industrial buildings and tourist accommodation commenced on or after 27 February 1992, the write-off rate will be increased to four percent per annum on the straight-line method.

Industrial buildings are to be defined as buildings which house manufacturing plant, packaging plant, supervisors' offices and a workers' lunch room. Warehouse buildings will be excluded other than those adjacent to a manufacturing site and used as temporary storage for raw materials and finished goods.

Office buildings and retail stores will not qualify for the four percent write-off and will continue to be eligible for the 2.5 percent amortization. As an anomaly, R&D buildings will similarly be confined to the 2.5 percent rate which is in contrast to the new four percent rate for industrial buildings.

D. *Development allowance*

As a measure of economic intervention, to act as an inducement for selected large-scale investment of a capital cost of A$ 50 million or more, a development allowance of ten percent of the cost will be permitted. The following are the details given by the Government.

(1) The ten percent deduction regime is to apply to eligible projects and will be based broadly on the existing, but now inoperative legislation for the investment allowance.
(2) An independent statutory authority will be established to certify which projects qualify. The main criteria will be:
- minimum capital cost of A$ 50 million;
- the project must be for the production of goods or services but retailing, wholesaling, office buildings, business or financial services, residential real estate and print or electronic media projects will be ineligible;
- a test of substantial Government assistance or (tariff) protection will be applied to exclude industries which are the beneficiaries of such policies;
- the project will need to meet certain tests that it will be efficient, with economic business inputs, and that it will be competitive by reference to international criteria.

(3) Expenditures after 27 February 1992 will qualify but registration of projects must be lodged by 31 December 1992. Final documentation will have to be lodged by 30 June 1995. The qualifying project will need to commence by 30 June 1996 and plant must be in first use by no later than 30 June 2002.
(4) Only new units of eligible property, being plant or articles within the meaning of the depreciation provisions, will qualify. The deduction for the allowance will be additional to depreciation.
(5) The allowance will be claimable in the year the unit of property is first used for the purpose of producing assessable income, or installed ready for use and held in reserve.
(6) The property must be acquired or constructed by the taxpayer and must be used in Australia by the taxpayer for the purpose of producing assessable income.
(7) The property must be retained by the taxpayer for at least 12 months and not be put to disqualifying use within that period.

37. Divisions 10C and D.

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(8) As a general rule, the allowance will not be available to a taxpayer who uses the property to produce income by leasing, unless the lessee contracts to use the property under a long-term lease in an eligible project.

(9) Expenditure on certain items of property will not qualify for the allowance, including:
- plant used in R&D, which otherwise qualifies for concessions under the income tax law;
- aircraft and trading ships;
- passenger motor vehicles;
- household appliances and furniture and fittings, unless used in the tourist accommodation industry;
- artworks and books;
- non-protective wearing apparel and accessories.

VI. CONCLUSION

It will be seen that Australia has struggled to develop a capital allowance system which is appropriate for its own economy in an international environment.

The frequent changes operative from arbitrary dates (which represent dates on which Government announcements are made) will seem chaotic against the background of international comparisons. Such timing of changes has been repeatedly criticized as adding substantial administrative costs to tax compliance.

More importantly, the frequency of change exacerbates risk aversion in investment decision making. And, there is no evidence new measures achieve their objectives.

PROPOSED SECTION 54A(1) IN TAXATION LAWS AMENDMENT BILL (NO 4) 1991*

For the purposes of section 55, the effective life of a unit of property owned by a taxpayer is whichever of the following periods is applicable:

(aa) if:
- (i) there is in force a determination by the Commissioner under subsection (1A) which specifies a period that the taxpayer may elect to adopt as the effective life of the property; and
- (ii) the taxpayer makes a written election to adopt that period;

that period;

(a) if paragraph (aa) does not apply – the period, worked out as at the time when the property is first used for assessable income-producing purposes by the taxpayer, during which it would be reasonable to conclude that the property would be held by the taxpayer assuming:
- (i) if the property was not new at that time – that the property was new at that time; and
- (ii) that the taxpayer was to hold the property until it was no longer reasonably capable of being used, by the taxpayer or by any other person, for:
  - (A) assessable income-producing purposes; or
  - (B) exempt income-producing purposes; and
- (iii) if, at the time the property was first used for assessable income-producing purposes by the taxpayer, it may reasonably be expected that the property will be subject to wear and tear by the taxpayer at a particular rate – that that rate were the rate of wear and tear to which the property will be subject; and
- (iv) that the property were to be maintained in reasonably good order and condition;

(ia) paragraph (aa) does not apply; and

(ib) the property was new at the time when the property was first used by the taxpayer for assessable income-producing purposes; and

(b) if:
- (i) at the time of that first use it would be reasonable to conclude that the property is likely to be:
  - (A) scrapped; or
  - (B) sold for scrap; or
  - (C) abandoned;

  by the taxpayer at a later time; and
- (ii) the period beginning at the time of that first use and ending at that later time is shorter than the period mentioned in paragraph (a);

  that shorter period.

(c) if:
- (i) paragraph (aa) does not apply; and
- (ii) the property was not new at the time when the property was first used by the taxpayer for assessable income-producing purposes; and
- (iii) assuming that the property was new at the time of that first use, it would be reasonable to conclude at that time that the property would be likely to be:
  - (A) scrapped; or
  - (B) sold for scrap; or
  - (C) abandoned;

  by the taxpayer at a later time; and
- (iv) the period beginning at the time of that first use and ending at that later time is shorter than the period mentioned in paragraph (a);

  that shorter period.

* Introduced in the House of Representatives on 19 December 1991. This Bill has been renamed Taxation Laws Amendment Bill 1992 and has been amended in the Senate.

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INTERNATIONAL:

PERMANENT ESTABLISHMENT PROVISIONS

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I. INTRODUCTION

A permanent establishment (PE) furnishes a treaty nexus for a host country to tax the taxable business and effectively connected investment income of persons, such as foreign entities. Without the existence of a PE, the business profits of a foreign entity are exempt from taxation by the host treaty country, and investment income is generally either exempt or subject to a reduced treaty rate of tax on gross income.[1]

The PE article of tax treaties provides that a person or business entity doing business in another country will be taxable in that other country only if its activities in that country pass a certain threshold. A person may intentionally avoid being taxed in the other country if it carefully plans its activities so that it does not exceed the threshold. An entity that has business activities below the threshold will not have its business profits taxable in the other (host) country. If it crosses the threshold, it will be taxable in the host country on all its income that is connected with its business operations in the host country. The utilization of a PE article enables a company to plan its activities so that it will pass the threshold in some countries and not in others.[2]

The concept of PE determines which of two treaty countries has the primary right to tax the income. An entity that does not want to pay taxes in a country into which it is trading or doing a transaction will want to avoid passing the threshold. An income tax treaty provides that, if an entity does have activities that pass the threshold to constitute a PE in the other (host) country, the host country will have the primary right to tax the income and the home country will have an obligation to relieve double taxation.[3]

In addition to the primary right to tax business profits, other tax aspects may be involved. The host country may be able to tax dividends, interest and royalties received by the enterprise if the right or property giving rise to the income is effectively connected with the PE. Capital gains also can be affected by the existence or non-existence of a PE.

Although a PE is a treaty concept and is normally not defined in domestic tax codes (e.g. the US Internal Revenue Code), the PE concept and tax treaties in general have basic and historical analogues in non-treaty taxation. The application of the PE concept interacts with concepts of foreign taxation in tax codes.

Treaties vary in their definitions of PE and business profits. For purposes of this discussion, three models will be reviewed: the 1977 OECD model tax treaty; the 1980 UN model tax treaty between developing and developed countries; and the 1981 US model tax treaty. After defining a PE, this article will review the treatment of PE provisions in the OECD/US and UN models. The potential use of an OECD/US-style PE article and a favourable limitation on benefits article[4] by a country with a strong international financial sector will then be reviewed. Emphasis will be placed on the recently negotiated protocol between the United States and Barbados. Thereafter, prospects for the PE article in CARICOM tax policy will be mentioned.

1. For a comprehensive review of the PE article in income tax treaties, especially from a U.S. perspective, see Williams, "Permanent Establishments in the United States", J. Bischel (ed.), *Income Tax Treaties* (1978), at 189-312.
2. For a concise and useful discussion of the PE article, see R. Rhoades and M. Langer, *Income Taxation of Foreign-related Transactions* (1991 cum. release), at § 10.02.
3. For instance, if a foreign entity engages in trade or business through a PE in Barbados, the host country Barbados can tax profits connected with that PE. Under its treaties, Barbados will also be able to tax the foreign entity on its dividends, interest, royalties and capital gains that are effectively connected with the PE. If the foreign entity does not have a PE in Barbados, then Barbados cannot tax the business profits, and the foreign entity will be exempt from tax or pay tax at a reduced rate on its investment income from Barbados.
4. A limitation on benefits or anti-treaty shopping article is an article in a treaty directed at limiting the benefits arising from the treaty to those persons that are intended beneficiaries. Such provisions define the intended beneficiaries normally as nationals, residents, holders of minimum amounts of equity, publicly-held companies and so forth.

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II. DEFINITION OF A PE

Conceptually tax treaties apply different standards to determine whether an entity or a person has crossed the threshold that constitutes adequate presence in the host treaty country to have a PE. Three texts are employed:

(1) The *asset* test provides the kind of assets, such as a branch, office, store or factory, maintained by an entity or enterprise in the host country that will amount to a PE.

(2) The *agency* test provides the extent to which the act(s) of an agent, broker, partner or subsidiary will amount to a PE even where the entity itself does not maintain a fixed place of business in the other treaty country.

(3) The *activity* test provides the extent to which an entity can conduct certain activities, such as storing, displaying, delivering or purchasing goods in the host treaty country, without such activities being deemed to constitute a PE.

In general a fixed place of business constitutes a PE only if it is used to engage in a continuous course of commercial activity.[5] Two tests must be fulfilled: (1) an active conduct of business must exist, which must be more than the mere conduct of business, and (2) continuity of activities. Each country has different interpretations of the rule. US law provides that an enterprise may be taxed if a PE exists at any time during the taxable year. It does not matter if the activity does not exist at the time particular income is earned.[6]

US law provides that income or gain is effectively connected with a US trade or business if it would have been so treated if it had been taken into account in an earlier year.[7] Prior to the enactment of the Tax Reform Act of 1986, foreign persons were not subject to US tax on business income and gains received in a year in which the business no longer existed. Foreign persons would receive this treatment by selling the US property at a gain in a year in which the business no longer existed or by selling property on the instalment basis while they engaged in business, recognizing most of the gain in subsequent years when the business no longer existed. Under the 1986 Tax Reform Act, income or gain attributable to another year is effectively connected with a US business if it would have been so connected had it been taken into account in that other year. The provision also embraces assets sold within ten years after being used in a US business.

III. TREATMENT OF PES IN THE MODEL TREATIES

A. *Background*

The main models for defining PEs are the Article 5 provisions in the OECD, US and UN models.

The essence of the concept of PE in the OECD and US models requires a definitive, organized contract or presence so that casual business connections or even a continuous stream of exports without a "business presence" of the foreign exporter will not trigger source taxation.[8] An important premise is convenience, in that some presence should exist before a foreigner must file returns and compute and pay a tax at source. The OECD model emphasizes more than minimal contact or presence.[9] In part the emphasis is a historical accident. Indeed the tax codes of some developed countries shift jurisdiction to tax exclusively to the source country when a PE exists in that country. The activities in the source country must reach an appropriate level of significance to justify the shift in the government which received the revenue from the activity.

Although developing countries have accepted the concept of PE, they have tried to expand the list of activities encompassed by that term. They have sought to narrow the extent to which the concept limited source jurisdiction. These countries emphasized that modern methods of business and communication made some of the requirements of the OECD model obsolete or unsuited to present circumstances. Many developed countries accepted their position for the most part. The UN model expands the scope of the OECD definition of a PE in several respects, thereby expanding source jurisdiction. The same effect is reached by altering certain aspects of the computation of the profits of a PE.

In 1963, the OECD published a draft model income tax treaty that was widely used in tax treaty negotiations, especially those between the 24 OECD member countries. In 1977, a final model treaty replaced the draft. The 1977 model follows the basic principles and general structure of the 1963 draft and expands some treaty articles. Both the 1963 draft and the 1977 final model were accompanied by extensive commentaries on the treaty articles. The commentaries constitute a form of legislative history of the treaty articles and part of the utility of the OECD model is its rich commentaries.

In 1981, the U.S. Department of Treasury published a model income tax treaty that is nearly identical to the OECD model treaty.[10]

In 1980, the United Nations published the UN Model Double Taxation Convention Between Developed and Developing Countries.[11] It provides a model income tax treaty which has the intent of providing a model more suitable to the needs of developing countries, since the 1977 OECD model was prepared for negotiations between two developed countries.

The basic difference between the UN and the OECD model provisions is that the UN provision lowers the components that constitute a threshold. The purpose of the lower threshold is to enable the host/developing treaty country to increase its potential jurisdiction to tax inbound investment/trade from

5. *Consolidated Premium Iron Ores Ltd.*, 28 T.C. 127 (1957), *aff'd*, 265 F.2d 320 (6th Cir. 1959), 3 AFTR 2d 1150, 1 USTC 9387; *Inez de Amodio*, 34 T.C. 894 (1960), *aff'd* 299 F.2d 623 (3d Cir. 1962), 9 AFTR 2d 826, 62-1 9283; Rev. Rul. 67-321, 1967-2 C.B. 470; Rev. Rul. 67-322, 1967-2 C.B. 469.
6. See, for example, the Barbados/US tax treaty, Art. 7(1).
7. IRC Sec. 864(c)(6) and (7); 1986 Tax Reform Act, Sec. 1242.
8. For a useful background discussion of the U.N. model PE provisions, see Surrey, "United Nations Model Convention for Tax Treaties between Developed and Developing Countries" (Amsterdam: IBFD, 1980), *Selected Monographs on Taxation*, Vol. 5.
9. OECD model, Art. 5, para. 4 and Commentary thereon.
10. For a side-by-side comparison, see Rhoades and Langer, *supra* note 2, at § 94.00 et seq.
11. For background, see Surrey, "UN Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries", 19 *Harvard Int'l Law Journal* (1978), at 1.

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persons based in the other treaty country. It is believed that increasing their ability to tax will increase revenue for developing countries.

B. *Summary comparison of provisions of models*

In order to understand the application of the PE article, it is useful to review the provisions of each paragraph, utilizing the OECD model.[12]

1. General definitions

According to paragraph 1 of all three models, a PE is "a fixed place of business through which the business of an enterprise is wholly or partly carried on".

According to the OECD commentary, the essential characteristics of a PE are a distinct "situs" and a "fixed place of business". The definition has the following conditions:

- a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;
- the place of business must be "fixed", i.e. it must be conducted at a distinct place with a certain degree of permanency; and
- the conduct of the business of the enterprise through this fixed place of business. This normally means that persons who are dependent on the enterprise (personnel) carry on the business of the enterprise in the state in which the fixed place is situated.

The term "place of business" embraces any premises, facilities or installations that are utilized to conduct the business of the enterprise, whether or not they are used exclusively for that purpose. A place of business can exist where the enterprise merely has a certain amount of space at its disposal (e.g. in the business facilities of another enterprise), even if they are not owned or rented or are otherwise at the disposal of the enterprise (e.g. by a certain permanently used area in customs depot for the storage of dutiable goods).

Because the place of business must be fixed, a PE can be deemed to exist only if the place of business has a certain amount of permanency and is not of a purely temporary nature.

The existence of tangible property such as facilities, equipment or buildings, or intangible property such as patents, procedures and similar property that are let or leased to third parties through a fixed place of business maintained by an enterprise of a treaty country in the other treaty (host) country will generally render the place of business a PE. However, if an enterprise of a host treaty country lets or leases facilities, equipment, buildings or intangible property to an enterprise of the other treaty (home) country, this will not constitute a PE of the lessor, provided the contract is limited to the mere leasing of the equipment, etc.

A PE can exist if the business of the enterprise is carried on primarily through automatic equipment and the activities of the personnel are restricted to setting up, operating, controlling and maintaining such equipment. The issue of whether or not gaming and vending machines and the like established by an enterprise of a home treaty country in the other host treaty country constitute a PE depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines.

A PE starts to exist when the enterprise starts to carry on its business through a fixed place of business. Once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently, a PE starts. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided this activity differs substantially from the activity for which the place of business is to serve permanently.

The PE ceases to exist when the fixed place of business is disposed of or when the activity through it ceases.

2. Specific inclusions

Under paragraph 2, a PE includes especially:

(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop; and
(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

The list is not intended to be exhaustive and contains examples that are considered *prima facie* as constituting a PE.

The UN and OECD PE articles, unlike the US model, provide that a PE includes a place of management. The "place of management" is only relevant where the laws of the two contracting states contain the concept of "place of management", as distinct from an "office".

It should be noted that, while subparagraph (f) refers to the extraction of natural resources, it does not mention the exploration of such resources, whether on or offshore. The treaty countries may agree upon the insertion of specific provisions as regards its activities of exploration of natural resources in a place or area in the other treaty country.

3. A building site or construction or installation project

Paragraph 3 provides that "[a] building site or construction or installation project constitutes a permanent establishment only if it lasts more than 12 months".

Although the OECD model requires a building site or construction or installation project to last 12 months, the US PE article requires the activity to endure more than 24 months and the UN PE article only requires a period of more than six months. The time period applies to each individual site or project. No account should be taken of the time previously spent by the contractor concerned on other sites or projects that are totally unconnected with it. If a building site is based on several contracts, it should be regarded as a single unit, provided that it forms a coherent whole both commercially and geographically.

12. For a useful summary of the OECD PE article on an individual paragraph basis, see Report of the OECD Committee on Fiscal Affairs, "Model Double Taxation Convention on Income and on Capital" (1977), at 59-69. See also Fuller, "Income Tax Treaties: Permanent Establishments and Business Profits", *Income Tax Treaties* (1982), at 27-63.

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A site exists from the date on which the contractor starts his work, including any preparatory work, in the country where the construction is to be established, such as if he establishes a planning office for the construction. It continues to exist until the work is completed or permanently abandoned. Any of the items that do not meet this condition do not of itself constitute a PE, even if there exists within it an installation; such as an office or a workshop within the meaning of paragraph 2, associated with the construction activity.

The term "building site or construction or installation project" embraces not only the construction of buildings, but also the construction of roads, bridges or canals, the laying of pipelines, and excavating and dredging. Planning and supervision of the erection of a building are also within this term, if the building contractor undertakes them.

In addition, unlike the US and OECD PE articles, the UN model expands the PE treatment for a "building site or construction or installation project" to include an "assembly" project and "supervisory activities" in connection with any enumerated project.[13]

4. Furnishing of services

Further, the UN PE article (paragraph 3b) states that a PE encompasses:

> The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

The taxation of the performance of consultancy services has become important for developing countries since the fees paid by developing countries for these services often involve large sums. The services generally are performed partly in the country in which the seller of the services resides and partly in the source country. Under the traditional OECD and US definitions, the latter services would not constitute a PE. Hence, the UN added the above paragraph. The six-month period could in special cases be reduced to three months through bilateral negotiations. Some of the members disagreed with the limitation of the "same or connected project" and would aggregate unrelated projects. General agreement was reached that only profits from services attributable to the source country should be taxable by it.[14] The Commentary to the UN model provides that some members from developing countries might favour the additional coverage of consultancy services where the remuneration exceeded an amount fixed in bilateral negotiations. However, most members disagreed for several reasons contained in the Commentary.[15]

5. Specific exemptions

Paragraph 4 provides:

Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

This paragraph sets forth a number of activities that are exceptions to the general rules of paragraph 1. They do not constitute a PE even if the activity is conducted through a fixed place of business. The essential feature of these activities is their character as preparatory or auxiliary activities. In this regard, paragraph (e) constitutes a general restriction of the scope of the definition set forth in paragraph 1.

The types of fixed places of business exempted by (e) are fixed places solely for the purpose of advertising or the furnishing of information or for scientific research or for the servicing of a patent or know-how contract, if such activities have a preparatory or auxiliary character. In practice, it is often difficult to distinguish between activities that have a preparatory or auxiliary character and those that do not.

The decisive factor is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case must be examined on its own merits. A fixed place of business whose general purpose is one that is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. For instance, if the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot obtain the benefits of sub-paragraph (e). A fixed place of business that has the function of managing an enterprise or even only a part of an enterprise of a group cannot be regarded as carrying out a preparatory or auxiliary activity, since such a managerial activity exceeds this level. When enterprises with international ramifications establish a

13. Surrey, *supra* note 7, at 15.
14. See Art. 17 (2) of the OECD model, relating to artistes and athletes, which permits source jurisdiction taxation without regard to time of stay or amount of remuneration if the income from the services of the entertainer accrues to another person. Usually the other person is, under the relevant commentary, a company employing the entertainer as to which the entertainer has some degree of control or he participates in its profits.
15. Surrey, *supra* note 7, at 16-17.

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so-called "management office" in countries in which they maintain subsidiaries, PEs, agents or licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, a PE will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2.

As long as the combined activity of a fixed place of business is merely preparatory or auxiliary, a PE should not be deemed to exist. Such combinations, according to the OECD Commentary, should not be viewed on rigid lines, but should be considered in light of particular circumstances.

The UN model does not specifically exclude as many activities from constituting a PE. For instance, the OECD and US PE articles exclude "the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise". The UN article omits delivery of goods from exclusion as a PE. Similarly, whereas the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery is excluded, the UN model again excludes delivery.

The OECD and US PE articles exclude "the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise". The UN model only excludes collecting information from constituting a PE.

Finally, the US PE article states that the maintenance of a fixed place of business solely for any combination of the activities mentioned in the activities excluded does not constitute a PE. The US model conditions this exception on the overall activity of a fixed place of business resulting from the combination being of a preparatory or auxiliary character. The UN model completely omits any version of the subparagraph.

6. Dependent agents

Paragraph 5 provides:

> Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Even though a subsidiary corporation does not constitute a PE, it could constitute a PE if the conditions of this paragraph exist, i.e. it could become a dependent agent.

Normally an enterprise should be treated as having a PE in a state if there exists under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that state within the meaning of paragraphs 1 and 2. Hence, paragraph 5 sets the conditions under which an enterprise is deemed to have a PE in respect of any activity of a person acting for it.

Persons whose activities may create a PE for the enterprise are so-called dependent agents, i.e. persons, whether employees or not, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies. Paragraph 5 provides that only persons with the authority to conclude contracts can lead to a PE for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the state concerned.

The authority to conclude contracts must cover contracts concerning operations that constitute the business proper of the enterprise. Hence, authority by the person to engage employees for the enterprise to assist that person's activity for the enterprise if the person were authorized to conclude, in the name of the enterprise, similar contracts relating to internal operations only, would not constitute a PE.

The UN PE article provides that, where a person, other than an agent of an independent status to whom other provisions apply, is acting in a host treaty county on behalf of an enterprise of the other treaty country, such enterprise is deemed to have a PE in the host treaty country in respect of any activities which such person undertakes for the enterprise if such person:

(a) has and habitually exercises in the host treaty country an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to the activities that are expressly excluded as not being a PE;
(b) has no such authority, but habitually maintains in the host treaty country a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

7. Independent agents

Paragraph 6 provides:

> An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

An enterprise of a treaty country that carries on business dealings through a broker, general commission agent or any other agent of an independent status cannot be taxed in the other treaty (host) country in respect of those dealings if the agent is acting in the ordinary course of his business. Such an agent, representing a separate enterprise, cannot constitute a PE of the foreign enterprise. Paragraph 6 merely classifies the situation.

A person will be within the scope of paragraph 6 and constitute a PE of the enterprise on whose behalf he acts only if he is independent of the enterprise both legally and economically; and he acts in the ordinary course of this business when acting on behalf of the enterprise.

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A person will not be considered independent of the enterprise he represents unless he is not overly obligated to the enterprise. For instance, if the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such persons cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk must be borne by the person or by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company just because of the parent's ownership of the share capital. Persons cannot be deemed to act in the ordinary course of their business if, in place of the enterprise, such persons undertake activities that economically belong to the enterprise rather than that of their own business operations. For instance, a commission agent who not only sells goods or merchandise of the enterprise in his own name, but also habitually acts in relation to that enterprise as a permanent agent having an authority to conclude contracts, would be deemed in respect of this particular activity to be a PE, since he is acting outside the ordinary course of his own trade or business, unless his activities are limited to those mentioned at the end of paragraph 5.

8. Insurance agents

The UN model has a paragraph not found in the other models. Paragraph 6 reads as follows:

> Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to reinsurance, be deemed of a Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

This provision is to obviate the possibility that agencies of foreign insurance companies that sometimes do not meet the requirements of a PE and may do large-scale business in a host treaty country will be taxable on their profits arising from such person. The provision is designed to assist developing countries collect revenue from the activities of foreign insurance companies.

9. Subsidiary corporations

Paragraph 7 provides:

> The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

The existence of a subsidiary company generally does not of itself mean that the subsidiary company has a PE on behalf of its parent company. For the purpose of taxation, such a subsidiary company is, of course, an independent legal entity. Even the fact that the trade or business undertaken by the subsidiary company is managed by the parent company does not constitute the subsidiary company a PE of the parent company. However, if a subsidiary company is regarded as a dependent agent under the same conditions set forth in paragraph 5, it will constitute a PE.

The US model also excludes from a PE the maintenance of a fixed place of business solely for any combination of activities mentioned in the paragraph listing activities excluded from a PE. The OECD model adds the provision that, to be excluded, the overall activity of the fixed place of business resulting from this combination must be of a preparatory or auxiliary character.

The UN model adds that, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of the paragraph.

IV. ADVANTAGES OF A TREATY APPROACH FOR TRADING WITH THE UNITED STATES

There exists significant potential advantages for persons wanting to trade and conduct activities in the United States and other major developed countries to utilize a treaty approach rather than rely on the tax codes. To understand the advantages requires a comparison of the treaty and the codes. Tax treaties all define and provide that a host treaty country can only tax business profits when a PE exists. The Internal Revenue Code provides that the United States can tax a person who has an "office or other fixed place of business".[16] The implication of the Code provision is that a place exists where business is regularly transacted rather than that in which only casual transactions occur. Although this concept resembles a PE, it is not as clearly defined and more difficult to plan to avoid.

In order to take advantage of serving in part as a base for active trade or business for non-Barbadians who want to invest in the United States, Barbados decided to revert to the OECD-style PE that facilitates avoiding having a PE in the United States.

The potential advantages of the proposed protocol with the United States arise from the opportunity for certain third-country persons, i.e. those who have an active trade or business in Barbados, to trade with the United States. In addition to the OECD/US-type PE provisions, the opportunities derive from the limitation on benefits provisions. Article 22(1) allows a person that is a resident of a treaty country, such as Barbados, and who derives income from the other treaty country, such as the United States, to the benefits of the treaty, provided the person meets certain conditions, such as being engaged in Barbados in the active conduct of a trade or business (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 treaty country is derived in connection with, or is incidental to, that trade or business. Another example would be a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange.

16. IRC Sec. 864.

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An example of the type of new business that Barbados can attract is the following:

P, a company organized under the International Business Company Act (IBC) of Barbados, manufactures products distributed in various countries. S, a domestic corporation whose principal place of business is in the United States, is a wholly-owned subsidiary of P. P sells its products at arm's length prices to S, a US distributor for the products. S, on its own behalf, then sells such products (at prices it determines) to independent retailers and wholesalers throughout the United States. In addition, P sells its products at arm's length prices to other unrelated and independent distributors in the United States. These distributors do not constitute PEs of P under the treaty.[17]

A goal of Barbados is to attract more utilization of Barbados for various services relating to trade and investment to and from the United States. For example, it currently serves as a host to US foreign sales corporations for outbound investment as a result of its conclusion of a tax information exchange agreement with the United States. Use of Article 5 in the OECD/US model, rather than Article 5 in the current US/Barbados treaty, would facilitate the effort of Barbados to attract business for trade and investment in and from the United States.

The growing telecommunications industry in Barbados, based on data processing, can serve increasingly to enable Barbados to provide services to entities that are trading into the United States and other countries, especially in the Western Hemisphere. The existence of an income tax treaty with an OECD-type PE and a favourable limitations on benefits provision enable Barbadians to provide marketing assistance through making and receiving phone calls and receiving faxes, and research and development work. It also facilitates Barbadian entities serving as regional headquarters companies.

What other activities could a Barbados IBC carry on in the United States without constituting a PE, assuming that it would otherwise qualify for benefits under the new Article 22 (limitation on benefits)? It could conduct some preparatory or auxiliary business activities even though they are admittedly business activities regularly conducted through a bona fide fixed place of business. These types of activities are exempted because the performance of such services for the parent enterprise is "so far antecedent to the actual realization of profits by its parent body that no profits can properly be allocated to it".[18] Hence, a showroom is permitted. However, a display at a fixed location accompanied by a marketing drive would not be.

In one case under the US/German treaty with an OECD-type PE a German bank was held not to have a PE in the United States, even though it conducted such business activities as obtaining credit reports, introducing customers to US banks and advertising throughout the United States. The IRS noted that such activities exempted the bank from having a US PE since they were of a preparatory or auxiliary character, even though a fixed place of business existed. The ruling also stated that no commercial bank activities were conducted by the US office.

Activities that bring the business organization in direct contact in the United States with customers might go beyond the preparatory or auxiliary stage. Activities of an "internal" nature, however, are more likely to qualify for one of its activities exemptions. Hence, training distributors' employees would more likely avoid a PE than would furnishing warranty work and ongoing services. Hence, the OECD Commentary specifies parts replacement as likely to result in PE status, as this activity is likely to involve contact with customers.

To avoid PE status, it is sometimes better to build a wall between exempt and non-exempt activities. For instance, the sales and services activities should be carried out by a US subsidiary rather than a representative of the IBC.

With respect to the use of agents in the United States, an IBC should use an independent agent, that is "a broker, general commission agent or any other agent of an independent status where such person is acting in the ordinary course of business". A PE will exist if business in the United States is carried on by a dependent agent, that is an agent "who has an authority to conclude contracts in the name of the enterprise and regularly exercises that authority".

A Barbados IBC would not have a PE in the United States if its only activities in the United States consisted of sales made by commission agents who also were acting for other principals in the ordinary course of their business.[19] To meet the independent agent exemption, the US broker should act for others, as well as for the US company or the Barbados IBC. Rulings and cases upholding the exemption have found that the independent agent acted for several principals.[20] An agent's independence can be compromised if the principal's permission must be obtained before signing.[21]

In order to avoid a PE, the contract with the US agent should provide that the agent has no authority to conclude contracts and that all contracts must be entered into (perhaps approved) by the Barbados company outside of the United States. This right to be approved or disapproved should be satisfied and followed in practice.

Assuming a Barbados IBC qualifies for the limitations on benefits article, it may be able to avoid a PE through the use of a representative office. The office should be able to advertise and maintain a stock of goods in the United States as long as sales and solicitation, as contrasted with advertising, are not regularly conducted at the same location. If a US agent regularly accepts orders, including those on terms and conditions set by the US company, by an agent in Germany at a fixed location, presumably this would constitute a "store or other sales outlet". Alternatively, it would probably constitute a fixed place of business under the general definition.

If the Barbados IBC wanted to provide after-sales activities, such as maintenance and repair of computers, it would be more

17. Surrey, *supra* note 7, at 16-17.
18. See OECD Commentary, Art. V, para. 3(12).
19. Cf. Rev. Rul. 55-617, 1955-2 C.B. 794; *Inez de Amodio*, 34 T.C. 894 (1960), *aff'd*, 99 F.2d 623 (3d Cir. 1962); *Donroy Ltd. v. United States*, 301 F.2d 200, 203-04 (9th Cir. 1962).
20. *Id.*
21. *Consolidated Premium Iron Ores Ltd.*, 28 T.C. 127 (1957), *nonacq.*, 1958-1 C.B. 7, *aff'd*, 265 F.2d 320 (6th Cir. 1959).

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difficult to arrange for an agent to do so without creating a PE. These activities would probably be best conducted by another person, say a US subsidiary, that would be subject to tax.

V. CARICOM TREATIES

In the context of Caribbean integration, the PE provisions and tax treaty policy generally will likely become more important both for potential harmonization of tax policy extra-regionally and within CARICOM. Hence, this section reviews PE and related provisions in CARICOM treaties.

The CARICOM countries that have tax treaties follow four principal models. The first model is the old UK extension treaty that results from the colonial relationship between CARICOM members and the United Kingdom. These treaties were concluded either between the United Kingdom and another developed country, or between the United Kingdom and one of the CARICOM countries as they were becoming independent. They follow some of the principles contained in an older OECD classical model treaty for developed countries. They do not cover as many subjects as the newer treaties. For instance, there are extensions of the tax treaties between the United Kingdom on the one hand, and Switzerland and Denmark on the other hand. Some of these treaties have been extended to Antigua,[22] Dominica,[23] Grenada,[24] Jamaica,[25] Montserrat,[26] St. Lucia[27] and St. Vincent.[28] These treaties follow to some extent the 1963 OECD model, although several even precede by almost a decade the 1963 OECD model.[29] Although they do not reflect in many cases the economic, political and juridical circumstances between the CARICOM contracting parties on the one hand, and Switzerland and Denmark on the other hand, they do provide some utility to private investors and the signatory parties. In most cases it would be preferable for CARICOM members to maintain these treaty relationships until they can establish a new treaty policy and revise them.

The second and perhaps most often used model is the UN model treaty between developed and developing countries.[30] The model emphasizes, inter alia: source-based principles to expand wherever possible the jurisdiction of the source (i.e. developing) country, higher withholding tax rates to attempt to increase the revenue of the source country and lower thresholds for imposing a PE, whereby the source country has jurisdiction to tax. The treaties have variations on the UN model treaty. Examples of these treaties are the treaties of Trinidad and Tobago,[31] Jamaica,[32] Guyana[33] and the earlier treaties of Barbados.[34]

These treaties have PE provisions based in part on the UN model. For instance, they provide that a building site or construction assembly, installation or dredging project, or a drilling rig or ship used for exploration or natural resources within a contracting state for one or more periods totaling 183 days in a 12-month period will constitute a PE. This contrasts with the periods of 12 months in the OECD model and 24 months in the US model. The treaties in the latter model contain many provisions that are designed to broaden the jurisdiction to tax of the host country. This is a means to enable the host country jurisdiction, which typically is the Caribbean country, to be able to raise revenue through the employment of their ability to tax.

A common feature of these models is higher withholding taxes than is common in tax treaties between OECD countries. For instance, withholding rates on dividends range typically from 10 to 25 percent rather than 5 to 15 percent as in the case of treaties between OECD countries. Withholding rates on interest are typically from around 10 to 25 percent rather than 10 percent, as in the case of treaties between OECD countries (in many cases 5 percent is the rate). Withholding rates on royalties and management fees are typically approximately to 20 percent rather than 5 percent, as in the case of treaties between OECD countries.

A third model is the one previously used by Barbados. Its model has evolved more from a strict application of the UN model in the 1970s to a hybrid model that blended some aspects of the UN and OECD models.

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22. See the Antigua/UK tax treaty, signed in 1947, as amended in 1968, or the Antigua/Switzerland treaty, signed on 26 August 1973, between Switzerland and the United Kingdom and extended on 30 September 1954, to Antigua.
23. See the Dominica/UK tax treaty, signed 7 March 1968, amending the 1949 treaty; the Dominica/Denmark treaty of 22 December 1954, extending the UK/Denmark treaty, signed 27 March 1950.
24. See the Grenada/UK tax treaty, signed 3 and 25 April 1968, amending the 1949 tax treaty; the Grenada/Switzerland treaty, signed 26 August 1963, extending the 30 September 1954 treaty.
25. See the Jamaica/Denmark tax treaty. An extension was signed on 22 December 1954, of the earlier treaty between Jamaica and Denmark.
26. See the Montserrat/UK treaty, signed 8 April 1968, amending the treaty of 1947; the Montserrat/Denmark treaty, signed 22 December 1954, extending the UK/Denmark treaty, signed 27 March 1950; the Montserrat/ Japan treaty, signed 25 September 1970, extending the treaty signed 4 September 1962; and the Montserrat/Switzerland treaty, signed 26 August 1963, extending the UK/Switzerland treaty, signed 30 September 1954.
27. See the St. Lucia/UK treaty, signed 5 April 1968, amending the treaty of 1949; the St. Lucia/Denmark treaty, signed 22 December 1954, extending the UK/Switzerland treaty, signed 26 August 1963, extending the UK/Switzerland treaty, signed 30 September 1954.
28. See the St. Vincent/UK treaty, signed 1 April 1969, amending the treaty of 1949; the St. Vincent/Denmark treaty, signed 22 December 1954, extending the UK/Denmark treaty, signed 27 March 1950; the St. Vincent/Switzerland treaty, signed 26 August 1964, extending the UK/Switzerland treaty, signed 30 September 1954.
29. For a discussion and the text of the 1963 and 1977 OECD model treaties, Report of the OECD Committee on Fiscal Affairs, *Model Double Taxation Convention on Income and Capital* (Paris: OECD, 1977).
30. For a discussion and the text of the UN model tax convention, see e.g. United Nations Department of International Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (United Nations NY, 1980 ST/ESA/102).
31. See the treaties between Trinidad and Tobago and Switzerland, signed 1 February 1973; the United Kingdom, signed 29 December 1966, amended 10 December 1969; Italy, signed 26 March 1971; Denmark, signed 17 May 1971; France, signed 5 August 1987; and Italy, signed 26 March 1971.
32. See Jamaican tax treaties with the United States, signed 21 May 1980; Sweden, signed 17 February 1985; the Federal Republic of Germany, signed 8 October 1974; and Canada, signed 4 January 1971.
33. See treaty between Guyana and Canada.
34. See the Barbados tax treaty with Sweden, signed 13 March 1949 (as concluded with the United Kingdom and extended to Barbados), subsequently modified and no longer in force; the treaty with Denmark, signed 27 March 1950 (as concluded with the United Kingdom and extended to Barbados and no longer in force); the treaty with Norway, signed 2 May 1951 (as concluded with the United Kingdom and extended to Barbados and no longer in force); the treaty with Switzerland, signed 30 September 1954 (as concluded with the United Kingdom and extended to Barbados); the treaty with the United Kingdom, signed 26 March 1970; the treaty with Canada, signed 22 January 1980; and the treaty with the United States, signed 31 December 1984.

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The PE article in the US treaty has aspects of the UN model. For instance, a PE includes a place of management, a building site or construction, assembly or installation or drilling rig or ship used for the exploration or development of natural resources within a contracting state, but only if such site or activity continues for a period or periods aggregating more than 120 days in a 12-month period.

For instance, in its 1983 income tax treaty with the United States, Barbados emulated the OECD treaty in the sense that it agreed to relatively low withholding rates of 15 and 5 percent on dividends and 12.5 percent on royalties and interest.[35] The treaty also contained a liberal limitation on benefits article that allows some offshore activities to benefit from the treaty. The treaty also has a broad non-discrimination provision that enabled Barbados offshore companies to obtain tax benefits in the United States on an equal basis with US persons. This provision enabled Barbados to attract, for instance, international business companies when the US partially terminated its income tax treaty with the Netherlands Antilles. Barbados also succeeded in obtaining exemptions on US insurance premium excise taxes. As a result, Barbados has become the second largest jurisdiction for hosting captive insurance companies (after Bermuda). However, the United States terminated the treaty, resulting in some small dislocation and a slow-down in the growth of this new industry. A unique feature of the Barbados/US treaty is that slightly before the conclusion of an income tax treaty in December 1983, the two governments concluded a tax information exchange agreement, thereby making Barbados eligible for hosting foreign sales corporations (FSCs). Barbados has become the second largest host of FSCs after the British Virgin Islands.

Another aspect of the 1983 Barbados/US income tax treaty is that it emulated the UN model in that it has low thresholds to impose a PE.

A fourth model is the current Barbados model. Starting a few years ago when Barbados began to diversify its tax treaty network and negotiated with three Nordic countries and then Germany, its model evolved to incorporate provisions more similar to those found in the 1977 model. It eliminated the expansion of the source country's power to tax by using PE and the provisions analogous to those in the 1977 OECD model convention. It lowered the withholding rates for interest and royalties to as low as five percent.

The reason that Barbados has done this is twofold. On the one hand, its offshore sector has begun to grow and, in order to prosper, it is preferable to have low withholding rates and the ability to use tax treaties. Barbados has also decided to revert to the OECD model treaty for purposes of the jurisdiction of the source country. One reason is that, in order for the Barbados' offshore sector, say IBCs, to be able to invest in and trade into the other country at a minimal tax rate, such Barbados entities need to be able to take advantage of high thresholds before the source country can impose tax on such investment/trade so that they can avoid the possibility of being taxed in countries like the United States. With a UN-type PE provision, it becomes more difficult for a Barbados IBC to provide services ancillary to trading into the United States and yet avoid US tax on such activities. For instance, as discussed in more detail above in the proposed protocol between Barbados and the United States, the combination of the PE article, which is analogous to the 1977 OECD model, and the limitation on benefits article, enables a Barbados IBC to assist a foreign company that wants to begin exporting or consolidating existing exports to the Western Hemisphere, especially the United States. By establishing a Barbadian IBC and by having an active trade or business in Barbados relative to its US activities, the Barbadian company can conduct activities ancillary to marketing and selling goods into the United States without any imposition of tax. There are other examples. However, the key point is that Barbados can attract investment to its offshore sector through emulating the OECD model. A second reason is that Barbados believes that, in the competitive market in which it must try to attract investment, a very low threshold by which the source country can impose tax and then high withholding rates does not necessarily increase revenue. In fact, since Barbados is a high-cost jurisdiction, the combination of high taxes and high operating costs (i.e. comparative higher wages) may preclude attracting new investment.

VI. POLICY ISSUES AND PROSPECTS

A continuing policy issue will be whether Barbados wants its PE article to follow a UN-type model which enables it to maximize potential income from foreign investment, or an OECD-type model that enables it to be more competitive from a tax perspective in attracting investment, and simultaneously attract foreign investment to its services sector through the use of tax treaties. The successful attraction of foreign investment through tax treaties requires limitation on benefits provisions that facilitate the use of the treaty by third-country investors. The proposed protocol to the US/Barbados tax treaty does this, partly by demonstrating specifically that certain third country persons, if they meet certain conditions such as conducting an active trade or business, can qualify for treaty benefits. The existence of this provision is quite a potential benefit and enables Barbados to attract investment to its services sector uniquely.

Other developing countries may have a different perspective and policy considerations. For instance, many developing countries might want to continue to have a broad jurisdiction in the PE article for the purpose of maximizing revenue. Among CARICOM countries Jamaica and Trinidad currently follow the UN model approach. These countries do not have as strong an international financial sector and the use of tax treaties to attract investment to the sector is not an intention.

35. See Barbados' treaties with Finland, signed 15 June 1989; Norway, signed 15 November 1989; and Sweden, signed 1 July 1991 (effective date 1 January 1992).

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EUROPEAN COMMUNITIES:

IMPLEMENTATION OF THE EC PARENT/SUBSIDIARY DIRECTIVE IN THE VARIOUS MEMBER STATES

Eamonn McGregor

The Council Directive of 23 July 1990 (sometimes referred to as the Parent/Subsidiary Directive and hereinafter referred to as the Directive) obliges member states to comply with its provisions before 1 January 1992. The purpose of the Directive generally is to eliminate withholding taxes on dividends in the country of source and to provide relief from double taxation for the parent company by the exemption or tax credit method. This article highlights the implementation measures introduced by each member state which are either permitted by way of a derogation or that have been introduced unilaterally.

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At the time of writing Belgium, France, Germany, Ireland, Luxembourg and Spain have introduced implementing legislation into their domestic law. Denmark and the Netherlands have introduced bills in their respective Parliaments. The Italian Parliament has issued certain criteria to the Government which are to be incorporated in the eventual legislation. The United Kingdom has issued a Consultative Document. Portugal and Greece have not introduced any legislation although, as a result of derogations granted to these two countries, their failure to do so will not have a significant impact on other member states. The comments in this article are based on the foregoing legislation and proposals.

Article 1 of the Directive requires that each member state apply the Directive
- "to distributions of profits received by companies of that state which come from their subsidiaries of other member states;
- to distributions of profits by companies of that state to companies of other member states of which they are subsidiaries".

I. DIVIDENDS RECEIVED BY A PARENT COMPANY

A. *Exemption or credit method*

The Directive permits member states to chose between the exemption method or the credit method. Under the exemption method dividends from a qualifying subsidiary are exempt from tax altogether. Under the credit method dividends received form part of taxable income of the parent company and a credit is given for any withholding and underlying tax paid by the subsidiary in the other member state up to a maximum amount of the corresponding tax payable in the parent company's state.

Belgium, Denmark, France, Luxembourg and the Netherlands already exempt dividends from qualifying foreign subsidiaries in their domestic legislation.

Strictly speaking, the Belgium system of exemption does not comply with the Directive as the dividend is initially comprised in taxable income and then a deduction equal to 95 percent of the dividend income is allowed as an expense. However, if there is insufficient income to absorb the deduction or if the Belgium company is in a loss position then the dividend deduction is permanently lost as it may not be carried forward or carried back as part of a loss.

Italy has opted for the exemption method.

Germany has opted for the credit method unless the dividends are already exempt under a double taxation agreement. With the exception of the 1925 treaty with Italy,

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 104-108 of the January/February 1992 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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I do not think this is a useful suggestion. Broadening comparables would necessitate research into external factors, such as the degree of comparability and the functions performed by the relevant open market parties. Applying for example the resale price method, starting from the price charged to an independent wholesaler and subtracting a margin for the function and risk of the last internal stage, is usually easier, more straightforward and more reliable than an analysis of the level of comparability of an external price. If the tax authorities use a "broad" CUP as a check, they are faced with problems of comparability as well.

This does not preclude that in specific sectors (e.g. oil) it may not be difficult to apply a broad CUP. It depends on the difficulty of evaluating the non-similar aspects. Such a method should, however, not be imposed on related parties who consistently and correctly apply free negotiation or the resale price or cost plus methods. It may function as a rough check as to whether the result of application of these methods is within reasonable boundaries.

III. CONCLUSION

I have reached the following conclusions:

- The 1979 OECD Report primarily represents the view of tax authorities on transfer pricing problems. It focuses on checking methods to be used by tax administrations.
- The basis of the arm's length standard is the neutrality principle. The crucial requirement is *bargaining* at arm's length. If the conditions for arm's length bargaining are met by MNEs, the result should be accepted as an arm's length price.
- The external CUP is primarily a checking method; it can only be a pricing method in a limited number of cases. Broadening comparables is not practical as a pricing method.
- The concept of the sound business manager acting vis-à-vis third parties is the proper standard of comparison. It involves discretionary power, simplicity and consistency.
- Consequently, the most appropriate transfer *pricing* methods are:
  - free negotiation (arm's length bargaining)
  - internal CUP
  - resale price method
  - cost plus method
  - external CUP (if available continuously)
  - any other method which a sound business manager transacting business with third parties would follow.

These generally do not conflict with statutory provisions on transfer pricing nor with case law, although they may conflict with guidelines issued by tax administrations.

ANNEX 1

IBFD Transfer Pricing Enquiry 1991

Usable response : 67 from 13 countries
Manufacturing and trade sector : 50
Service sector : 17

	Goods	*Services*	*Intangible*
Comparable uncontrollled price[1]	8	6	21
Resale price	7	3	5
Cost plus	16	44	15
Resale price and cost plus	11	-	1
Combination of the three basic methods[2 3]	12	10	6
Other methods[4]	3	2	8
	57	65	56

1. Covers both internal and external CUP.
2. CUP if available; otherwise resale price or cost plus.
3. Although a question on arm's length bargaining was not included, in two cases it was mentioned as the primary method.
4. Mainly profit split (goods); cost funding (services and intangibles); percentage of sales or turnover, discounted cash flow and return on assets (intangibles).

ANNEX 2

Resolution IFA Cancun

As a result of the debate on the above topics in the panel the following resolution was unanimously adopted at the IFA Congress in Cancun on 15 October 1992:

> Paragraphs 2 and 38 of the OECD Report recognize that within affiliated groups, conditions for arm's length bargaining may be fulfilled. This could be the case if the persons having a decisive influence on the transfer price have diverging economic interests; where civil law rules prescribe certain behaviour; where group entities have their own profit responsibility and are free to contract with third parties; or where there are significant minority or even majority interests.

The OECD Report should provide criteria to identify such situations and provide that, if they are found to be present, the price that has been established should be accepted as an arm's length price.

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> acted in such a manner as third parties independent of each other would have done (arm's length dealing). The standard here is the relation given in a situation of *free competition*. The underlying principle is the normal degree of commercial prudence shown by a sound and conscientious business manager vis-à-vis unrelated parties.[5]

The Administrative Principles further state that a sound business manager will derive the price to be charged from the data which are available or accessible to him.

Helmut Becker has made a comparative study of the relationship between the arm's length principle and the concept of the reasonable businessman.[6] I conclude from his article that such a relationship exists only in Germany and Denmark. In the Netherlands the reasonable businessman is the governing principle for determining the profits of an enterprise, but it is not used for transfer pricing purposes. In other countries the concept of the sound business manager is a general principle of commercial law. I feel that the concept of the sound business manager should play a central role in judging transfer pricing practices – a role more prominent than that of the external CUP method.

The concern of a sound business manager operating within an MNE is to obtain reasonable remuneration for the goods, services and intangibles of his group entity in relation to the functions performed and risks assumed by that entity (as would be the case with independent parties).

Dutch and German literature and case law on the sound business manager concept establish a number of criteria, such as simplicity, consistency and a certain amount of discretion.

Simplicity in this context means the avoidance of burdensome clerical work involved in finding external CUPs by applying information which is readily available within the group or generally accessible outside the group.

Searching for external CUPs may be very onerous. It is often impossible or very difficult to obtain evidence about the open market situation. A functional analysis of an external situation may be necessary; otherwise it may be impossible to ascertain whether the external price is a real comparable price. Such an analysis cannot usually be made in practice. A sound business manager's pricing system can therefore only be based on external CUPs when such prices and the open market situation can be clearly and consistently ascertained.

On the other hand, information necessary to apply the internal CUP method and the other methods recognized as basic arm's length methods (the cost plus method and the resale price method) is largely available to the group entity itself. Application of these methods would require a functional analysis of the group members concerned, but that would not normally cause any difficulty.

The consistency aspect of acting as a sound business manager would require that the free negotiation, internal CUP, cost plus or the resale price methods be used consistently and correctly over a number of years.

The fisc should normally not adjust profits if an external CUP is found which does not deviate to a considerable extent from the price arrived at by the consistent application of the above methods. An external CUP which deviates considerably from a freely negotiated price within a group may justify an adjustment for past years if the manager knew of the CUP or if he should have known of the price (the latter test is objective). An external CUP known to the parties should normally have influenced the negotiations.

In the case of the cost plus and resale price methods an external CUP which deviates considerably may provide evidence that the functions performed within the group are not adequately remunerated. Knowledge of such a CUP or application of a "should have known" standard may justify adjustments for past years.

Discretion means that there is a framework within which the sound business manager may operate, i.e. a sound business manager may choose from various alternatives. He would determine a price to be charged with necessary care from the data available or accessible to him, appraising the situation and making decisions on the basis of his knowledge of the business and the market.

E. *Resale price method and cost plus method*

As indicated above, the role of the external CUP as a pricing method is necessarily limited. Free negotiation (arm's length bargaining) is the primary arm's length pricing method, but it can not be made mandatory for MNEs. Free negotiations would, for instance, not be an appropriate method if the enterprise as a whole is highly integrated or a if specific entity in the group is not a unit with an individual profit responsibility. A sound business manager must therefore have a reasonable degree of discretion to establish a transfer pricing system in accordance with the arm's length principle.

Two methods are widely used for transfer pricing: the resale price method and the cost plus method.[7] The IFA Report raises the question whether the resale price and cost plus methods comply with the narrow definition of arm's length pricing.[8]

According to paragraphs 11 and 12 of the OECD Report, CUPs are used "ideally", but in practice "it will often be necessary in order to establish an arm's length price to use either the cost plus method or the resale price method". Whether these methods comply in practice with the arm's length standard depends on the appropriateness of the profit element included (see the end of paragraph 12), but the methods themselves are undoubtedly arm's length pricing methods.

F. *Broadening of comparables*

The IFA Report proposes broadening the application of (external) CUPs as a solution to the transfer pricing problem.

5. The reference to a "sound business manager" for transfer pricing purposes is based on case law of the Bundesfinanzhof, giving it greater legal force in Germany than an administrative interpretation of the law.
6. See H. Becker, "The Arm's Length Principle and the 'Reasonable Businessman'", Vol. 14 *Tax Planning International Review*, No. 8, August 1987.
7. See annex 1 to this article.
The last but one sentence of Chapter II, paragraph 2 of the IFA General Report, should read as follows: approximately 90% of the reporting multinationals use the three basic methods, not a fourth method.
8. See IFA Report at 36.

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In my opinion there are two different origins of the arm's length principle:

(1) the adjustment of the income of shareholders who have received extraordinary benefits from a company which have not been officially declared as dividends. Majority shareholders are able to derive such benefits as a result of their special position. The adjustment in such cases is made by deeming such benefits to be hidden profit distributions or constructive dividends. It is applied, for example, in Switzerland, Germany (in addition to the correction method under the Aussensteuergesetz) and the Netherlands.

(2) the specific anti-avoidance rules introduced in the United Kingdom in 1915 and in the United States in 1917, aimed at discouraging tax avoidance through the manipulation of transfer prices via relationships with foreign subsidiaries.[4]

These antecedents epitomize the *neutrality principle* which, in my opinion, underpins the arm's length principle. A tax system which embraces the neutrality principle is one that does not influence taxpayer decisions or choices; in other words, a system that makes the tax burden independent of choices made or actions taken by the taxpayer. Taxpayers with a controlling interest in a company are placed in the same position as other taxpayers through application of the arm's length principle which neutralizes the advantage of the former.

B. *Bargaining*

The essential requirement of the arm's length principle is that there should be *bargaining* at arm's length. Bargaining at arm's length between related parties is achieved if the bargaining conditions are similar to those existing between non-related parties.

Paragraph 2 of the 1979 OECD Report states that the conditions for arm's length bargaining are sometimes fulfilled by MNEs when the group members have considerable autonomy and have reasons for recording favourable results. Paragraph 38 makes a similar point.

Indeed, in many multinational groups authentic internal competition and serious bargaining among group entities is brought about by factors such as:

- own profit responsibility;
- manager remuneration (partially) related to profits;
- group entities being allowed to buy from non-related parties if their prices are lower.

If such factors are genuine elements of the structure and transfer pricing system of a group the basic requirements for arm's length bargaining are fulfilled and the prices resulting therefrom should be accepted as arm's length prices.

The OECD Report does not specifically arrive at this conclusion. Instead it approaches the problem from a negative perspective:

"Divergencies from arm's length prices will not necessarily always occur" (paragraph 2); ".... it should not be assumed that the prices actually charged within an MNE will never be arm's length prices" (paragraph 38).

It would be very useful if the OECD would elaborate on this aspect and indicate precisely in what circumstances it can be assumed that the conditions for arm's length bargaining are fulfilled.

C. *The role of the comparable uncontrolled price method (CUP)*

The CUP method is presented in the 1979 OECD Report and the IFA Report as the primary transfer pricing method: "the CUP method offers the most direct way of determining an arm's length price" (paragraph 48 OECD Report).

In my opinion, this statement is unilaterally based on the perspective of tax authorities. Paragraph 11 of the OECD Report itself gives evidence for this thought:

> Making a *judgment* whether a particular transfer price conforms to the arm's length principle would ideally require direct reference to prices in comparable transactions between enterprises independent of each other or between the group and unrelated parties.

The word "judgment" indicates that the CUP is primarily meant to be a *check* to enable the tax authorities to ascertain whether the result of bargaining between related parties is comparable to that between non-related parties.

Paragraph 11 of the OECD Report correctly states that a distinction should be made between prices in comparable transactions outside the group concerned, that is between unrelated third parties ("external CUP"), and prices charged between group entities and unrelated parties ("internal CUP")

The internal CUP is part of the pricing system of the MNE concerned and represents an arm's length price as it also results from bargaining between unrelated parties. Information on internal CUPs is generally readily available to group members. However, the situation is radically different in the case of external CUPs. Only a very limited number of cases provide sufficient and sufficiently continuous evidence of external CUPs on which to base a *pricing* system (the oil sector offers a good example). I would therefore *not* categorize the external CUP as a primary pricing method.

An external CUP which is widely known in the relevant economic sector concerned would have a high degree of authority for the parties so it would be difficult to justify any deviation. The bottom line is that a *sound business manager* would not buy from a related party at a particular price if the open market price was lower.

D. *Sound business manager*

Paragraph 2.1.1 of the 1983 German Administrative Principles on transfer pricing explicitly refers to the sound business manager:

> Business dealings between related persons have to be judged for tax purposes according to whether those involved have

4. The arm's length principle may also have precedence in the substance-over-form principle. See Art. 7 of the Dutch Income Tax Act: "benefits, under whatever name and in whatever form".

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INTERNATIONAL

THE ARM'S LENGTH PRINCIPLE AND THE ROLE OF COMPARABLES

Hubert Hamaekers

I. PRELIMINARY COMMENT

The IFA General Report on Transfer Pricing in the Absence of Comparable Market Prices (IFA Report)[1] is based to a large extent on interpretations of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises (OECD Report). The latter report was adopted in January 1979 by the OECD Committee on Fiscal Affairs and was unanimously recommended by the OECD Council of Ministers to its member states. The report, which explored what at that time was largely terra incognita, went on to become the most influential document on transfer pricing ever to be published internationally.

It should be emphasized that the OECD Report was written by representatives of tax administrations and therefore represents the view of tax authorities who are charged with the difficult task of ascertaining whether the arm's length principle has been correctly applied by multinational enterprises (MNEs) (see e.g. paragraph 11: "making a judgment"; paragraph 17: "examining", and paragraph 33: "some of the problems facing tax authorities").

Admittedly, the Business and Industry Advisory Committee to the OECD has exerted some influence on the report, but this has not altered its focus. The OECD Report focuses on checking methods for tax authorities. The Report is not primarily designed to establish a pricing system for MNEs, but rather to indicate what would be acceptable to the various tax authorities.

The OECD Report is included in a recommendation to the member states directed at their tax administrations. Consequently, its principal legacy has been the development of administrative guidelines, general rulings and other non-statutory instruments with limited legal force; in short, the Report represents the interpretation of the tax authorities.

One result of this unilateral interpretation is that in order to achieve reasonable results in controversies involving tax authorities and taxpayers on transfer pricing matters, the tax courts are often forced to evolve specific case-by-case solutions.[2]

The IFA Report makes a substantial contribution to a better understanding of transfer pricing methods by distinguishing between pricing methods and checking or assessing methods. A report on developing arm's length pricing systems, written from a business perspective, would inevitably differ from the OECD Report both in perspective and methodology.[3] It is an appropriate task for a neutral body such as IFA to attempt to bridge the gap between the tax authorities and business and to present a balanced approach to transfer pricing. The timing is excellent since the development of new transfer pricing regulations in the United States is proceeding in a somewhat less extreme direction than a few months ago. A revision of the 1979 OECD Report is also underway.

II. THE NATURE OF THE ARM'S LENGTH PRINCIPLE

A. *General*

The arm's length standard is the governing principle for the tax relationships between entities of internationally operating groups.

Hubert Hamaekers is Chief Executive of the IBFD and former Chairman of the OECD working party on transfer pricing and multinational enterprises. This article contains Mr. Hamaekers' contribution to the panel discussion on Transfer Pricing in the Absence of Comparable Market Prices, IFA Congress, Cancun, October 1992. His task was to distinguish the essence of the arm's length principle and the role of the comparable uncontrolled price.

1. Professor G. Maisto, *Cahiers IFA*, Volume LXXV11a (Kluwer: Deventer, 1992).
2. See IFA Report, at 28.
3. See, for example, *Report on Transfer Pricing in the Ethical Pharmaceutical Industry* (forthcoming, IBFD Publications: Amsterdam).

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This has been our experience in dealing with information which we have reviewed. The cost of the effort is repaid many times.

As more businesses automated, it was found that information was being provided by some on paper and by others on magnetic tapes.

We are now transferring a mix of paper, disks and tapes. To date this has not been put into a standard format.

OECD countries have been involved in such exchanges and the Council of the OECD developed a standardized form, although Canada has not used it. The same experience has been taking place in other OECD countries as well, that is, increased computerization and information being transmitted on paper, tape and diskette.

The OECD has formed a working group to develop a standard format which the members could use for the electronic transmission of information. There were technical matters to resolve to ensure that a system could be developed which can capture information and transmit it, which will be of use to the recipient country. A format has been developed which should meet the needs and be usable. Work remains to be done as we need to determine where we are going with this.

The electronic exchange of information can be effected, but it remains for the countries involved to put the machinery into effect. However, there are matters of protection which concern us. There is a right to privacy as recognized by the Council of Europe Convention on this issue. In many of our countries there are Privacy Acts which attempt to protect information, so it is incumbent on us to ensure that while the necessary information is provided, there is adequate protection. The information intended to be transmitted should be correct and it must go to the proper person. There is also the question of storage. There is always a potential for error. Some of these are concerns applicable to any exchange, but electronic exchanges have special problems. The facsimile transmission is an example of the problem that does exist. One incorrectly entered digit can spell disaster.

Electronic transmissions will take place, but the sending and receiving countries must develop systems which capture the data and which have a degree of compatibility. The data must be capable of matching within the receiving system and the necessary detail must be useful. It must be protected and controlled.

INTERNATIONAL ORGANIZATIONS

Canada has had considerable involvement in international organizations and the various activities undertaken by them. I shall restrict my comments to organizations with a tax involvement and from which we have gained experience.

Many of these organizations have as a principal goal the mutual assistance which the members can bring thereto. To achieve the ends it is irrelevant whether the organization is primarily one of developed countries or is of a more varied constituency such as CIAT or CATA.

We have been a member of the OECD since its inception in 1960. The working parties under the Committee for Fiscal Affairs have afforded us an opportunity to exchange ideas and be privy to the developments in the field of taxation in the developed countries. Issues such as transfer pricing in Working Party 6, the exchange of information in Working Party 8, and most particularly the development of the model convention in Working Party 1, have been relevant to our own system.

The focus of an organization such as the OECD can change as is seen by the current initiatives being taken in the field of training in Central and Eastern European countries. Valuable experience is being gained through the formation of the new training centres, which may have a much broader impact than we think at present.

CIAT with its 28 members and the CATA with its 43 members provide different fora, since the countries represent a worldwide mix of the developed and the developing countries. In these we gain knowledge and have the opportunity to carry out our obligations to participate and share. These organizations, along with COTA and the Paris-based CRÉDAF, provide a vital link for the developing countries and an access to experience, advice and assistance.

In Canada we also have the government agency, the Canadian International Development Agency (CIDA), which has as a prime goal the provision of financial and technical aid to the developing countries. We have direct experience through CATA and CIAT through the provision of training in cooperation with CIDA. Other similar organizations exist in the United States and in the United Kingdom. CIAT has been fortunate in enlisting the aid of such countries as France, Germany and Spain in this respect. Avenues exist in other countries which CIAT might explore as evidenced by the interest in the further development of the Strategic Plan. There is also the United Nations, the International Monetary Fund and the World Bank which can play a role.

The use of international organizations is not solely one of raising funds. They have provided for us a means of learning and for broadening our contacts. This is equally true for the other members.

In any organization we must always be clear in our own minds as to the focus of the organization. It must always be the need of the organization and the members which steer the direction.

CONCLUSION

In summary, the essence of both parts of this topic, the exchange of information and international organizations, involves the concept of cooperation. With the increasingly complex world economy and the need to deal with international tax avoidance and evasion we must draw closer together and share our information bases.

International organizations are the other part of the area of cooperation, whether it is to give help, receive it or provide mutual assistance such as through the valuable roles played by CIAT. There are challenging opportunities for organizations such as the World Bank to make meaningful contributions to the development of governmental organizations in the developing countries, but the real task lays with organizations such as CIAT to be the focus for cooperative development.

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Members of CIAT should feel encouraged to explore the adoption and use of the model, because it offers another means of cooperation in the combatting of tax avoidance and tax evasion. Our laws may vary somewhat, but the need to obtain information to administer them does not.

Multilateral Conventions

Generally speaking there is a trend towards greater interdependence, although there are some notable exceptions to that phenomenon. The European Community (EC) has taken strides to drop barriers and attempt harmonization, although the tax systems are still a long distance from that goal. There is the interest in greater cooperation in such ways as the use of simultaneous examination programmes. There is also a tangible example of this in the Convention on Mutual Administrative Assistance in Tax Matters which was developed under the aegis of the OECD at Strasbourg.

That Convention recognizes three avenues of cooperation:
(1) exchange of information, including simultaneous examinations and participation in tax examinations abroad;
(2) assistance in recovery; and
(3) service of documents.

The member countries of the EC have an extensive network of tax conventions on a bilateral basis, and it remains to be seen whether the multilateral approach makes a significant addition. Of course if the relationships change over the next one or two decades the whole pattern of tax conventions could change, with the EC negotiating treaties for the group of countries with other nations, or groups of nations. That may also be open to other regions of the world, particularly if we see similar economic unions.

Where the bilateral conventions do not exist, or exist only in small numbers, the multilateral approach may provide at the very least an interim measure, pending the adoption of a more extensive bilateral network. The multilateral convention may also be the way of the future, supplanting the bilateral. In any event, it is hoped that cooperation would be the result.

The Need for Rules

Canada uses the OECD Model in negotiating its conventions and that Model has commentaries which assist us in interpreting the conventions. However, in carrying out the exchange provisions which are operational matters, Canada has little in the way of rules, except the provisions themselves. While they indicate certain criteria to apply to exchanges we do not always know how well the criteria are applied. Control is a problem.

A typical provision dealing with the exchange of information contains the following conditions on any exchange:
- it can only be used for tax purposes;
- it can only be disclosed to persons involved in tax administration;
- it will be treated as secret;
- it will not disclose any trade or business secret or be contrary to public policy.

Canada views its treaty obligations very seriously, but there is a concern that our treaty partners should meet their obligations under the treaties, in particular that they will use the information only for the purposes specified in the convention.

We have a consultation process to enable us to determine the safeguards in place in the treaty country before we provide information. No information will be exchanged unless we are satisfied that the information will be kept confidential by the foreign tax administration and that it will be acted on in a manner that is respectful of due process.

While we are acutely aware of the need to exchange information, we must be concerned in regard to its use. We have always protected taxpayer information in Canada and provided severe penalties for breaches of confidentially. We must make the best effort to ensure its proper use.

FOREIGN-BASED INFORMATION – CANADIAN LEGISLATION

It has always been difficult to obtain foreign-based information, whether it is in a treaty country or not. It has emphasized the need for treaties. When we use a treaty to obtain information, it signals that we have exhausted all of the processes available to us in Canada, or that we can find no accessible source of information available to us. The tax treaty does give us a further avenue of access. However, when we are dealing with various forms of tax avoidance, the information is not always available in a treaty country, but rather in one of the more traditional tax haven countries.

In dealing with a parent and subsidiary situation, with the subsidiary in an offshore jurisdiction, it has been impossible for the most part to obtain the documents from the subsidiary. It is usually argued that the two companies are separate legal entities and the offshore corporation cannot be forced to provide that information.

In our 1988 tax reform package provisions were introduced into our law which allow us to make a formal demand requiring a Canadian taxpayer to produce foreign-based information that is deemed to be relevant to the case at hand. The taxpayer has the right to challenge the demand and may apply to the courts for an order which would confirm, vary or deny the requirement to produce.

The failure to produce the information does not immediately result in a penalty or sanction; however, a failure to produce prevents the taxpayer from using the information in subsequent legal proceedings.

TECHNOLOGY AND EXCHANGES

Our conventions generally allow for automatic exchanges of information, and these have been referred to as first arising in the 1942 Convention with the United States. The first exchanges of this type were, of course, all on paper and Canada has sent on a regular basis a very large volume of information slips which have disclosed payments of interest, dividends and royalties to persons with addresses in that country. If the information is matched against returns filed under that tax system, it is possible to find non-reporting.

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Information obtained by the Department may only be used for the purposes of administering the ITA unless there is authority to give it to someone else. Officials who knowingly give information to persons not otherwise entitled are subject to severe penalties, although there are exceptions to these rules. Certain government Departments are given access to information because we administer certain programmes for them. The Department of Finance has access to information required to develop tax policy and we provide information to provincial Revenue authorities solely for the purpose of administering the provincial income tax laws.

The enabling legislation for the many tax treaties which we have also provides for an override of the provisions in the ITA, giving us the ability to provide information to our treaty partners. This is particularly relevant in the context of this panel discussion.

TAX CONVENTIONS AND AGREEMENTS – EXCHANGES OF INFORMATION

While Canada had ventured into the international area in the 1930s in shipping and with an agreement with the United States regarding withholding, it did not have a true tax convention until it signed one with the United States, which became operable in 1942. That agreement lasted until 1984 when the 1980 Convention came into force.

We had no experience in the field, our history in international relations was very short. Time and experience have shown that the exchange provisions are effective, and that any fears which might have existed were ill-founded. If the parties want to make it work, it will work.

The 1942 Convention essentially provided for the exchange of information upon specific request and for the automatic exchange of a large variety of information on items such as dividends, interest, royalties and other payments being made to residents of the other state. This article has been operative and continues under the present Convention with large volumes of data being exchanged. Technology is providing new opportunities in this area.

That Convention and its successor have been used extensively by the parties in regard to specific cases. They have been useful tools in dealing with cases involving cross-border activity.

Evidence has been provided and where required, witnesses to corroborate. These activities have also led to a simultaneous audit programme and a simultaneous criminal investigation programme. These programmes have been developed utilizing the powers that are available under domestic law in conjunction with the Convention. Both parties identify cases for review and subsequently select cases which have a mutual involvement. Where a case has been selected for investigation, each party will independently conduct an investigation in its own country, using the powers available under the domestic law. The tax convention becomes the method of exchanging the information, because as noted, there would not be another way of doing it.

Canada now has 50 tax conventions in force, with others near ratification, or in the process of negotiation. Most of these conventions have an exchange of information provision which permits exchanges by specific request, automatically and spontaneously.

Our experience in the area of spontaneous exchange has not been extensive, and perhaps not always satisfactory, but it is an area of exchange which has potential. It requires our tax authorities to be watchful in the audit of cases which show an involvement of taxpayers from other treaty partner countries. Where transactions are observed which show that the other revenue authority would have a tax interest therein, advice can be given of what has occurred. If the taxpayer has reported any income which might be taxable, nothing has been lost, but if the information discloses non-reporting, then the treaty has been effective.

While we exchange information to assist us in collecting tax, we must not forget that the ability to exchange information under the mutual agreement procedure assists us in resolving cases of double taxation. Tax conventions have the stated purpose of avoiding double taxation and combatting fiscal evasion. The avoidance of double taxation has a benefit to our citizens and brings certainty into economic relations, being a forum for problem resolution. It can generally be said of tax conventions that they introduce stability into relations by providing rules for persons operating in another country.

It must be stressed that tax conventions are only as good or only as effective as we wish to make them. They can be ineffective, as is the case of one convention, where information cannot be provided for the enforcement of domestic law. We need information in increasing amounts to maintain our pace with the global economy, but for the purpose of our domestic laws. The convention can also be ineffective if the other party is unwilling to allocate the resources to respond to activity under the convention. The convention has a great potential for bridging international information gaps, but only if the parties approach it seriously.

Treaties for the Exchange of Information

Canada's experience over the years has been with comprehensive tax treaties, which embraced not only the exchange of information, but also the avoidance of double taxation. The exchange of information acknowledges the tax administrator's need to gather information to do his job, while the avoidance of double taxation is one of the stabilizing forces in international commerce.

A review of our treaties and those of other developed nations show the far more complex rules to avoid double taxation and the relatively simple approach to the exchange of information. Too little has been said in our tax conventions, although the more recent ones are more explicit.

The model treaty compiled by CIAT is a very useful document, because it displays in some detail the rules which should apply in exchanging information. However, it should be noted that the CIAT model does not impose on the requested state any burden beyond that contained in its own laws.

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CANADA:

EXCHANGE OF TAX INFORMATION AND INTERNATIONAL TAX ASPECTS

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Dramatically improved means of transportation and communication have changed the ways in which people do business and the ways in which they interact with each other. Transactions occur with rapidity and over long distances in space and short distances in time. Technology is transforming this process and has changed forever the more traditional ways of communicating and doing business.

Tax administrations are equally affected by these accelerating changes. Our problem is twofold: in giving the service which a more sophisticated and technologically oriented public expects and requires, and secondly, maintaining a compliance programme which keeps pace with the changes which are occurring in the commercial world.

In responding to the public, Revenue Canada has taken significant steps in ensuring that modern services are developed and made available. We have in excess of 30 years of experience in computer technology, during which period the industry has advanced far beyond what one could have predicted.

Electronic filing of tax information returns is rapidly becoming commonplace and quickly leading to a significantly reduced paper burden, and perhaps in the long run a paperless society. Information is readily available to the client through electronically operated telephone systems which reduce the human element in the delivery of information on questions of interpretation, refunds and other related matters. Funds are transferred automatically and now an individual can receive his refund in his account at the bank.

The technological revolution has put severe burdens on those in compliance, and that is really what we are concerned with in our discussions today. How can we as administrators cope with the changes and the continuing growing need for more and better information? Keeping up is a challenge, because we have to understand what is happening if we are to apply the law evenly and effectively. The need for the right information has not disappeared, merely the traditional ways of getting it. The need for cooperation among tax authorities has never been more necessary.

In a perfect world, all of the information which we would require to make a decision on a particular matter would be readily available and would enable us to make the correct decision in the best interests of the taxpayer and the revenue. Unfortunately, it is far from a perfect world and one of the problems which we face is getting the information which we require, particularly in dealing with taxpayers' affairs. It is a problem on the domestic scene, even where we have statutory authority. On the international scene our problems increase due to the fact that our laws do not have extra-territorial application. However, it is clear that international cooperation can assist us in overcoming our difficulties in accessing information.

I would like to explore the Canadian system and our views in regard to the exchange of information, and the vehicles for so doing.

THE CANADIAN TAX SYSTEM

Canada has a self-assessment system, which is generally considered to be an economical and efficient means of collecting tax. Under this system the taxpayers are obligated to file returns at the end of a taxation year reporting income and remitting any taxes due at that point. This involves the maintenance of records and the periodic remittance of taxes through the relevant period by the taxpayers. A self-assessment system places the initial burden on the taxpayer.

In order to insure, or at least encourage, voluntary compliance, it is necessary to provide taxpayers with accurate and timely information. They have to be able to understand what they are expected to do. As well, to expect compliance there must be confidence in, and respect for, the system. This involves an even handed treatment of taxpayers. Where there is substantial non-compliance, the burden is placed on those who comply. To ensure a distribution of that burden, it is essential that we have compliance programmes and forms of verification.

The Department has an audit programme, an examination programme, a late and non-filer programme and a special investigation programme. Some of these require information, information which is not always available from the taxpayer. This is particularly the case when the audit or investigation involves a tax avoidance or evasion scheme.

Taxpayer Information Under the Income Tax Act

The Income Tax Act (ITA) gives our department considerable powers to obtain information. An authorized person has the right to enter premises to review the records of a taxpayer or one who may have information related to a matter under review. Demands may be made for information, and in unusual circumstances, search warrants may be issued by the courts where there are serious matters of tax evasion involved.

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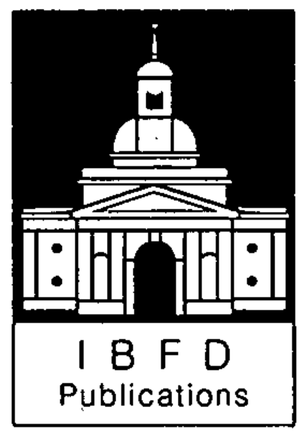

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There is no question that the role of Customs and the traditional Customs brokers will change dramatically with the proposed system. However, unless protected by government legislation, their roles will be altered drastically anyway. The introduction of microcomputers and other office technologies has reduced the demand for bookkeepers to a fraction of what it was a decade ago. Most of the work done by Customs and Customs agents is simply the filling of forms in multiple copies. Much of this work will be eliminated by computerization. Since the introduction of telephones, fax machines and courier services has revolutionized business communications around the world, the Customs services in most countries must be completely overhauled if they are not to be dead-weight burdens on the economic systems they are supposed to serve.

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IFA NEWS

GERMAN-US BRANCHES

The German-US joint branch meeting was held 9-10 October in Washington, D.C. Speakers included Dr. Berndt Runge of the German Finance Ministry and Fred Goldberg, US Assistant Secretary of the Treasury for Tax Policy.

UK BRANCH

The November technical meeting was held on 24 November - the topic this month was global trading with Jonathan Hooley from KPMG Peat Marwick as guest speaker.

US BRANCH

The new address for the US branch is as follows:
522 Fifth Avenue, Suite 2150
New York, New York 10036-7601
Tel. (212) 921-8448
Fax (212) 398-0212

Frank Walsh resigned as salaried Executive Director on 24 April. No successor is being sought at the present time.

On 3 June, the US branch co-sponsored a Conference on Tax and Trade Policy with the Tax Foundation. Four members of Congress were among the speakers.

A Placement Committee is being formed to act as a clearinghouse for members requiring tax expertise whether as employees, partners or associates, or managers or principals. Volunteers for the Committee are requested to contact Dave Tocher, Chairman at:
tel. (215) 564-4404
fax (215) 564-1533.

The annual branch meeting will be held 4-5 March 1993 at the Copley Plaza Hotel in Boston. Speakers and topics will be announced shortly.

The US branch has been of assistance to the Commissioner's Advisory Group's Task Force on Transfer Pricing. The Task Force is trying to catalogue public sources or information and grapple with comparative pricing problems.

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In the case of import taxes, a prepayment of the taxes at the bank based on an estimated amount due before the importer goes to Customs will reduce the incentive for the Customs officials and the importer to negotiate. Since it will be very difficult for Customs to give an illegitimate refund, they are left with little to give the importer in exchange for a bribe.

In brief, the steps for the operation of such a system would be as follows:[20]

1. The importer would notify the local office of the agent of his intent to import goods from a specific foreign supplier and would notify the supplier of the identification of the government's agent. The importer would also give the agent the identification number of his bank. The importer would prepay for the services of the agent, or make payment in the same way that they now pay for the services of the Customs brokers.
2. The agent would notify the foreign office closest to the producer of the goods, by electronic mail or fax, of the information supplied by the importer.
3. When the goods are ready for shipment, the exporter would notify the office of the agent. The agent would make an inspection of the goods and procure the information necessary for the preparation of a report which would replace the present import documents of the country. This report would identify the importer, the exporter, the importer's bank, the type of good (by harmonized code), quantity and value of the goods. In the case of containerized cargo, the agent should seal the container immediately after inspecting the merchandise.
4. The information should be sent by electronic mail to the office of the agent in the importer's country. This information would be matched with the taxes and tax rates, and a report would be prepared that would replace the traditional import documents prepared by Customs. Part of this report would be a withholding tax statement, covering all the taxes due on the shipment. The completed report would then be sent to the importer, with a copy to the importer's bank. In addition, an account for the importer would be set up in the revenue division of Customs.
5. The importer would pay the withholding tax at his bank, for which the bank would issue a receipt. It would notify Customs through a revenue entry in its account that the tax payment had been made. This process could be completed before the goods ever arrived at the point of entry into the country.
6. The importer would then take the documents (either physically or through electronic transfer) to Customs for final clearance of the goods. Ideally, the document that the importer receives from the agent would be the pro forma bill of entry. Once the goods arrive in the country, Customs would check for possible causes for examination. In most cases, goods for which the Customs withholding taxes have been paid would be released without further payment or refund. However, Customs should have the authority to carry out a physical inspection, and if warranted, to change the estimated assessment if they find an inaccuracy.
7. A final audit should be made by an independent authority of any changes made by Customs to the final assessments of duties and taxes from that initially estimated by the government's agent.

VII. CONCLUSIONS

The type of system outlined is now operating in Indonesia with spectacular results. It also fits in with the direction of the administrative reforms for the VAT that are now being implemented by European revenue departments. It is also fully consistent with the plans that the United States and Canada are making for trade administration in the new North America Free Trade Area. In the case of North America, it will likely be brokers, teaming up with surveyors or accounting firms, who will become the governments' agents as described above.

Criticisms of such a system by traditional Customs organizations have usually focused on three areas. First, the service of hiring the agent (surveyor firms have charged between 0.5 percent to 1.5 percent of the value of the goods being inspected) is said to be expensive relative to the formal administrative costs of the Customs service. Second, the use of such surveyor agents has in some countries duplicated the traditional Customs functions and has not significantly improved the overall integrity of the Customs administration. On occasion, falsification of the agent's documents has taken place. Third, the use of such agents is likely to take away some of the work traditionally carried out by Customs administrations and Customs brokers.

The comparison between the cost of pre-shipment inspection and that of the domestic Customs service is fallacious. The savings in compliance costs, including financial and time savings, and the reduction in the incidence of theft, that will be enjoyed by the importer (if pre-shipment inspection is properly organized) should be compared with the net financial cost of employing the surveyor agents. Given the potential for huge savings for importers and exporters, this service should be paid for by these firms directly, not by the government. The argument that the new system is too expensive is not a valid one since it does not take into consideration the external costs to society that the current system poses. The increases in efficiency should more than make up for the higher expense.

Pre-shipment inspection has not worked very well in a number of situations where it has been used. In every one of these cases, the information from the surveyors was simply given in paper form to Customs and the importers. No effort was made to have the surveyors estimate the amount of taxes due or to require that the taxes be prepaid to the financial institutions, or be withheld by them, prior to any contact with Customs. Giving accurate information to a corrupt and inefficient Customs service does not increase the efficiency of the system. In order to be successful, the information from the surveyors should be used to estimate and pay a withholding tax, *before* the importer makes any contact with Customs.

20. A more complete description of such a system can be found in Ricardo Godoy, Glenn Jenkins and Richard Patten, *A Tariff, Excise and VAT Withholding Tax System For Imported Goods For Bolivia*, Harvard Institute for International Development (28 June 1991).

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accompanied by a great deal of negotiation between the Customs and the import brokers or agents hired by the importer.)

5. Customs then determines what taxes apply to the goods and makes an assessment of the taxes owing. (The negotiations between the Customs and the import brokers often continue at this stage.)
6. The importer pays the taxes owing to the Customs cashier. The importer is given a receipt.
7. The importer then takes the receipt back to the Customs office, and after verification that the receipt is genuine, the goods are released to the importer.
8. Customs, after some delay, sends the money to the Treasury.

Under this system, unless Customs officials follow the goods to the final destination in the country where they are unpacked from the container, they really have no independent way of verifying the importer's claim as to its contents. This is also a situation where corrupt Customs officials thrive. If a bribe is accepted to reclassify the goods to a commodity with a lower tariff rate, it is difficult for others in Customs to identify the fraud. At the same time, the Customs official can blackmail the importer because destuffing the container at the port is sure to result in breakage, losses and great delays. In the Dominican Republic, where all containers are "theoretically" inspected, the waiting time for port clearance in 1990 averaged more than a month, with widespread corruption and theft of goods.

The experience of developing countries has shown that a system of selective examination and post-clearance audits intended to ensure compliance is faced with great difficulties. In this case, the goods are given "quick release" from the port and the final payment is made later, with some inspection of the goods at the importer's warehouse and also a random audit of the books and records of the importer.

The first problem with this system is that auditing skills are very scarce in these countries, and auditors in the private sector usually earn some multiple of the official salaries of the Customs service. Consequently, not many want to work for the government. Second, rampant corruption is almost always generated when the Customs officers are permitted to visit the importer's factory. At that point, there is absolutely no system for controlling what happens, since in many cases, the fruits of corruption are one of the primary attractions for these skilled people becoming employees of the Customs service. The result is that the reports will usually come back to the Customs office with no finding of fraud.

The authorities, therefore, find themselves in a dilemma. Either they let the goods flow quickly through the ports and give up large amounts of revenue through fraud and contraband, or they inspect the containers at the port and destroy the economics of containerized shipping while still stimulating corruption and revenue losses.

B. *An alternative system*

Under the proposed system, the information flows are kept separate from the goods flows. This is the type of system that was introduced in Indonesia and resulted in a reduction of the time required to release goods to a small fraction of what it was previously.

Since information flows can move so much faster than physical goods, there has been a deliberate effort in Indonesia to complete the traditional Customs and revenue functions in a way that does not interfere with the rapid flow of goods. This same principle is now also used by Singapore in its Tradenet System. In the case of Tradenet, the ships manifests are sent ahead in electronic form so that all the import documents are completed and duties paid before the ship arrives at the port.[18] However, as Singapore has neither a system of tariffs nor value added taxes, the problems associated with the classification and valuation of goods do not arise.

The first basic principle of the proposed reformed administrative system is that all the new information needed for trade and revenue purposes which applies to a shipment can be more easily, accurately and cheaply obtained at the place where the exported goods are being shipped, than at any other point. Given that the costs of transferring information electronically are trivial, the information on type of good, value of goods and quantity of goods should be obtained when the goods are being put into the container, and not when the goods are being taken out. In order to do this, the government would have to employ the services of an agent (a surveyor, Customs brokers or, perhaps in the future, international Customs agents) who would provide this service worldwide. A number of surveyor companies already exist that do provide these services globally. As is the case with banks or professional auditing accounting companies in a competitive environment, they will only survive in business if they provide accurate, honest information because that is the service which governments are paying them for.

The second basic principle is to reduce the opportunities for corruption and fraud. A withholding tax, based on the information obtained at the point of export by the private agents hired by the importing government, should be paid by importers through the commercial banking system. Income-withholding tax systems, operated with private and public employers as withholding agents, have proven to be the most effective means of increasing taxpayer compliance. The VAT is basically a sales tax collected through the use of a system of withholding at each stage of economic activity. This concept needs to be extended to all taxes, including those on internationally traded goods.

The use of banks, rather than government collection bureaus, to receive government revenue has proven in many countries to be much more effective. Banks have a compelling incentive to maintain the security of funds if they are going to survive as financial institutions. The privatization of such functions through the use of banks has also greatly increased taxpayer compliance in such unorthodox situations as the collection of property taxes in Indonesia.[19]

18. Harvard Business School, *op. cit.*, at 1.
19. Kelly, Roy, *Implementing Property Tax Reform in Developing Countries: Lessons from the Property Tax in Indonesia*, Harvard Institute for International Development (1992), at 12.

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tive rates on international transportation are available to developing countries if they refrain from entering conference-line agreements or setting up shipping company monopolies. In 1985 the government of Indonesia deregulated the country's international shipping arrangements and implemented a fundamental reform of the Customs Department. Consequently, the costs of shipping a container from Indonesia to Europe in 1987 was only 60 percent of the pre-1985 rates. Furthermore, the rates for shipping containers from Indonesia to Singapore were only 50 percent of what they were in 1985. By comparison, over the same period the competitive rates for shipping a container from Singapore to Bangkok were slowly rising.[16] While many, if not most, developing countries still maintain high-cost shipping and Customs administration systems, Indonesia is a clear example of the enormous returns that can be earned by an economy from the reform of policies and the introduction of modern administrative methods.

The inflated costs of cargo unloading and processing at ports and airports, combined with the costs created by the uncertainty of the time required to clear and the theft that is epidemic around such ports and airports, are major impediments to trade and development for many countries. While the reduction of these costs by appropriate administrative policies and investments are possible, it has often proven to be difficult.

Efficient ports not only reduce domestic transportation and handling costs, but they also affect the type of international shipping lines that are willing to stop and deliver and pick up goods. Wasted time in a port is very costly to a large modern ocean going vessel. When a ship pulls into a port, only a few hours are scheduled for the loading or unloading of cargo. If the ship cannot be accommodated quickly, it will proceed to the next port for unloading. If goods cannot be unloaded quickly in Bombay or Bangkok, it might be less costly to take the cargo to Singapore or Sri Lanka and leave it there for shipment to the final destination using small carriers. The rapid movement of goods is essential for the competitiveness of a port. Furthermore, cargo containers need to be utilized efficiently. They must be unloaded at the importers' premises and loaded at the place of export quickly so that they are not under-utilized. If this cannot be done, container companies will be very reluctant to use that port.

This point can be illustrated with examples from Sri Lanka and Bolivia. The port of Colombo in Sri Lanka has managed to implement a very efficient system for the movement of container traffic. On the other hand, the ports of Thailand, Bombay and Madras are extremely congested and containers move very slowly because of poor systems and facilities. As a result, over 50 percent of the containers going through Colombo are there for transshipment to these other ports. Such transshipment has become a valued service to the countries of the region and the Port Authority of Colombo has become a highly profitable state enterprise.

In contrast, the inefficiency of the land transportation system in Bolivia has caused international container companies to prohibit their containers from entering Bolivia. This has created a huge efficiency loss as importers have to destuff the containers in Peru and ship the goods as bulk freight to Bolivia. The results have been high rates of damage and theft. A similar problem arises with goods being considered for shipment through the Port of Dar-es-Salaam in Tanzania and then by rail to the interior countries of Southern Africa.[17]

Containerization has been a very important technological innovation that has had a major impact on the way in which administrative institutions facilitate international trade. While it represents a tremendous source of cost-savings in the movement of goods, it is, at the same time, a smuggler's dream (and a Customs officer's nightmare). Containerization completely camouflages information if Customs departments use traditional procedures. This procedure calls for Customs to get all its information on the goods at the time the ship (airplane) arrives at the port (airport) with a manifest, and bill of lading. These documents contain a statement about the number of containers being unloaded, with an account of the contents described according to a set of specifications which includes a physical description of the goods and the number of items. Containerization makes it very difficult to verify much of this information.

When opened, the goods at the front of the container might be entirely different from what might be found behind them, and so on. Furthermore, it is virtually impossible for Customs officers, or the consignee's employees, to get all the merchandise back into the same container it was taken out of. The result is usually a high incidence of theft at the port, resulting in great delays and uncertainty. Consequently, the economies of transportation brought about by the use of containers may be dissipated through the country's ineffective Customs and port systems.

VI. A PROPOSAL FOR MODERNIZING THE CUSTOMS AND REVENUE ADMINISTRATION SYSTEMS FOR TRADED GOODS

A. *Traditional administration systems*

The traditional system of Customs control can be described in its simplest form as follows:

1. The importer informs the exporter that he wants to buy a certain quantity of goods of a particular type.
2. The exporter sends the goods and the documentation to the country of the importer; these are received by Customs.
3. The importer goes to Customs and provides the Customs service with any further documentation, such as import licences. The importer's agents will provide Customs with pro forma copies of the entry documents.
4. Customs then tries to determine from the invoices of the exporter, and from any other information available, the type, quantity and value of the goods being imported. If the Customs officer finds it necessary, a physical inspection of the goods will be carried out, either at the port or at the importer's premises. (This determination is often

16. Shugart, Christopher, "Next Steps in Deregulation of Indonesia's Interisland Shipping Sector", *Memorandum*, Harvard Institute for International Development (1988).
17. From research by the author in these countries.

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operates not so much because the authorities use the information on credits claimed to go out and audit large numbers of suppliers, but rather because taxpayers know that the authorities do possess such information and are able to screen tax returns for signs of evasion. Hence, the government has the ability to carry out much more effective audits. The actual field auditing done must be more accurately focused and should be carried out with a high level of supervision in order to insure that this activity maintains its integrity. Audits need to be carried out on those with a higher-than-average potential for evasion. At the same time, a modern information system can be used effectively to enhance rapid detection of stop filers, or filers who are making errors that can be detected from an analysis of administrative data.

The cost of storing data and the organization of information into reports to enhance compliance has fallen rapidly and is likely to continue to fall. There remains the question of how to capture the basic data in a cost-effective manner. Traditionally, the information on imported goods subject to VAT has been acquired by Customs at the point where the imported goods enter the country. The falling costs of communication and the advances in the capabilities of Customs brokers and surveyor firms would indicate that the basic data should be obtainable much earlier. In Indonesia, the system is designed so that the importers and corresponding exporters are identified, and information is obtained as to the type, quantity and value of the goods, as well as the rates of taxes and duties applicable, when the importer first places the order for the goods and when the goods are ready to be shipped by the exporters.[14]

The VAT system also imposes important information requirements on exports. Without good information on the type, quantity and value of goods being exported by all VAT payers, the VAT system would be open to great abuse. Value-added tax fraud often comes about due to the zero rating of exports, an economically desirable policy because it eliminates the taxes that the producer has paid on intermediate inputs. This is done by providing a zero rate of tax on export sales and refunding any excess credits that might arise as a result of taxes already paid on inputs. The classic form of tax fraud in these circumstances is for a firm to overstate the value of its exports, as well as the amount of inputs used and taxes paid on the inputs through creating false invoices. In such cases, the ratio of inputs to outputs may appear to be legitimate when firms claim to have a large amount of excess credits. Often, such enterprises are able to successfully demand cash refunds for the excess credits. Unless the authorities have reliable information on the value of exports, the dishonest exporters will have a very easy time defrauding the Treasury.

The case of Bolivia illustrates the importance of this point. In 1986 Bolivia implemented a major and successful reform of its tax administration that placed heavy emphasis on the VAT. To date, they have not been able to coordinate their internal tax administration with the Customs administration. As a result, a number of cases of over-invoicing of exports has taken place. Recently, the tax authorities have been able to detect enterprises using such scams and have collected very substantial amounts in excess refunds and penalties from the owners.

While public finance scholars have tended to think of the introduction of a VAT as an important move away from the use of trade taxes, they have generally overlooked the fact that the VAT system would need an administrative mechanism, similar to the one used to collect import duties, that is capable of taxing imports. Since VAT is also levied on domestic transactions, it will require close coordination, or perhaps integration, of the Customs and domestic tax administrations.

The elimination of trade borders and tariffs in the European Economic Community created the need for a mechanism to account for the value added taxes due on imports and the proper treatment of exports. The result has been one of the most important innovations to date in tax administration, and an innovation that could potentially revolutionize the way in which future trade and value added taxes will be administered around the world. From 1 January 1993 the current system of border checks for VAT will be eliminated. From then on cross-border sales will still be zero-rated for VAT as far as the exporter is concerned, provided that both customer and seller are registered for VAT in their respective countries. The customer will then pay the VAT at its country's rates. If the customer is not a registered taxpayer, the exporter will collect the tax at the normal rate for the exporting country. Each quarter, traders will have to provide both their own registration numbers and those of their customers to their national tax authority, as well as information on the value of sales made to each intra-Community customer. A new computer system will be used by member states to exchange such information, and soon traders will be able to confirm the VAT status of the customers via the computer.[15]

American Express, Visa and Master Charge can conduct credit card checks around the world and airlines have on-line reservation systems that operate constantly worldwide to place individuals on specific seats on specific planes. It is apparent, therefore, that there is available the technological know-how necessary for tax and trade administrations to be able to enjoy the efficiencies of capturing the information once, and then using it as a common database. There is a need, however, for governments to realize that it is in their countries' economic self-interest to cooperate internationally in this regard. The integration of the EEC and the continued economic integration of Canada and the United States have proven that governments are able to create the political will to cooperate in this way. Once the industrialized countries have set up the information systems, it will be cheaper for them to give free access to the rest of the world, rather than to have the advanced information technology of the industrialized world attempting to interface with the inefficient, corrupt, paper-piling administration systems found elsewhere.

V. TRANSPORTATION INNOVATIONS AND INTERNATIONAL COMPETITIVENESS

A large component of the cost of internationally traded goods are both international and domestic transportation. Competi-

14. Government of Indonesia, *Presidential Instruction No. 4*, 1985 and *Presidential Instruction No. 3*, 1991. Société Générale de Surveillance S.A., *Preshipment Inspection of Exports to Indonesia* (1991).
15. "Computer to Replace 60m VAT Forms", *Financial Times* (8 April 1992).

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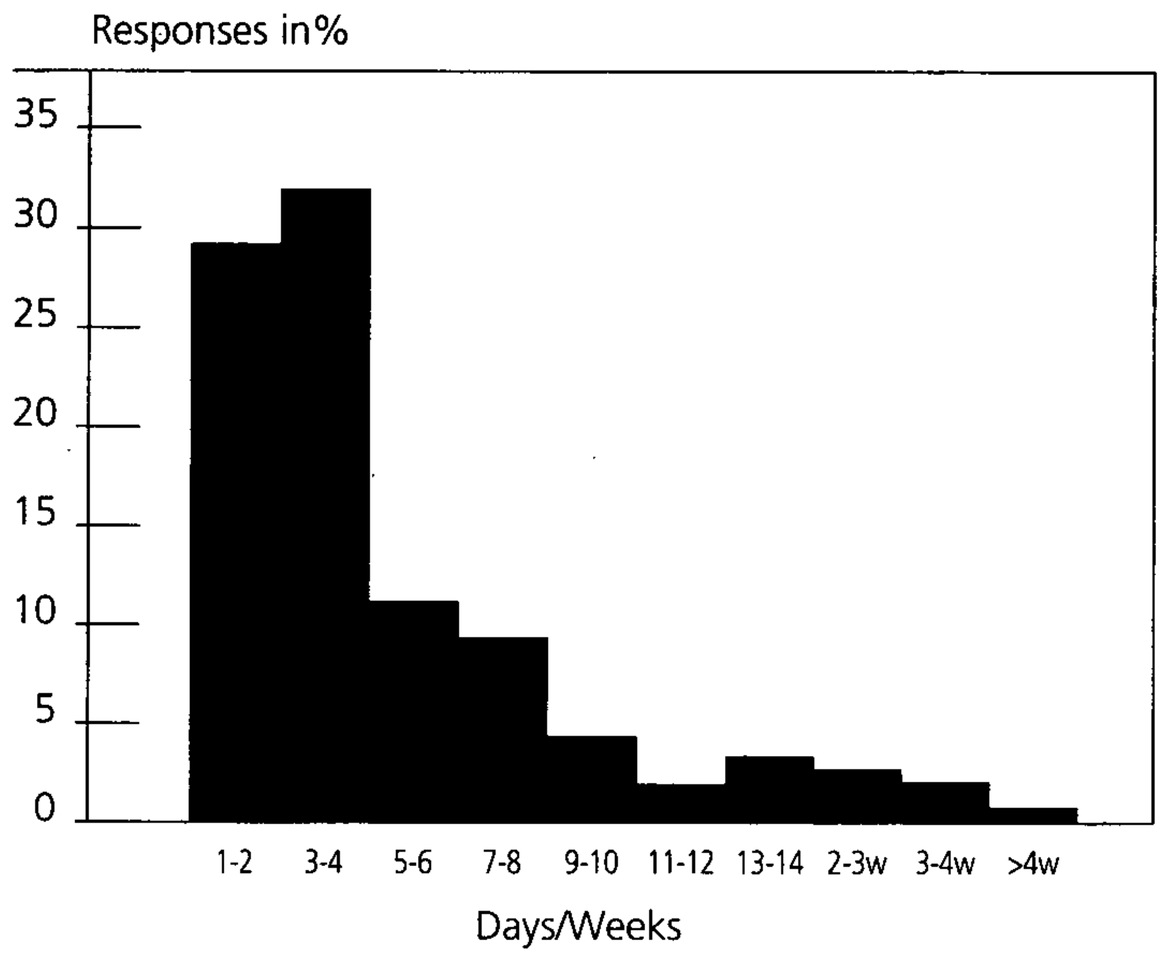
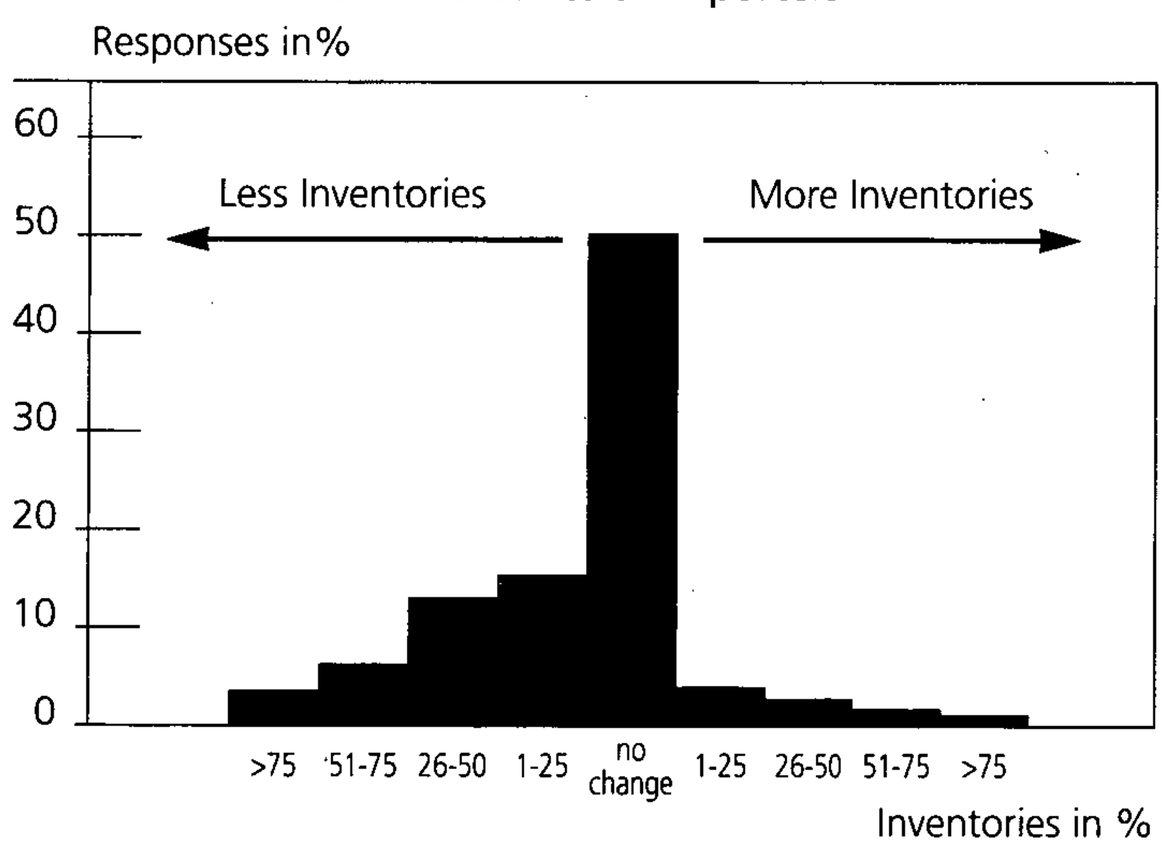
B. *After 1985*



by 140 percent. Yet, as a result of the reforms, over 35 percent of importers say that they have been able to *reduce* their inventories from 1985 levels and another 50 percent report that they have been able to maintain the same level of inventories. The results of this survey are shown in Figure III.

FIGURE III

Impact of trade administration reform on inventories of importers[10]



While the inefficiency of the Indonesian Customs and ports prior to 1985 would be difficult to exaggerate, we find that there is also a potential for huge cost savings through the modernization of procedures for relatively efficient countries such as Malaysia. In 1990 the cost of the traditional manual method of completing the paperwork associated with international trade was estimated to be equal to M$ 15.2 billion (US$ 5.74 billion), an amount equal to 12.2 percent of the value of its total trade (imports + exports) for that year.[11]

The trade administration reforms implemented in Indonesia and Singapore, and currently being implemented between Canada and the United States, have taken advantage of the advances in information technology to capture and process information on the goods being imported well before they appear at the point of entry. This represents a very significant departure from traditional Customs administration and points to a pattern of reform that might break the cycle of collusion, corruption and delay that is characteristic of most of the Customs departments of developing countries.

IV. EFFECTIVE VALUE ADDED TAX ADMINISTRATION

Taxes and the information collected on imported goods and services are essential elements in the successful operation of a value added tax system. Taxes collected at the time goods are imported make up a large part of the net tax revenues actually collected under most VAT systems. In Indonesia, since the trade administration reform of 1985, about 40 percent of net VAT revenues have been collected through applying the VAT to imported goods that have been processed by the new system.[12] In addition, during the first five years of the new system, revenues increased from ten to 16 percent of total government revenues, with no change in tax rates. This is in spite of the introduction of a large effective-duty exemption system for imports used in the manufacture of exports.

Knowledge of the quantity and value of imports provides an important starting point for capturing information about potential domestic taxpayers and the level of their activities. Domestic producers and sellers are likely to have either imported directly or bought some of their inputs from importers. A VAT system can only operate effectively if the tax authorities have some concept of the relative magnitudes of the inputs used by various production processes. If the tax administration has this information, it will be able to make reasonable estimates of the tax liabilities that should be accruing in that sector. This knowledge also allows the tax authorities to begin to classify different types of taxpayers in order to provide them with the information that will make it easier for them to comply with the law. It is this concept of using information about the nature of the taxpayers to provide better and more accurate service to them that is at the heart of the major operational changes being implemented by the United States Internal Revenue Service, Revenue Canada and the Australian Department of Revenue.[13]

Extensive auditing of taxpayers is simply not a realistic option for most developing countries in the next decade. They have neither the level of skills in tax administration nor the ability to control the level of corruption that is likely to result from extensive contact between the auditors and the taxpayers if site audits are held. Much has been made of the self-policing nature of a VAT. This self-policing principle

10. *Id.*, at 11.
11. Yeow, J. "Working Towards Lesser Paperwork", *Business Times* (25 March 1992).
12. Société Générale de Surveillance S.A., *Annual Report 1988, 1989* and *1990*. International Monetary Fund, *Government Finance, 1988, 1989* and *1990*.
13. *Compliance 2000: Report to the Commissioner of Internal Revenue*, Internal Revenue Service, Washington D.C. (1991); and from conversations of the author with officials from Revenue Canada and the Australian Inland Revenue Service.

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ings, especially when considering the factors under government control that affect domestic business decisions about whether to locally develop the capability to export or, alternatively, invite a foreign investor into the country to manufacture items for export. UNCTAD has estimated that the costs of international trade for developing countries could be reduced by about US$ 75 billion per year through more efficient trade procedures, including Customs' computerization.[4]

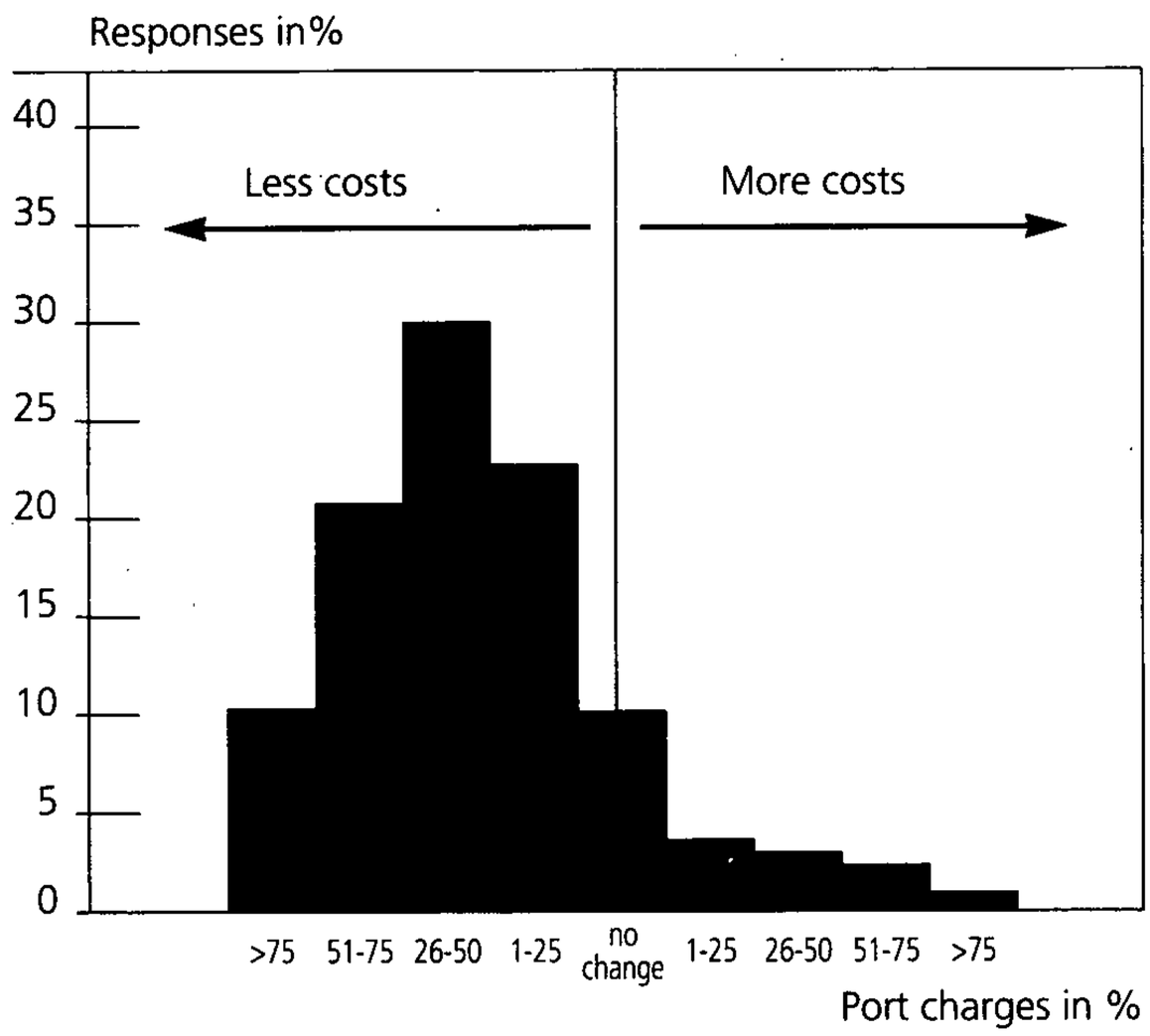
In 1987 Singapore began to completely rethink and reform the way trade was administered. The result was perhaps the most efficient communications system for processing imports and exports in the world. A recent study of this reform concluded that "turnaround time for processing of typical trade documents was reduced from a minimum of one day and as many as four days (in 1987) to about 15 minutes (in 1990)".[5] According to the report, most transactions are actually completed in ten minutes.

The direct contract costs to the government for designing and implementing this system totaled more than S$ 20 million (US$ 11.75 million), not including the investment made by the various ministries and statutory boards in conceiving the project, developing the requirements and specifications, and managing the contracting.[6] However, the benefits from savings by government agencies and the trading community by 1992 are estimated at S$ 1 billion (US$ 588 million) *annually*.[7] These are tremendous cost savings for a small country with a Customs and trade administration system that would have been classified, even prior to this improvement, as one of the best in the world.

Although the total savings to Indonesia from its reform of Customs and ports administration in 1985 have not been calculated, the sample evidence has been dramatic. A study prepared by the Importers Association of Indonesia estimated that the total costs of imports used in manufacturing was reduced by 20 percent of the cif price. In terms of port charges, a survey of importers in 1989 indicated that more than 30 percent paid 26 to 50 percent less in port clearance charges than they did prior to 1985. In total, 85 percent of the importers pay less than they did before the reform. Figure I shows the results of the survey.

FIGURE I

Savings in port clearance charged due to trade administration reform in Indonesia[8]

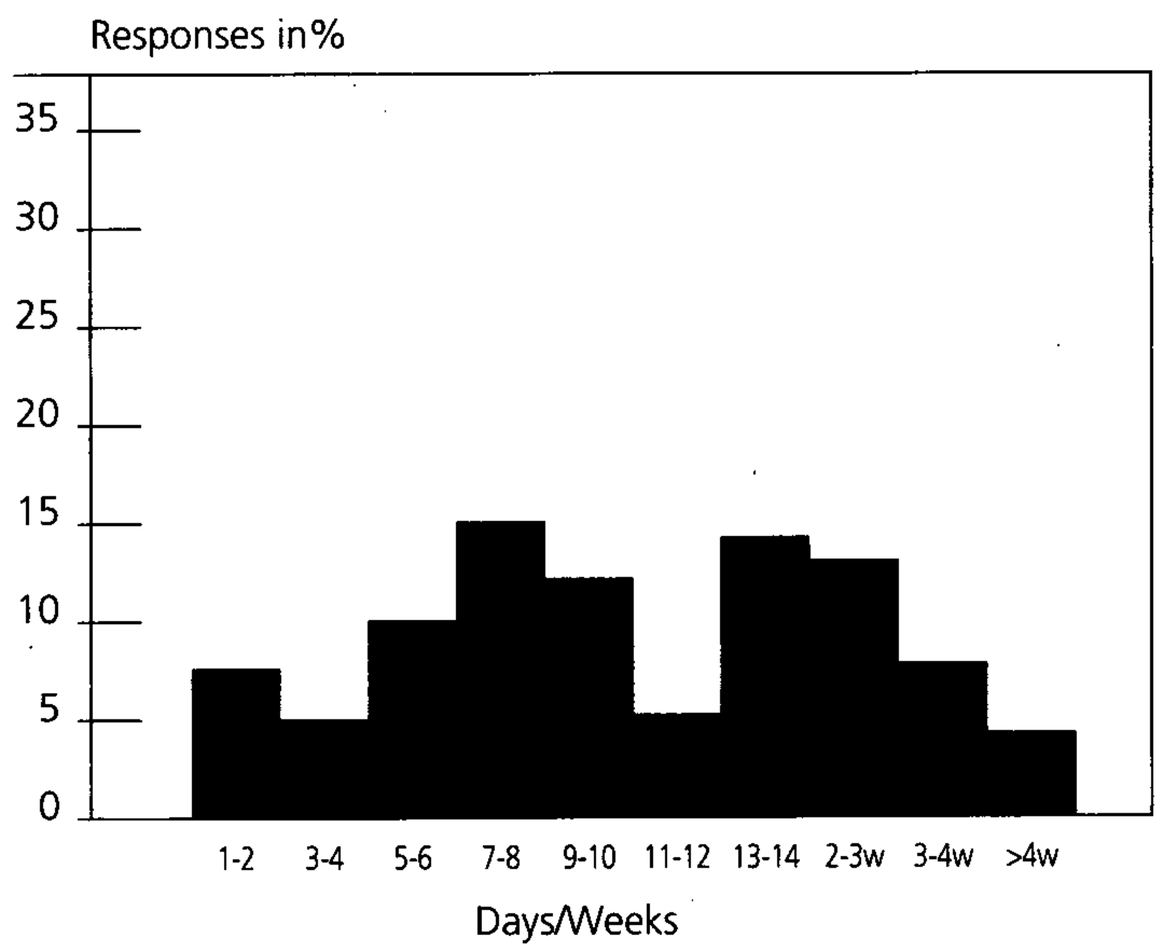


A key element in the cost savings from trade administration reform is the speed of port clearance. This captures the efficiency of the entire trade administration systems including Customs, port handling and other control organizations. Before 1985, only 13 percent of the importers could clear their goods from the port within four days. By 1989, over 63 percent of the imports could be cleared in less than four days. The median time for clearance has fallen from ten days to three days. The results of the survey are shown in Figures IIA and IIB.

FIGURE II

Speed of port clearance

A. *Before 1985*[9]



The reduction in uncertainty with respect to the timing of port clearances is reflected in the behaviour of businesses in their holding of inventories. Inventories are held to smooth the fluctuations between purchases, production and sales. The higher the uncertainty of supplies, the greater the amount of inventories that firms will have to hold in order to maximize profits. At the same time, the cost of holding inventories represents a major cost of doing business. The impact of the trade administration reform in Indonesia has been dramatic. During the period from 1985 to 1989 the real value of imports grew

4. *Id.*
5. Harvard Business School, *Singapore Tradenet: A Tale of One City*, Case 9-191-009 (1990), at 10.
6. *Id.*
7. "SingaPort '92, Global Connections", *Business Times* (25 March 1992).
8. Société Générale de Surveillance S.A.,"Survey of Importers on Impact of INPRES 4/1985", *Annual Report 1989*, at 9.
9. *Id.*, at 10.

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The hypothesis of this paper is that the world is undergoing a set of innovations in information technology and communications that can radically alter the opportunities available, and thereby increase the prospects for successful fundamental public sector administrative reform. Just as the fall of the Berlin Wall could be partially traced to the inability of the East German government to isolate its population from the knowledge of what life was like elsewhere in Europe, it will likewise be more difficult for countries such as India, Pakistan and Thailand to preserve an inefficient ports system in an increasingly globalized economy where Singapore, Sri Lanka, Hong Kong and Taiwan are able to move goods through their ports in hours, rather than days or weeks.

In this paper, I discuss a number of key administrative reforms that must accompany changes in international trade and taxation policies, if genuine economic reform is to take place. In each of these cases, it would appear that developing countries are likely to have greater success of experiencing economic reform if they were to implement administrative methods that utilize state-of-the-art techniques rather than look back at what historically has worked successfully in the industrialized world.

II. TRADE REFORM AND INSTITUTIONAL INNOVATION

Economists have spent a great deal of time and effort analysing the policies that are most appropriate for promoting international trade, competitiveness and economic growth. Often ignored, however, is the impact made by domestic institutional arrangements used to administer the international movement of imports and exports. Such institutions are crucial inputs in the whole process of international trade and in the operation of economic policies in this area.

Here, we will focus on three elements of the relationship between these institutions and economic policy. The first is transportation; the physical means through which goods are moved between countries. The second are the mechanisms for Customs control, and the third is the fiscal system. All three of these principal elements of trade policy and institutions have undergone significant changes in recent years, more or less independently of each other. In each area, the changes have come about through the development of new technology.

With respect to international transportation, the principal innovation has been the containerization of goods for shipment by air, sea and land. Containerization now allows manufactured goods and perishables to move in a way that had previously been associated with the shipping of primary products.[2] It permits goods to be moved securely, quickly and safely through the ports, and between different modes of transportation. Problems of theft and damage, as a result of improper handling, have largely disappeared. Consequently, the manufacturing industries of developing countries have been able to enjoy great cost savings and increased competitiveness in world markets.

In the case of fiscal systems, it is the widespread adoption of VAT in more than 60 countries which has brought about a tax policy revolution in both developing and industrialized countries. Trade taxes, both in the form of tariffs and export taxes, have traditionally played a more significant role in the fiscal systems of developing countries than in those of the more advanced countries. However, the desire to industrialize following an export-promotion policy, rather than one of import substitution, has accelerated the tendency to use a VAT system on domestic consumption in order to raise revenues, instead of taxing imports. Although there has been strong resistance to the introduction of VAT in several countries, there has not been a single case of a country dispensing with this tax once it has been implemented.

The theory behind the way in which VAT is designed to operate is well known. However, it is not as well-recognized that for VAT to work efficiently, it needs to utilize the administrative systems that traditionally have been used to manage international trade. The values of the goods and services imported, the value of exports, and the identities of the importers and exporters are key pieces of information for the effective administration of a value added tax. They are also essential pieces of information for the administration of international trade.

In most countries, it is the Customs service that obtains this information in order to determine whether the goods should be allowed to enter the country, to assess the duties and other taxes, including VAT, due on imported goods, and to provide data to construct the trade statistics necessary for macro-economic management. This is often a costly, time consuming and corrupt process. It has been estimated that such transaction costs worldwide may amount to ten percent of total merchandise trade.[3]

In the 1980s, the world witnessed one of the greatest technological innovations experienced by mankind in the area of communications and information technology. Communications "space" has been reduced so that it is often easier and cheaper to communicate between cities of different countries than it is to communicate between the different local offices of a Customs Department. The low cost of modern information technology and the ease of its use have currently made it more accessible to the Customs and Revenue Departments of the poorest of developing countries than were mainframe computers to public administrations in industrialized countries a decade ago.

The huge leaps in effectiveness and cost savings provided by these innovations require that we reflect on the type of institutions developing countries should have in order to facilitate international trade in the 21st century. The advances in information technology in the past five years have given the developing countries greater flexibility than ever before in the design of solutions.

III. SOME EVIDENCE OF THE IMPACT OF INSTITUTIONAL INNOVATIONS

The efficiency of the country's administration of Customs and ports usually completely dominates most other tax sav-

2. For example, flowers, fruit and garments are shipped daily from Sri Lanka and Kenya to Europe by containers.
3. "Trade on better terms", *The Economist* (21 March 1992), at 76.

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INTERNATIONAL:

ECONOMIC REFORM AND INSTITUTIONAL INNOVATION

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I. INTRODUCTION

Since the early 1980s, a fundamental shift in policies related to taxation and international trade has been made by many countries, both developed and developing. Over 30 countries, as diverse as New Zealand, Indonesia, Mexico, Canada, Chile, Jamaica, Cyprus, Kenya, Sweden and Malawi, have undertaken fundamental tax reforms that have radically reduced income tax rates, while eliminating special incentives and broadening the tax base. In many cases, a shift has been made away from raising revenue from trade and special sales taxes to using a broad-based value added tax (VAT). This switch in tax policies away from the use of highly distortionary taxes on imports, exports and specific sales taxes has signaled a general adoption of policies that interfere less with the markets for goods and services.[1]

The need for foreign exchange to service foreign debts, combined with the demonstrated success of the export-oriented policies of the newly industrialized countries of Asia, and the rapid globalization of international business have all played a role in bringing about a fundamental shift in the industrialization policies of many countries. Similarly, many countries with such varied histories as Indonesia, Mauritius, Canada, Mexico, Chile, Kenya and Hungary are at various stages of shifting the focus of their industrial policies in order to help their firms meet the demands of a competitive global market, rather than a stagnant domestic one.

In the past, centralized governments and state-owned enterprises were often the primary instruments for the provision of an array of public services considered necessary for bringing about both social and economic development. The result has often been capital structures, i.e. schools, hospitals, roads, ports and utilities, but not functioning organizations. Capital projects could be financed and built by the troika of central governments, state-owned enterprises and international agencies, but none of these could adequately supply the working capital to operate the facilities efficiently, nor did they have the freedom or incentives to provide the services needed for a competitive economy. As a result, many countries are now attempting to decentralize their decision-making apparatus to include lower levels of government. This process is usually accompanied by an attempt to tap stable revenue sources, such as user fees and property taxes for the operation and maintenance of public services. At the same time, the relationship between the state-owned enterprises and the government is being radically altered through privatization and commercialization policies whose objectives are to make the operation of the public enterprises more efficient and more responsive to the markets that they serve.

In each of these areas, whether it be tax reform, trade reform or government reorganization, changing the laws is a necessary, but not sufficient, condition for fundamental change. While the laws may be in great need of modernization, it is the administrative practices and rent-seeking behaviour of public sector organizations that have been the fundamental obstacles to economic reform. Corruption, arbitrary treatment of individuals and costly delays for public services are symptoms of public administration systems that either have been allowed to be captured for the benefit of the administrators themselves, or by specific groups in society who, for historical reasons, were able to create an administrative system beneficial to themselves.

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1. *Lessons of Tax Reform*, World Bank (1991).

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ance. It is the last area where many developing countries have made the least progress. This is partly because some combination of economic liberalization, a slow-growth world economy and the fiscal sins of the past has put countries in the position of making some very hard fiscal choices. Among these are:

- Should government expenditure growth be capped in order to control the deficit, or should taxes be increased?
- Should the entire tax system be adjusted to become more investor-friendly, even at the cost of making it less progressive? Should this be done by providing special preferences to targeted taxpayers?
- Should taxing and expenditure powers be decentralized to lower-level governments, or should centralization be continued?

Finally, there is a more rosy outlook – the possibility that the 1990s will see a turning point that the modellers have not picked up. Countries have learned the lessons of specialization and gains from trade in the 1980s; Asian and Latin countries have made remarkable policy adjustments; and even the industrialized United States is taking a more outward view. Central economic planning is on the decline in most places, the socialist economies are in transition and most industrialized economies seem to see economic union as a better route than competition. Technology continues to advance at a rapid pace. It is a time for innovation, and arguably a time for very substantial economic growth.

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ment would be allocating the resources (and governments do have a bad record of picking winners), and the tax system would be more fair.

The disadvantage is that the government, by not matching the incentives provided in the neighbouring country, may give the impression that the business climate is not hospitable to new domestic and foreign investors. Moreover, there is the question of what to do about the existing incentive programme. It may be politically entrenched and its removal could have a high transaction cost. Moreover, the market may long ago have capitalized the effects of this preferential treatment. Blejer and Cheasty (1990, pp. 66-81) mention yet another disadvantage. The adoption of trade liberalization programs may lead to substantial short-run fiscal costs, in the form of reduced tax revenue and pressures to provide subsidies to those individuals and companies hurt by the reform.

D. *Will government be centralized or decentralized?*

There has been a worldwide reaction against the over-centralization of government. This has held for low- and high-income countries alike. Especially in large countries, there has been an erosion of confidence in the ability of the central government to decide on what is the best package of services for each local area, and to deliver that package of services. On the tax side, there is a reaction against what are perceived to be high taxes that are not returned in the form of services with identifiable local benefits. Fiscal decentralization, and whether to pursue it, are new questions being debated in countries such as China and Russia, and old questions of concern in countries such as Colombia and Argentina.[8]

Why is this a hard fiscal choice? On the face of it, it seems a reasonable proposition that as economic development and urbanization proceed, the local level should be more involved in the tax and expenditure decision-making process. But if the next decade places a high premium on macroeconomic policy to make developing economies more stable and more attractive to foreign investors, then central governments need even more control over the major fiscal instruments.

Consider first the implications of fiscal decentralization, i.e. giving more taxing powers and expenditure responsibilities to the lower levels of government. The advantage is that government is brought closer to the people, in that they may now have more say in choosing the mix of services they receive and the level of taxes they will pay. It is also possible that overall revenue mobilization may be improved, because some taxes are inherently better administered at the local level (e.g. property taxes), and because there is a substantial untapped fiscal capacity that lies below the cutoff point for central government income and value added taxes. The instruments of fiscal decentralization are local tax powers, the assignment of local expenditure responsibility and the design of a grant system that guarantees local governments a claim on central resources. Such assignments reduce the flexibility of the central government to pursue a stabilization programme, to equalize services within the country and to implement its development spending priorities.

The other direction is continued fiscal centralization. If the central government controls the major instruments of taxation, expenditure and debt, it is more able to pursue the programme of macroeconomic policy that is seen as so vital for the development of Latin America in the next decade. Moreover, if budgets are to be austere, all the more reason to allow the centre to decide on the purpose and location of infrastructure investments, and all the more reason to give the centre discretion to pursue whatever equalization is affordable. If education and health expenditures are key investment areas for growth in the next decade, then central direction (if not central control) over these expenditures would seem critical. The problem is that especially large countries, where populations have diverse needs and preferences, are not easily governable from the centre. Central government bureaucracies break down, people (and investors) become disaffected and local-level development opportunities become lost.

There are relatively few ways out of this difficult choice. In many countries the local governments have been given only minor expenditure responsibilities and no control over a broad-based tax. There has been no major attempt to invest in their capacity to provide good government, and they have no certain claim on central revenues. To continue this policy by making minor adjustments will not be a true move toward fiscal decentralization. In other countries (Brazil is a good example), subnational governments do have a definable claim on total government revenues, and such a claim cannot be easily backed away from in the name of a need for greater central control.

V. CONCLUSIONS

The outlook for the world economy is for a resumption in real economic growth after the dismal performance of the past two years. Growth will be slow until the mid-1990s, but thereafter is projected to be stronger. The structure of this growth, according to the average of the forecasts examined here, is for a lower rate of inflation and a lower real rate of interest.

Overall, however, the 1990s will not bring a real growth for most developing and industrialized countries that is any greater than that realized in the 1980s, and most projections expect it to be slightly lower. The implications of this outlook are that export markets in industrialized countries will not grow as fast as had been hoped, and that capital inflows to developing countries may be of lesser magnitude than had been hoped. Should a more pessimistic set of assumptions be adopted (increases in oil prices, failure of the GATT negotiations, and a failure to bring the US budget deficit under control), then the outlook would appear even less favourable for low-income countries.

Most analysts advise lower-income countries to adopt a strategy of stabilizing their economies and restoring the confidence of investors. This is said to be best accomplished by trade, price and exchange rate liberalization; control of inflation by a stable money supply; exchange rate adjustments; privatization of industry where appropriate; and fiscal bal-

8. The subject of fiscal decentralization is reviewed in Bahl and Linn (1992), Chapters 12 and 13.

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loopholes are almost certain to remain in the system, the fairness objective will be compromised. Another problem is that broadening the tax base often means bringing interest income into the tax net, and possibly discouraging savings or encouraging capital flight.

The other choice is to hold to the more narrowly based, progressive rate structure. It is nominally progressive and seems to provide incentives for savings and investment by providing preferential treatment for capital income: many countries exempt capital gains and interest income, and give credits or deductions for certain types of investments. Progressive rate structures are popular with politicians because they at least give the illusion that the rich are being treated differently under the tax system. The biggest disadvantage is that the narrow base forces a high marginal tax rate, which in turn discourages investment and work effort, or encourages evasion and avoidance. The progressivity of the graduated rates is often lost to the special treatment of capital income, the provision of loopholes to mitigate against the high marginal tax rates and contribute to the success of higher-income individuals in evading the tax. Bird (1992, p. 93) notes that even if one is not willing to go so far as the flat-rate tax, steeply progressive rates have no place in a well-designed income tax in developing countries.

The trend around the world (and in some Latin American and Caribbean countries) has been in the direction of simplification, base-broadening and less rate graduation. For example, Jamaica adopted a broad-based, flat rate (33 1/3 percent) individual income tax in 1986 (see Alm, Bahl and Murray [1991]), and Argentina has recently proposed a 30 percent flat-rate individual income tax, with the exemption of dividends paid to local and foreign shareholders (Asorey [1992]).

C. *Should the tax system be structured to encourage investment?*

The superficial answer to this question is "yes", and the possible shortage of capital flow to developing countries and the power of the new trading blocs makes it even more important that tax systems be export- and investor-friendly. On the face of it there seems to be no choice involved, but there are endless suggestions about how one restructures a tax system to encourage investments. And there are major tradeoffs involved, in that an investment-friendly tax system may also be one that is less friendly to income distribution or to fairness objectives. Hence the choice.

One alternative is to follow an interventionist policy and use tax policy to attract investment. Low- and middle-income countries could adjust their tax systems to increase the after-tax rate of return to investors in many ways:

- Reduce marginal individual income tax rates.
- Provide special income tax treatment of fringe benefits received by higher-income individuals.
- Exempt dividends from the individual income tax.
- Exempt interest income from taxation, but allow it as a deductible cost.
- Enact a value added tax (VAT), or increase reliance on the VAT, and zero-rate all exports.
- Allow repatriation of profits without penalty.
- Reduce corporate income tax rates, accelerate depreciation allowances and provide a proper inflation adjustment for inventories.
- Provide tax incentives for "preferred" investors.

Many of these are adjustments that should be made in the tax system no matter what strategy is being followed (e.g. elimination of the double taxation of dividends, repatriation without penalty, zero-rating of exports). But particularly the issues of whether special tax incentives for investors should be allowed, whether higher-income individuals should receive a friendlier treatment and whether interest income should be free of tax, raise serious questions. Proponents argue that lower income tax rates on higher-income individuals leave them free to save more and give them an incentive to invest more. These individuals have the highest marginal propensity to save and are the entrepreneurs of the economy: the ones most likely to take investment risks. Many countries have bought into this argument and provide escapes from high individual income tax rates, which higher-income individuals are best equipped to use. These include tax-free interest income, non-taxable fringe benefits and the effective exclusion of capital gains from the tax base. Company tax preferences might include tax holidays and accelerated depreciation for incentive firms. (Typically, the VAT is not used as a major part of the incentive package.) Such incentives are thought to attract particular industries and to show signs of a hospitable business climate for foreign and domestic investors. The pressure to adopt incentives grows with the use of such programmes by neighbouring countries.

The disadvantages of the interventionist approach are that each of these preferences imposes a cost that must be made up with a higher tax rate somewhere else in the system. These higher nominal rates, and the distortions of economic choices introduced by the preferences themselves, introduce an inefficiency into the economy and have a real cost likely measured in terms of slower growth. There are few places in the tax system where the lost revenue can be regained. Among the possibilities are a higher income tax rate for lower-income workers, a lower standard deduction under the income tax, higher income tax rates for those companies that are not on the preferential treatment list, higher "sin" taxes on alcoholic beverages and cigarettes and fewer exemptions under the VAT. The result is likely to be that the overall tax system will be less progressive, or even regressive, and this will be a cost of adopting the interventionist approach.

The other choice is to go for a tax system that is neutral with respect to economic choices. The basic argument here is that there is no strong evidence that targeted incentives work, and so why introduce distortions into the tax system? This strategy would involve broadening the tax base and lowering the rate for all taxpayers. Such a system would tax all income at the same rate, zero-rate exports, not penalize repatriated profits, equalize the individual and company tax rates and find a way to approximate true economic depreciation. It might adopt a flat-rate income tax, but it would not provide preferential treatment either to high-income individuals or to businesses. The advantage is that the market and not the govern-

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faster than projected, but there may be some amount of relief that will allow important expenditure programmes to be better covered. Expenditures may be reallocated to infrastructure and human capital investment (1) if interest rates fall and the debt service claims on the budget are less, (2) if privatization reduces the claim on government resources, and (3) if the financing of some government-provided services is shifted to beneficiaries. There is some evidence that new resources will materialize because of initiatives in these three areas, but the amounts may turn out to be modest. The IMF (1992) projects that debt service payments as a percent of the total value of exports of goods and services will fall in Western Hemisphere countries from 31.5 percent in 1991 to 28 percent in 1997.

There also is the question of whether any new-found resources actually will be allocated to essential purposes. The 1990s will be a time in many countries when there will be pressures to subsidize prices in the aftermath of privatization, increase public employee compensation and restore lost tax preferences. However, the IMF survey of 31 Latin American countries (IMF [1992], pp. 72-76) indicates that the education and health expenditure share of GDP increased in the 20 countries where the deficit was reduced and fell in the 11 where it was not. The results of this analysis also showed that the share of capital expenditures in GDP did not fall significantly in the deficit-reducing countries.

Adjustments made on the tax side also can lessen the pain associated with hard fiscal choices. Reductions in the average tax rate for all present taxpayers can be realized if a more efficient tax administration broadens the tax net and captures those who have successfully evaded or avoided payment. There are many opportunities to do this, because typically the tax base in low-income countries is quite narrow. Perhaps the best targets of opportunity in this area are the self-employed under the individual income tax, value added tax exemptions, import tax exemptions or preferential rate treatments, and real property.

The pain of this fiscal choice will vary from country to country, depending on the situations from which they start. Jamaica, with a tax-GDP ratio now approaching 30 percent, has a quite different situation from that of Guatemala, with a ratio of under ten percent. The difference between the situations in these two countries is illustrative. To compete effectively in the 1990s, Jamaica will have to find a way to slow the growth in the public sector. It cannot afford a fiscal deficit with the present instability in its economy, and tax increases would seem out of the question given the present high rate of taxation in the economy. The hard choice facing Jamaica is how to cut expenditures when expenditure needs are so great. Guatemala's situation is better. There is ample room for a tax increase to cover the expenditure needs of its population, and the fiscal deficit is not a great one. The most difficult choice in Guatemala is whether to risk an increase in taxes in a country with a long tradition of resistance to higher taxation.

B. *How will personal income be taxed?*

Most developing countries are beset with policy and administrative problems in their individual income tax systems. The revenue yield is often not up to the mark because of loopholes that have narrowed the tax base and because of poor administration and widespread evasion, especially among the self-employed. A common reaction is for the government to raise the rate – which leads to more avoidance, evasion and undesirable allocation effects – and the cycle continues. This pattern neither builds confidence in the government's ability to lead macroeconomic policy, nor does it contribute to a sound revenue base to support a balanced budget. Individual income tax structures in low-income countries, and in Latin America, are often complicated and usually have multiple objectives. The main goal is revenue generation, but many government officials and political leaders would argue that income redistribution is another important objective. Accordingly, in many countries, income taxes are characterized by progressive rate structures, relatively high floors and special deductions to protect the poor. Some countries use the income tax to achieve other allocative goals – everything from the stimulation of the life insurance industry to the encouragement of savings to relieve the cost of commuting to work.

The individual income tax can play a very important role in low-income countries, and it does in many countries. It can be a major revenue raiser, it can siphon off the administrative resources of the tax department, it can impose high compliance costs on payers, it can add progressivity to the overall revenue system and it can have a direct effect on the ability to save, invest, take risks and work harder. Another important feature of income taxes is that the nominal tax structure is very visible to voters while the actual pattern of effective tax rates is not. As a result, political leaders are quite sensitive about making even rational changes in the nominal tax structure, because it might give the appearance of providing a special tax treatment to the higher income.

One choice for individual income taxation is simplification, a path that many countries in the region have already taken. This may involve adopting a flat rate, eliminating most deductions and credits, and broadening the tax base to include all forms of income. The advantage of this approach is that it eliminates the horizontal inequities in the system by taxing all income at the same rate, and it gives no special preferences. Because it is simple, it reduces both compliance and administrative costs. Because it is applied to a broad base, the (nominal) flat tax rate is low by comparison with the previous marginal tax rate; therefore savings, investment, risk taking and work effort are encouraged. A more difficult issue is what to do about capital income taxation. Here the issue becomes whether countries should opt for a consumption tax.

There are some disadvantages to a broad-based, flat-rate tax regime. The most important is that it is not consistent with the ability-to-pay cannon of justice in taxation. Since the sacrifice of a dollar in taxes is greater for a low-income than for a high-income person, it is thought fair to tax the lower-income person at a lower rate. Since a flat tax does not do this, it imposes a greater burden on the poorer family. The result is that flat taxes are usually perceived as inequitable, and in fact may be regressive in their distribution of tax burdens. Other disadvantages may arise in connection with the base-broadening that accompanies the flat tax regime. Because some

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Arguably, the area where reform is most necessary, and in some countries has been slowest, is fiscal and tax policy. This is not to say that substantial fiscal reform has not taken place. Many Latin American governments have undertaken adjustments and have moved to eliminate or substantially reduce the size of their fiscal deficits. And in many cases, they have been successful. An IMF survey of 31 Latin American countries during the decade ending in 1991 shows that the fiscal deficit fell in 20 countries and increased in 11. The average decline in the deficit for the 20 countries (between 1986-1988 and 1989-1991) was 4.7 percent of GDP, and the average increase in the 11 countries was 1.8 percent of GDP (IMF [1992], pp. 23-25).

Even in countries where policy reform has taken place, the economic impacts have often been compromised by a weak tax administration (Bahl and Martinez [forthcoming]). The challenge facing many Latin American countries is to reform their fiscal systems, including tax policy and tax administration, in a manner consistent with this general macroeconomic policy direction, and consistent with the constraints provided by the world economy. This will make the fiscal choices more difficult.

There will be a slower growth in the industrialized economies in the early 1990s (compared to the average of the 1980s), hence very likely a slower growth in capital flows to developing countries and an export market that does not expand as fast. This means more competition among developing countries for external investment and for export markets; therefore more of a competitive edge is needed in the fiscal policies that must be designed.

The remainder of this paper outlines the most important of the fiscal choices:

1. Should there be growth in government expenditures, or declines in taxes and borrowing?
2. Will the taxation of income be driven by economic efficiency concerns or by vertical equity concerns?
3. Should tax systems be redesigned to stimulate investment, with lower (or no) taxes on capital income?
4. Should government become more centralized, or should fiscal decentralization be pushed?

A. *Will the government sector grow?*

A continuation of the adjustment policies of the past few years would not suggest a growing public sector in Latin American countries in the 1990s. The results of the IMF survey of 31 Latin American countries showed that the average level of government expenditures fell from 24.4 percent in 1981-1985 to 20.6 percent in 1989-1991. The decline was due to a combination of lower debt service expenditure and lower expenditures for subsidies, transfer payments and public employee wage bills (IMF [1992], pp. 72-76).

The outlook for Latin America is for a stronger economic performance than in recent years, but not for a robust growth that is above the long-term trend. The baseline projections are for a rate of real per capita GDP growth that will approximately match that which took place on average over the 1965-1989 period. This implies that, if the tax share of GDP remains constant, the government sector will be able to expand its real expenditures by about two percent per capita per year. This outlook, coupled with the possibility of a reduction in the revenue share of GDP, implies a modest growth in expenditure programmes, and therefore a tight control over expenditure practices. By the World Bank's pessimistic projections, and assuming no increase in taxes or borrowing relative to GNP, real per capita expenditure growth could be as low as 1.3 percent per year. If this less optimistic growth path prevails, then the fiscal situation is even tighter.

One choice, therefore, is fiscal austerity. At the extreme, this would imply no increase in the tax share, i.e. that taxes will grow no faster than the rate of growth in GNP. It also implies no increase in borrowing, other than for long-lived projects with a demonstrable payback. Even here, however, any new debt incurred would have to be supported within the limits of revenue that the present tax system will generate in the future. The austerity scenario poses major problems for some countries, in particular those which already have high levels of taxes relative to GNP. It leaves precious little to invest in new infrastructure and in health and education, which are cornerstones in the strategy to increase the competitiveness of low- and middle-income nations. It also cramps government initiatives to redress inequalities in the distribution of income through the improvement of public services to the poor.

The other choice is to resume an expansionary fiscal programme, by increasing the effective average tax rate (relative to GDP) and/or by borrowing to expand infrastructure and to cover annual deficits. Certainly there are reasons to argue in favour of a larger public sector. There will be more investment in infrastructure and in human capital, and more scope for providing redistributive services. The costs of environmental protection, an issue which the world must discover in the 1990s, will claim a substantial amount of resources. The World Bank (1992b, Chapter 9) estimates the cost at two to three percent of the GDP of developing countries by the end of the 1990s. Though all of this will not be government sector costs, the amounts involved are equivalent to ten percent or more of the budgets of most developing countries.

There also are the political advantages of higher expenditures which appear to outweigh the political disadvantages of deficits, at least over the expected tenure of elected leaders. The downside of this strategy is that resources will be drained from the private to the public sector, with whatever that implies for the overall rate of growth in investment (versus consumption) in the economy. If the expansion is financed with higher taxes, then the competitive position of the country may be compromised, and the return to investors may be less attractive. There may be a feeling that the business "climate" is not right for new investment. If the expansion is financed by borrowing to cover annual deficits, then the economy will be less stable and less attractive to foreign capital and to the return of flight capital. Confidence in economic management will not be restored.

Are there compromises on these choices? Is it possible to spend more without raising taxes or sacrificing important public expenditure programmes? The answer is that the fiscal choices will be difficult if the world economy does not grow

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ly will be a net transfer of resources to these countries from the rest of the world through the mid-1990s. However, both the IMF (1992) and the United Nations (1990) project a stronger growth in Eastern Europe and the former USSR than in most of the rest of the world.

Some Eastern European countries, however, may be able to move more quickly to take advantage of proximity to the European market. Czechoslovakia, Hungary and Poland, for example, have recently signed an agreement that provides for a free trade area with the EC. Quantitative restrictions have been removed in all three countries, and tariffs are being lowered.

China is a different story. The adjustment process has been neither so swift nor so painful, and real output increased by about seven percent last year. The state enterprises have been brought under semi-autonomous management, given some autonomy in operating decisions, and switched from a remittance to a tax regime. All of this has occurred in less than a decade. The speed with which the Chinese economy develops and shifts to an export orientation is another major question mark underneath these long-term forecasts. The United Nations projects the Chinese economy to grow at a real rate of 5.6 percent between 1990 and 2000. This is well above the world growth rate, but below that experienced in China in the 1980s.

The other concern about the competition from the transition economies is that they will attract foreign capital that otherwise may have been destined for less developed countries. The World Bank (1992a, pp. 7-8) argues that this is not true in the case of non-concessional loans, though creditworthiness will be scrutinized more closely in the case of all potential borrowers. In the case of concessional loans, however, this concern about competition will be valid unless donors increase their aid budgets.

2. The new trading blocs

The performance of the new trading blocs is another important factor that can affect the long-term economic outlook for developing countries. The two major changes to consider here are the EC and the North American Trade Agreement. One view is that the preferences given to countries within the blocs will reduce the size of markets for exports from less developed countries (or for that matter, from any country outside the trading blocs). It is possible that increased intraregional trade promoted by the agreement will be accomplished at the expense of what otherwise might have been increased international trade. One is the (unlikely) policy of a "trade fortress" stance by one of the blocs. Another is the possible diversion of scarce skills from multinational to regional trade negotiations.[7]

The other view is that the 1992 EC initiative will lead to specialization in production and efficiency gains that will result in an overall economic growth and therefore an increased demand for imports that will offset any negative effects. Most students of this debate seem to be in this latter camp, and argue the further advantages that:

- Countries within the trading bloc are pressured to reform their macroeconomic policies.
- Progress on multilateral trade negotiations may be enhanced because the number of parties in the negotiations is fewer.
- Export entry is easier because the rules for trading with a single bloc of countries are easier to learn than are the rules and institutions for a number of individual countries.

IV. FISCAL CHOICES FOR THE 1990S

Most analysts of the Latin American economic crisis of the 1980s are in agreement that domestic policy changes must be enacted and sustained if economic growth is to be restored. The last decade saw an interventionist approach in many countries, whereby domestic industry was protected from foreign competition in some cases and stifled by public enterprises in others, exchange rates were overvalued, and governments were in deficit and borrowed heavily. The next decade must see more of a laissez-faire approach to economic management and an opening of the Latin economies to take advantage of a changing international economy. The immediate objectives of this policy are to increase the rate of economic growth by increasing export volume, attracting external investment capital, increasing the efficiency of domestic industry and providing adequate public services in an environment of stable prices.

The principles that lie behind the formulation of such domestic policies may be summarized as follows:

- The best approach to attracting foreign investment and re-attracting flight capital is a stable macroeconomic performance. Low and steady rates of inflation, small deficits on the government and trade accounts, and a stable exchange rate will do more to attract and retain economic activity than will even the most attractive package of targeted incentives.
- The government should not take an interventionist approach except where the presence of important externalities demands it. Tax, trade and industrial policies should be coordinated and should interfere as little as possible with the market.
- The rate of investment in health and education should be increased.
- Borrowing should be limited by the growth in taxable capacity, the present level of debt burden and the intrinsic value of projects.

In fact, the 1980s did see a major turnaround in macroeconomic policy in the Latin American region. The elimination of quantitative restrictions and the reduction in tariff rates in many countries reduced barriers to trade, and the results will be felt fully in the 1990s. Countries have come to grips with the burden of their external debt by negotiation with creditors, limiting future borrowing and more carefully scrutinizing the purpose of loans. Lower interest rates in the early 1990s will provide further relief. Substantial progress has also been made in the area of privatization of public enterprises, e.g. in Argentina, Brazil, Mexico and Venezuela.

7. De la Torre and Kelly (1992).

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ized countries could move toward a new series of bilateral arrangements and developing countries could see their potential markets shrink.

Global integration could slow in the 1990s. The GATT agreements are the major issue of uncertainty. The slower growth in the industrial economies in the early 1990s almost certainly means that, compared to the 1980s, export markets will not be as robust and the flow of investment capital to the rest of the world will not be so great. The decline in transportation costs seems to be approaching a bottoming-out, hence that stimulus will not be as strong (World Bank [1991a]). Finally, there is the issue of whether the LDCs will stay their policy course of the late 1980s and continue to adopt investor- and trade-friendly policies.

B. *Development finance*

The projections reviewed above assume that the substantial capital resource constraint facing the developing countries can be relaxed. The three candidate sources of capital are direct foreign investment, return of flight capital and foreign assistance.

During the last half of the 1980s the level of direct foreign investment increased from $ 47 to $ 132 billion, at a faster rate than total world investment. This suggests a growing world economic integration. However, the share of direct foreign investment going to the developing countries fell from 24 percent to 13 percent over this same period. Two thirds of this amount went to East Asia and Latin America, and in the latter case primarily to Brazil, Argentina, Mexico and Colombia (Finance and Development [1992]). If the developing economies are to capture a greater share of foreign direct investment, they will have to continue the economic liberalization policies which began in the late 1980s. The IDB sees this as possible and expects that the attractive rate of return on foreign investment in Latin America will result in an increase in the volume of foreign direct investment by a factor of about 2.5 before the end of the century (IDB [1991], pp. 18-19).

The second source of external financing is the return of flight capital. The IDB (1991, p. 19) estimates the total amount to be about $ 170 billion, equivalent to about one third of the region's total external debt. The World Bank (1991a, pp. 124-25) estimated that, during the 1980-84 period, the amount was as high as $ 40 billion for Mexico and $ 27 billion for Venezuela. The IDB points out the potential of this source of finance with the following conjecture: if investors decided to hold constant the real value of their assets abroad, and bring home only the annual return, there would be a re-entry of about $ 10 billion by the end of the century (IDB [1991], p. 19). This is equivalent to about half the expected flow of direct foreign investment.

The determinants of capital flight and the determinants of investment capital inflows are much the same. Capital flight occurs because domestic macroeconomic policies (or political instability) cause investors to lose confidence in the economy and seek alternative locations for their investments. They seek out locations which give them some combination of safety on their principal and a higher after-tax rate of return. The ability of developing nations to attract investment capital will depend on whether they can sustain policies that will restore confidence in their economies (Goldstein, et al. [1991], pp. 1-44). Greene and Villanueva (1991) found evidence that the rate of total private investment in developing countries is positively related to the rate of real GDP growth, the level of per capita GDP and the rate of government investment. They also found that the investment rate is negatively related to real interest rates, and the levels of inflation and debt. Latin American countries have liberalized trade to a significant extent in recent years. Argentina, Bolivia, Brazil, Colombia, Costa Rica, Ecuador, Honduras, Mexico, Peru and Venezuela have eliminated quantitative restrictions and lowered tariff levels. In some cases the reforms have been broad-based and have included reduction of the fiscal deficit, a cap on borrowing and significant privatization of industry.

Finally, there are the traditional sources of direct external assistance in the form of loans. These are expected to be modest for the Latin American region, declining from $ 9 billion in 1993 to about $ 4 billion at the end of the century (IDB [1991], p. 19). The result will be a very modest increase in total debt outstanding over the next ten years. Much of the borrowing requirements for Latin America will be filled by the World Bank, the IMF and the IDB.

Will the sources of direct foreign investment and official loans be sufficient to meet the financing needs of developing countries in the next decade? There are two reasons to be cautious in the forecast of what might be expected. One is the slower growth in the industrial economies in the first half of the 1990s. And since the US deficit problem does not appear close to resolution, the level of savings may be less than has been assumed in these forecasts. The other is the competition for funds from (a) the newly emerging economies in Eastern Europe, and (b) the countries of the European Community (EC) as they adjust to their new economic roles.

C. *New markets and new economic power*

The performance of the world economy over the next ten years will be shaped by two other important factors: the performance of the transition economies and the policy directions taken by the new trading blocs.

1. The transition economies

Before the 1990s end, the transition economies (Eastern Europe and China) may substantially impact the share of world economic growth gained by the developing countries by (a) providing new export markets, (b) providing a new competitor for exports to the industrialized countries, and/or (c) siphoning off some of the external capital flows that otherwise might have found their way to the developing countries.

How quickly might the new competition for the world export market occur? The answer will vary from country to country. The breakup of the Soviet Union and its economic influence zone is still in process. The economic liberalization process that is now underway in much of Eastern Europe and in the former Soviet Union Republics will be painful, and now it appears that the transition will not be short-lived. There like-

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entation and by 2.2 percent per year in those with an "inward" trade orientation. However, Roemer and Radelet ([1991], pp. 64-65) review a contrary literature and conclude that the now-conventional prescription of outward-looking policies is based more on economic principles than on empirical evidence.

There is, in fact, global evidence that a sorting out process is leading nations to find their comparative advantages (World Bank [1992a]). Total world trade has increased. In the manufacturing sector, trade increased at an average rate of 4.9 percent while output increased at a rate of 3.9 percent. The share of technology-intensive manufacturing has increased in the industrialized countries, while the share of labour-intensive manufacturing exports in developing countries has risen. Within manufacturing, there are many country-specific examples of specialization as firms have sought out cheap labour and taken advantage of lower transportation costs and newer communications technologies.

On the other hand, this specialization may not have gone so far as the rhetoric. The difference between the growth in trade in manufacturing and the growth in output is narrower now than it was a decade ago. Even the penetration of industrial country markets by LDC manufactured goods is not so widespread. The World Bank (1992a, p. 31) reports that the developing country share of industrial country imports of labour-intensive manufactured goods almost doubled between 1965 and 1989, rising from 9.8 to 18.8 percent. However, this increase is due entirely to East Asia, whose share increased from 1.4 to 12.4 percent over this same period. This means that the *share* of all other developing nations actually declined during this period. The *volume* of trade, however, has increased substantially.

The impetus for global integration comes from several factors. The cost of transportation and communications has fallen, reducing the "distance" constraint to increased trade. The gap between the rich and the poor nations in the growth of income and the relative inflation of currency values has enhanced the labour cost advantage of low-income countries. The price of primary commodities has been low for some time in world markets. Finally, changes in production processes and strategies, such as the increasing variety of product lines and product quality, require a closer working relationship between importers and exporters. This enhances economic integration and development of the trade sector in developing economies.

To growing (but not yet industrialized) countries, global integration means gaining jobs, government revenue and access to foreign exchange. But it also means gaining the technology necessary to sustain a higher rate of productivity and growth in the long run. Productivity increases will lead development in the more competitive and more technically complex world economy of the 1990s. The World Bank (1991a, p. 88) notes that "...growth in productivity, the best proxy for technological change, has accounted for as much as 30 percent of GDP growth in the East Asian countries". A major issue of development policy, therefore, will be technology transfer. Removing barriers to the sharing of technology should be high on the list of priorities for stimulating development.

Three key areas will define the progress of global economic integration in the next decade. Labour mobility, capital mobility and trade are the principal ways in which modern techniques of production and communication are spread, and the means by which comparative advantages are discovered and become part of a country's economic strategy. Increased international labour mobility could lead to substantial gains for the world economy, and for most countries involved in either the import or export of labour. Emigration to labour-short economies may relieve labour surplus economies of the pressures of a high unemployment pool, and therefore may lead to an overall improvement in the distribution of income. The main drawbacks are the problems of "brain drain" in some of the low-income economies, and the resistance by host country workers to being crowded out by migrant workers. There also is the advantage that movements of skilled labour are an important way to diffuse technology, and foreign labour has in many cases been invaluable to labour-short economies.

Capital mobility, especially in the form of direct foreign investment, is another important source of technology transfer that can stimulate economic growth and trade between countries. Case studies of Hong Kong and Mexico have shown that the presence of foreign firms has increased the diffusion of technology and improved the efficiency of local firms (World Bank [1991a], p. 94). The experience of foreign firms in management and marketing techniques can benefit local firms who are trying to gain a foothold in world markets. Moreover, the volume of trade with a country may be substantially increased by direct foreign investment simply because of the trade channels that are opened with affiliates. A recent study reports that in the early 1980s intrafirm trade within the largest 350 transnational corporations (TNCs) contributed about 40 percent of global trade.[6] One need only imagine the opportunities for transfer pricing, tax evasion and tax avoidance to speculate on how daunting is the task of administering a tax system that does not have an export orientation.

Trade liberalization is perhaps the most important question mark in assessing the outlook for the world economy in the 1990s. It is clear that developing countries must gain access to the markets for manufactured goods in industrialized countries. LDCs in aggregate sell less than five percent of their manufacturing output to other developing countries, and more than four fifths of the world market is in industrialized countries. On the other hand, developing and industrialized countries alike have erected restraints to trade. The trade barriers in industrialized countries have not been significantly relaxed in the 1980s, with a few exceptions. Most observers seem to agree that developing country exports to industrialized countries could increase, even in the presence of the trade restraints that are in place (World Bank [1992a]). A successful GATT round, however, could lead to substantial gains for low-income countries. One estimate is that a five-percentage-point reduction in manufacturing tariffs by industrialized counties would lead to a real GNP gain of 1.6 percent per year in low-income debtor countries, and 1.4 percent per year for countries in the Western Hemisphere (IMF [1990], pp. 74-75). However, if the GATT negotiations fail, industrial-

6. See World Bank (1992a), at 33.

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TABLE 3

Real GDP and real GDP per capita growth rates for low- and middle-income economies, 1965-2000
(annual percentage change, unless noted)

Region or group	GDP, 1989 (billions of dollars	Population, 1989 (millions)	Real GDP growth: Trend, 1965-89	Real GDP growth: Projection for 1990s: Baseline	Real GDP growth: Projection for 1990s: Downside	Real GDP per capita growth: Trend, 1965-89	Real GDP per capita growth: Projection for 1990s: Baseline	Real GDP per capita growth: Projection for 1990s: Downside
All low- and middle-income economies	3,303	4,053	4.7	4.9	4.1	2.5	2.9	2.2
Region								
Sub-Saharan Africa	171	480	3.2	3.6	3.5	0.4	0.5	0.3
Excluding Nigeria	142	367	3.3	3.6	3.1	0.4	0.4	0.0
Asia								
East Asia	895	1,552	7.2	6.7	5.6	5.2	5.3	4.2
South Asia	351	1,131	4.2	4.7	4.2	1.8	2.6	2.1
Europe, Middle East, and North Africa	828	433	4.2	3.6	3.2	2.2	1.8	1.4
Latin America and the Caribbean	964	421	4.3	3.8	3.1	1.8	2.0	1.3
Income Group								
Low-income economies	996	2,948	5.1	5.5	4.8	2.9	3.5	2.9
Middle-income economies	2,308	1,105	4.5	4.5	3.7	2.5	2.6	1.9

Source: World Bank data, as reported in World Development Report 1991.

TABLE 4

Indicators of Economic Growth: Actual and Projected Amounts[a]

	1990	1991	1992	1993
Real GDP				
All Developing Countries	3.5	3.3	6.7	5.4
Western Hemisphere Developing Countries	–0.1	2.8	2.7	4.2
Industrial Countries	2.5	0.8	1.8	3.3
Real per Capita GDP				
All Developing Countries[b]	1.2	1.3	–1.6	2.5
Western Hemisphere Developing Countries	–2.1	0.8	0.6	2.1
Industrial Countries	1.8	0.2	1.1	2.7

a. Annual growth rates.
b. Excluding Eastern Europe and the former USSR
Source: World Economic Outlook 1992, various tables.

III. FACTORS SHAPING THE WORLD OUTLOOK

Some major issues lie underneath these long views of the growth of the world economy, and of the share of that growth which will belong to the developing countries. The first is the extent to which the process of global economic integration will continue. The second is the adequacy of the supply of investment capital for developing countries. This potential constraint to development is partly beyond the control of low-income countries, i.e. it is more a consequence of the performance of the world economy. However, the way in which investment capital is distributed among nations is partly a result of how government policy in developing countries faces up to the problem of imbalances in financial resource flows, i.e. the resource claims of debt repayment and domestic government expenditures on one side of the fiscal equation, versus the supply of resources available from taxes and external assistance on the other. The third major issue is the worldwide effects of trade and income growth of the new trade alliances in Europe and North America, and of the new economic order in Eastern Europe and the former Soviet Union.[5]

A. *Global integration*

For the developing countries, the cornerstones of economic policy are to find markets for exports, to find sources of capital for industrial and infrastructure development, and, increasingly, to develop competitive production technologies. The late 1980s saw major steps in the direction of economic integration, as countries liberalized their trade regimes and adopted macroeconomic policies that were more conducive to foreign and domestic investment. The outlook for the world economy in the 1990s is much stronger if this trend continues. The IMF (1990) provides some support for this argument in a study of 41 developing countries for the 1983-1989 period. They find that potential GNP grew by 7.7 percent per year in those countries with an "outward" trade ori-

5. A longer treatise on the world economy would consider several of the big uncertainties that make forecasts in this decade especially difficult: political instability and war, the further development and transfer of technology, the prospects for changes in energy prices and the environment.

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TABLE 2

The International Economic Climate in the 1990s: A Comparison of Recent and Projected Indicators
(average annual percentage change, unless noted)

Indicator	Trend 1965-89	Recent experience 1980-89	Recent experience 1990	Projections for the 1990s: World Bank baseline, 1990-2000	World Bank downside, 1990-2000	IMF baseline, 1991-96	Project LINK, 1991-95	WEFA Group, 1991-95	DRI, 1991-95
High-income OECD members									
Real GDP	3.1	3.1	2.6	2.9	2.2	3.1	2.8	3.2	3.1
Inflation[a]	6.6	3.8	3.7	3.6	4.3	3.4	3.4	4.4	3.3
Interest rate (%)									
Nominal[b]	8.6	10.2	8.4	7.4	9.6	..	7.7[c]	8.6	7.9[c]
Real[d]	3.1	5.8	4.3	3.4	5.1	3.9	4.0[c]	4.3	4.9[c]
World trade[e]	4.1	4.1	5.0	5.8	4.5	..	5.6	4.3	..
Real price of oil[f]	9.3	–10.1	22.2	–0.6	0.9	–3.0	0.9	0.8	–2.0

a. GDP deflators in local currency for World Bank and IMF projections; for others, inflation is measured by consumption price deflator.
b. Six-month LIBOR on dollar deposits.
c. US three-month Treasury bill rate; the real rate is the Treasury bill rate deflated by the US GNP deflator; DRI projections are for the US long-term government bond yield deflated by the US GNP deflator.
d. LIBOR deflated by US inflation rate (percentage change in the GNP deflator).
e. World volume of exports.
f. Average OPEC price of oil deflated by the manufacteres unit value exported by industrial countries; Project LINK is the average price for Saudi Arabian exports deflated by the GNP deflator.

Sources: World Bank data; IMF 1991; WEFA Group 1991; DRI/McGraw-Hill 1990; Project LINK 1991; as reported in *World Development Report 1991*.

The United Nations (1990) projections for the industrialized countries and the world economy generally agree with the results presented above. They project a real per capita GDP growth rate of 2.6 percent for the 1990-2000 period, a growth that is significantly below the long-term trend.

The medium-term outlook as seen by the IMF (1992) is somewhat more optimistic (Table 4). For 1992 and 1993, they see a significant increase in real GDP growth, reaching 3.3 percent by 1993. This is higher than most of the long-term projections summarized in Tables 2 and 3, though it is lower than the Fund's even more optimistic view in 1991 (IMF [1992], Chapter 1). The 1993 results are driven by assumptions of lower interest rates and a lower general rate of inflation, and by the projection of a significant increase in the volume of world trade by 1993.

B. *Developing economies*

The long-term projections for developing and middle-income economies, as reported by the World Bank, are reproduced in Table 3. According to the World Bank baseline scenario, it is expected that the average growth in per capita real GDP in developing countries will exceed that of the 1980s, but there are wide variations around this mean. Some countries, and even some regions, will not fare well. Low- and middle-income countries in Africa, the Middle East and Latin America are expected to grow at less than the international average rate. For the Latin American countries, the real per capita GNP growth rate is projected to be less than the average rate realized over the past 25 years. The reason for this expected weak performance in many countries is that they remain plagued by the same problems as in the 1980s: high real rates of interest, low commodity prices and the resource drain associated with the debt overhang. The performance of the world economy has two conflicting effects on Latin American countries. The slower growth in the industrial economies in the early 1990s will dampen export markets and therefore retard growth in exports by all low-income countries, and it will slow the flow of capital from the industrialized to the developing countries. On the other hand, the lower real rate of interest will provide some relief to heavily indebted countries.

Under the World Bank's pessimistic scenario, the projected growth for all developing economies is 0.8 percent per year slower, and for Latin America is 0.5 percent slower (than the baseline forecast). In effect, it would be a continuation of the 1980s. Oil importers fare particularly badly in this scenario, because of the assumption of a higher price for oil.

The United Nations (1990) projects that all developing countries will experience a per capita GDP growth of two percent between 1990 and 2000, but that countries in Latin America and the Caribbean will grow at half this rate. This projected poor performance for Latin America and the Caribbean would be well below the historical levels of growth in per capita GDP of 2.4 percent in the 1970s and 2.7 percent in the 1960s.

The IMF medium-term projections for developing countries in the Western Hemisphere are for a modest growth in real GDP and per capita real GDP in 1992, but for a significant increase in both in 1993 (Table 4). The large increase in 1993 is associated with continued liberalization of economic policy, a significantly lower rate of inflation and a dramatically improved fiscal balance (IMF [1992], Chapter 3).

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II. PAST AND PROJECTED ECONOMIC PERFORMANCE

The weak performance of low-income countries in the past decade, and of Latin American countries in particular, is described in Table 1. There was little increase in per capita GNP in either group over the 1980-89 period, and the standard of living in many developing countries did not grow.[3] Meanwhile, the growth among (high-income) OECD countries was robust enough that per capita GNP nearly doubled over this same period, and the gap between rich and poor countries widened considerably.

TABLE 1

Economic Performance in the 1980s: Selected Regions and Indicators

	1980	1989	Change
Per Capita Real GNP (in 1987 US dollars)			
Latin America[1]	1920	1950	$30 (1.5%)
Low Income	310	330	$20 (6.5%)
OECD High Income	10650	19240	$8590 (80.7%)
Investment as a Percent of GDP			
Latin America	24.3	19.5	–4.8% of GDP
Low-Income	25.5	28.4	2.9% of GDP
OECD High-Income	22.0	21.8	–0.2% of GDP

1. Including the Caribbean.
Source: World Tables 1991, Tables 1 and 15.

What of the 1990s? The results of several forecasts, based on econometric models, are summarized in Tables 2 and 3 (as reported in World Bank [1991a]). Some projections give both a "baseline" and a "pessimistic" forecast, based on a set of upside and downside assumptions. Shorter-term projections, prepared by the IMF, are shown in Table 4.

A. *Industrialized countries*

For high-income industrialized nations the baseline projections for real GNP growth range from 2.8 to 3.2 percent per year. In other words, the models predict a growth no greater, on average, than the 3.1 percent that took place in the 1970s and 1980s. In fact, the average of these projections would have a slower growth rate than that of the last 20 years. All of the baseline forecasts, however, call for a substantial rebound from the dismal economic performance of the past few years.

The structure of this growth is expected to differ from that of the past decade. Four of the six forecasts see a lower rate of inflation, and all project a lower real rate of interest and an increased volume of exports.

Though the assumptions in these forecasts vary from model to model, the World Bank baseline assumptions are perhaps representative. They assume (World Bank [1991a], p. 27) that:

- The real price of oil will not rise measurably, at least not until the second half of the decade. Petroleum prices will depend on the strength of the recovery of the industrial economies. By even the most optimistic forecasts, industrial growth will not be strong until the second half of the decade.
- The recession in industrial countries will end, but an "average" forecast is that G-7 countries will grow markedly slower than in the past decade (World Bank [1992], p. 7). Full recovery to higher levels of growth will not take place until the late 1990s.
- The United States will resolve its fiscal deficit problem. This assumption is probably overly optimistic since the US deficit has risen in absolute terms this year, and the Gramm-Rudman-Hollings target of a balanced budget in 1993 will not be achieved. The Congressional Budget Office (1991) estimated that the budget deficit will fall under present policies, but will not reach balance until 1996.
- Economic growth in Europe and Japan will remain strong as policy reforms lead to increases in productivity. An average forecast for the 1991-95 period is for Japan to grow at about 3.8 percent per year, compared to four percent in the 1980s. It is assumed that Japan's export growth will not be as robust as in the past, and the real rate of investment will be lower. Germany, by this same averaging, is expected to grow at 2.8 percent, well above its two percent growth in the previous decade. (World Bank [1992a], p. 7).
- Net flows of capital to developing countries will gradually expand. It is assumed that economic policies in developing countries will strengthen the competitive position of these countries in attracting capital, and that their creditworthiness will be restored.
- Real interest rates will not fall to as low a level as was achieved during most of the 1960s and 1970s, but will be well below those of the 1980-89 period.
- The GATT talks will be successful, except in agriculture.

The World Bank also produces a pessimistic forecast, made by altering the above assumptions. In this scenario the price of oil is higher, the GATT talks are unsuccessful in all areas and overall world trade is slower, and both the United States and Japan experience economic difficulties. By the lowest of the four forecasts reported, the G-7 countries grow by 2.3 percent per year between 1991 and 1995. This compares with an actual growth of 2.8 percent in the 1980s.[4]

According to the Bank model, the downside scenario (compared with the baseline forecast) will lead to a higher rate of general inflation, a substantially higher real rate of interest, a reduction in the volume of world trade and a reduced flow of capital to low-income countries.

3. The World Bank ([1990], at 39) reports that there was considerable progress in reducing poverty in the 1960s and 1970s, but that the picture for the 1980s is mixed. "In some regions the poor have suffered serious setbacks, whereas in others the progress of previous decades has continued and has even accelerated."

4. The four forecasts are Data Resources Incorporated, National Institute of Economic and Social Research, The Wharton Econometric Forecasting Association Group and Consensus Economics Incorporated (World Bank [1992a]).

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INTERNATIONAL:

TRENDS IN THE WORLD ECONOMY: IMPLICATIONS FOR FISCAL CHOICES

Roy Bahl

Roy Bahl is Professor of Economics and Director of the Policy Research Center, Georgia State University, Atlanta, Georgia. *He is indebted to Professor Jorge Martinez for a number of helpful comments.*

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I. INTRODUCTION

The 1980s were difficult for Latin America. Per capita real GNP increased by only $ 30 (1.5 percent), and ten of the 27 countries in the region had a lower per capita GNP in 1989 than they had in 1980. Between 1981 and 1985, there was virtually no growth in the region. The situation did not improve markedly in the early 1990s. Per capita real GNP declined by 0.1 percent in 1990 and grew by only 0.8 percent in 1991.

The reasons for this poor economic performance in Latin America and in low- and middle-income countries elsewhere have been well studied and researched: the debt overhang; the worldwide recession in the early 1980s and the US recession at the end of the decade; a high real rate of interest; and a continuation of domestic policies that were not conducive to economic growth. With respect to the latter, the following are often listed:[1]

- restrictions on trade to protect domestic industry slowed national (and international) economic growth;
- investment was hurt by high real rates of interest and by overvalued exchange rates;
- public sector enterprises proved to be an inefficient way to deliver many goods and services;
- government fiscal and tax policies led to deficits which have contributed to inflation, and failed to provide the best playing field for investors;
- meeting the needs brought on by immediate economic crises diverted the attention of governments away from investment in human capital through health and education programmes.

The world economic outlook for the remainder of the 1990s, according to the projections surveyed here, is for a continued but slow recovery through 1992, for world trade to increase and for economic growth to return (by the mid-1990s) to approximately its long-term path of about three percent per year. However, the variation in this growth rate among nations may be greater than in the past. Those countries with richer endowments of natural and human resources, and those with economic policies more compatible with growth, will do better. Indeed, there are reasons to be optimistic about the 1990s. The Inter-American Development Bank (IDB) labels the 1990s a decade of hope and points to the turnaround in domestic policy in Latin America at the end of the 1980s: "...reevaluation of past policies led to the adoption of a series of fundamental reforms aimed at correcting some of the existing macroeconomic disequilibria as well as some of the distortions in the countries' product and factor markets, in order to establish a more solid foundation for future growth."[2] While it is too early to tell whether policy reform has gone far enough in Latin American countries, it is clear that the world market in which they will compete is likely to be very different from that of the 1980s.

This paper is about the prospects for the world economy in the 1990s and the fiscal choices that this environment implies. In the next section a number of projections are reviewed and compared with the actual economic performance of the past decade. Then we turn to a review of the broad trends and structural changes that will affect the competitive position and policy stance of low-income countries, and to the major uncertainties that may alter these trends. The final section of the paper outlines some of the important fiscal choices that will be forced.

1. For good discussions of the problems, see Tanzi and Chu (1989); and Blejer and Cheasty (1990).
2. See IDB (1991), at 1.

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times provide for more extensive powers which override domestic limitations.

Mr Beith mentioned the close cooperation with the United States, including simultaneous audits and simultaneous criminal investigations. Automatic exchange with the United States is very intensive. Spontaneous exchange, however, is incidental. Canada's 50 tax treaties represent a definite potential for cooperation if all treaty partners take it seriously.

Mr Beith mentioned a specific power of Revenue Canada since 1988. Canadian parents are required to provide information on subsidiaries in low or non-tax jurisdictions. The taxpayer may, however, challenge this requirement in court. As an example of a trade secret he gave the functional analysis of a group company. Mr Beith stressed that it is very useful for Canada to be a member of organizations whose membership includes both developing and developed countries.

Mr Ruben Aguirre of Mexico discussed exchange of information on the basis of comprehensive tax treaties and special agreements. Apparently Mexico sees advantages in special agreements, particularly because they are not limited to direct taxes as is usually the case with comprehensive tax treaties. The CIAT model also covers all taxes. Mr Aguirre further discussed the limitations to the exchange of information, and discussed the functioning of the mutual agreement procedure.

Mr Luis Hobbie of the United States focused on tax information exchange agreements (TIEAs), which are concluded separately from comprehensive double taxation conventions. The United States has concluded 11 such treaties thus far. TIEAs not only cover information upon request, spontaneous exchange and automatic exchange but also information on trends and practices in a particular industry, changes in laws, studies of market segments, etc. In his view simultaneous examinations may have the broader function of an industry-wide examination for a better understanding of the operation and organization of certain taxpayers.

He presented legal limitations on exchange of information as serious obstacles to international cooperation. The new strategy of the IRS, called Compliance 2000, focuses on increased cooperation with other governments, the use of magnetic media, a maximum period of time to deal with foreign requests and a new model for selecting cases for simultaneous examinations.

The discussion related to the interesting aspect as to whether in case of fraud conditions and limitations relating to the exchange of information, such as prior notification, would be waived. Mr Beith said that the question was not so relevant for Canada because Canada does not impose a prior notification requirement.

In sum the presentations were very interesting and produced valuable, sometimes new, insight into tax developments. The discussions were lively and usually more balanced than a neutral observer (i.e. an observer not belonging to a tax administration) would expect as the position and protection of the taxpayer was given due attention.

The organization of the technical aspect was excellently attended to by the CIAT Secretariat. The organization of the meeting by the Jamaican tax authorities was perfect and the hospitality and atmosphere very warm.

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Mr Manuel Estela of Peru discussed the formidable problems of tax administrators in his country in combatting tax evasion and corruption. The future looks somewhat better because the tax system will be reformed and the tax administration reorganized.

Mr Wong of Honduras, Mr Etcheberry of Chile and Mr Gaitero Fortes of Spain discussed the modernization of the tax administration in their respective countries.

Mr Wong described the modernization of the tax administration as an integrated aspect of tax reform. One of the objectives of tax reform is to achieve more efficiency and effectiveness of the tax administration, in particular by modernizing the collection, control and recovery systems, and by simplifying procedures. He advocated a pragmatic approach to modernization, and a high degree of administrative autonomy and decentralization of powers within the tax administration. He pointed to a draft tax code containing principles of taxation, procedures and sanctions. Reforms of the various direct and indirect taxes are underway. Simplification measures include a reduction of income tax return filing requirements by eliminating wage earners and increasing the tax-exempt amount for individuals.

Mr Etcheberry referred to computerization of taxpayer files which was already at a high level. Interaction with the taxpayers' computers, more support from information technology and decentralization of data processing are three areas of modernization. He discussed the use of radio transmitters, portable telephones and facsimile machines to improve the speed of verification procedures.

Mr Etcheberry stated that the management practices of a modern enterprise were used as the prototype for reorganizing the tax administration. This includes areas such as specialization, decentralization of decision making, more global evaluation of performance, strategic management of human resources, short lines of communication and a new sanctioning system for VAT evasion. The latter has been highly effective.

Mr Gaitero Fortes referred to the recent creation of the State Agency of Tax Administration (SATA), which covers domestic taxes and customs duties. SATA is also charged with managing the resources of other public entities.

Mr Gaitero Fortes – disagreeing with the conclusions reached by Mr Etcheberry – stressed the special aspects of the public sector which makes privatization of tasks and using organizational models of the private sector inappropriate. He admitted, however, that some working methods from the private sector may improve the functioning of the administration. He would not exclude the assistance of private companies in the areas of automation, security, production of forms, etc.

Mr Gaitero Fortes also discussed the objectives of SATA:
- greater autonomy;
- to deal with application of the new direct taxes and the creation of the single market in the EC;
- establish a planning system and a relationship between objectives and resources;
- promotion of voluntary compliance.

Mr Gaitero Fortes concluded his discussion by mentioning the high level of computerization of the Spanish tax administration.

The discussion that followed focused on various practical problems of the modernization of tax administrations.

The fourth subject of the General Assembly was *International Tax Aspects*. Mr Henk Nemelc of Surinam was the moderator.

Mr Spierdijk of IFA was the first speaker. He explained the background and functioning of IFA, of which he is the secretary general. He then commented on some points of Dr Shome's lecture.

Mr Spierdijk asserted that there tends to be an element of competition between countries when it comes to the lowering of their taxes – particularly with a view to attract foreign investment. According to Mr Spierdijk, this reduces the scope for the experimental taxes outlined by Dr Shome. He feared that an assets tax would deter foreign investment, particularly by capital-intensive industries.

When income taxes are reduced, withholding tax on payments to other countries should be reduced as well. Mr Spierdijk further elucidated on the developments in the EC, particularly the Ruding Committee Report on the harmonization of corporate taxes. According to the Report, the efforts expended on exchange of information relating to multinational enterprises could be reduced considerably if advance rulings were given and advance contacts between authorities were made. He further referred to the discussions during the Stockholm IFA Congress in 1990 and explained the dilemma regarding taxpayer notification in the event of an exchange of tax information. On the one hand, notification impedes the effectiveness of the exchange, and on the other, it protects the reasonable expectations of the taxpayer.

Mr Spierdijk concluded his lecture by pointing to a difference between the approaches of the UN Ad Hoc Group and the United States to the exchange of information. The former requires that domestic remedies first be exhausted. The US Code of Good Practice states that the exchange may take place before the domestic investigation.

During the discussion that followed the comment was made that the tax authorities often cannot ascertain whether or not the information concerned is a business secret. Notifying taxpayers in advance of an exchange may avoid future claims for damages.

Other points that were raised during the discussion related to VAT and exchange of information, and the advantages of an assets tax and solutions for the problems mentioned by Mr Spierdijk. An interesting comment in this context was that a minimum tax is not meant to be levied in practice.

Mr Beith of Canada explained the Canadian tax system and the powers of the tax administration. He rightly remarked that where there is substantial non-compliance the tax burden is placed on those who comply. He referred to the limitation that information obtained may only be used for the purpose of administering the income tax. Officers who do not observe this rule are subject to severe penalties. Tax treaties some-

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- one speaker expressed a preference for corporate income tax based on profits, but others stressed the positive features of an assets tax;
- reducing rates does not increase simplicity, but abolishing deductions does;
- the relationship between rates and compliance;
- would double taxation arise in case of a tax on debits?

The tax models presented by Messrs Galper, Greany and Ramos of KPMG, Washington, D.C. are very relevant for tax policymakers. The models, which have been successfully tested in several countries, enable policymakers and tax administrators to gain knowledge about the taxpayer population and the tax bases that produce revenue. Tax policy decisions are supported by estimation of revenue and distributional effects of the various options. Questions were raised about the effect of tax evasion and substitution and the aspect of consolidation in relation to the models.

In his contribution on future trends in fiscal policy, Dr Edling of Germany discussed the modern function of government. One task of fiscal policy is to create a general climate and framework favourable to the proper functioning of the market and competition. He emphasized the importance of reducing the influence of the tax system on resource allocation.

Dr Edling discussed expenditure tax as an alternative to comprehensive income tax. He referred to the negative aspects of tax incentives, which tend to erode the tax base and cause distortions.

Environmental taxes may be applied to compensate for market failures. Dr Edling sees an enormous potential for user charges. He further emphasized the importance of good public expenditure management.

Taxing powers should be allocated to the appropriate level of government for reasons of efficiency and flexibility. The position of the poor should be improved through public spending as taxes cannot affect their position in a positive way.

The situation of low income individuals and expenditure tax was raised during the discussion. The comment was made that the tax approach of large countries does not apply to the small Caribbean countries. It was also said that a low rate of VAT for food should be viewed as a tax expenditure because the rich spend substantial amounts on food. Doubts were raised as to the ability to administer an expenditure tax.

On the topic of legal innovations in Colombia, Mr Sarmiento Pérez remarked that the tax administration of his country suffered from rigid procedural rules which did not give sufficient powers to combat evasion. He stated that only five percent of assessments were actually paid. New recovery rules and procedures were established in 1988, with a constitutional basis added in 1991 which includes safeguards for a correct procedure. Mr Sarmiento referred to various forms of joint liability included in the system. Officers of the tax administration are motivated in their recovery task by a productivity premium.

Ms Maribel Sousa of Panama quoted an important principle: a law must be in ideological harmony and in accordance with the legal consciousness and interests of the time. She described the deficiencies of the current tax system and administrative procedures in Panama. A special feature is that the tax procedure follows cumbersome civil law procedures.

The 1991 tax reform reduced the income tax rates. A draft general tax code which provides the general criteria and principles of taxation has been prepared; however, the various taxes are levied under specific laws.

Mr Randolph Kong of Trinidad and Tobago discussed the sanctions connected to the self-assessment system of income taxation, and the penalties under the new VAT system. A major objective in his country is simplification of taxpayer obligations and procedures.

The third main theme of the General Assembly was *Future Trends of the Tax Administration*, moderated by Mr Tarcizio Dinoa Medeiros of Brazil.

Mr Edison Gnazzo of CIAT started the discussion by referring to political, economic, social and technological factors that will impact on the functioning of tax administrations in the future. He signaled the decreased importance of customs duties as a result of international integration, the harmonization of taxes and the growing importance of trade between related enterprises. All this will have an impact on tax administrations.

A central task – on a national and an international level – will be the battle against the informal economy. Mr Gnazzo expected a greater functional and financial autonomy of the tax administrations and unification of tax and customs administrations.

Information systems, data processing and modern means of communication and payment will become very important. The function of banks in the tax collection process will increase.

Taxpayer assistance, for example through telephone enquiries, will be a priority as will establishing a legal balance between taxpayer rights and the powers of the tax administration.

The above trends will need to be accompanied by a corresponding increase in the level of education and more international cooperation between tax administrations.

Ms Annie Clair of France discussed the functions of the French tax administration, which includes the cadastre, issuing official documents on real estate, the administration of State property and certain economic control activities.

Ms Clair referred to external factors, such as complexity and evolution of legislation, EC developments and technological developments that affect the tax administration. These factors require modernization of working methods, higher levels of training, improved internal communication and a decentralization of powers.

She described the redistribution of powers between the General Directorate of Customs and Indirect Taxes and the General Directorate of Taxes, which is also responsible for VAT levied inland. Greater effectiveness is expected from cooperation between the tax administration and certain professionals who assist taxpayers.

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Professor Glenn Jenkins of Harvard lectured on the practical aspects of a reform of the public sector. He referred to developments in information and communication technology that create opportunities to simplify administrative procedures in international trade and taxation, as well as opportunities to reduce compliance costs of the trade and fiscal systems.

He distinguished tax reform, trade reform and decentralization. Professor Jenkins' comments on tax reform focused on the shift to VAT in many countries, away from the distorting taxes on imports, exports and sales. Trade reform involves a shift from the inbound view and the protected domestic market, to orientation on the global market and exports.

The administrative aspects of imports and exports, including customs control, must be improved through communication and information technology. The end result of such a shift would be rapid processing and low costs for both traders and the tax administration.

Decentralization implies transferring the decision-making authority from central government to the level of government which is closer to practice. An alternative to decentralization is privatization.

Dr Francis of Jamaica examined the Jamaican situation in the context of the economic performance in Latin America. He referred to the drastic reforms in income tax and consumption tax. In contrast to previous speakers Dr Francis favoured the continued centralization of the Jamaican administration to ensure consistency and coherence of fiscal policy. Only a high level of growth will facilitate improvement of the standard of living; however, this is not likely in the present environment.

Mr Yu-Ming Yang of Taiwan appeared to agree with Professor Bahl that trade blocs like the EC and North America will work positively for the economic development of developing countries. He anticipated that the development will proceed more rapidly in developing countries, because they are able to learn from experience gained in developed countries. He stressed the need for political and fiscal stability to ensure development.

Mr Yang also emphasized the importance of education for development and the positive Taiwan experience in this area. Mr Yang further thought that a broad tax base and decentralization were not always appropriate.

During the discussions Dr Francis correctly remarked that trading blocs generally do not impede the import of raw materials, but only manufactured goods.

Professor Jenkins responded to a question by Mr Yang, by stating that the trick is to get the marginal rate down and the effective rate up, which means closing loopholes and changing the demands of lobbyists.

Other remarks and questions related to a tax on the increasing value of property, coordination of revenue and customs administration, fiscal balance, small taxpayers and simplification.

The topic of the second day was *Future Trends of Tax Policy and Legislation*, moderated by Mr Ricardo Cossio of Argentina.

The first speaker, Dr Shome of the IMF, discussed the trend of shifting from income taxes to consumption taxes. This trend is supported by supply side economists, as well as by the fact that income tax is difficult to administer, its base erodes or is small and taxpayers are difficult to trace. VAT, on the other hand, is easier to monitor and collect.

Dr Shome outlined the income tax trends tax in 18 Latin American countries. The average high rate of personal income tax decreased from 48 percent in 1979 to 35 percent in 1991. He also indicated that between 1979 and 1991 the average exemption level increased and the upper income bracket decreased. This surprising effect can be explained by the influence of parliaments; they generally favour lower rates but are also inclined to keep existing exemptions in place. Corporate income tax went down on average from 44 percent in 1979 to 36 percent in 1991. Dr Shome also demonstrated that the level of withholding taxes on foreign remittances went down on average from 16.6 to 10.6 percent.

Dr Shome pointed to Bolivia as an example of a drastic tax reform. A flat rate of ten percent is levied as a personal income tax; a three percent net worth tax is levied in lieu of corporate income tax; there is no discrimination between domestic and foreign enterprises; and a single VAT rate of ten percent is levied. A unique feature of the Bolivian VAT is that VAT paid is creditable against the personal income tax.

Dr Shome presented a table with tax-to-GDP ratios dividing Latin America into high, medium and low-tax countries. Interestingly enough, after the simplification measures were adopted Bolivia doubled its tax ratio, but it remains a low-tax country. Nevertheless, Dr Shome concluded that tax reform does not have a dramatic impact on the tax-to-GDP ratio.

In the second part of his lecture Dr Shome presented some relative novelties in taxation, such as a minimum corporate income tax based on gross assets, net worth or gross receipts.

The Mexican assets tax was cited as an interesting example of a levy on gross assets. Although Dr Shome remarked that simplicity is a characteristic of this tax, he emphasized that precise regulations on valuation, the treatment of losses and monetary correction were necessary. A cash-flow tax, however, may be complicated and lead to international complications.

In order to capture the financial sector with its potentially large tax base, Dr Shome proposed a low tax on bank debits, which would operate as an excise tax on bank services where VAT is too difficult to operate. A tax on real property could be levied where cadastral systems are used.

A recent trend is environmental taxes, levied because the costs of environmental damages are generally not reflected in the price of goods. An environmental levy would take these costs into account, and revenue generated should be used to curb pollution.

Dr Shome further discussed the role of withholding taxes and features of tax harmonization.

A lively discussion followed during which the following points were debated:

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INTERNATIONAL:

TAXATION VIS-À-VIS TRENDS IN THE WORLD ECONOMY:

SUMMARY OF PRESENTATIONS AND DISCUSSIONS AT THE 26TH CIAT GENERAL ASSEMBLY

Hubert Hamaekers
Chief Executive, International Bureau of Fiscal Documentation

The theme of the General Assembly of CIAT was "Taxation vis-à-vis Trends in the World Economy", which was divided into four topics.

The first topic related to trends in the world economy, with emphasis on the economic developments in Latin America and the Caribbean, the effect of integration processes in Europe and elsewhere, and the effects of economic liberalization in Eastern Europe and China on the world economy.

The second topic concerned future trends in tax policy and tax legislation, covering in particular new forms of taxation, the growing importance of VAT, broadening the tax base and reduction of individual and corporate income taxes, the distortive effects of the tax treatment of savings and loans, integration of individual income tax and social security contributions and the treatment of distributed profits. Legal innovations designed to improve the payer compliance were also brought under this topic.

The third topic was of an organizational nature: future trends of the tax administration, including the use of new technologies and management techniques to improve the functioning of tax administration.

The final main topic of the Assembly was the international tax aspects, focusing on international tax avoidance and evasion and cooperation between tax administrations to counteract such practices.

The first day centred on *Trends in the World Economy*. Mr Rodrigues Porto of Portugal was the moderator.

Professor Roy Bahl of the United States reviewed the economic projections of the IMF, the World Bank and related organizations for the 1990s. He produced the assumptions for the optimistic model, including the assumption that the US fiscal deficit problem will be resolved within the next four years, which he found unlikely. He also produced the assumptions and figures of the pessimistic forecast.

Professor Bahl identified three factors which shape the world outlook. First, global integration, which will resolve the comparative advantages of countries, primarily as a result of lower transportation costs and newer communications technologies. Specialization resulting from global integration will positively influence low and medium-income countries. Trade liberalization, however, is a prerequisite for this development.

Capital attraction, which encompasses direct foreign investment, return of flight capital and foreign aid, is the second important factor. According to the pessimistic view, slower growth in the industrialized countries will affect capital available, and both the EC and Eastern Europe may siphon off much capital.

The new markets and new trading blocs are the third factor. The optimistic view projects interactive effects resulting in a larger share for developing countries. The pessimistic view operates on the premise that trading blocs will function as fortresses which will impede international trade.

Professor Bahl also examined the reasons underlying the poor economic performance in Latin America during the 1980s – the interventionist approach, protection of local industry, inefficient public enterprises, high interest rates and fiscal policies which contributed to inflation.

This decade must see an opening up of the Latin American economies, an increase in export volume and an improvement in the efficiency of local industry.

Professor Bahl advanced eight rules for fiscal and tax policy, including:

- growth of the government sector should remain within the GDP rate of growth;
- planning models to estimate the effects of policy are necessary;
- the tax base should be broadened and rates reduced;
- decentralization; and
- taxes should be simple: taxes are poor instruments to accomplish social policy – trying to achieve this through the tax system complicates it considerably.

According to Professor Bahl transfer pricing rules cannot be simple since 80 percent of world trade takes place within multinational enterprises.

Professor Bahl was moderately optimistic about the economic development of low and medium-income countries. The level of trade and direct foreign investment will increase and new markets in China and Eastern Europe will positively affect exports from developing countries.

During the discussion, several delegations commented on the size of government, transitional problems, tax culture, legal stability, equity and justice, efficiency and justice, solidarity and the effect of the new trade agreements.

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INTERNATIONAL: ECONOMIC REFORM AND INSTITUTIONAL INNOVATION 588 *Glenn P. Jenkins*

The experiences of countries that have fundamentally changed their fiscal and trade policies demonstrate clearly the need for rapid administrative reform to accompany the policy changes, if these economic reforms are to be successful. Recent innovations in information technology and communications, and the institutional developments in transportation, customs control and taxation have greatly increased the potential for administrative reforms to contribute to cost savings and improvements in efficiency. This paper takes into consideration these recent developments, and puts forward a proposal for modernizing the customs and revenue administration system for international trade that is likely to foster growth and efficiency in an increasingly competitive international environment.

CANADA: EXCHANGE OF TAX INFORMATION AND INTERNATIONAL TAX ASPECTS 598 *R.M. Beith*

Mr Beith deals with his topic by first outlining the essentials of the Canadian tax system, and the powers of the tax administration to obtain information from taxpayers. He then focuses on Canada's 50 double taxation agreements and how the exchange of information provision has been used, including the initiation of simultaneous audits and criminal investigations. The rules which allow Revenue Canada to make a formal demand on a Canadian taxpayer to produce foreign-based information are discussed, as are the delicate issues arising from the electronic exchange of information, e.g. the taxpayer's right to privacy. Mr Beith concludes that international organizations can play a valuable role by functioning as a learning fora, broadening contacts and encouraging cooperation.

INTERNATIONAL: THE ARM'S LENGTH PRINCIPLE AND THE ROLE OF COMPARABLES 602 *Hubert Hamaekers*

This article contains Mr. Hamaekers' contribution to the panel discussion on Transfer Pricing in the Absence of Comparable Market Prices, which was delivered at the 1992 IFA Congress in Cancun. Mr. Hamaekers' task was to discuss the essence of the arm's length price and the role of the comparable uncontrolled price.

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The 26th General Assembly of the Inter-American Center for Tax Administrators (CIAT) was held in Jamaica 15-19 June 1992. The theme of this year's assembly, "Taxation vis-à-vis Trends in the World Economy" is both timely and relevant. Four topics were dealt with under the general theme: "Trends in the World Economy", "Future Trends of Tax Policy and Tax Legislation", "Future Trends of the Tax Administration", and "International Tax Aspects". This issue features four of the papers presented during the Assembly. A fifth paper, "Trends and Future Directions in Tax Policy Reform: A Latin American Perspective", presented by Mr Parthasarathi Shome, appeared in the September issue of the *Bulletin*.

INTERNATIONAL: TAXATION VIS-À-VIS TRENDS IN THE WORLD ECONOMY: SUMMARY OF PRESENTATIONS AND DISCUSSIONS AT THE 26TH CIAT GENERAL ASSEMBLY — 571 *Hubert Hamaekers*

Mr Hamaekers summarizes the addresses presented during the 26th CIAT Assembly.

INTERNATIONAL: TRENDS IN THE WORLD ECONOMY: IMPLICATIONS FOR FISCAL CHOICES — 576 *Roy Bahl*

The world economy is in recovery in mid-1992, and there is every prospect that the coming years will be significantly better than those of the late 1980s. The Latin American region realized an increase in real per capita GDP in 1991, the first increase since 1988. The eastern bloc of countries is joining the world market economy, and significant economic liberalization is underway in many developing countries. But with the new challenges of the global market economy come new concerns: will the new competitors help or hurt the trade position of low-income countries, will there be an adequate flow of investment capital to the low-income countries, and will social and environmental concerns be significantly de-emphasized in favour of deficit reduction packages?

This paper considers these questions in light of projections for the performance of the world economy in the 1990s. The projections for developing and industrialized countries, and for various regions of the world, are surveyed and consideration is given to how this outlook might be bent by changes in the world economy and how domestic fiscal policies might be shaped by this outlook.

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period, the ruling may be extended for another period of 48 months, resulting in a maximum period of validity of 96 months. The period of coverage under the old ruling was 60 months, with very little possibility of an extension. Under the new ruling, periods of previous stay and employment in the Netherlands are deducted from this period unless the employee did not stay or work in the Netherlands for at least 8 years before recommencing employment in the Netherlands.

5. Transitional rules

The new 35% ruling came into force on 1 September 1992 and is the one applicable to expatriates arriving in the Netherlands as of that date. For those individuals already in the Netherlands on that date and already granted the 35% ruling, the old ruling remains applicable unless the individual elects to be covered under the new one because the latter is more beneficial for him. This election is obviously also available to foreign employees who have applied for the old ruling which has not yet been granted.

For those people whose coverage under the 35% ruling has expired, an extension of up to 36 months, reduced by any period of non-coverage, is possible. In addition, those individuals not eligible for the 35% ruling under the old rules but who qualify under the new rules may apply for coverage. In that case, the total 96-month period will be reduced by the time already spent in the Netherlands.

6. Application

There is no deadline for filing the application for the new 35% ruling. However, if the foreign employee is assigned to the Netherlands to work for a foreign employer without a permanent establishment in the Netherlands, the application should be filed within four months after the individual's starting date of employment in the Netherlands. In that case, the foreign employer should be appointed as wage tax withholding agent. In other cases, no such appointment is necessary as Dutch resident employers (including a Dutch permanent establishment of a foreign employer) are obliged to withhold wage tax based on the Wage Tax Act 1964.

IV. FINAL REMARKS

The new 35% ruling may be seen as the most radical change since its introduction in the 1950s. The new ruling applies to foreign employees arriving in the Netherlands after 1 September 1992. Expatriates who arrived in the Netherlands before that date may also be covered by the new ruling, according to the transitional rules. Although, in principle, more employees are eligible for the beneficial tax status, it remains to be seen how strictly the condition of "specialist" and "not readily available on the labour market" will be interpreted by the tax inspector. The new 35% ruling provides for a tax-free reimbursement instead of a fixed deduction as under the old ruling. Another important change is the option for the expatriate to elect the non-residence status.

The Ministry announced that the new ruling is a predecessor of a new act, most likely to be laid down in the Wage Tax Act 1964. As such, the Dutch Parliament will need to give its approval in due course. The Ministry also announced the publication of explanatory notes to the new ruling to take away a number of unclear items. No fundamental changes are anticipated, however.

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IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS UK, Tel.: 71-6374383, Fax: 71-6313214.

DECEMBER 1992

International Tax Seminar on the International Business Relations between Internationally Related Enterprises from The Point of View of German Field Auditors, Zürich (Switzerland), 3 December (German):
Internationales Steuerseminar Zürich, c/o Bank Leu AG, z. Hd. Frau Salzberg, Postfach, CH-8022 Zürich, Tel.: (41)(1) 2192399, Fax: (41)(1) 2193583.

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whose skills are not readily available on the Dutch labour market. The above means that the following employees do *not* qualify for the scheme:

- employees without advanced degrees and qualifications;
- lower paid employees;
- trainees;
- employees who are transferred within an international group and who have not worked outside the Netherlands for the group for a period of at least two and a half years;
- individuals who are deemed employees, such as artists, athletes, members of the supervisory board of directors and temporary employment agency workers;
- employees possessing skills readily available on the Dutch labour market;
- entrepreneurs and self-employed individuals.

The mere fact that the Dutch labour market does not offer sufficient personnel to fill the vacancies is not a reason for granting the ruling. A possible indication could be whether or not work permits have been granted by the regional labour office to non-EC nationals (EC nationals do not require a work permit in the Netherlands).

D. *Features of the new ruling*

1. Tax-free allowance

The new 35% ruling is often referred to as the 35% reimbursement ruling. Under the old ruling, the expatriate was entitled to a fixed *deduction* of 35% of gross wages. Once the new ruling is granted, the employer may give the employee a *reimbursement* for extra costs incurred due to his temporary stay in the Netherlands, which allowance is tax-exempt insofar it does not exceed 35% of a certain base. According to the regulations, this base is equal to 100/65 of the salary subject to wage tax. To illustrate with an example:

An expatriate meeting the conditions of the new ruling is compensated as follows:

Base salary	1,000
Cost of living	100
Housing	100
Other	125
Total	1,325

According to the ruling, his employer may pay the employee a additional tax-free allowance of up to 35% of 100/65 x 1,325 = 713. Of course, not many employers are prepared to incur an additional salary expense of 713. The position of the employer is that his total salary expenses should remain at the same level. To achieve the optimum result for both the employer (costs at same level) and the employee (highest net salary) the expatriate package in this example should be structured in such a way that base salary and allowances are equal to 65% of 1,325 (= 861). The tax-free 35% allowance is then calculated at 35% x 100/65 x 861 = 464. The result for the employer is that the total salary expense remains at the same level. Thus, all compensation packages may need to be structured so that base compensation is no more than 65% of gross compensation. This may require a reclassification of a portion of base compensation as a "tax-free allowance". Careful planning is required where the reclassification results in a base salary less than the base the employee would have had in his home country, as the base compensation is used for determining home country benefit and pension entitlement.

2. Other reimbursements, including school fees

In addition to the 35% tax-free reimbursement, an employer's reimbursement of the costs of attendance at an international school is also tax-free. The reimbursement is tax-free if it is limited to the cost of the school's tuition fees and transport costs. Unreimbursed education expenses are no longer deductible under the new ruling. Any other reimbursement for business expenses is treated in accordance with the Wage Tax Act which is more advantageous to the employee than under the old ruling.

3. Non-residence status

Based on the original regulations which were published on 4 June 1992, the normal rules with respect to determining the residence status would apply for expatriates benefiting from the 35% ruling. Residence in the Netherlands is a test of facts and circumstances. Generally, expatriates accompanied by their family in the Netherlands are considered a Dutch resident for tax purposes. The potential consequences of this change are considerable, particularly for US citizens who continue to be taxed on their worldwide income while residing overseas. Due to criticism of this rule, the amendment of 28 August 1992 gives the possibility for the foreign employee to opt to be treated as a non-resident for tax purposes (the deemed non-residence status).

Based on the latter amendment, the new 35% ruling has an attractive feature not available under the old ruling: the foreign employee can choose to be treated as a non-resident or to be covered by the normal rules with respect to residence (of course, the option only applies in those cases where the foreign employee is Dutch resident based on facts and circumstances). As a deemed non-resident, the expatriate is subject to personal income tax on Dutch-source income only. Investment income, for example, is not regarded as Dutch-source income and is therefore not taxable, nor is a net wealth tax levied on non-Dutch net assets. As a resident taxpayer, the expatriate is taxed on worldwide income and net wealth, thus including investment income and (non-Dutch) net assets, but is able to claim a deduction for expenses such as alimony, interest paid, life annuity premiums and extraordinary expenses for sickness, disability, study, etc. Whether or not it is beneficial to opt for the non-residence status must be determined by taking into account all income and expenditure – and the sources thereof – of the foreign employee. An expatriate having mortgage interest in his home country may prefer to be treated as a resident taxpayer, thus able to claim a deduction for those expenses, while an expatriate with substantial investment income is better off electing for the non-residence status.

4. Period of validity

The ruling will be granted for an initial period of 48 months. If the foreign employee still meets the conditions after this

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- non-Dutch nationals employed as teachers by an international school in the Netherlands.

An additional requirement was that the employee be assigned to the Netherlands on a temporary basis. This temporary period should not exceed five years, which is the maximum period for which the ruling can be granted. For high level executives assigned to the Netherlands to start up a new business here, an extension of this five years period may be possible.

B. *Features*

To compensate for extra expenses incurred by an expatriate temporarily working in the Netherlands, the 35% ruling provided for a fixed deduction equal to 35% of gross employment income. Gross employment income includes base salary and all allowances paid by the employer to cover expenses with a combined business and personal character (cost of living, housing, foreign service premium, etc.).

An expatriate covered by the 35% ruling was deemed to be a non-resident taxpayer of the Netherlands, except for employment income. A non-resident taxpayer is subject to Dutch personal income tax on Dutch-source income only. Investment income, e.g. interest and dividends, is not regarded as Dutch-source income and, consequently, is not taxable in the Netherlands. Furthermore, a non-resident is not subject to Dutch net wealth tax on non-Dutch net assets. The deemed non-residence status is maintained under the new ruling and is therefore discussed in more detail in Section III.D.3.

III. THE NEW 35% RULING

A. *General*

On 4 June 1992, the Ministry of Finance published new regulations on the 35% ruling. The new ruling applies to foreign employees arriving in the Netherlands after 1 September 1992. This new ruling was highly criticized by tax practitioners as it was felt to be much more restrictive than the old one. As a result of this criticism, the Ministry announced, on 28 August 1992, amendments to the new ruling; the Ministry also clarified the definitions of certain terms, thereby removing the major concerns. The new ruling now stands as follows.

B. *Conditions*

The new 35% ruling no longer requires an intra-group transfer in order to qualify for the special tax status. The 35% ruling is generally available for employees coming from abroad to work for a temporary period in the Netherlands. Note that the ruling may also apply to Dutch nationals returning to the Netherlands who have spent at least eight years outside the Netherlands. The employee must either reside or otherwise stay and work in the Netherlands and be employed by a Dutch resident employer or foreign employer who is appointed as wage tax withholding agent in the Netherlands. The most crucial difference from the prior 35% ruling is the requirement that the individual have special skills or knowledge not readily available on the Dutch labour market (the "specialist" test).

Compared with the old 35% ruling, the number of employees eligible for the beneficial tax status is increased substantially. In principle, all foreign employees temporarily working in the Netherlands could benefit, rather than international group employees only, as under the old ruling. In addition, the requirement with respect to the temporary assignment in the Netherlands is more relaxed. Although it is still a prerequisite that the Netherlands assignment be temporary, this term has not been defined. It is, therefore, possible that a 12-year assignment could be considered temporary. Under the old ruling, the term temporary was defined as a period not exceeding 5 years. The only new condition is that of the specific professional expertise.

C. *The specialist test*

The text of the new ruling states that the 35% ruling will only be granted to individuals with skills or knowledge not readily available on the Dutch labour market. The Secretary of State has mentioned a number of elements in order to clarify this condition. For instance, it is important that the employee:

- is highly qualified and/or specially trained;
- has acquired experience, expertise and/or education outside the Netherlands which is not readily available on the Dutch labour market;
- has a specifically defined role;
- performs a function which would be equally or more highly compensated, on a net-to-net comparison, in his home country than in the Netherlands.

At a recent seminar, hosted by Coopers & Lybrand Amsterdam, the head of non-resident taxation at the Dutch tax inspectorate gave explanatory notes on this specialist test. There had been widespread concern that this test, if strictly interpreted, could exclude the majority of executives of international business. The tax inspector assured the attendees, however, that this was not the Ministry's intention. This was confirmed by the Secretary of State in a letter to the Dutch parliament. According to the opinion of the tax inspector, the following employees will meet the condition of specific professional expertise:

- managers within an international group with a special role in the company;
- scientists with specific professional knowledge;
- key personnel within the group, such as top managers and product specialists;
- those persons who bring know-how into the Netherlands, even if not previously employed;
- specialists;
- employees from middle and top management who, within the scope of job rotation, temporarily work in the Netherlands, provided that they had several years of experience within the group. For example, employees who worked for a period of at least two and a half years outside the Netherlands can be presumed to have acquired a certain expertise which is not available on the Dutch labour market.

Note that an additional requirement is that the specific expertise is not readily available on the Dutch labour market. In case of job rotation, the employee is deemed a specialist

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NETHERLANDS:

TAX STATUS OF EXPATRIATES

By John A. Rompelman and Wim H. Kanbier, Coopers & Lybrand
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I. INTRODUCTION

Foreign employees temporarily transferred to the Netherlands may benefit from a special tax status, provided a number of conditions are met. This preferential tax treatment for expatriates dates back to the 1950s and is usually referred to as the 35% ruling. On 1 September 1992 a new 35% ruling became effective which can be considered a radical change from its predecessor. Thus the need for this article is obvious. In Section III, the article deals with the conditions and features of the new ruling. Before doing so, Section II reviews the history of the expatriate tax status, including the 35% ruling which still applies to employees who arrived in the Netherlands prior to 1 September 1992.

II. HISTORY

The favourable tax treatment of certain expatriates working in the Netherlands was first introduced by the Dutch tax inspectorate in the 1950s. At that time, the Dutch economy was recovering from World War II, with support from the United States. To encourage US companies to start up activities in the Netherlands, US employees were granted a special tax status whereby only a portion of their salary was subject to Dutch personal income tax. In principle, an employee transferred to the Netherlands on a temporary basis incurs higher costs than a Dutch resident, partly due to his short stay in the Netherlands. These extra costs could not easily be quantified, and therefore a tax facility was introduced for expatriates temporarily working in the Netherlands. In 1970, the tax concession was extended and became available also to foreign employees of non-US companies. The tax concession for expatriates is known as the 35% ruling. Although the ruling was not officially published, it was generally known in the business community.

In 1986, a revised version of the ruling was published as a result of the law on publication of internal administrative rules. This ruling was amended regularly (1988 and 1990), but its basic conditions and features remained the same. In line with the bi-annual sequence of the amendments, the Ministry of Finance published a new 35% ruling on 4 June 1992 which is discussed in Section III. The radical changes made in the new ruling may be illustrated by the provisions of the predecessor to the new ruling, the 35% ruling of 28 December 1990. This ruling is summarized below.

A. *The 35% ruling of 28 December 1990*

This 35% ruling (Ministry of Finance Resolution of 28 December 1990, No. DB90/2400) applies to expatriates who arrived in the Netherlands between 1 January 1990 and 1 September 1992. It was generally available for expatriates transferred by a foreign employer to a Dutch resident group company. To qualify, a foreign national (in exceptional cases Dutch nationals could also benefit) must have been employed by the group prior to his assignment to the Netherlands *or* must have been recruited abroad with the intention of being temporarily assigned to the Netherlands as part of an international career plan. In addition, the following non-international group employees could also benefit from the beneficial tax status:

- foreign nationals recruited abroad with special skills and know-how;
- non-Dutch nationals transferred within a non-commercial institution in circumstances comparable to employees of international groups;

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In addition to basic corporate tax (assessed at 25 percent of the monthly taxable profit), a surtax for companies in general at the rate of ten percent (15 percent for financial institutions) is to be levied as from January 1992 on monthly income exceeding 25,000 UFIRs.

Expenses relating to royalties and technical assistance fees paid under contracts signed, approved by the National Institute of Industrial Property and registered with the Central Bank of Brazil after 31 December 1991 are deductible when paid by Brazilian companies to legal entities or individuals domiciled abroad, which directly or indirectly control the voting capital of the Brazilian company. Such expenses are not deductible when paid by a Brazilian branch to a foreign head office.

The eight percent withholding tax on net profits of stock corporations, partnerships and sole proprietorships will be eliminated on income arising as of 1 January 1993. However, the exemption for dividend distributions made to resident individuals or legal entities remains in effect.

Under the tax reform dividends and profits distributed to nonresidents will be taxed at 15 percent (from the current 25 percent) as from 1 January 1993. However, the Finance and Tax Committee of the Congress of Deputies has produced a draft law proposing a reduction of the withholding tax to ten percent in 1993, five percent in 1994, and total exemption as from 1995.

The supplementary (excess profit tax) surtax on income and dividends distributed to individuals and legal entities resident or with their principal place of business abroad, for three-year periods ending after 31 December 1991, is also abolished.[9]

PAYMENT OF TAX

Several changes were made to the rules governing the payment of tax.[10] For taxable events relating to income subject to withholding tax as from 1 January 1992, the tax must be paid on the day after the tax is withheld, without monetary adjustment (which is calculated by conversion of the amount of tax into UFIRs and then back into cruzeiros at the UFIR rate on the payment date).

Withholding tax on income distributed to individuals domiciled or resident outside Brazil must be paid by the last business day of the month after the taxable event, or remittance, in the case of profits of Brazilian branches, agencies or representatives to foreign head offices. In all other cases, the tax must be paid on the date of the taxable event.

Profit participation programme (PIS) and social investment fund (FINSOCIAL) contributions must be paid on the 20th day of the month after the month in which the taxable event occurred. Contributions to the PIS and FINSOCIAL are imposed pursuant to Article 195, I of the Constitution, and are allocated to finance social security, together with funds from the federal, state and municipal governments.

The PIS contribution, instituted by Supplementary Law No. 7 of 1970 and funded with deposits calculated at 0.65 percent on the gross operating income of companies, is intended to integrate the employee into the life and development of the company. The fund is administered by a Directive Council and an executive secretariat, and is comprised of employees and businessmen.

The social contribution on revenue (which is based on two percent of monthly billings of companies, i.e. gross income on sales of merchandise and services of any kind) is allocated to finance expenses in activities related to health, social security and social assistance areas.

When profits are deemed distributed to partners of civil companies providing professional services regulated by law and to partners/owners of companies based on arbitrated profit and to micro-companies,[11] the tax must be paid by the last business day of the month after the profits were deemed distributed. In all other cases, the tax must be paid by the last day of the 15-day period following the taxable event.

PENALTIES FOR LATE PAYMENT

Taxes paid in arrears are subject to a penalty of 20 percent, which may be reduced to ten percent if the tax is paid by the last business day of the month when the tax became due. Interest will also be applied at the rate of one percent per month (or fraction thereof) from the first day of the month after the tax became due. Both penalties are calculated on the amount of the tax due, updated by monetary adjustment.

9. In addition to the normal 25% withholding tax, a "supplementary" tax was levied when distributions of profits and dividends, net of the 25% withholding tax, exceeded in a three-year period an average of 12% per year of the registered capital (original investment plus reinvestment).
The supplementary tax was due on profit distributions in excess of the established limits, even though related to profits of prior years. It was also due on nondeductible expenses of the legal entity when paid abroad. The tax was calculated every year with reference to the appropriate three-year period, which was "movable", i.e. the last two years of a three-year period were also computed as the first two years of the subsequent three-year period.

10. No changes were made in respect of taxable events which took place on or before 31 December 1991, i.e. the term established in previous law remains applicable.

11. Under Law No. 7,256, micro-companies are deemed to be legal entities and sole proprietorships, whose gross income (ascertained between 1 January and 31 December) is equal to or less than the amount equivalent to 96,000 UFIRs as established by Art. 42 of Law No. 8,383 (one UFIR is the equivalent of approximately US$ .50).
Micro-companies enjoy a number of advantages, ranging from simplified organization and bookkeeping to exemption from several taxes, e.g. income tax, tax on transportation and communication services, and social contributions.
It should be emphasized, however, that Law No. 7,256 excludes certain legal entities from the exemption benefit, whether due to their form of organization (joint stock companies), situation of their partners or owners (companies whose partners or owners are individuals domiciled abroad) or due to the nature of their activities (companies importing foreign merchandise).

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The 1988 Constitution created new forms of taxation, some of which have led to inequities and difficulties, such as the social contribution levied on corporate taxpayers, which essentially imposes double taxation, and the tax on large fortunes, where international experience has clearly demonstrated that such a tax produces little revenue and encourages the outflow of capital.

To ameliorate the effects of this situation, various proposals have been advanced to amend the Brazilian Constitution, three of which merit consideration:[3]

The first proposal advocates a complete fiscal reform by adopting a comprehensive tax system, increasing penalties for tax evasion and taking the neutrality principle into account. It is proposed that the federal income tax law provide an exemption for low-income taxpayers and a single ten percent rate for all other groups, without deductions. A state tax on consumption (at a maximum of ten percent) would be calculated on the end price of goods and services. Municipalities would collect the urban property tax. Additionally, a tax on foreign trade would be imposed to control industrial policy and the flow of trade, and a land tax would be levied to foster the productive use of land.

The second proposal reduces the number of taxes to five: income tax, tax on the distribution of goods and services, property tax, foreign trade tax and the social contribution. Income tax, the foreign trade tax and the social contribution would be collected by the federal government. The states would collect the tax on the distribution of goods, services and financial instruments, and municipalities would be responsible for real property tax. Proponents assert that the existing seven taxes on distribution would be embodied in a single tax, two kinds of income tax would become one, and four different property taxes would become a single tax. This would considerably streamline the tax collection process, and simplify matters for both business and the taxpayer.

The third proposal advocates a tax on all financial transactions, and consists of a levy of one percent on all bank transactions, checks, on-line transfers, etc. at both ends of the transaction.[4] All of the various forms of taxation of individual income by the state would be replaced by a single tax on financial transactions, thus eliminating an entire range of taxes, and leaving only a few that are desirable for extra-fiscal reasons (e.g. the rural territory tax, which would serve as an instrument of agrarian reform), and service charges.

The foremost advantage of this system would be the elimination of much of the red tape involved in inspection and administration of the collection process; the system would become more efficient and transparent. Taxpayers would also benefit because by reducing the number of rules, terms for payment and systems, the number of personnel engaged solely in the tax collection process could also be reduced.[5]

While these proposals were being studied, the Government proposed an emergency fiscal reform with a view to increasing revenue and achieving an equilibrium which would demonstrate to international financial agencies (such as the IMF) that Brazil is making a good faith effort to tidy up its public finances. This reform was approved and published as Law 8,383.

FISCAL UNIT OF REFERENCE – TAX INDEXATION

Law 8,383 instituted the Fiscal Unit of Reference (UFIR) as a value measurement. This unit is established daily and is used as a basis for the adjustment of income and other federal taxes. The UFIR is based on the National Consumer Price Index (INPC) accruing from February to November 1991, and the Extended Consumer Price Index (IPCA) of December 1991. The UFIR cannot be used to adjust the price of goods or services, salaries, rents or royalties, although they may be adjusted under the INPC.

CORPORATE TAXATION

Law 8,383 changed the base period for corporate taxes from annual to monthly as from January 1992, and such taxes are now due as and when profits are derived.[6] Legal entities taxed on their actual profits must determine their results on a monthly basis, and apply monetary adjustment. If it is in the interest of the company, the monthly tax due may be calculated by estimate, but the results must be determined monthly.[7] The basic corporate tax rate remains unchanged at 25 percent.

Legal entities wishing to opt for taxation based on arbitrated profit in the 1992 calendar year must have had a total gross income in 1991 not exceeding one billion cruzeiros.[8] As from the 1992 fiscal year, legal entities may opt for taxation based on arbitrated profit if their gross income is equal to or less than 300,000 UFIRs in the option month, or 3,600,000 in the previous year.

Taxation based on arbitrated profit will be permitted in the case of voluntary assessment, in accordance with the following: monthly taxation of the arbitrated profit; consideration of automatic distribution to the partners of an amount corresponding to the arbitrated profit less corporate income tax, and this amount is withheld at source at the rate of 25 percent.

The instalments for prepayment of income tax and social contributions for the 1992 financial year, paid in 1991, will be updated in accordance with the accrued variation in the INPC from the month of payment up to December 1991.

3. These proposals are currently being studied by a Congressional Commission and should soon be submitted for the approval of the Chamber of Deputies.
4. Such a tax has already been included in a bill submitted to the Chamber of Deputies.
5. Studies estimate that 20% of the revenue obtained from taxation is consumed by State and corporate fiscal bureaucracy.
6. This rule also applies to social contributions and the withholding tax on net profits.
7. In accordance with Art. 39 of Law No. 8,383, tax may be estimated only by companies where tax accruals are based on real profit.
8. A company may opt for taxation on presumed profit in the following circumstances:
1. it is a sole proprietorship, limited liability company or general partnership;
2. it has derived an annual gross income in an amount not exceeding Cr$ 200,000.000;
3. more than one half of its total gross operating income derives from the sale of its own manufactured products, merchandise acquired for resale, or rendering of cargo services or industrialization of products with materials supplied by the party that placed the order;
4. its corporate purpose does not involve real estate (purchase, sale, subdivision of lots, etc.); and
5. in the case of a company, all partners must be domiciled in Brazil.

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BRAZIL:

TAX REFORM

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INTRODUCTION

On 31 December 1991 a tax reform, embodied in Law 8,383, was passed, and is effective as from 1 January 1992. In general the reform establishes a new indexation unit (the "UFIR") which is used for the payment of income and other federal taxes, and it amends the rules governing the payment of corporate income tax by legal entities established in Brazil.

This article summarizes the fundamentals of the Brazilian tax system and discusses the main changes instituted by Law 8,383.

TAX SYSTEM

The current Brazilian tax system contains approximately 58 different kinds of taxes.

The Constitution distributes the powers of taxation among three levels of government: federal, state and municipal. The federal government has jurisdiction to levy the following taxes:

- income tax;
- manufactured goods tax;
- financial transactions tax;
- import tax;
- export tax;
- land tax; and
- tax on large fortunes.

The state government enacts taxes on:

- inheritances and gifts;
- distribution of goods, municipal and interstate transportation services, and communications; and
- ownership of automobiles.

The municipal governments have taxation powers over the following:

- real estate tax;
- retail sales of liquid and gas fuels (except diesel oil); and
- services (except for those services, i.e. communications, municipal transportation, etc., which fall under the jurisdiction of the federal and state governments).

In addition to these taxes there are numerous social security contributions and compulsory loans. Social insurance contributions include social security, education salary, the profit participation programme and the programme of civil servants' equity formation.[1] The law grants the federal government the exclusive authority to institute a compulsory loan, which may only be instituted by supplementary law or to cover extraordinary expenses resulting from a public calamity, foreign war or in the event of an urgent public investment that is of national interest. As a result of the contributions and loans, Brazil is one of the highest taxed countries in the world.[2]

Although the National Tax Code was progressive for its time, the current system is comprised of a conglomeration of taxes entailing high collection costs and a consequent burden on taxpayers that is conducive to tax evasion, the accelerating rate of which is a source of concern to both the government and the public.

1. A social contribution is levied on legal entities and other entities treated as taxpayers of the corporate income tax in order to finance the social security system. The charge is levied at a rate of 10% on profits before the deduction of income tax and after deduction of the contribution itself.

2. In 1992 the Brazilian *effective* federal corporate tax rate is 51.6%. For practical purposes the corporate tax burden at the federal level is calculated to be as follows:

		Effective rate of tax
Net profits	100	
10% social contribution		(9.09)
	90.01	
30% corporate tax		(27.27)
10% additional tax		(9.09)
gross available for distribution	54.55	
8% withholding		(4.36)
net available for distribution	50.19	
effective fed. corp. tax:		
9.09 + 27.27 + 9.09 + 4.36 = 49.81		
5% local surcharge (on 27.27 + 9.09)		(1.81)
		51.62%

Computation presented by Tax Manager, Arthur Andersen, Rio de Janeiro, IFA Congress 1989.

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owned by a foreign group must receive ministerial approval before registration.

Incorporation of a Barbados company is not required since local corporate law allows the registration in Barbados of an existing overseas company. It is deemed an external company and must appoint a person in Barbados with a power of attorney to act on its behalf. It must also file in Barbados copies of its charter documents with the latest amendments notarized by the relevant functionary in its place of incorporation. The regulations promulgated under the Companies Act provide for all the necessary forms that must be completed to register the company. For persons desiring confidentiality, they normally use a nominee or trust agreement to nominate a corporate or individual shareholder to hold the share for the corporation owning the foreign-going vessel.

The SIA provides concessions to approved shipping companies engaged in the following activities:
- operating ships to carry passengers or cargo;
- leasing ships; and
- shipbuilding, including constructing, altering, refitting, equipping, maintaining and repairing ships.

The concessions include a ten-year tax exemption and freedom from customs duty on all materials connected with the company's shipping activities.

In lieu of taxation, the Shipping (Fees) Regulations 1982 establish fees payable on every Barbadian registered ship. The registration fee is BDS$ 1.25 per gross register ton for vessels of 5,000 gross register tons or less, and BDS$ 1.00 per gross register ton for those greater than 5,000 gross register tons. An annual fee equal to ten percent of the initial registration fee is also payable. A variety of nominal fees apply to administrative activities.

Flag registration in Barbados can be significantly less expensive than in some established flags of convenience countries.[3]

X. SHIPPING INFRASTRUCTURE

A. *Treaty network*

Barbados is a party to the following International Maritime Organization conventions:
- The International Convention for Safety of Life at Sea 1974, as amended [SOLAS (as amended) 1974];
- The International Convention on Load Lines 1966 [LL 1966];
- The Convention on the Facilitation of International Maritime Traffic 1965, as amended [FAL (amended) 1965];
- The International Convention on the Tonnage Measurement of Ships 1969 [TONNAGE 1969]; and
- The International Regulations for Preventing Collisions at Sea 1972, as amended [CORLEG (amended)].

B. *Port facilities and service sector*

The Barbados Port Authority has installed modern equipment at the Bridgetown Port. The container terminal can handle 15,000 container movements annually.[4] The port also has bulk unloading facilities used primarily for wheat, corn and soya beans.[5]

Port security is provided by the Royal Barbados Police Force, Her Majesty's Customs and the Barbados Port Authority Security. Under the Customs Act, private warehousing facilities should be available at the port. Fees are approximately US$ 480 per year. At least seven companies provide freight forwarding services and some have considerable experience in transshipment, particularly in the Caribbean. Fees for their service average US$ 60 per bill of lading.

C. *Duty legislation*

Although no duty-free zones exist in Barbados, attractive concessions are available. Under Section 114 of the Customs Act (Cap. 66), goods for trans-shipment or in transit are exempt from import and export duties. Also, the Duties, Taxes and Other Payments (Exemption) Act (Cap. 678) empowers the Minister of Finance to exempt any business undertaking from duty, tax or other payments.

Various competitive opportunities therefore exist for non-Barbadian persons engaged in foreign shipping to use Barbados entities for reducing taxes in the circumstances as discussed above.

XI. CONCLUSION

This brief presentation has sought to focus on the analytic parameters related to the tax treaty treatment of transportation income in Barbados and also some practical opportunities available, as well as the legal and operational infrastructure which seeks to complement those opportunities.

Barbados is strategically situated at the gateway of the Atlantic Ocean, is committed to a vibrant international business sector and boasts a well proven social infrastructure. The tax treatment of transportation income will therefore continue to assume a special place in the development of policy and legislation.

3. For instance, "one-off" charges for a 65,000 dwt bulk carrier (30,000 grt. 25,000 nrt) to be registered new in Panama would be US$ 28,280 and for Liberia these fees would be US$ 30,031, Barbados would however charge US$ 16,317.50.

4. The container parks can accommodate 1,384 containers in lane-stacked positions. They can cope with 50,000 container movements annually. The entire system is monitored by an up-to-date Marconi communications network with subsequent recordation facilities. The container berth is 215 metres long and has a container freight station with a floor area of 5,314 square metres. Cold storage facilities are provided by a local company under sub-contract to the Port Authority to handle, among other things, trans-shipment reefer cargoes. The facility has a receiving rate of over 350,000 tons per day.

5. This facility includes a six-story workhouse, 14 "Lippe" type metal silos (each with a capacity of 9000 tons), and a 669 square metre flat storage warehouse of reinforced concrete capable of receiving 2,400 tons.

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In cases where profits are derived from other business enterprises, the concept of permanent establishment, the question of apportionment of profits and allowance of tax credits takes on as much importance as any other general business activity.

VII. US–BARBADOS INCOME TAX TREATY AND SHIPPING

The US–Barbados treaty can offer tax planning benefits for shipping. Under the treaty, profits from a Barbados resident's operation of ships in international traffic are exempted from taxation in the United States, even if the profits are attributable to a permanent establishment in the United States, and whether or not the ship is registered in Barbados.

International traffic is specifically defined as any transportation by ship except transportation solely within either Barbados or the United States. Profits from shipping operations embrace operating profits as well as profits derived from renting ships if the ships are operated in international traffic by the lessee or if the rental profits are incidental to operating profits. Incidental rental profits include rents from bareboat charters. Shipping profits also include profits from the use, maintenance or rental of containers and related equipment used to transport goods or merchandise in international traffic. Furthermore, the exemption applies to shipping profits from participation in a pool, a joint business or an international operating agency.

A company other than a US company with a business which is managed and controlled in Barbados is a Barbados resident. Management and control in Barbados are achieved if annual general meetings and a majority of other meetings of directors and shareholders are held in Barbados. In addition, an international business company (IBC), as defined by the International Business Companies Act, will be considered a Barbados resident if it is incorporated in Barbados or its business is managed and controlled in Barbados.

An IBC pays Barbados income tax at the rate of 2.5 percent of its profits. Any dividends, interest, royalties, rent or management fees paid or deemed to be paid by one IBC to another or to a person not resident in Barbados are exempted from all taxes in Barbados. If an IBC must employ expatriate staff with special skills not otherwise available in Barbados, such persons may earn as much as 35 percent of their salary free from Barbados income tax and payable in a currency of their choice outside of Barbados. Any other person, not a company, resident in Barbados for purposes of its tax is also a Barbados resident.

To qualify for the treaty's shipping profits exemption (i) more than 50 percent of the beneficial interest of a Barbados resident (in the case of a company, more than 50 percent of each class of stock) must ultimately be owned by individuals that are US or Barbados residents or US citizens; and (ii) no substantial part of a resident's income can be used to meet liabilities to persons that are not US or Barbados citizens.

If these two conditions are not fulfilled, the exemption is still available to a Barbados resident for income derived in connection with, or incidental to, an active trade or business in Barbados. Additionally, the exemption is still available to a company if there is substantial and regular trading in its principal class of shares on a recognized stock exchange.

VIII. TRANSSHIPMENT OPPORTUNITIES

Issues arise concerning the coverage by the treaty in transshipment situations. Transshipment occurs when goods are shipped from a non-treaty country to Barbados and offloaded to a Barbadian consignee, then reshipped by the Barbados entity, now the consignor, to a US consignee.

One issue is whether the Barbadian consignor can be considered an enterprise resident in Barbados. In *Vogel v. Kohnstamn*,[1] the English Queen's Bench held that a foreign company was not resident in a country merely because it traded through an agent in that country. However, the issue in that case was residence for purposes of the court's jurisdiction. Further, the agents were doing business on their own behalf and not exclusively for the foreign company. The current test for tax purposes would appear to be whether the Barbadian consignor is doing business on his own account or as a branch of the international enterprise. Factors to be taken into account include whether the Barbadian consignor acts in a similar capacity for other companies or whether a principal-agent relationship exists where the latter is a branch of the whole international enterprise.[2]

IX. FOREIGN FLAG SHIPPING

Since the enactment of the Shipping Act 1981 (SA) and the Shipping (Incentives) Act 1982 (SIA), Barbados has begun to compete for foreign flag shipping. Ships can be registered under the Barbados flag as well as managed, maintained and built in Barbados. The Director of Maritime Affairs in the International Transport Division of the relevant Ministry administers the Acts. Comprehensive regulations set forth the forms and fees. The Acts underscore safety and incorporate all the major maritime safety conventions.

The SIA allows registration of various types of vessels. The Act is designed primarily to attract ships engaged in "foreign-going trade". Trade is foreign-going if it is to or from, but not within, the states of the Caribbean Common Market and Community (CARICOM), or between ports outside CARICOM.

To register, a foreign-going vessel must be a minimum of 500 gross register tons and not more than 20 years old. The owners may be of any nationality. The shares in a Barbadian ship may be owned by individuals or corporations under either sole or joint ownership.

Under the Shipping Act Cap. 296 (1982), a foreign registration must first be cancelled before a ship can be registered in Barbados. However, the Minister in his discretion may waive all of the Act's requirements. This is important because a ship

1. 173 QB 133, (1971) ZA 11 ER 1928.
2. Following *DeBeers Consolidated Mines, Ltd. v Howe* [(1906) AC 455], the residence of a person and an individual is a question of fact. It is unlikely in such circumstances that the consignor will be considered to be anything other than a Barbados resident company.

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acceding to this, is itself given the sole right to tax those operations which operate from within its own jurisdiction. This has been described in the literature as the principle of "reciprocal exemption", and it is this approach which finds favour in the 1977 OECD model treaty, the standard form UK double tax treaty which Barbados inherited on independence (for ease of reference, "the colonial model") and the 1980 UN model convention. It is this principle which is outlined in all the treaties to which Barbados is a signatory.

The peculiarity of income treatment derived from air and shipping transport operations should be qualified in view of the fact that a tax treaty is essentially a political vehicle which seeks to apportion the right to tax in what is deemed by the contracting states to be the most equitable manner.

However, the classical principle of "reciprocal exemption" is eroded by the inequality of bargaining power between contracting states. Developed countries have large air transport fleets and large merchant marines, while in developing countries there is little or no activity in these areas. Further, developing countries will usually spend much more to improve their infrastructure in order to accommodate ships and aircraft, and accordingly, to bolster their own development and attract industrial activity.

The "accepted" mechanism in the international arena is to keep the principle of "reciprocal exemption" inviolate but to allow the developing state to use indirect taxation, not covered by the treaty to recoup and maintain what is essentially a very expensive "investment".

This basic inequality has, however, been recognized in a limited way in the UN model convention which offers an alternative basis for taxation of income derived from shipping operations. Article 8(b) of that convention reads:

> Profits from the operation of ships in international traffic shall be taxable only in the contracting state in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other contracting state are more than casual. If such activities are more than casual, such profits may be taxed in that other state.

IV. ENTERPRISES TO BE TAXED

The OECD model treaty article confines itself to profits from the operation of ships or aircraft in "international traffic". In the CARICOM tax treaty, the Barbados–Canada tax treaty and the Barbados–US tax treaty, the limitation is expressed in similar language. However, in the Barbados–UK tax treaty and the other colonial model treaty (Switzerland), the article will apply only to profits from the operation of shipping or aircraft other than profits from voyages of ships or aircraft confined solely to places in the other state (i.e. not the state of residence).

"International traffic" is defined in the Barbados–US treaty as meaning any transport by ship or aircraft except where such transport is solely between places in the other contracting state. No definition is given in the Barbados–Canada tax treaty but the term international traffic is deemed to include traffic between places in one country in the course of a voyage which extends to more than one country.

The addition of the phrase "international traffic" exempts air and sea transport operations which are solely within either contracting state. It properly removes from the ambit of treaty consideration, profits from operations exercised solely within either the state of residence or the state of source.

Yet, it must be noted that the application of the article, however expressed, excepts operations conducted solely within the other treaty state. Hence, due recognition has been given to the right of the source state to tax an enterprise on profits derived from the operation of the transportation service solely within its jurisdictional boundaries.

V. TAXATION JURISDICTION

With the exception of the limited alternative set out in the 1980 UN model convention, the accepted basis of taxation under the tax treaty is to vest the sole right to tax in one state only.

The determination of which state as set out in the OECD model is the "place of effective management". However, in none of the tax treaties to which Barbados is a signatory is the test of "effective management" the established basis. The CARICOM tax treaty and the Barbados–UK tax treaty use "residence" as the test, while the Barbados–Canada and Barbados–US treaties refer to "an enterprise of a contracting state". An "enterprise of a contracting state" is defined as an enterprise carried on by a resident of a contracting state.

The distinction is important; the focus of the OECD model is the place from which the enterprise is actually managed, i.e. the place where day to day management is carried on. In treaties to which Barbados is a signatory, preference is given to the residence of the taxpayer.

Effective management is a separate and singular test and is not premised on the definition of residence as provided for under domestic law. The OECD model recognizes this distinction and provides that in cases where a person other than an individual is resident in both contracting states, the matter is determined by the place of effective management. However, only in the CARICOM treaty is this provision included; in all other cases, the issue is to be resolved by the mutual procedure provisions available to the taxing authorities.

VI. PROFITS DERIVED

It is important to define "profits derived from air or shipping enterprises".

In the OECD model commentary, the term has been deemed to include profits from activities which by reason of their nature or their relationship with profits directly obtained from transport may all be subsumed under the phrase "profits derived". The commentary itself gives a number of examples, from the leasing of ships and aircraft to questions of advertising and public relations. However, in all cases, the question is one of degree, and of how closely integrated the peripheral activity is into the general service.

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BARBADOS:

TAXATION AND TRANSPORTATION IN BARBADOS: AN OVERVIEW

Dr Trevor Carmichael

I. INTRODUCTION

Taxation will continue to play a greater and more significant role in national economies and the international environment as governments seek to increase revenue through their ever-increasing efforts to extend their taxing nets. The effort to expand taxing jurisdictions continues to be a major activity of most governments. It are indeed only the practical enforcement difficulties and the juxtaposed interests of the other governments which restrict this propensity for tax expansion. International law, such as it is, has no capacity to control this urge and instinct to tax extra-territorially. Accordingly, the tax treaty continues to be an important weapon of compromise, at one and sometimes the same time being a shield as well as a sword, depending on the bargaining power and capacity of the individual countries involved.

Transportation has no less a special place in a developing country such as Barbados since it is integrally linked to tourism specifically and economic development in general. The recent air transport vacuum in Barbados created by the loss of two major airlines, the recent loss of some scheduled charters and the ongoing efforts to establish more permanent air links to major metropolitan destinations all underscore the importance of this sphere of economic activity and national development.

This article seeks to isolate some key variables in a tax treaty analysis of transportation income; namely, an examination of the need for special treatment; the tax treaty approach itself; aspects of tax treaty negotiations; the enterprises to be taxed; the taxation jurisdiction; and the profits derived. Finally, an effort is made to focus specifically on some of the special benefits under the US–Barbados income tax treaty, and to examine the local shipping incentives and shipping infrastructure which seek to complement these benefits.

II. NEED FOR SPECIAL TREATMENT

Profits derived from the operation of a shipping or air transport enterprise are given separate treatment in tax treaties. The special nature of these enterprises requires such treatment, as they are particularly exposed to the problems of dual and multiple taxation.

Under the usual "Business Profits" article, the *primary* right to tax is given to the country of residence. The term "residence" is defined by the treaty itself and local legislation. The article maintains the right of the "source" state to tax profits which may be attributed to the business activity of the "permanent establishment" which is situated in that source state. It is generally not difficult to satisfy the test of permanent establishment, and an air or sea operation which provides vital yet minimal activity would be taxable in the jurisdiction in which it maintains an office.

The severe practical and theoretical difficulties involved, and the failure of the traditional treaty concepts to deal adequately with these concerns require that such income be given separate attention.

III. TAX TREATY APPROACH AND TAX TREATY NEGOTIATIONS

The accepted international mechanism for dealing with profits from air or shipping operations is to give to one contracting state the *sole* right to tax. The other state in

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The author is grateful to Mr Andrew Ferreira for his thoughtful comments on aspects of the paper and to Mr Bruce Zagaris with whom he had collaborated on an enlarged paper dealing with the United States tax aspects.

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(1) A certificate of the German insurer or reinsurer from the appropriate Finanzamt that it has been a resident of Germany for the entire taxable period for which a refund is sought;
(2) A power of attorney from each US insured party or its broker authorizing payment of the refund to the representatives of the German insurer or reinsurer, if that is to be the case;
(3) Information establishing that the German insurer or reinsurer is eligible to claim benefits under the Treaty by qualifying for one of the entitlement categories of Article 28;
(4) Information on the tax accounts into which the excise tax was initially paid; and
(5) Information on each insured party and policy for which a refund is sought, including names, addresses, dates, policy numbers, premiums amounts and excise tax amounts.

The guidelines for the residency certificate from the Finanzamt and for qualifying under one of the entitlement categories of Article 28 are the same as in Rev. Proc. 92-39 for obtaining an exemption from the excise tax.

3. Application to other treaties

Rev. Proc. 92-14 provides that the guidelines therein may also be used by persons claiming a refund under any other US treaty that provides an exemption for the insurance excise tax and that contains a Limitation on Benefits article that is similar to Article 28 of the US-German Treaty. This would include the treaties with Finland, India and Spain. In such cases, the required residency certificate will be that issued by the appropriate government office of the treaty country involved. For persons claiming refunds under other US treaties, i.e. those without a Limitation on Benefits article similar to Article 28 of the US-German Treaty, the refund procedure is set forth in Rev. Proc. 81-3.[30] This would apply to the treaties with Cyprus, France, Hungary, Italy, Malta, Romania, the United Kingdom and the USSR.

V. EFFECTIVE DATES

The Treaty exemption for the insurance premium excise tax is effective for taxes paid or credited (1) on or after 1 January 1990, if attributable to premiums paid to insurers or reinsurers that are residents of the territory that comprised the Federal Republic of Germany or West Berlin until 3 October 1990, and (2) on or after 1 January 1991, if attributable to premiums paid to German insurers and reinsurers that are residents of the territory that comprised the German Democratic Republic or East Berlin until 3 October 1990.[31]

30. 1981-1 C.B. 618.
31. Art. 32(1)(a) of the Treaty and Section 1 of Rev. Proc. 92-14.

IFA NEWS

BRAZILIAN BRANCH

On 30 July the branch hosted a lunch session in which Dr Sacha Calmon Navarro Coelho, Federal Judge in the City of Belo Horizonte, State of Minas Gerais spoke on "Limitations to the Action of Judiciary Power".

On 31 August Dr Ordélio Azevedo Sette gave a luncheon address on "MERCOSUL - Economic, Financial and Tax Aspects".

The branch held a seminar on 15 September to discuss a proposed bill which, if approved, will substantially modify the current corporation law.

HONG KONG BRANCH

On 18 November 1992 the branch is presenting an update on the latest tax developments in the United States and Australia, together with a report on the IFA Congress in Cancun. On 18 January 1993 there will be a presentation of the United Democrats' view of taxation in Hong Kong.

US BRANCH

Erratum

Re: Volume LCCVIIb of the *Cahiers de Droit Fiscal International* (Tax consequences of international acquisitions and business combinations); National Report of the USA by Mr Charles Kingson.

Correction:

The first sentence on page 623 of the above-mentioned *Cahier* should read as follows:

> "A similar structure exists with respect to a combination between an imputation country, Germany, and the Netherlands, a non-imputation country".

The change, which was requested before publication, makes the paragraph consistent.

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Rev. Proc. 92-39 requires that the obligation to pay any excise taxes owed be secured by an irrevocable letter of credit issued in favour of the IRS in an amount agreed to by the IRS and the German insurer.[23] The letter of credit must be effective within 30 days after the closing agreement is signed by the Commissioner of Internal Revenue and any draw-downs by the IRS must be replaced within 60 days after such draw-down in the amount then agreed to by the German insurer or reinsurer and the IRS. Rev. Proc. 92-39 requires that the letter of credit be issued by either a US bank that is a member of the Federal Reserve System or by a US branch or agency of a foreign bank that is on an approved list of the National Association of Insurance Commissioners.

The closing agreement requires that the certificate of residency from the Finanzamt be renewed and resubmitted to the IRS every three calendar years and that the eligibility of the insurer to claim Treaty benefits under the Article 28 categories be recertified annually. A record retention requirement is also imposed on the insurer, which applies to insurance records and to the information that the insurer is relying on to demonstrate qualification under Article 28 of the Treaty. Such records and information must be retained for a six-year period and must be made available to the IRS for inspection upon request.

3. Effect of IRS exemption

Once a German insurer or reinsurer has obtained an exemption from the IRS, any person making payment of an insurance premium thereto is relieved from the obligation to collect and remit the excise tax provided that such person (1) has knowledge that the German insurer has obtained a certificate from its local tax office (Finanzamt) that it has been a resident of Germany for the taxable period in which the premiums are paid or for the three months prior thereto, (2) has knowledge that the German insurer or reinsurer has entered into a closing agreement with the IRS that is in effect for the taxable period, and (3) does not have knowledge that the German insurer is ineligible to claim benefits under the Treaty for the taxable period. The certificate referred to in (1) above may take the form of a list compiled by the Finanzamt in which the German insurer or reinsurer files its tax return, and such certificate must be retained by the person paying the premiums.

4. Application to other treaties

Rev. Proc. 92-39 provides that the guidelines therein will also be applicable to insurers and reinsurers claiming benefits under the US treaties with Finland, India, Spain or any other US treaty that enters into force after the effective date of the guidelines, which is 18 May 1992, and that provides an exemption for the insurance excise tax and contains a limitation of benefits article that is similar to that contained in the US-German Treaty. In such cases, the required residency certificate will be that issued by the appropriate government office of the applicable treaty country.

The IRS guidelines for closing agreements by insurers or reinsurers that claim exemption from the excise tax under US treaties other than those listed in Rev. Proc. 92-39 are set forth in Rev. Proc. 84-82 (applicable to France and Italy)[24] and Rev. Proc. 87-13 (applicable to Cyprus and formerly Barbados),[25] subject to modification by Rev. Proc. 92-39 with respect to the permitted class of issuers of letters of credit. German insurers or reinsurers that sought recognition of their Treaty exemption after the effective date of the Treaty but prior to the issuance of Rev. Proc. 92-39 did so in reliance on Rev. Proc. 84-82.[26]

B. *Guidelines for tax refund*

The guidelines for claiming a refund of insurance premium excise taxes paid or credited after the effective date of the Treaty are contained in Revenue Proc. 92-14[27]. The guidelines provide that a refund may be claimed either by the German insurer or reinsurer or by the US insured party (or its broker) that paid the tax, but not by both.[28] The guidelines are effective as of 21 January 1992.

The procedure to be followed for a refund of the excise tax is that the applying party must file a Statement Under Penalties of Perjury with the IRS in the form required by Rev. Proc. 92-14, and must also submit certain specified documents and information that substantiate entitlement to the refund. In addition, the applying party must submit a Form 823 (Claim for Refund and Request for Abatement) within the statutory time limit. This is generally three years from the time the tax return was filed, i.e. the Form 720, or two years from the time the tax was paid, whichever is later.[29]

1. Statement under penalties of perjury

The form of the Statement under Penalties of Perjury is set out in Rev. Proc. 92-14 in alternate versions, one to be used if the applying party is the German insurer or reinsurer (Section 4.03) and the other to be used if the applying party is the US insured or its broker (Section 4.04). The Statement contains the representations and warranties that substantiate the claim for the refund under the Treaty. In particular, this includes a representation that none of the risks for which refund of the excise tax is sought have been reinsured with non-treaty exempt persons. The applying party must also agree to retain its insurance records and the information that demonstrates qualification under Article 28 of the Treaty. Such records and information must be retained for a six-year period and must be made available to the IRS for inspection upon request. The Statement must be signed by both the German insurer or reinsurer and the US insured party.

2. Supporting information and documents

Rev. Proc. 92-14 requires that the following information and documents be submitted to the IRS by the party applying for a refund of the excise tax:

23. Two recent closing agreements by the IRS have required letters of credit in the amount of $ 75,000. See IRS Letter Rulings 9218020 and 9225018.
24. 1984-2 C.B. 779. For a recent example of a closing agreement involving the French Treaty, see IRS Letter Ruling 9218020 (24 January 1992).
25. 1987-1 C.B. 596.
26. See, e.g., IRS Letter Ruling 9225018 (18 March 1992).
27. 1992-3 I.R.B. 31 (21 January 1992).
28. Sec. 4.01 of Rev. Proc. 92-14.
29. See IRC Sec. 6511.

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German insurers or reinsurers that seek to qualify under the active trade or business category of Article 28(1)(c) of the Treaty may do so by either meeting a 25 percent German active business safe harbour or making a facts-and-circumstances showing. The safe harbour requires a 25 percent Germany-connected average of three ratios: first, the ratio of the value of assets used or held for use in the active conduct or a trade or business in Germany to the value of assets held worldwide; second, the ratio of gross premiums received for insuring risks located in Germany to gross premiums received for risks worldwide; and third, the ratio of payroll and commission expenses for services performed in Germany to payroll and commission expenses worldwide. The average of these three ratios must exceed 25 percent, and no single ratio may be less than 20 percent.[18]

For purposes of computing the German assets ratio in the 25 percent safe harbour, an asset is treated as used or held for use in Germany only if it is held for the present needs of the business, and not for future needs or for diversification, was acquired and is held in the ordinary course of such business, or is held in direct relationship to the business.[19] In addition, the office or fixed place of business in Germany must be a material factor in the acquisition of the asset and the realization of the income, gain or loss with respect thereto. Tangible assets are treated as held in Germany only if they are physically located there. The value of the insurer's assets is determined on quarterly-end averages using generally accepted accounting principles as applied in Germany.

If the insurer or reinsurer is unable to meet the 25 percent safe harbour, Rev. Proc. 92-39 permits a showing to be made that the premiums are derived in connection with an active trade or business in Germany based on ten specifically listed factors or other supportive information. The factors include:

(1) The location of an office in Germany;
(2) The ratio of payroll and commission expenses for services performed in Germany to payroll and commission expenses worldwide;
(3) The presence of employees and agents in Germany who have and habitually exercise the authority to sign policies and approve claims;
(4) The taxation of the insurer in Germany on a residence basis;
(5) The ratio of gross premiums received for policies or risks located in Germany to gross premiums received worldwide;
(6) The ratio of gross premiums received for policies or risks located in Germany to gross premiums for policies or risks located in the United States;
(7) The ratio of the value of assets for active business held in Germany to the value of assets held worldwide;
(8) Whether the insurer is subject to German insurance regulations with respect to risks located in Germany;
(9) The percentage of the stock of the insurer that is owned by persons entitled to claim benefits under the Treaty, or in the case of a mutual insurance company the percentage of the insurers policies that cover risks of persons not entitled to claim benefits under the Treaty; and
(10) The percentage of the insurer's gross income (excluding investment income not attributable to insurance income) used to meet liabilities to persons not entitled to claim benefits under the Treaty.

The insurer may also submit any other information that indicates that it is engaged in an active business in Germany.[20]

German insurers or reinsurers that seek to qualify under the combined 50 percent stock ownership and base erosion test of Article 28(1)(e) of the Treaty are required to submit a shareholder list to the IRS that includes the names and addresses of all the direct and indirect shareholders and the percentage of stock owned by each. They are also required to submit, for the immediately preceding calendar year, a statement of the base erosion ratio, i.e. the ratio of payments on liabilities to persons not entitled to claim benefits under Article 28 of the Treaty to worldwide income (excluding investment income not attributable to insurance income).[21]

2. Closing agreement and letter of credit

As a condition of obtaining recognition of exemption from the excise tax, Rev. Proc. 92-39 requires that the German insurer or reinsurer enter into a closing agreement with the IRS. The form of the agreement is set out in Section 3.11 of Rev. Proc. 92-39. The closing agreement requires, inter alia, that the German insurer agree to file IRS Form 720 (Quarterly Federal Excise Tax Return) and pay the excise tax for any premiums received that are not eligible for exemption under the Treaty. This will include any premiums received for US risks that are reinsured by the German insurer with non-treaty exempt persons.

The German insurer may consider a reinsuring party to be exempt under the US-German Treaty or under another US treaty if either (i) the reinsurer is a party to a closing agreement with the IRS to that effect, or (ii) the reinsurer provides evidence to the German insurer that it is a US resident or a resident of a US treaty partner that is exempt from the excise tax without regard to an explicit anti-conduit clause.

In practice the verification requirement will mean that an insurer that claims an exemption under the German Treaty and reinsures its US risks with a third-country insurer will be required to obtain a copy of such insurer's closing agreement with the IRS, or know that one exists, or obtain a residency certificate if the third-country insurer claims benefits under a US treaty that lacks an anti-conduit clause. The closing agreement requirement will apply to reinsurers claiming exemption under the US treaties with Cyprus, Finland, France, India, Italy and Spain (and Germany for that matter), while a residency certificate will be required in the case of insurers relying on the treaties with Hungary, Malta, Romania, the United Kingdom and the USSR. The IRS plans to publish periodically a list of the names of the foreign insurers and reinsurers that have entered into closing agreements.[22]

18. Rev. Proc. 92-39, Sec. 3.06.
19. See Reg. § 1.367(a)-2T(b)(5).
20. Sec. 3.07 of Rev. Proc. 92-39.
21. Sec. 3.12(b) of Rev. Proc. 92-39.
22. Rev. Proc. 92-39, Sec. 4.

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If the German insurer is not so engaged, the anti-conduit rule treats the transaction as if the US insured had paid the primary premium directly to the non-treaty exempt recipient, in effect ignoring the middle position of the German insurer. The Joint Committee Explanation illustrates this as follows:

> For example, assume that a German company not engaged in a US trade or business insures a US casualty risk and receives a premium of $ 200. The company reinsures part of the risk with a Danish insurance company (not currently entitled to an exemption from the excise tax) and pays that Danish company a premium of $ 100. The four percent excise tax on casualty insurance applies to the premium paid to the German insurance company to the extent of the $ 100 reinsurance premium. Thus, the US insured is liable for an excise tax of $ 4, which is four percent of the portion of its premium paid to the German insurer which was used by the German reinsurer to reinsure the risk.

This characterization ensures that the excise tax can be collected at the four percent rate for primary insurance, if such rate would otherwise be applicable, rather than at the one percent rate for reinsurance, and effectively carries out the purpose of the anti-conduit rule by preventing German insurers not only from being used as treaty shopping vehicles, but also from being used to convert higher-taxed primary insurance transactions into lower- taxed reinsurance transactions.

If the German insurer is engaged in business in the United States, the anti-conduit rule treats the transaction as if the German insurer itself, and not the US insured, had transferred the insurance premium to the non-exempt foreign insurer. The Joint Committee Explanation provides that the German insurer is treated in this case as if it were a US resident paying the premium to the foreign insurer. The character of the transaction as being one of reinsurance is not changed. To use the above example as an illustration, the one percent rate would be applied to the $ 100 premium paid to the Danish reinsurer, and a tax of $ 1 would result.

The rationale for this outcome is that a German insurer engaged in business in the United States, absent the Treaty, would normally be subject to net basis income tax on the retained portion of the risk, and not to the excise tax (by reason of the Section 4373(1) exception), and it is not the function of the anti-conduit rule to alter the treatment of the reinsured portion of the risk in such a situation. In other words, not to treat the German insurer differently by reason of application of the anti-conduit rule than any other foreign insurer would be treated if it had no treaty protection to begin with. The Joint Committee Explanation points out that this result will obtain even in the case where the German insurer does not have a permanent establishment in the United States and thus is not subject to net basis income tax on the retained portion of the risk due to Article 7 of the Treaty.

The Joint Committee Explanation provides that the US insured has the responsibility to determine the extent to which the primary insurance is reinsured with a non-exempt person, and the US insured will therefore have the attendant responsibility of collecting the excise tax at the appropriate rate in the event that there is reinsurance.

IV. IRS IMPLEMENTING PROCEDURES

The IRS has issued two revenue procedures with guidelines for implementing the Treaty exemption for the insurance premium excise tax. One procedure provides the guidelines for obtaining recognition by the IRS of the German insurer's or reinsurer's entitlement to an exemption from the excise tax, and the other procedure provides the guidelines for obtaining a refund of the excise tax.

A. *Guidelines for recognition of exemption*

The guidelines to be followed by a German insurer or reinsurer to obtain recognition of exemption from the excise tax are contained in Revenue Procedure 92-39.[16] The guidelines require that the German insurer submit a private ruling request to the IRS establishing its entitlement to the exemption, and also that it enter into a closing agreement to undertake liability for the excise tax in the event it is determined that any premiums paid are not eligible for the exemption under the Treaty. The latter undertaking must be secured by a letter of credit drawn in favour of the IRS. The ruling request must comply with the general IRS procedures for obtaining private rulings[17] and also with the special procedures of Rev. Proc. 92-39. The guidelines are effective 18 May 1992.

1. Qualification under Article 28

As part of the ruling application, the German insurer is required to demonstrate that it is qualified to claim benefits under Article 28 of the Treaty (Limitation on Benefits). To do so it must submit a copy of its certificate of German residence issued by the Finanzamt (see below) and must show that it falls within one of the entitlement categories of Article 28, which are listed in Rev. Proc. 92-39 as follows:

(1) The category for companies whose principal class of shares are substantially and regularly traded on a recognized stock exchange (Section 3.05 of Rev. Proc. 92-39 and Article 28(1)(d) of the Treaty);

(2) The category for companies that are actively engaged in a trade or business in Germany and receive the premium income in connection therewith (Section 3.06 or 3.07 of Rev. Proc. 92-39 and Article 28(1)(c) of the Treaty);

(3) The category for companies that meet the combined requirements of (i) 50 percent stock ownership by persons eligible to claim benefits under the Treaty and (ii) compliance with the base erosion test (Sections 3.08 and 3.09 of Rev. Proc. 92-39 and Article 28(1)(e) of the Treaty); and

(4) The category for companies granted competent authority relief to claim benefits of the Treaty even though they do not come within any of the categories specifically listed above (Section 3.10 of Rev. Proc. 92-39 and Article 28(2) of the Treaty).

16. 1992-20 I.R.B. 24 (15 May 1992).
17. These are currently found in Rev. Proc. 92-7, 1992-1 I.R.B. 135. They are updated and re-issued at the beginning of each calendar year. The German insurer or reinsurer will also be required to pay the IRS "user fee" provided for in Rev. Proc. 90-17, 1990-1 C.B. 479, or in any successor revenue procedure.

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Under Section 4373(1) the excise tax does not apply if the premiums are effectively connected with the US trade or business of the foreign insurer. In that event, the foreign insurer is subject to tax on the premium income on a net basis unless protected by a treaty. As noted in the Explanation of the Treaty by the Staff of the Joint Committee on Taxation, a foreign insurer will not ordinarily be considered to be engaged in business in the United States if it does not have an office or dependent agent in the United States.[11] The IRS has held that foreign insurers not engaged in business in the United States are not subject to US withholding tax on insurance premiums even though such premiums are considered to be periodical income from US sources.[12] The basis for the holding is that the excise tax was intended by Congress to be a substitute for the income tax.[13]

The Joint Committee Explanation also notes, however, that there may be situations in which a foreign insurer engaged in business in the United States, and thus subject to net basis income tax, reinsures all or a portion of a US risk with a second foreign insurer that is not engaged in a US business. In that event, the foreign insurer will be exempt from the four percent excise tax on the primary insurance, but the one percent reinsurance excise tax will be imposed on the reinsured portion of the risk. The rationale for this result is that the premium for the reinsured portion of the risk has not been subjected to US net basis taxation, i.e., upon payment the reinsurance premium will be deducted by the primary insurer in computing its net basis income tax, and, upon receipt it will not be subject to net basis income tax in the hands of the foreign reinsurer, since the latter is not engaged in business in the United States. The one percent excise tax will thus apply in order to insure that the reinsured portion of the risk is subjected to some form of US taxation.

III. THE UNITED STATES-GERMAN INCOME TAX TREATY

A. *Scope of treaty exemption*

The inclusion of the excise tax in Article 2 of the Treaty (Taxes Covered)[14] effectively precludes the application of the tax to German insurers and reinsurers in all circumstances, subject to the anti-conduit rule discussed below. This is because such insurers will either: (a) be engaged in business in the United States through a permanent establishment, in which event net basis US income tax will apply under Article 7 of the Treaty (Business Profits) and the excise tax will be precluded by Section 4373(1) of the Code; or (b) not be engaged in business in the United States through a permanent establishment, in which event the insurance premium excise tax will be precluded by Article 7 and also by Article 21 (Other Income) since insurance premiums are not dealt with in a specific provision of the Treaty and are thus taxable only in the residence of the recipient.

The Joint Committee Explanation makes clear that the scope of the exemption from the excise tax provided by the Treaty is full and complete:

> More specifically, income of a German insurer from the insurance of US risks or US persons will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption). The waiver applies even if that insurance income is not attributable to a US permanent establishment maintained by the German insurer and hence not subject to US net basis tax pursuant to the business profits article (Article 7) and other income article (Article 21).

The Joint Committee Explanation notes that inclusion of the excise tax in the new Treaty is a change from the 1954 Treaty, but is consistent with the 1981 US Model Treaty and with other recent treaties concluded by the United States, notably those with Finland, France, Hungary, India and Spain.

B. *The anti-conduit rule*

The insurance premium excise tax is included within the scope of the Treaty only to the extent that the risks to which the premiums apply are not reinsured with persons who are not entitled to claim benefits under the US-German Treaty or under any other US treaty that provides a similar exemption for the insurance premium excise tax. The Treasury Department Explanation refers to this limitation as the "anti-conduit" rule for reinsurance.[15] The purpose of the anti-conduit rule is to prevent insurers and reinsurers that qualify under Article 28 of the German Treaty from being used as treaty shopping vehicles by insurers located in non-treaty-exempt jurisdictions.

If the reinsuring party is a non-German insurer, the Taxes Covered and Limitation of Benefits articles of any potentially applicable US tax treaty must be examined to determine (1) whether such treaty contains an exemption from the excise tax, and (2) whether the reinsuring party is entitled to claim benefits thereunder. The anti-conduit rule does not require that the limitation on benefits article of such other treaty be similar to Article 28 of the US-German Treaty, but only that the reinsuring party be entitled to claim benefits under whatever formulation of the limitation on benefits article, if any, is included in such other treaty.

If the anti-conduit rule is violated, the result is that the excise tax is applied as if the premiums were paid to an insurer located in a non-treaty jurisdiction. The disqualification results, however, only to the extent of the proscribed reinsurance, not to the transaction as a whole, and the tax consequences as to the disqualified portion are then determined under the normal domestic rules for imposing the excise tax. As discussed in Part II above, the outcome under the domestic rules depends in part on whether or not the German insurer is engaged in business in the United States.

11. Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Federal Republic of Germany Prepared by the Staff of the Joint Committee on Taxation.
12. See IRC Sec. 861(a)(7).
13. Rev. Rul. 89-91, 1989-2 C.B. 129, modifying and superseding Rev. Rul. 80-222, 1980-2 C.B. 211. In Rev. Rul. 89-91, the IRS rejected the theory that insurance premiums lack a high content of net income.
14. Art. 2(1)(a)(bb).
15. Treasury Department Technical Explanation of the Convention and Protocol Between the United States of America and the Federal Republic of Germany For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital and Certain Other Taxes.

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UNITED STATES:

GERMAN TREATY EXEMPTION FOR FOREIGN INSURANCE PREMIUMS

J.G. Rienstra

I. INTRODUCTION

The recently adopted US-German Income Tax Treaty includes the United States excise tax on foreign insurance premiums as a tax covered by the Treaty.[1] This is consistent with the 1981 US Model Treaty[2] and with recent US treaty practice, and it brings to 12 the number of US treaties that now include coverage of the insurance premium excise tax. The other US treaties are those with Cyprus, Finland, France, Hungary, India, Italy, Malta, Spain, Romania, the United Kingdom and the USSR.

The recently signed treaty with the Russian Federation does not include coverage of the excise tax, and the prior coverage under the treaties with Barbados and Bermuda was terminated by the United States effective for premiums allocable to periods after 31 December 1989.[3] The Internal Revenue Service (IRS) takes the position that the insurance premium excise tax must be specifically referred to in the Taxes Covered article of a US treaty or it will be considered excluded as a non-income tax.[4]

II. OVERVIEW OF THE INSURANCE PREMIUM EXCISE TAX

Sections 4371 through 4374 of the Internal Revenue Code (IRC) impose an excise tax on premiums paid to foreign insurers for the coverage of certain risks located in the United States. The excise tax serves the same function with respect to insurance premiums paid to foreign insurers as the withholding tax on interest, dividends and royalties paid to foreign investors.

The rate of the insurance premium excise tax is four percent of the premiums paid for casualty insurance and indemnity bonds, one percent of the premiums paid for life, sickness and accident insurance, and for annuity contracts, and one percent of the premiums paid for reinsurance of any of the foregoing.[5] The tax is collected by means of withholding and quarterly remittance using IRS Form 720 (Quarterly Federal Excise Tax Return) by the person making payment of the premiums to the foreign insurer or non-resident agent, solicitor or broker.[6] Although withholding and remittance is required by the US person who makes actual payment of the premium, which is normally the US insurance broker, all parties to the insurance transaction, including the foreign insurer and its agents and brokers, are liable under the statute for the excise tax.[7]

The excise tax applies to premiums paid to a foreign insurer or reinsurer. This is defined as an insurer or reinsurer that is a non-resident alien individual, a foreign partnership or a foreign corporation, but not a foreign government, municipality or other corporation that exercises taxing power.[8] In the case of casualty insurance and indemnity bonds, the risks to which the excise tax applies are defined by reference to the location of the risk and the residence of the insuring party, i.e. the risk must be located wholly or partly in the United States, and must be insured against by a domestic corporation, domestic partnership or resident individual, or insured against by a foreign corporation, foreign partnership or non-resident individual, that is engaged in business in the United States.[9] In the case of life, sickness and accident insurance, and annuity contracts, the excise tax applies if the life or hazards to which the premiums relate are those of a person who is a citizen or resident of the United States.[10]

J.G. Rienstra is a member of the research staff of the IBFD.

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V. Effective Dates

1. The excise tax was not covered by the prior U.S.-German Income Tax Treaty, which dates from 1954.
2. Art. 2(1)(a).
3. See IRS Notice 89-89, 1989-2 C.B. 407 implementing Section 6139 of the Technical and Miscellaneous Revenue Act of 1988.
4. See Rev. Rul. 84-169, 1984-2 C.B. 216 (specifically applicable to the excise tax on investment income of private foundations, but generally applicable to all US excise taxes).
5. IRC Sec. 4371. Under legislation currently pending in Congress, the tax rate on reinsurance premiums for casualty insurance and indemnity bonds may be increased to four percent if the insurance income (including investment income) relating to the policy is not subject to tax by a foreign country at an effective rate that is substantial in relation to U.S. income tax rates. At the present time, neither the legislation nor the Congressional reports define what effective rate of foreign tax will be considered "substantial". (Cf. the 90% high tax exception to Subpart F, IRC § 954(b)(4)). The legislation also authorizes the IRS to adopt enhanced collection and enforcement procedures to ensure that the tax due on reinsurance premiums is collected. The legislation is proposed to be effective for reinsurance premiums allocable to periods after 31 December 1992. H.R. 776, 102nd Cong., 2d Sess., § 20132 (National Energy Security Act of 1992).
6. Reg. § 46.4374-1(a).
7. IRC Sec. 4374.
8. IRC Sec. 4372(a).
9. IRC Sec. 4372(d).
10. IRC Sec. 4372(e).

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The proposed regulations provide certain anti-abuse rules under which the IRS may adjust the computation of interest expense allocable to ECI.[39] In general, these anti-abuse provisions will apply if necessary to reflect a transaction in accordance with its substance, to prevent evasion of taxes or to reflect clearly the income of the trade or business. For example, the IRS may offset loan amounts to or from related persons if the purpose of the loans is to increase the actual ratio.

The proposed regulations do not contain a provision under which a foreign corporation could make new elections upon finalization of the proposed regulations. For example, a foreign bank using the 95 percent fixed ratio under the existing regulations may wish to elect to use the actual ratio rather than the new 93 percent fixed ratio. It is unclear whether the IRS will permit new elections upon issuance of new final regulations, although the unilateral change in the effect of this election would support an argument that new elections should be permitted.

VI. CONCLUSION

Many of the new provisions included in the proposed regulations are controversial. In general, it appears likely that the new rules will result in smaller interest expense deductions for foreign corporations doing business in the United States. For example, the proposed regulations would likely result in a smaller proportion of the foreign corporation's assets being treated as US assets than under the existing regulations, with the ultimate result that a smaller proportion of the foreign corporation's interest expense will be treated as incurred to finance these assets. In addition, the proposed rules impose new limitations on the leverage ratios used to compute US liabilities of foreign banks, which should also tend to reduce the proportion of the foreign corporation's interest expense allocated to the United States. Finally, the proposed regulations adopt for all foreign corporations a narrower definition of liabilities ("booked liabilities") considered to be booked by the US trade or business which, together with new limitations on interest rates which may be applied in computing interest expense on liabilities not considered booked in the United States, will also tend to reduce US interest expense deductions.

39. Prop. Regs. § 1.882-5(e).

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paid or accrued during the taxable year by the US trade or business on booked liabilities, reduced by the product of the "scaling ratio" and the interest paid or accrued.[31] The scaling ratio is computed using the following formula:

$$\frac{\text{Booked liabilities} - \text{US liabilities}}{\text{Booked liabilities}}$$

If interest expense must be scaled back under this rule, the scaling ratio must also be applied to reduce any (i) income, expense, gain or loss that is ECI and attributable to notional principal contracts identified as hedges of booked liabilities, and (ii) exchange gain or loss that is ECI and attributable to booked liabilities.[32]

If the amount of US liabilities exceeds booked liabilities, interest expense allocable to ECI is the sum of the total interest expense on booked liabilities plus the amount of "excess interest" expense attributable to the "excess" US liabilities.[33] Excess interest is determined by multiplying the excess US liabilities by a prescribed interest rate.[34] For banks, the prescribed rate is equal to 90 percent of the taxable year's daily average rate in the LIBOR on US dollar demand deposits, while for non-banks the rate is 110 percent of such average. This contrasts with the rule under the existing regulations which permits taxpayers to use their actual average interest rate on US dollar liabilities booked by its branches or offices outside of the United States, or, alternatively, any method that approximates the actual rate and is consistently applied (e.g. 30-day LIBOR). In cases where the foreign corporation has US liabilities in excess of booked liabilities, Step Three of the proposed regulations may result in a smaller US interest deduction than the existing regulations, especially for corporations with lower credit ratings.

V. ADDITIONAL SIGNIFICANT PROVISIONS AND CONSIDERATIONS

The proposed regulations specifically reject the so-called "treaty method" under which a permanent establishment ("PE") would be treated as a separate entity under relevant provisions of an income tax treaty. The proposed regulations incorporate the IRS' position (previously published in Rev. Ruls. 85-7, 1985-1 C.B. 188 and 89-115, 1989-2 C.B. 130) that the regulations apply to determine the interest expense deduction allowable to a PE of a foreign corporation entitled to the benefits of an income tax treaty. In addition, the proposed regulations emphasize that interbranch transactions will not be considered to create assets or liabilities.[35]

The proposed regulations clarify existing rules limiting a foreign corporation's interest expense deduction to no more than the total amount of the foreign corporation's interest expense for purposes of IRC Section 163. In addition, provisions of US tax law which operate to disallow, defer or capitalize interest expense (e.g. IRC Sections 265, 267, 163(j) and 263A) are to be applied after the proposed regulations (i.e. to the amount of interest expense allocated to ECI under the proposed regulations).[36]

For banks, two special elections are provided by the proposed regulations which, according to the preamble, are intended to assist them in pricing their loans. In general, a bank can elect to use historical data in computing its actual ratio (the "historical data" election), and/or make an election to compute the amount of interest allocable to ECI on a daily basis (the "daily interest computation" election).

A. *Historical data election*

Under the historical data election, the proposed regulations can be applied using an actual ratio computed for a hypothetical tax year ending six months before the end of the foreign corporation's taxable year.[37] For example, an actual ratio computed on 30 June 1992 for a hypothetical year ending on that date could be used by foreign banks in determining their allocable interest for the year ended 31 December 1992. However, see the discussion of the daily interest computation election below for uncertainties which may arise in computation of the actual ratio if the daily interest computation election is made in addition to the historical data election.

B. *Daily interest computation election*

The regulations also provide an election to compute allocable interest expense on the basis of "daily total amounts". The mechanics of the daily interest computation are not clearly set out in the proposed regulations. The election appears to require that US liabilities be determined by multiplying the amount of US assets (determined on a daily basis) by an actual ratio computed under the general frequency rules discussed above (i.e. at least quarterly or, in the case of large banks, monthly). However, the language of this provision seems to suggest that the taxpayer is to use an "actual" ratio based on the sums of the values of worldwide liabilities and assets as of the last periodic computation of such amounts (i.e. quarterly or monthly).[38] This contrasts with the general definition of the actual ratio as the *average* of such sums, computed on an annual basis. Further uncertainty arises if an historical data election (discussed above) is made in combination with an election to compute interest daily. An example in the proposed regulations appears to suggest that the historical ratio (i.e. the actual ratio computed for a hypothetical period ending six months earlier) should be computed on a "rolling" basis. For example, if interest expense of a large bank is computed for each day in January, an historical ratio computed for June of the previous year (i.e. the month ended six months prior to the month of computation) appears to be required, while the historical ratio from the previous July should be used in computing daily amounts of interest in February.

An election to use historical data in computing the actual ratio and/or to compute interest daily will be effective for the taxable year beginning after the date the election is made.

31. Prop. Regs. § 1.882-5(d)(3).
32. Prop. Regs. § 1.882-5(d)(3)(iii) and (iv).
33. Prop. Regs. § 1.882-5(d)(4)(i).
34. Prop. Regs. § 1.882-5(d)(4)(ii).
35. Prop. Regs. § 1.882-5(a)(3), (b)(1)(iii) and (c)(2)(ii)(B).
36. Prop. Regs. § 1.882-5(a)(1) and (2).
37. Prop. Regs. § 1.882-5(c)(2)(iv)(B).
38. Prop. Regs. § 1.882-5(d)(5).

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actual ratio using the spot rate on the date the computation is made (i.e. quarterly or monthly as required). Whichever currency is chosen for the computation, it must be used consistently from year to year.[22]

IV. STEP THREE: DETERMINATION OF APPLICABLE INTEREST EXPENSE

Step Three provides rules for determination of the amount of interest expense attributable to US liabilities and, thus, allocable to ECI of the foreign corporation. The proposed regulations eliminate use of the "separate currency pools" method, and a modified version of the "branch book/dollar pool" method of the existing regulations would generally apply. In general, the computation of interest expense allocable to ECI will depend on whether the amount of liabilities properly recorded on the books of the US trade or business ("booked liabilities") is greater or less than the amount of US liabilities computed in Step Two above.[23] For this purpose, a new definition of booked liabilities is provided.

A. *Definition of booked liabilities*

Under the proposed regulations "booked liabilities" are liabilities which are properly reflected on the books of a US trade or business.[24] This generally requires a "direct relationship" between the liability and the US trade or business. The existence of such a direct relationship is a question of fact. In addition, the proposed regulations list certain categories of liabilities which will and will not normally be considered booked liabilities. In general, these rules correspond to the branch tax rules for determining liabilities of a US branch (i.e. liabilities, the interest on which is considered paid by the US branch).[25]

Other significant changes to the definition of booked liabilities made by the proposed regulations include:

1. Special rules for banks

For banks, the proposed regulations provide a new category of high-cost liabilities which will normally not be considered booked liabilities. This rule is provided to prevent a foreign corporation from booking its highest cost liabilities in the United States in order to increase its US interest expense deduction. Under this rule, if a liability of a bank is subject to a rate of interest in excess of three percentage points over the applicable federal rate for obligations of similar maturity, the liability will not be considered a booked liability of the US trade or business.[26]

The proposed regulations permit treatment of certain liabilities booked by trades or businesses outside the United States as booked liabilities.[27] Under the proposed regulations, a liability will be considered a booked liability of the US trade or business if the bank's US branch employees perform substantially all material activities required to incur the liability and if (i) the liability funds a US asset or (ii) the place of payment of interest on the liability within the meaning of IRC Section 6049 is within the United States. This rule is similar to the rule provided for branch tax purposes in Notice 89-80 which typically applies to liabilities recorded on the books of offshore "shell" branches of foreign banks.[28]

2. Special rules for non-banks

For branch tax purposes, if certain payee notification requirements of Notice 89-80 are met, a non-bank may currently identify the liabilities of its non-US branches as, in effect, liabilities of its US branch. Liabilities identified under this rule will not be considered booked liabilities under the proposed regulations, unless the liabilities also satisfy the direct relationship requirement for booked liabilities discussed above.[29]

3. Special rules applicable to all foreign corporations

A special discretionary anti-abuse rule may apply if a foreign corporation has currency mismatches with respect to booked liabilities and US assets of its US trade or business. In general, if the amount of booked liabilities denominated in a currency other than the US dollar varies by more than ten percent from the value of US assets in that currency, the IRS may invoke special rules which would (i) apply the "scale back" rules (see discussion below) to any amount of booked liabilities in a currency which exceeds the threshold amount of US assets in the currency, or (ii) treat any amount by which booked liabilities in a currency fall short of the threshold amount of US assets denominated in that currency as an amount of excess US liabilities subject to London interbank market (LIBOR) rates of interest for that currency similar to those described below. For purposes of this provision, the effect of financial instruments may be taken into account if gains or losses from such contracts are considered ECI. Thus, the amount of liabilities (and related interest expense) in a specific currency may in effect be increased or reduced at the discretion of the IRS if there are currency mismatches with respect to the booked liabilities and US assets of a foreign corporation. However, this rule will not apply if the taxpayer can show that the mismatch is representative of the foreign corporation's worldwide position in the particular currency.[30]

B. *Computation of interest allocable to ECI*

If the amount of booked liabilities exceeds the amount of US liabilities, the interest expense allocable to ECI is the interest

22. Prop. Regs. § 1.882-5(c)(2)(iii)(B).
23. Prop. Regs. § 1.882-5(d)(1).
24. Prop. Regs. § 1.882-5(d)(2)(i).
25. Regs. § 1.884-4T(b) and Notice 89-80, 1989-2 C.B. 394. Effective for taxable years beginning on or after 13 October 1992, recently issued final Regs. § 1.884-4(b) will replace the prior temporary rules. However, the final regulations do not materially alter the temporary rules other than as discussed in footnote 28. In any case, recently issued *proposed* branch tax regulations would generally define "branch interest" (i.e. interest considered to have been paid by a US branch) by reference to the definition of booked liabilities included in proposed regulations.
26. Prop. Regs. § 1.882-5(d)(2)(iii)(B).
27. Prop. Regs. § 1.882-5(d)(2)(ii)(C)(2).
28. However, the proposed regulations do not appear to impose the "depositor notification" requirements adopted in Notice 89-80 for liabilities of shell branches for branch tax purposes. Final branch tax regulations issued on 10 September 1992 delete the depositor notification requirement for branch tax purposes as well.
29. Prop. Regs. § 1.882-5(d)(2)(iii)(E).
30. Prop. Regs. § 1.882-5(d)(2)(v).

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liabilities to its worldwide assets ("actual ratio") or (ii) the elective "fixed ratio" which represents deemed leverage.[12]

A. *Applicable leverage ratios*

The proposed regulations continue to permit banks and most other foreign corporations to elect to apply a fixed ratio to determine the amount of their US liabilities. However, the fixed ratio for a US banking, financing or similar business would be reduced from 95 to 93 percent. In addition, the proposed regulations do not permit insurance companies to elect the fixed ratio. For other corporations, however, the fixed ratio would remain at 50 percent.[13] An election to use the fixed ratio is binding and, once made, must be used by the taxpayer in all subsequent years unless the IRS consents to a change.

If the fixed ratio is not elected, the actual ratio will apply. However, for banks, the proposed regulations limit the actual ratio to 96 percent.[14] Thus, banks with an actual ratio of worldwide liabilities to worldwide assets in excess of 96 percent will not be permitted a full allocation of interest expense to the United States.[15] No limitation applies under the existing regulations. Although the proposed regulations do not impose a limitation on the actual ratios of foreign corporations other than banks, such ratios may be limited in practice by the normal US debt/equity rules.

B. *Adjustments to asset values in computing worldwide assets*

As in the case of US assets, adjusted basis is used to value worldwide assets, unless a binding election to use fair market values is made.[16] Where adjusted basis is used, the adjustments to the basis of US assets (discussed above) are ignored, and certain other adjustments are required to compute the amounts of worldwide assets used to compute the actual ratio.

In general, the foreign corporation's adjusted basis in the shares of a 20 percent owned corporation must be increased for accumulated earnings and profits of the 20 percent owned corporation (and of any lower-tier 20 percent owned corporations) attributable to the shares held.[17] Similarly, the basis of the shares in such corporations must be decreased (but not below zero) for deficits in earnings and profits attributable to the shares held. For this purpose, financial statement retained earnings may be used if earnings and profits calculations are not otherwise performed.

In addition, the adjusted basis of worldwide assets of a foreign bank entitled to use the reserve method should be reduced by the reserve for bad debts allowable under IRC Section 585.[18]

Whether a corporation utilizes the fair market value or adjusted basis to value its assets, additional adjustments are required if the corporation has an interest in a partnership. The value of a partnership interest held by a foreign corporation should reflect the foreign corporation's share of partnership liabilities, determined on the basis of the foreign corporation's allocable share of the partnership's interest expense. Therefore, where adjusted basis is used, the outside basis of the foreign corporation's partnership interest is reduced by its share of partnership liabilities (determined under IRC Section 752) and increased by the product of partnership liabilities multiplied by the corporation's share of partnership interest expense and divided by the interest expense of the partnership.[19] Although the proposed regulations indicate that fair market value should be similarly adjusted, it appears that the foreign corporation's share of partnership liabilities (determined on the basis of allocable partnership interest expense) should be added to the fair market value amount, with no decrease for allocable partnership liabilities under IRC Section 752. This is because the fair market value of the partnership interest should already reflect the partner's investment net of liabilities.

C. *Worldwide liabilities*

In general, the amount of worldwide liabilities to be used in computing the actual ratio includes non-interest bearing as well as interest bearing liabilities, determined under US principles. A partner's share of a partnership's liabilities is the proportion of the total partnership liabilities which the partner's allocable share of total partnership interest expense bears to total partnership interest expense.

D. *Computation of actual ratio*

A foreign corporation's actual ratio must be computed using the average of the sums of both worldwide liabilities and worldwide assets. For purposes of determining the average, these sums must be computed at the most frequent, regular intervals for which data are reasonably available, but not less frequently than quarterly. For large banks (within the meaning of IRC Section 585(c)(2)), the sums of worldwide liabilities and worldwide assets must be computed at least monthly.[20] A bank can also elect to determine its actual ratio based on data from a hypothetical taxable year ending six months before the end of the taxpayer's actual taxable year.[21] (This election is discussed in more detail below in Section V.) Once established, the frequency of the intervals used in the computation of the actual ratio cannot be reduced unless the consent of the IRS is obtained.

The actual ratio must be computed in a single currency, either the US dollar or the functional currency of the home office of the taxpayer. In general, a particular asset or liability value should be translated into the currency chosen to compute the

12. Prop. Regs. § 1.882-5(c)(1).
13. Prop. Regs. § 1.882-5(c)(3).
14. Prop. Regs. § 1.882-5(c)(1) and (2)(i).
15. The preamble to the proposed regulations indicates that US banks are currently required to maintain a 4% equity to assets ratio, and that the Treasury and Federal Reserve are preparing a report on the applicability of the requirement to foreign banks with US operations.
16. Prop. Regs. § 1.882-5(c)(2)(iii)(A).
17. Prop. Regs. § 1.882-5(c)(2)(iii)(C). The term "20% owned corporation" is defined to include any corporation (foreign or domestic) in which the taxpayer owns directly or indirectly 20% or more of the total combined voting power of all classes of stock entitled to vote.
18. Prop. Regs. § 1.882-5(c)(2)(iii)(D).
19. Prop. Regs. § 1.882-5(c)(2)(iii)(E).
20. Prop. Regs. § 1.882-5(c)(2)(iv)(A).
21. Prop. Regs. § 1.882-5(c)(2)(iv)(B).

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A. *Definition of US assets*

As originally issued, the proposed regulations modified the branch profits tax rules by excluding from US asset classification direct interests in US real property (i.e. property described in IRC Section 897(c)(1)(A)(i)), except in the year in which gain or loss arises from such interests.[4] However, on 25 June 1992 the IRS issued a correction of the reference to IRC Section 897(c)(1)(A)(i) in the original version of the regulations. The correction refers instead to Regs. § 1.884-1T(d)(5). As corrected, the explicit classification of all direct US real property interests ("USRPIs") as US assets for branch tax purposes will not apply for purposes of the proposed regulations. Instead, for a USRPI to be considered a US asset for this purpose, the general definition of US assets in Regs. § 1.884-1T(d)(1)(ii) must be met. That is, a USRPI will be considered a US asset for purposes of the proposed regulations only if all income from the use and all gain from the disposition of the USRPI is (or would be if used or sold) ECI. Thus, it appears that US rental real estate should qualify as a US asset if an election is made under IRC Sec. 882(d) to be taxed on rental income as ECI. In addition, a USRPI which is used in a US trade or business but does not directly generate ECI (e.g. a manufacturing facility or a bank building) should qualify as a US asset under this provision.[5]

The proposed regulations also exclude from or include in US assets certain other narrow categories of assets (e.g. shares in a FSC or certain assets of captive insurance companies), and restate the general US tax principle that transactions between offices or branches of the same corporation do not create US assets.[6]

B. *Valuation of US assets*

In general, US assets are valued under the proposed regulations at their adjusted basis for purposes of determining taxable gain or loss. However, like the existing regulations, the proposed regulations provide an election to use fair market values to value US assets.[7] If elected, the fair market value method must be used by the taxpayer in all subsequent taxable years, unless the IRS consents to another method.

Whether adjusted basis or fair market value is used to value US assets, the proposed regulations require that the value of certain assets which produce both ECI and non-ECI (and are therefore treated only in part as US assets for branch tax purposes) be reduced to reflect the proportion of the asset that generates ECI. Under the proposed regulations the assets subject to this rule (and the rules for determining the value attributable to ECI) were described in Regs. § 1.884-1T(d)(2)-(10) and (12).[8] (Upon adoption in final form, the reference should be to recently issued final Reg. § 1.884-1(d)(2)-(4).)

For purposes of determining the US asset with respect to shares of a corporation which are considered to be effectively connected with a foreign corporation's US trade or business, the proposed regulations require the value (adjusted basis or fair market value) of these shares to be reduced to the product of the following formula:[9]

$$\frac{\text{Dividends received} - \text{dividends received deduction}}{\text{dividends received}} \times \text{value of shares}$$

Applied literally, this formula will result in the shares of a corporation being considered to have a zero value in a year in which dividends are not received, resulting in effective disallowance of the interest incurred to carry such shares. Even in the year in which dividends are received, this formula results in 70 or 80 percent of the value of the shares as not being treated as a US asset. This is particularly relevant for foreign banks, which often consider their investments in domestic subsidiaries to be effectively connected with their US trade or business.

For banks that are permitted an addition to bad debt reserves under IRC Section 585 (i.e. generally banks with average assets not in excess of $ 500 million and which are not members of a parent-subsidiary controlled group of corporations with average assets in excess of $ 500 million) the adjusted basis of their US assets must be reduced by the amount of the IRC Section 585 bad debt reserve.[10]

C. *Computation of total US assets*

The proposed regulations provide that the total value of US assets to be included in the computation of interest expense allocable to ECI is the average of the sum of the values of all US assets computed at the most frequent, regular intervals for which data are reasonably available, but not less frequently than quarterly.[11] A special election permits banks to choose to determine the amount of their interest expense allocable to ECI on a daily basis. In this case, the value of US assets must be computed on a daily basis. This election is discussed in more detail in Section V below.

III. STEP TWO: DETERMINATION OF US LIABILITIES

Step Two requires the foreign corporation to determine the portion of its worldwide liabilities considered to fund US assets ("US liabilities"). The amount of US liabilities is computed by multiplying the value of US assets by (i) the leverage ratio reflecting the ratio of the corporation's worldwide

4. Prop. Regs. § 1.882-5(b)(1)(ii)(A)(1).
5. The final branch tax regulations no longer include a provision corresponding to Temp. Regs. § 1.884-1T(d)(5), which automatically included all USRPIs as U.S. assets. Instead, the final branch tax regulations provide a rule similar in effect to the rule adopted by the correction to the proposed regulations issued on 25 June.
6. Prop. Regs. § 1.882-5(b)(1)(ii) and (iii).
7. Prop. Regs. § 1.882-5(b)(2)(i) and (c)(2)(iii)(A).
8. Prop. Regs. § 1.882-5(b)(2)(iii)(A). Marketable securities considered US assets under the expansion capital election of Regs. § 1.882-iT(d)(11) are not considered US assets for purposes of the proposed regulations, Prop. Regs. § 1.882-5(b)(2)(ii). The preamble indicates that such assets are considered to be funded by capital (rather than debt) and should therefore not attract interest expense to ECI.
9. Prop. Regs. § 1.882-5(b)(2)(iii)(B). However, recently issued proposed regulations under IRC § 864 would limit the cases in which stock would be considered to generate ECI, and, therefore, the cases in which stock would be a US asset.
10. Prop. Regs. § 1.882-5(b)(2)(iv).
11. Prop. Regs. § 1.882-5(b)(3).

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UNITED STATES:

PROPOSED RULES FOR DETERMINING DEDUCTIBLE INTEREST OF A FOREIGN CORPORATION'S US TRADE OR BUSINESS

Paul J. Biehl, Peter J. Connors and Barry Ruddell

I. INTRODUCTION

On 24 April 1992 the IRS issued Prop. Regs. § 1.882-5, relating to the determination of interest expense of foreign corporations allocable to such corporations' income ("ECI") which is effectively connected with the conduct of a US trade or business. Subject to certain limitations on deductibility of interest expense of foreign corporations, interest expense allocated to ECI under the proposed regulations is deductible in determining a foreign corporation's US taxable income. Special rules are provided for foreign banks and insurance companies. The proposed regulations, if adopted, will replace the existing regulations, effective for taxable years beginning after the date the proposed regulations are adopted.

Although similar to the existing regulations in approach, the proposed regulations generally conform the rules for allocation of interest expense with the branch tax rules.[1] The proposed regulations generally retain the principle underlying the existing regulations that worldwide interest expense is fungible and supports all assets of a foreign corporation. Like the existing regulations, the proposed regulations implement this fungibility principle through a three-step process under which the amount of a foreign corporation's worldwide interest expense considered to support its US trade or business is determined and allocated to ECI. Step One of the three-step process requires the foreign corporation to determine the portion of its worldwide assets which is related to its US trade or business ("US assets"). Step Two requires the foreign corporation to determine the portion of its worldwide liabilities which is considered to fund US assets ("US liabilities"). Step Three provides rules to determine the amount of interest expense attributable to US liabilities and therefore allocable to ECI of the foreign corporation.

In general, it appears likely that the new rules will result in smaller interest expense deductions for foreign corporations doing business in the United States. The following discussion summarizes the significant provisions of the proposed regulations within the framework of the three-step process described above.

II. STEP ONE: DETERMINATION OF US ASSETS

Step One requires the foreign corporation to determine the portion of its worldwide assets which is related to its US trade or business ("US assets").[2] The proposed regulations generally conform the definition of US assets with the definition of US assets for purposes of the branch tax by adopting the definition of US assets provided by Regs. § 1.884-1T(d), subject to certain modifications.[3] Under Regs. § 1.884-1T(d), an asset is a US asset if it is described in Regs. § 1.884-1T(d)(2) through (12), or if all income from the use and all gain from the disposition of such property is (or would be if the property were used or sold on the determination date) effectively connected with the conduct of a trade or business in the United States. In general, the proposed regulations would result in a smaller proportion of the foreign corporation's assets being treated as US assets than under existing regulations and, therefore, in a smaller allocation of interest expense to ECI.

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1. The proposed regulations generally conform the interest expense allocation rules with the rules included in the temporary branch tax regulations. Upon their adoption in final form, the proposed regulations should conform with recently issued final branch tax regulations.
2. Prop. Regs. § 1.882-5(b).
3. Prop. Regs. § 1.882-5(b)(1). Under final branch tax regulations issued on 10 September 1992, the cross-reference will generally be to Regs. § 1.884-1(d). Although the definition of U.S. assets has been changed in certain respects by the final branch tax regulations, those changes generally represent technical fine-tuning and will presumably apply for purposes of the proposed regulations when adopted in final form.

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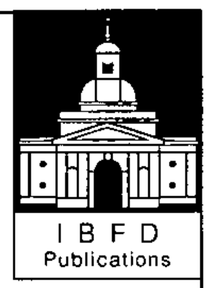

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Strict penalties on excess emissions could be balanced by measures to ensure that permits would be available for purchase in case of emergency.

5. Potential barriers to trading

For the potential economic benefits of an emissions trading programme to be fully realized, it is essential that well-functioning permit markets develop. There are three types of barriers to trading that could inhibit the development of an active market in permits:

- high transaction costs created by cumbersome and/or unclear trading rules established by the regulatory authority,
- the inability of willing buyers and sellers to identify one another, and
- the hoarding of permits.

To ensure the integrity of the system, the trading rules would have to allow for the effective monitoring of emissions and trades. However, they should not create transaction costs so high as to discourage willing buyers and sellers from trading. For example, requiring prior approval of trades would make exchange cumbersome and inhibit trading. In addition, prior approval of trades does not necessarily ensure the integrity of the programme.

There are two possible ways to ensure that potential buyers and sellers of permits would be able to find each other. The regulatory authority could publish a regular list of permit holders, identifying those that have permits to sell and those interested in buying. Alternatively, this function could be undertaken by private sector firms that could also act as brokers.

Firms that are unsure of acquiring permits on the market at a later date may be inclined to hoard surplus permits to meet future needs. They may also be inclined to hoard permits as a means of gaining an advantage over competitors. To some extent, permit markets are self-regulating against this tendency; the more permits are withheld from the market, the greater their price will be, and the greater the implicit cost of withholding. Firms would also be less inclined to hoard permits if the permits were frequently reissued. The possibility of hoarding would be avoided if permits could not be carried over from one period to the next, although it may be desirable to allow permits to be carried over into subsequent periods. The regulatory authority could promote active trading, and thus reduce the incentive to hoard, by holding back a certain number of permits and auctioning them off at intervals.

6. Banking of permits

The banking of permits would allow a company to save unused permits from one period, carry them over and apply them to emissions in a later period.

As pointed out earlier, this could inhibit permit trading, as firms might be inclined to accumulate excess permits for future use. However, banking does offer certain advantages. It prevents instability which might occur in the price of permits near the end of a trading period as permit holders attempt to unload any excess permits before they expire. More importantly, banking can accommodate businesses that experience pronounced business cycles, and can give firms more flexibility in meeting emission reduction targets or in phasing out polluting substances.

Banking can provide other advantages when the programme calls for a progressive reduction, over time, in the number of permits allocated. In such cases, it can provide an incentive to firms to invest in pollution control earlier, rather than later, and thus accumulate surplus permits to sell at what is likely to be a higher price.

IV. CONCLUSION

From this analysis of MBIs for the control of pollution, it is clear that no single instrument will be sufficient. The nature of the environmental damage and its causes will usually dictate which class of market interventions will be politically and administratively most effective. There remains a critical need for innovations to be initiated in this area of public policy. Such innovations are needed not only in the administrative, monitoring and compliance areas, but in the design aspects of such MBIs as well.

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and, environmentally speaking, it would be undesirable to allow trading which would increase emissions in the summer months.

One way in which seasonal environmental problems could be addressed within a trading programme would be to issue permits exclusively in the season in which the problem arises. Alternatively, separate permits could be issued for other times of the year in which the problem is less severe. A third option would be to issue separate permits, but to allow their trading if it would result in emissions being reduced during the season with more severe environmental problems.

In addition to seasonal variations in emissions, in the case of certain environmental problems, there may be episodes in which the concentration of a pollutant is particularly high. Weather conditions, for example, can lead to episodes of high concentrations of ozone during the summer months. It may be desirable to incorporate the possibility of implementing supplementary controls in the trading system that could deal with such short-lived or episodic problems.

3. Initial allocation of permits

When a trading programme is first launched, the total number of permits must be allocated among the sources of pollution included in the programme. Two options for the initial distribution are worth considering. One is to allocate the permits to existing emission sources based on historical emissions. In this case, the ultimate distribution of the permits would be determined by the market as licence holders buy and sell their permits. The other option is to hold an auction, in effect leaving the distribution to the market right from the start of the programme.

Distribution on a historical basis requires choosing a period to serve as the basis for the initial allocations. The period should be recent enough for the allocations to be consistent with current output levels, thereby enabling firms to carry on their business. It should not, however, be so recent that firms could have knowingly increased their emissions in order to increase their initial allocation. The period could be a several year average. This would compensate for temporary fluctuations in emissions caused by business cycles and shut-downs. In finalizing initial allocations based on the historical period, adjustments should be made to take into account any prior emission reduction actions taken by firms, in order not to penalize those that have already restricted emissions.

An auction would require the sources of pollution to pay for permits. The market would, in effect, determine the initial distribution among the firms. This would relieve the regulatory authority of the necessity of determining the number of permits to issue to each source according to the type of procedure discussed above.

From the standpoint of realizing the potential economic benefits of a trading programme, there is little difference between the two options. Auctioning, however, may encourage the potential benefits to be realized sooner. For example, auctioning, if announced well in advance, can encourage corporations to compare the expected costs of purchasing permits with the costs of investments in pollution abatement. It is true that these cost comparisons and the appropriate investments would eventually be undertaken under a functioning trading market regardless of the initial means of distribution. Nevertheless, under an auctioning system, these results might be realized sooner.

Auctioning can, however, create a set of market structure problems that must not be ignored:

- If the permit market is dominated by a small number of large firms which compete with smaller firms in the product market, the large firms could seek to bid up the price of permits as a means of driving their weaker competitors out of business. Distribution on the basis of historical emissions might be preferable to an auction in such cases of market power.
- Auctioning creates more uncertainty for the sources of pollution than allocation based on historical emissions. Auctioning is likely, therefore, to be less acceptable to industry.

It is interesting to note, however, that the method of initial allocation of permits does not affect the congruity between a tradeable permits system and the polluter pays principle. Irrespective of how the permits are distributed, the polluter bears the cost of cutting back emissions.

The initial allocation of permits will also determine the tax treatment from the perspective of both buyer and seller. If the permits are auctioned, it is very easy to determine the cost basis of the permit. However, if the permits are distributed based on historical emission records, the cost basis is more difficult to determine, and in most cases may be taken to be zero, with subsequent sales being taxed as either capital gain or operating income based on the sales realization.

The depreciation treatment of pollution permits is dependent on the life of the permit. These issues will depend on seasonality, permit banking, etc. The United States, which has the most experience with pollution permits, has not resolved these issues completely, and it stands as one of the main drawbacks to trading.

4. Monitoring and enforcement

Once established, a trading programme would require two types of monitoring. These are (i) the monitoring of emissions, as required under any regulatory programme, and (ii) the monitoring of trades. Under current regulations in most countries, large-scale sources of pollution — which are the kind most likely to be included in a tradeable permits programme — are often responsible for monitoring and reporting emissions on a regular basis. This would continue under a trading programme as well. Additionally, these sources should be required to report any trades.

The integrity of the system would require the establishment and enforcement of penalties for exceeding the emission levels allowed by permits. The penalties should be high enough to be an effective deterrent to wilful violations over an extended period, but not so high as to impose an unfair burden on companies that produce excess emissions in a given period for reasons beyond their control.

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be established in local communities or existing service stations and other commercial businesses could be used as collection points.

Under the first option, where special local depots would be established, efforts must be made to ensure that they are individually able to accumulate used oils in quantities large enough to be serviced by the oil reprocessing facilities. The depots could also serve as collection points for other products. This would reduce the fixed-cost distribution for all products involved, while at the same time increasing convenience for consumers and making collection potentially more successful for all products.

Under the second option, collection depots could be established at existing service stations and other small lubrication operations. Some of these outlets may already have a contract with a collection service and, therefore, they may be equipped with the necessary holding facilities. For others, the facilities would have to be built. The advantage of using an existing facility, such as a service station, is that people would find it more convenient to use it, thereby generating a higher recovery rate. On the other hand, however, such service stations might be discouraged from participation for fear of receiving oil contaminated with counterfeit substances.[38] In general, difficulties associated with detecting adulterating substances would pose a serious problem for the deposit refund system for lubricating oil.

Similar schemes may be designed to encourage the safe disposal of industrial solvents and other toxic chemicals. It is necessary to ensure in all these cases that the deposit be large enough to serve as an incentive to bring the solvent to the collection centre for disposal.

C. *Tradeable pollution permits*

Under this approach, the responsible regulatory authority sets a ceiling on total allowable emissions of a pollutant. It then allocates the allowable emissions total among the sources of the pollutant. It does this by issuing permits which authorize plants or other sources to emit a stipulated amount of the pollutant over a specified period of time. Permits can be bought and sold; hence the name "tradeable permits".

Tradeable permits have been used in the United States for lead-permit trading among refiners during the phase-out of leaded gasolines. Under this system, refiners were allowed to trade lead reduction credits. These credits were generated when refiners reduced the lead in gasoline by more than the amount required under the regulatory programme. A trading programme is used for reducing water pollution in the Fox River in Wisconsin.

In 1988, a system of fully tradeable CFC production permits was introduced by the United States as part of its programme to phase out CFCs. Permits were issued to producers and importers in proportion to their 1986 production or import levels. Under this system, the number of permits declines over time in step with the phase-out schedule. There are no restrictions on the use of CFCs produced within the permit limit.

In the most ambitious trading programme undertaken so far, the 1990 amendments to the US Clean Air Act established a comprehensive tradeable permits system for SO_2 emissions from electric utilities. The first phase of the programme, which begins in 1995, targets the power plants with the highest rates of SO_2 emissions. In 2000, the number of permits or allowances will be reduced, and the programme will be extended to all power plants.

Tradeable permits offer a number of advantages:

(a) there is a high degree of confidence that pollution control targets can be met,
(b) the scheme is flexible enough to accommodate growth in the industry without compromising environmental quality, and
(c) since the scheme deals with quantities (i.e. total pollution loads) rather than prices, it is insensitive to inflation. In contrast, environmental taxes, which are normally specific, need to be regularly indexed to inflation.

The scheme also has a number of limitations. In order to realize the full benefit potential of tradeable permits, it is important that the permits be made freely tradeable within individual industry groups and between industries. Usually, some restrictions are necessary to prevent abuse. However, the success of the tradeable permit programme depends critically on the number of sources available for potential trades. The greater the number of sources targeted by the permit programme, the greater the likelihood of free competitive trading.

To achieve competitive trading, the following design issues are important:

1. Definition of the trading area or zone

A trading area or zone is the geographical area within which sources of a given pollutant would be allowed to buy and sell permits.

From the perspective of environmental protection, the ideal trading zone is one that encompasses an area throughout which emissions can be traded without exacerbating the environmental problem in any one portion of the area. Thus, the definition will depend upon the extent of environmental impact, i.e. whether it is localized or more widespread. Ideally, each zone should cover an area in which the environmental problem is similar.

Another factor in the definition of trading zones is the amount of emission per zone. In order to realize all the potential cost savings from emissions trading, there must be a sufficient number of sources in each trading zone to create an active market in the buying and selling of permits.

Related design issues concern the mediation of trading between zones.

2. Seasonal and episodic controls

Some environmental problems vary greatly by season. For example, ground-level ozone is mainly a summer problem

38. Robert Anderson, Lisa Hofmann and Michael Rusin, *The Use of Economic Incentive Mechanisms in Environmental Management*, Research Paper No. 051 (Washington, D.C.: American Petroleum Institute, June 1990).

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Energy Conservation: Before examining this argument in greater detail, it is useful to draw a distinction between reuse and recycling. Recycling is a general term that does not always imply the reuse or refilling of the same container. Deposit refund systems always encourage recycling, but their effect on energy conservation may depend on the form of recycling.

In the case of aluminum or steel beverage cans, the cans are always melted down and the metal recycled. Recycling aluminum cans in this manner saves 95 percent of the energy required to manufacture them from raw materials.

However, in the case of glass bottles, the level of energy conserved (or the incremental energy expended) can depend on whether the bottles are crushed for remelting or refilled. It has been argued that refillable bottles may actually result in more net energy consumption than crushing the glass and recycling them since the sanitization process for refillable containers requires water that needs to be heated, thus increasing energy consumption.[35] It is also argued that shifting to refillable bottles will increase transportation costs.

The above point is made only to show that the concern over the level of energy conservation should not be central in influencing the decision to introduce a deposit refund law. More substantively, the energy conservation debate can be used to consider policy choices between making the use of refillable bottles mandatory versus allowing the decision to be made privately in the market.

2. Lead acid batteries

Lead acid batteries are often improperly disposed of in some of the wealthy industrialized countries. Most of the lead which enters landfills and incinerators in the United States comes from storage batteries.[36] Although a substantial amount of lead from motor-vehicle batteries is recycled in the US each year, the share of batteries recycled has been decreasing during the last 30 years.[37]

A deposit refund system for lead acid batteries is attractive primarily because it encourages the safe disposal of lead acid batteries. More specifically, it prevents lead from being leached from unlined landfills or being emitted into the atmosphere from incinerators. Encouraging the recycling of lead from batteries is a possible secondary objective.

Under a deposit refund system, a deposit would be collected as a tax when manufacturers sold batteries to distributors, retailers or original equipment manufacturers. Retailers would collect their deposits by returning their used batteries to redemption centres, which would, in turn, redeem their deposits from the administering agency. The deposit must be large enough to encourage a substantial level of return, but small enough to avoid a significant theft problem.

A similar deposit refund scheme may be used for car bodies, rubber tires and objects such as refrigerator shells. In all these cases, the toxic nature of the object is not of concern as much as the litter and solid waste problem. The unpleasing sight of rusting car hulks in open public spaces is probably familiar to most people. This gets to be a problem because individuals in many countries have to pay to have automobiles disposed. However, if the price of the car included a deposit that would be collected as a tax and refunded at the time of disposal, at specifically designated facilities, there would be a strong incentive to claim the refund at the end of the automobile's useful life.

3. Used lubricating oils

The improper disposal of lubricating oil has both health and ecological consequences. The most serious problems occur when it is dumped into storm sewers or placed in unsecured landfills, contaminating ground and surface water supplies. To a lesser extent, it causes air pollution when burned as fuel.

The two principal sources of used oil are the industrial sector and the automotive sector. A large share of the used oil generated by the industrial sector is reused internally, for example, as fuel in industrial generators and boilers, or collected for reprocessing or recycling.

The automotive sector includes service stations, oil change outlets, the farm/rural sector and independent small transport companies. Some of the used oil generated by this sector, particularly by the larger commercial operations, is now collected for reprocessing or recycling, although a much larger share could be recovered from commercial automotive sources. Most of the oil generated by the oil change outlets, the farm sector and small transport companies is inappropriately discarded. Even if these disposal practices were made illegal, the possibility of being caught and fined is very low.

There is a market for some of these used lubricating oils and some enterprises offer centrifuging and re-refining facilities to remove impurities. In some cases, the oil, while unsuitable for its original use, can be utilized as a fuel. In cases where the reprocessed oil can be used for its original purpose, the economic benefit is greater. Unfortunately, in most countries, these reprocessing facilities are readily available only in some of the bigger industrial or urban areas. In addition, the collection of these oils is often restricted to the larger industrial sector, which, as pointed out earlier, is not the principle source of improper disposal.

A deposit refund system for used lubricating oils should focus on the smaller sectors. The simplest version of such a programme would require consumers to pay a deposit to retailers for each quart of oil purchased. They could then receive a refund when they returned the used oil to redemption centres. The programme design should ensure that the existing enterprises engaged in the collection of used oils from the large industrial and commercial service sector are not affected.

Two options are available for the structure of deposit refund schemes for used oils. Collection depots for used oils could

35. National Soft Drink Association, *Forced Deposit Laws ... There are no Winners*, USA (1985).
36. See Stavins and Whitehead (1992), at 28.
37. In 1955, the recovery rate of used motor-vehicle batteries was over 90%; by 1988, it was approximately 75%. Annual fluctuations around this trend, however, have been substantial and are closely linked to prices of virgin and refined lead. See Putnam, Hayes and Bartlett, Inc. *The Impacts of Lead Industry Economics on Battery Recycling* (Cambridge, Massachusetts: June 1986), Report to the Office of Policy Analysis, US EPA.

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the cost-efficiency and design issues often differ due to implicit public policy concerns or objectives, as well as the physical peculiarities of the substance itself. We will thus deal with each of the above cases in turn in order to address the design methods of a workable deposit refund scheme.

1. Beverage containers

Deposit refund schemes for beverage containers have been used as measures to control litter and encourage recycling.

Typical deposit refund legislation for beverage containers would need to address the following design aspects:

- The need for a definition of the term "beverage" that would often explicitly exclude dairy products, natural fruit juices, wine and other alcoholic beverages except beer.[30]
- The law could also prohibit the sale of such beverages in disposable containers. A disposable container may be defined as one not intended or designed for return or reuse. Alternatively, a higher tax could be imposed on disposable containers. Unfortunately, this would mean higher administrative costs.
- A refund value that would be added to the price of the beverage should be established. Consumers who purchased the beverage containers would thus pay the price of the refund value, in addition to the standard sale price.

  The refund value can be of either a single or multiple-tier type. A single-tier refund sets a single refund value for all containers. A multiple-tier refund would distinguish containers based on certain characteristics and establish differential refund values. For example, (i) containers made of particularly desirable raw materials could bear lower deposit values, while all others would require a higher mandatory deposit, and (ii) containers reusable by more than one beverage producer could also be eligible for a lower deposit.

  The administrative complexity of a system would increase in direct proportion to the number of such differentiated rate schedules. However, the differentiated rate structure ideally provides environmentally more appropriate incentives.
- A scheme for the redemption of the deposit on containers that are returned should be defined. Usually, dealers[31] and certified redemption centres would be required to receive empty containers and refund deposits.

  The redemption scheme may be varied to suit the particular circumstances and needs of the retailing sector. Issues to be considered include:
  - whether dealers should accept only beverage containers of the "kind, size and brand" sold, or whether they should be required to accept all containers carrying deposits;
  - whether dealers should be compensated, by means of a handling fee, for their effort, cost of storage, etc.;[32]
  - whether dealers should be allowed to refuse beverage containers that are not clean when returned, (and if so, what should the appropriate standards of "reasonable" cleanliness be).
- Standards for container labelling should be set. The labelling requirements depend largely on the type of deposit-refund structure, i.e. the number of tiers, etc.
- Penalties that may be imposed on manufacturers and dealers who do not follow the requirements laid out in the deposit refund law need to be established.
- Responsibility for the implementation, monitoring and enforcement of the programme should be given either to a single bureau or to a group of public agencies.

There are many arguments both for and against deposit refund schemes for beverage containers. For each argument, there have been a substantial number of counterarguments, which to some extent explains why such schemes have been legislated in only nine US states. The arguments are often based on volumes of statistics advanced by both the proponents and opponents. These statistics are, understandably, contradictory and any public policy decision will have to take into consideration the specific circumstances in each nation. The following discussion draws on some of the arguments that have been used in the United States.

Litter Control: Deposit-refund systems have been fairly effective in curbing litter in public places and other locations. In a number of US cities, the litter from beverage containers has been substantial, with volumes of up to 60 to 70 percent of the total. The deposit refund systems have reduced litter volumes by 30 to 61 percent in states that have adopted such schemes. The reduction in beverage container litter alone ranges from 75 to 85 percent.[33] In New York, litter control costs have been reduced by $ 50 million since the deposit refund bill was passed, while in Maine, cleanup costs have been cut in half since the deposit law took effect.

Solid Waste Reduction: Solid waste disposal has in recent years been faced with the combined problems of high-cost and the lack of available landfill space. The argument that deposit refund schemes reduce solid waste and, therefore, provide indirect cost savings has, however, not been very credible. Beverage containers form only a small percentage of total solid waste volume. In the United States, bottles and cans account for no more than five percent of the total solid waste volume. Thus, a national deposit refund system may decrease total solid waste volume by no more than two percent.[34] Thus, although a deposit law may reduce solid wastes to a greater or lesser extent, based on national consumer profiles, the issue concerns whether or not the reduction in itself warrants the adoption of a programme that will force the beverage industry to modify the way it produces, distributes and sells beverage containers.

30. Senate Bill 38, Sec. 10-213.4, Virginia General Assembly, United States.
31. Persons engaged in the sale of beverages and beverage containers to consumers.
32. Most states in the United States with mandatory deposit refund schemes have instituted a handling fee equal to 20% of the value of the deposit.
33. Environmental Action Foundation, Briefing Papers: Litter Reduction 2, as quoted in Weinberg (1987).
34. See Perry Weinberg, "Mandatory Deposit Legislation in Virginia: Recycling the Bottle Bill", *Virginia Journal of Natural Resources Law*, Vol. 7 (1987), at 194.

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than unleaded gasoline because it is environmentally more damaging.

Environmental taxes on inputs have three important advantages:

- They do not require the monitoring of the levels of emissions, effluents or waste leaving each source of pollution. This means that the costs of implementing and administering an input tax can be smaller than that for an emissions or effluent tax. For example, excise taxes imposed on motor fuels at the refinery gate are administratively simple. These taxes also provide some price incentive to conserve fuels and, therefore, reduce vehicle exhaust emissions.
- Since an excise tax on pollution-generating inputs can be collected directly from the producers of these inputs, it is likely that the number of taxpayers will be considerably less than in the case of an effluent tax.
- By changing the relative prices of various inputs, this approach can encourage firms to use the taxed input more efficiently and to switch to untaxed inputs that are better for the environment. Over the long term, the charge can continue to encourage firms to change their input mix and to invest in the development of environmentally preferable inputs and more efficient technologies.

The United States and Denmark have imposed taxes on chloro-fluoro carbons (CFCs), which are ozone-depleting chemicals used as refrigerants for cooling applications and also as solvents in the production of semiconductors. These taxes have been difficult to administer because they also raise complex issues, such as determining the treatment that should be accorded to imported products containing CFCs. Strictly, these imports should also be taxed to avoid giving imported goods a competitive advantage. However, applying a suitable charge to each of these products can be a difficult task if the technical information on the manufacturing process employed is not available.

It may also be difficult to apply an input tax when some inputs or uses are much less damaging than others. Under these circumstances, the most appropriate tax structure would be one with differentiated tax rates. In practice, however, there may have to be some trade-offs the various mechanisms that can be technically designed into the structure of the charge in order to achieve a given environmental target.

(c) *Environmental taxes on final products*

Environmental taxes on final products are best used to combat environmental problems closely linked to consumer demand for certain products or commodities. A tax on final products raises the tax-inclusive price so as to better reflect the total costs associated with the production, consumption and/or disposal of the product.

Examples of this approach would include imposing a tax on certain commodities that add to the flow of solid waste, such as disposable products that compete with reusable alternatives.

One of the significant benefits of a well-designed product charge is the direct relationship it has to the preferences and choices of the consumer. Product taxes increase consumer awareness of the environmental implications associated with the use of a particular product or commodity. Product taxes also allow flexibility in consumer response. Some may prefer to conserve or reuse existing supplies, while others may shift to alternative products that are better for the environment.

Compared to other types of environmental taxes, a final product tax may be more easily adapted to address concerns about international competitiveness. If a tax is imposed on a final product, it can easily be accompanied by a corresponding duty on imports and an exemption for exports. This can be done without the complex tax structures needed to achieve similar results through emissions or input taxes.

B. *Deposit refund systems*

Deposit refund systems link special front-end charges or deposits, which are refundable when quantities of the substance in question are turned in for recycling or proper disposal. These schemes are intended to achieve some or all of the following objectives:

- protect public health and welfare,
- encourage recycling,
- reduce the burden on solid waste disposal systems, and
- reduce litter.

A common example of the deposit refund system is the one used for beverage containers in the United States. The refund provides the consumer with the incentive to seek proper disposal of containers, i.e. bottles and/or cans. Since 1971, most states in the United States have at least considered some form of a deposit refund bill on bottles and cans, while nine states have succeeded in enacting such a bill.[29] There have also been efforts to establish a nationwide programme requiring mandatory deposits.

Deposit refund programmes have been proposed for a variety of materials, including vehicle tires and car bodies. The strongest case is made, however, for products with very high costs of improper disposal, e.g. lead acid batteries, industrial solvents and used lubricating oils. In these instances, the toxicity of the waste is of particular concern. Waste-end fees such as user charges for garbage disposal are not totally appropriate because these materials require special handling. Further, raising these waste-end fees to cover the costs of disposal can increase the likelihood of illegal dumping of these substances. The ecological consequences of such illegal dumping, especially due to their toxicity and associated clean-up problems, can be substantial. Input taxes, as discussed in the earlier section, may provide incentives to use less of the substance or encourage the search for cheaper substitutes, but will not solve the problem of improper disposal or illegal dumping. Deposit refund systems, therefore, represent a cost-effective way to manage these categories of toxic wastes and other hard-to-dispose objects like car bodies and tires.

Deposit refund schemes can be structured to handle a variety of substances or consumer goods, including beverage containers, e.g. bottles and cans, lead acid batteries, used lubricating oils and other industrial chemicals. In each of the above cases,

29. The states are Vermont, Maine, Massachusetts, Connecticut, Delaware, New York, Michigan, Iowa and Oregon.

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times the ozone depletion factor for the chemical. The ozone depletion factor for each chemical is fixed and specified in the law and the base tax rate is revised as required. The tax is imposed at the time the manufacturer or importer sells or uses the ODC.

The above definition of the base is fairly simple and is easily applied when the ODCs are used in a virgin state. However, complexities arise whenever (i) an ODC has been used in the manufacture of an imported product because determining a reasonably accurate countervailing tax would require detailed information on the actual manufacturing process employed, or some other means of calculating a presumptive levy based on similar products manufactured domestically, and (ii) the ODC is a feedstock in a process where it is totally consumed or transformed so that there is no ozone-depleting effect. In this case, the issue is whether or not an exemption should be granted.

4. The tax rate

Setting an appropriate rate for the environmental tax can be a difficult operation. Ideally, the rate should raise the costs of using an environmental resource so that it reflects costs imposed on third parties. As discussed, however, this approach rests on the unrealistic assumption that one can identify and assign monetary values to all the externalities linked to the use of an environmental input. A next-best approach is to set the rate according to a predetermined target for the environment and the anticipated response to various changes in price signals.

In selecting a tax rate, it is also important to distinguish between long-term and short-term objectives and responses. In general, the long-term response to a given tax rate is likely to be larger because it will include the changes in capital stock and durable goods that can benefit the environment. This suggests that an environmental tax that sets out to encourage changes in patterns of production or consumption over a number of years can be effective at a lower rate than one intended to achieve major results in the first year or two.

(a) *Environmental taxes on emissions, effluents or solid waste*

Environmental taxes can be imposed on airborne emissions, water effluents or solid waste at the point of release into the environment. This is the most direct way to apply a charge on harmful pollutants or waste materials. One example of this type of approach would be a tax on the emissions of common industrial air pollutants, such as sulphur dioxide (SO_2). For the management of water resources, an environmental tax could be levied on the discharge of certain chemicals, suspended solids and other substances into rivers, lakes and other bodies of water.

This type of environmental tax can achieve a close link between the amounts payable under the tax and under the environmental resource. For producers, the tax would cause an increase in costs at each level of production. Under normal conditions of supply and demand, the charge paid by producers would also move through the price system to product markets. As a result, the prices of final products would better reflect environmental costs and consumers would be encouraged to switch to products that were less harmful to the environment.

This approach has the additional advantage of allowing producers complete flexibility in choosing the most cost-effective method of reducing their discharges, whether over the short-term or over longer planning horizons. Therefore, any changes they make to their equipment or production patterns in order to reduce the pollutants in question can reduce their payments of the charge.

International experience with these taxes has shown them to be of limited use in the development of effective incentive-oriented charges. The country with the most experience with emission taxes is France and studies have shown that the rates were set too low to provide much of an incentive for improving environmental decision-making.[27] It was found that to have the desired effects, their levels would in most cases have to be quadruple the current levels.

Germany has been using a system of effluent taxes that combines a basic regulatory approach with an environmental tax. Producers who meet certain pollution reduction standards are permitted to pay a lower rate of charge on their emissions. Those who do not meet the standards for their sector are required to pay the full amount of the charge on all of their discharges.[28]

Administratively, higher rates are found to require complex tax structures and administrative mechanisms. Low rates enable governments to adopt simple estimating procedures for applying the taxes. Taxes based on actual discharges are considered to involve higher costs of administration and enforcement. The issue of enforcement is crucial since a heavy charge on the disposal of certain substances or materials generates an incentive for polluters to look for ways to avoid paying the charge. Some of these responses can be environmentally damaging, as is the case with illegal dumping. When this practice involves hazardous wastes, the environmental costs of this form of cheating can be heavy. Controlling these types of environmentally damaging behaviour can require costly enforcement measures that go beyond the administrative procedures of existing tax systems.

One of the possible ways of reducing the costs of administration and enforcement is to apply the environmental tax on inputs or products, rather than on emissions or effluents.

(b) *Environmental taxes on inputs or materials*

Where taxes on effluents or emissions pose major problems for design or implementation, a charge levied at an earlier stage in the pollution cycle may be the preferable approach. In some situations, it may be more practical to impose the charge on certain inputs or materials. This type of charge may be set according to the input's potential to generate emissions, effluents or solid waste. If some inputs to production processes are more damaging than others, it may be possible to develop a set of tax rates that recognizes these differences. For example, leaded gasoline may be taxed at a higher rate

27. D. Olivry, *OECD Case study for France*, ENV/ECO/86.10.
28. *Supra* note 22, at 929-966.

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Another issue is the administrative difficulty involved in making a clear distinction between what should be subject to the charge and what should be excluded. Experience with the manufacturer-level taxes, such as excises and sales taxes, has shown that these definitions will be tested over time by various businesses and taxpayers. The result of these challenges can shift the definitions in unintended directions unless it is possible to legally defend the distinction.

The base definition issues associated with taxes on input materials and final products are similar to standard sales and excise taxes.

Defining a base for environmental taxes on emissions, effluents or solid waste raises measurement and monitoring issues that are unique. One of the major distinctions in the case of effluent taxes is that substances that have no intrinsic value are being taxed. These substances leave no traces of recorded monetary transactions and provide no incentive for storage. Further, physical constraints eliminate the storage option. For example, it is virtually impossible to store air pollutant emissions for periodic stock measurement nor is it practical to have firms store effluents in specially built containers. Consequently, measurement needs to be conducted on a flow basis. More importantly, there is only a single time and event (taxable transaction) that can be used for determining the tax. In this case, it is the moment the effluent or air polluting emission is discharged.

In the case of environmental taxes on input materials or final products, there are a number of potential taxable events. Goods can be taxed when manufactured or sold. Here again, there are options as to the sale amount at which the tax may be imposed. Although some potential transactions are more favourable from the standpoint of administrative ease, the presence of others allows for audit checks or verification.

Measurement often poses a problem in the case of effluent taxes. Most finished goods and inputs have well-defined standards and tools for measurement. Effluents and emissions are more difficult to define because it is not the simple volume of discharge that is important, but rather the constituent pollutants that are present in the discharge. Effluent tax base definition must, therefore, include an explicit set of measurement procedures and standards to ensure uniformity and fairness in tax application.[20] This is both to avoid having to constantly deal with disputes that could arise, as well as to provide an objective legal basis for resolving disputes that do arise.

Two examples of base definitions in existing environmental taxes are considered below:

- effluent charge base definition in Germany, and
- excise tax base on ozone-depleting chemicals definition in the United States.

(a) *The definition of the effluent charge base in Germany*

The German Effluent Charge Law (ECL) provides the states (i.e. "Lander") with the power to levy charges on direct discharges into public waters of specified effluents.[21] Firms and households discharging into municipal sewage facilities are not charged directly.[22]

The German example has shown that for a charge to be successful, it should be restricted to a limited number of readily identifiable effluents. The ECL contains all the data needed to calculate the waste water discharge bill or tax. The pollutants considered for purposes of effluent charges are settleable solids, chemical oxygen demand, cadmium, mercury and toxicity for fish. In the first step of base definition, the ECL establishes the discharge right and includes all the physical, chemical and biological data and monitoring procedures pertaining to waste water quality.[23] This part of the law also serves to establish the measurement procedures in case of a dispute.

For each firm, the state also specifies a total discharge, based on historical volumes, of waste water allowable per year. Since the effluent charge is combined with a permit procedure, maximum effluent levels are also specified. The actual effluent discharged by the firm must be of a quality equal to or higher than the minimum requirements laid out in the administrative regulation. The taxable base is specified in terms of concentration per cubic metre of discharge volume or per ton of product produced.[24] A firm's discharge is then converted into damage units using coefficients provided in the law. The tax liability is determined by multiplying the number of damage units by the tax rate per damage unit. This tax rate is revised annually based on an established increment.[25] To provide an incentive to limit one's pollution load, higher charges are imposed per damage unit if firms exceed the permit limit. These excesses are allowed only twice a year. Lower charges per damage unit are used to compute the total tax liability for those who discharge below permit limits.

(b) *Definition of excise tax base for ozone-depleting chemicals*

Following the signing of the Montreal Protocol on Substances that Deplete the Ozone Layer, provisions aimed at reducing the use of such chemicals were included in the US Revenue Reconciliation Act of 1989.[26]

The above provisions impose an excise tax on ozone-depleting chemicals (ODCs) sold or used by manufacturers, producers or importers of these chemicals or by the importers of any products manufactured using ODCs. The tax is the product of the chemical's weight (in pounds) times the base rate

20. To illustrate the problem with measurement, take the example of sulphur dioxide in air pollutant emissions. The reading taken by the same instrument placed in a chimney can change based on its distance from the inner wall of the chimney. The readings can also be affected by the orientation of the device to the direction of gas flow. Clearly this does not make an emission tax a simple tax to monitor.
21. Abwasserabgabengesetz (1976), i.e. Effluent Charge Law (ECL) Art. 3(1).
22. For a more detailed discussion of the ECL, see Gardner Brown Jr. and Ralph Johnson, "Pollution Control by Effluent Charges: It Works in the Federal Republic of Germany, Why not in the U.S.", *Natural Resources Journal*, Vol. 24 (October 1984).
23. ECL Art. 4(4).
24. For example, chemical oxygen demand (COD), mercury and cadmium discharges are based on production volumes, whereas settlelable solids and toxicity towards fish are based per unit of wastewater discharged.
25. ECL Art. 9(4).
26. Secs. 4681 and 4682 of the Revenue Reconciliation Act 1989, effective 1 January 1990, outline the taxation of the sale and use of such ozone-depleting substances. The IRS has provided guidance for implementing the excise tax on ozone-depleting chemicals (ODCs) in Notice 90-8, IRB 1990-5, 14, and Notice 90-9, IRB 1990-5, 21.

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in which one activity leads to emissions of various pollutants and any measures designed to limit the production of one pollutant can affect the emissions of others. Under such conditions, decisions about what constitutes an appropriate charge on one pollutant must take into account measures planned to reduce other emissions.

In addition, it is important to create a close link between the tax and those decisions that have an important bearing on a given environmental objective. In some situations, the most appropriate tax structure may be a system of charges covering a wide variety of decisions or activities. In other situations, the most promising approach may be to target the environmental tax on a specific problem or area of decision-making that is not being adequately addressed by other measures.

2. Selection of competent authority

The most critical determinant of an effective tax is that a competent authority legislate, implement, monitor and enforce the tax. Although these functions may be conducted by more than one agency, it is necessary that the final authority be vested in a single entity.

The competent authority is required to ensure the following:

- It should facilitate a fair dispute resolution procedure. This is an important way to increase the public acceptability of the tax.
- It should allow for uniform base definitions and rates of taxation across the geographical boundary in question.[16] It is important that the principles on which the environmental tax is based be applied uniformly. Distortions in trade and competition are thereby avoided.
- In instances where a sovereign government has to negotiate internationally about cross-border environmental concerns, applications of countervailing duties on imported goods in cases where the domestically-produced goods bear environmental tax burdens, bilateral tax conventions, etc., it is necessary that a single authority be available to make decisions.

The choice of whether the authority that would bear responsibility for legislating and implementing an environmental tax should be federal, state or municipal is wholly dependent on the existing constitutional division of power, as regards taxation and environmental law, between the federal and local governments. It is not possible to define an ideal authority framework because circumstances vary based on national constitution, size of the nation, existing structure of administrative law, etc. Below is a brief discussion of the division of taxation powers in the United States, which has a federated government structure.

In the United States, for example, water pollution control had been dominated by state regulation until the mid-1960s. By then, however, it was apparent that state regulation was failing to achieve the kind of water pollution control desired by the public. At first, federal intervention was gradual. In the Water Quality Act of 1965, Congress sought simply to oversee state regulation and made no attempt to regulate waste discharges directly. In 1969, the federal government allowed the Corps of Engineers permit system to regulate directly the discharge of wastes into public waters by industries. In 1972, the federal government changed the rules of the game entirely, taking over the responsibility for water pollution control from the states and essentially reversing the federal/state roles. Thereafter, state regulation is allowed only under strict federal supervision.[17]

The courts have supported this expansion of the federal government's role in the environmental law field, as well as other areas of social and economic regulation. They have done so via an increasingly broad interpretation of Article I, Section 8(3) of the federal constitution, the so-called "commerce clause".[18] This clause states that Congress has the power "to regulate commerce with foreign nations, and among the several states...".

This broad interpretation has given the US Congress ample powers to make laws concerning environmental policy. The states also have the legal power to enact effluent charge laws if they choose to do so. However, they traditionally have enacted most of the legislation in the health and environmental fields. Even if a state chooses to enact a particular environmental tax, it would have to ensure that it did not violate the "dormant" commerce clause. This clause ensures that the impact on interstate commerce is not unreasonable, an extremely important consideration since environmental taxes can affect location and production decisions of firms. It is interesting to note that most federal legislation in the environmental field provides that state laws on the same subject are not preempted if they are more strict than the relevant federal act.[19]

At the same time, there are valid arguments for allowing a state more flexibility in determining the level of the charges. In other words, having a federally legislated uniform environmental tax across the entire country may not be optimum. It might be desirable to allow states or local governments to have some flexibility in varying the charge by a certain amount, either above or below the standard set.

3. The tax base

The environmental effectiveness of a tax will depend on whether or not it is possible to define a suitable base for the charge. In this regard, imposing a tax on certain substances, but not on harmful substitutes, would raise questions about the environmental implications, economic costs and fairness of the charge. Moreover, the task of determining what should be included in the tax base is difficult when there are great uncertainties regarding the scientific properties, environmental implications and practical applications of various substances and products. The problem, of course, is not restricted to environmental taxes; it also comes up in relation to regulations, tradeable permits and other instruments.

16. This geographical boundary should effectively encompass the zone of environmental concern. It could be as a small local government jurisdiction or extend across a nation or group of nations (e.g. the EEC).
17. U.S. Public Law 92-500, 86 stat. 880 (codified as amended at 33 U.S.C. Sec. 1342(b)(1982)).
18. See, e.g.,*Wickard v. Filburn*, 317 U.S. 111 (1942); *Perez v. United States*, 402 U.S. 146 (1971).
19. See, e.g., Clean Water Act, 33 U.S.C. Sec. 1370(1982); also, Resources Conservation and Recovery Act of 1976, 42 U.S.C. Secs. 6948, 6947(1982).

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estimate the full extent of environmental damage because it is widespread, often not easily quantifiable, and takes a long time to accumulate.

A more workable system of setting charges is one based on ambient standards. This can be accomplished in two stages. First, technical experts describe the consequences of different levels of ambient quality, for example, human health at different levels of ambient sulphur dioxide. Then, a target level of ambient quality is chosen and a charge for emissions is set at the level necessary to attain this target. The level of the charge for each area necessary for achieving the target level of air or water quality is obtained by estimating the relationship between different charge levels and the emissions from different sources based on the average marginal costs of these sources.[15]

III. ENVIRONMENTAL TAXES, DEPOSIT REFUND SYSTEMS AND TRADEABLE POLLUTION PERMITS

A. *Environmental taxes*

Environmental problems can arise when the market system fails to establish appropriate price signals and incentives in relation to environmental resources. For instance, some of these resources can be used "for free", although their use imposes external costs in the form of water pollution, reduced air quality or other environmental consequences. In some cases, the market price that does prevail covers the private costs of an environmental input, but not the external costs incurred by third parties. When environmental resources are underpriced in this way, producers and consumers are likely to make excessive use of these inputs relative to others that are higher priced. Underpricing also provides insufficient incentives for the development of new technologies to control environmental pollution.

An appropriate environmental tax can compensate for these deficient market signals by raising the price of using environmental inputs to a level that better reflects the total, private and external, economic costs of these resources.

Environmental taxes can be levied on:
- emissions, effluents, or solid waste being released into the environment,
- inputs or materials known to be a source of environmental pressures, and
- final products linked to environmental degradation.

A well-designed environmental tax has great benefits. It confers on producers and consumers the flexibility needed to minimize the costs of achieving a given environmental goal. Faced with an emissions tax, for instance, each firm can compare various ways of reducing emissions and choose the solutions that match its circumstances. The range of possibilities might include changing the product mix, modifying production technologies or installing equipment that can filter or clean the "end-of-pipe" emissions. To the extent that different firms can have different costs for pollution abatement, a charge can encourage firms facing lower abatement costs to go further in cleaning up their operations. In this way, an overall environmental target can be achieved for the whole economy. By comparison, traditional regulations tend to be more costly to the economy, particularly if all firms are required to adopt the same method of pollution control.

Price incentives generated by environmental taxes have long-term consequences. An environmental tax encourages the long-term development and use of "cleaner" processes and products. Regulations offer no comparable incentives for firms to develop and adopt more effective pollution control techniques once the regulatory requirements are met. Moreover, as mentioned earlier, regulated firms may be unwilling to support the development of better abatement technologies.

In some situations, an environmental tax may have advantages over a system of tradeable permits. Taxes raise the cost of pollution while allowing pollution levels to be determined through market mechanisms. A permit, by contrast, sets the level of pollution and leaves the costs (in the form of a market price for permits) to be determined by the market. In the case of an environmental charge, therefore, the polluter knows up front both the costs of investing in pollution abatement and the tax that is payable on continued levels of pollution. In a tradeable permit system, however, the polluter does not have advance knowledge of the price that the market will eventually assign to the permits.

Design issues

The prospects of realizing the potential benefits of environmental taxes depend on the following technical and legal design considerations:
- recognizing the fundamental characteristics of the environmental problem,
- choosing a competent authority to legislate, implement and monitor the tax,
- establishing a suitable tax base, and
- setting an appropriate tax rate.

1. The fundamental characteristics of the environmental problem

For some environmental problems, an environmental tax is unlikely to be an effective solution. For example, in situations where even small amounts of a dangerous substance can seriously damage the environment and human health, regulatory controls would be the preferred instrument. At most, an environmental tax may serve as an incentive for consumers or producers to speed up their adjustments to regulatory requirements.

In general, environmental taxes are best suited to situations where there is a reasonably simple and well-understood relationship between the polluting action and its physical impact on the environment. When the relationship is more complex, the development of effective taxes can pose design problems that may result in impractical tax structures. For example, it is difficult to design a simple tax structure to cover situations

15. Panayotou, T., "Economic Incentives in Environmental Management and their Relevance to Developing Countries", from *Environmental Management in Developing Countries*, Denizhan Erocal, ed. (Paris: OECD 1991), at 98-101.

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held as the future standard that it must use or meet, without allowing it any opportunity to benefit from the innovation.

Despite awareness of its disadvantages, the command-and-control approach continues to be used by a number of nations in their approach to environmental protection. The motivations have been discussed extensively by Bohm and Russell.[12] The roots of this anathema towards economic instruments for pollution control is the adversarial attitude that has characterized the beginnings of the environmental movement in many instances. Pollution has often been characterized more as a moral failing of corporate leaders than as a by-product of modern civilization. The characterization, though successful from a political standpoint, has unfortunately resulted in widespread antagonism towards corporations and a suspicion that anything supported by business is probably bad for the environment. In fact, for many years, MBIs were regarded as "licences to pollute".[13] Needless to say, environmental groups frequently apply different and more rigorous standards when measuring market-based systems against their command-and-control options.

Besides the external forces that have resisted the imposition of market-based environmental protection measures, there has been opposition from within the environmental bureaucracy. A number of individuals in these agencies perceive, sometimes correctly, that their work routines, organizational power or even existence, may be threatened by such market-based approaches. For example, market-based policies would not require the service of engineers in the environmental protection administration whose task is to evaluate technologies for disparate sources of emissions across the country. Instead, decisions to select particular technologies to control air pollution would be left up to individual firms. However, the environmental protection administration could provide a valuable service by acting as a clearing-house for information on the capabilities of, and experiences with, various control technologies.

In addition to opposition from the market players, there is also resistance from the firms themselves.[14] Firms seem to prefer regulation because they feel that MBIs would result in costs that may be additional to the existing regulation compliance costs. There is also the implicit feeling that they could have more influence on regulations through negotiations.

Finally, governments may also prefer to be slow in proceeding since there is an element of uncertainty regarding revenues and the inflationary and distributional effects of the various market instruments. Fiscal instruments such as taxes and charges are also politically unpopular in some countries. This is because they are often poorly administered and viewed as being unfair in their application.

1. Principal advantages of MBIs

(a) *Cost-effectiveness*

Compared with most regulatory instruments, economic mechanisms allow a given degree of environmental protection to be achieved at lower cost. This is due to the flexibility inherent to market-based approaches.

To illustrate this advantage, let us consider an example: Assume that it costs source A $ 500 per ton to reduce emissions and source B $ 3,000 per ton. Requiring each source to cut back emissions by one ton results at a total cost of $ 3,500. If, on the other hand, the sources were allowed to trade emissions reductions, source B could pay source A a negotiated amount — say $ 2,000 — to reduce emissions on its behalf by one ton. As a result, the total cost of reducing emissions would be $ 1,000, with a cost savings of $ 2,500. An environmental tax set at an appropriate level would have a similar result.

(b) *Continuing incentive*

Economic instruments provide a continuing incentive for firms to cut back pollution and, therefore, to develop and implement new pollution control technologies and processes. Under regulation, there is generally little incentive for a firm to go beyond required performance standards. This is because:

- Research and development (R&D) into improved pollution control is costly, and its adoption may not lead to direct cost savings.
- Firms may believe that if better technology is discovered, the government will require that it be adopted to achieve higher emission reductions.

(c) *Lower compliance and administrative costs*

MBIs, in some cases, involve lower administrative costs for both governments and industry than would be possible under the regulatory approach. For example, the use of environmental taxes or tradeable permits eliminates the need for government certification of production processes and technologies.

(d) *Accommodates growth and entry of new firms*

Economic instruments can more easily allow for the expansion of existing companies and the entry of new ones into the industry than would be possible with a regulatory approach. While both the regulatory approach and MBI instruments can involve a trade-off between targeted emissions and growth, MBI instruments can be modified more easily to allow growth and entry without greatly increasing pollutant loads.

D. *The measurement problem*

That market-based instruments are theoretically superior to regulatory tools is well established. Nevertheless, despite its many merits, the system of MBIs has not yet been extensively used nor its details fully worked out. The main drawback is the ability of the market or government to set prices for environmental resources. Ideally, charges for destructive uses of the environment, such as the discharge of untreated waste, should be equal to the damage or external cost that these activities generate. In practice, however, it is very difficult to

12. See Bohm P. and Russell C.S., "Alternative Policy Instruments", from *Handbook of Natural Resource Economics*, Kneese A.V., ed. (Amsterdam: North-Holland, 1985).
13. Alm, Alvin L., "The Postregulatory Environmental Protection Regime", *Environmental Science and Technology* 23 (1989), at 1338-1339.
14. See Bohm and Russell, *supra* note 12.

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principle and the use of MBIs leads to a critical policy stance, i.e. the elimination of subsidies for pollution reduction. Economic theory leads us to understand that there is no net economic difference between a tax on pollution and a subsidy to reduce pollution. The PPP favours placing the entire burden of pollution abatement on the polluter. This distinction is only normative, since there will in reality be a partial or full transfer of the burden onto the consumer, depending on the relevant demand elasticities. Thus, an MBI embracing the PPP only eliminates the subsidy option from consideration.

The PPP was accepted by the OECD member countries in the 1985 Declaration on Environment Resources for the Future, in which they undertook to introduce more flexibility, efficiency and cost-effectiveness in pollution control. In particular, they pledged to carry out a consistent application of the PPP and more effective use of economic instruments, in conjunction with the environmental regulations.[7]

The Recommendation on the Implementation of the Polluter-Pays-Principle[8] (adopted in 1974) specifies that member countries, as a general rule, should not assist polluters in bearing the cost of pollution control by granting subsidies or tax advantages. Exceptions to this rule (to be notified through the OECD Secretariat) were allowed only if all of the following conditions were met:

- if they related to industries, areas or plants where severe difficulties would occur,
- if they were limited to well-defined transition periods adapted to the specific socio-economic problems associated with the implementation of a country's environmental programme,
- if they were not likely to create significant distortions in international trade and investment.

Britain adheres most closely to the PPP in the area of industrial pollution control. It is a firm government policy to make industry responsible for the installation and operation of pollution control equipment capable of reducing emissions to the legally acceptable level. If a particular company cannot afford to buy the necessary anti-pollution equipment, the government does not offer subsidies.[9]

In keeping with this policy guideline, Britain has no specific legislation regarding the tax treatment of expenditures related to pollution control equipment. Equipment expenditures are, therefore, subject to the general taxation provisions contained in the current legislation.

C. The advantages of MBIs

To assess the advantages and structure of the MBI incentive approach, it is useful to first examine the more common regulatory approach.

Traditionally, regulatory instruments have been used as the primary mechanisms for translating environmental policy into objectives and results. This approach consists mainly of imposing standards regarding emissions and discharges and product or process characteristics through licensing and monitoring. The basis for this control is some form of legislation or government decree. The polluter's compliance is mandatory and non-compliance sanctions are quite common.

The principal distinguishing feature of a regulatory approach is that it forces all polluters to bear identical shares of the pollution control burden, regardless of their relative costs of control. This is economically inefficient since the actual cost of reducing a unit of pollutant can vary widely based on plant age, process characteristics, etc.

There are two basic types of regulatory instruments – uniform technology standards and uniform performance standards. Technology standards specify the method, and sometimes the equipment, that firms must use to comply with a regulation. Usually, technology standards do not explicitly specify the technology, but instead establish standards on the basis of a particular technology.[10] In one case, all firms in an industry might be required to use the "best available technology" to control water pollution; in a more extreme example, electric utilities may be required to utilize a specific technology, such as electrostatic precipitators, to remove particulates. Performance standards, in contrast, set a uniform control target for each firm while allowing them some latitude in deciding how to meet it. Such a standard might set the maximum allowable units of pollutant per time period, but be neutral with respect to the means by which each firm should reach this goal.

The regulatory (command and control) approach just described is inferior to the economic incentive approach for two main reasons.

Relatively high costs are imposed on society

Technology or performance standards can force some firms to use unduly expensive means of controlling pollution. In a survey of eight empirical studies of air pollution control, it was found that the ratio of actual, aggregate costs of the conventional command-and-control approach to the aggregate costs of least cost benchmark ranged from 1.07 for sulphate emissions in the Los Angeles area to 22.0 for hydrocarbon emissions at all US DuPont plants.[11] The reason for this is that the costs of controlling emissions can vary greatly between, and even within, firms and the right technology in one situation may be wrong in another.

Discourages technological innovation

The regulatory approach tends to gravitate against the development of technologies that could provide greater levels of control. Little or no financial incentive exists for firms to exceed their control targets. (However, it should be noted that both types of standards contain a bias against experimentation with new technologies.) A firm will not be enthusiastic to develop a new control technology that could subsequently be

7. *OECD and the Environment* (Paris: OECD, 1986), at 20.
8. *Id.*, at 27.
9. Secretary of State for Environment and others, *This Common Inheritance*, Common Service 6, No. 1200 (1990), at 271. This publication, known as the White Paper, contains the government's proposals for the next environmental protection bill. Some policies in the Paper, such as the placing of the financial burden of pollution control on industry, restate existing policies.
See also, *The Economist*, 18 August 1990.
10. This section of the paper draws from p. 4 of Stavins and Whitehead (1992).
11. Tietenberg, T.H., *Emissions Trading: An Exercise in Reforming Pollution Policy* (Washington, D.C.: Resources for the Future, 1985).

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II. THEORETICAL FOUNDATIONS OF MBIS

A. *The demand for MBIs*

Market-oriented pollution control strategies have emerged due to a realization that traditional regulatory approaches are inefficient for most pollution abatement.[1] First, the spending required in order to comply with increasingly stringent environmental laws and regulation is becoming a major cost of production. The US Environmental Protection Agency (EPA), for example, estimates that over $100 billion is spent annually to comply with federal regulations.[2] Governments are, therefore, investigating control options and mechanisms that would maximize the pollution abatement per dollar spent.

Second, it is increasingly clear that the costs of installing and operating the necessary control equipment vary greatly both within and between industries. To get the most efficient (least cost) reduction in pollution, industries with the lowest abatement costs should reduce their level of pollution with due compensation from industries with higher abatement costs. To provide a sense of the cost variability, we refer to a 1992 study that estimated the investment in pollution abatement equipment and operating costs of pollution control activities by manufacturing industries.[3]

The study indicated that pollution control expenses form only a small part of the total costs of most industries. Expenses are concentrated in a relatively small number of activities, with three sectors – chemicals, petroleum refining and primary metals – accounting for 55 percent of the total spending. Investment in pollution abatement consumes more than 20 percent of the total investment for the pulp and paper, petroleum refining and primary metals industries. The primary metals industry has the largest share, at slightly more than two percent of the total expenditures on pollution abatement.

Third, concerns over the impact of environmental regulations on the strength of the national economy and the nation's ability to compete in international markets is acute. Consequently, policy-makers place an increasing emphasis on the degree and type of burdens placed on businesses and individuals.

B. *The economics of MBI instruments for pollution control*

Efficiency arguments in favour of public intervention to mitigate pollution problems are well established.[4] Fundamentally, it is recognized that market failures do occur, with the end result that the true social cost of a product or physical input is not reflected in its price. These failures are termed "externalities". An external effect occurs when the welfare of a household depends not only on its own actions, but also on the actions of others. If the activity imposes an adverse impact on others, it is termed a negative externality. Polluting activities are a prime example of negative externalities.

When there are pollution externalities, the market mechanism fails to induce the polluter to consider the costs on others of his/her activity. In other words, a free market without corrective intervention would result in pollution emissions in excess of the "optimal" levels. More specifically, an industry would pollute until its private marginal benefits equalled its private marginal cost.

An externality is manifest when the welfare of those hurt by the pollution, expressed in terms of social benefits and costs, does not influence the polluters because the costs do not directly affect their decisions to pollute (i.e. the costs of environmental damage are external to the polluter).

Economic theory suggests that if the monetary value of the environmental damage caused by pollution can be determined, an environmental charge equal to the cost of damage could be established to serve as a disincentive for environmentally harmful behaviour. By imposing this charge on polluters, the cost of pollution is internalized, automatically encouraging them to reduce pollution to the "optimal" level.

1. Equivalence of taxes and subsidies

Environmental charges are commonly viewed as taxes imposed on the polluter. However, an established monetary value does not necessarily have to be a tax; the same optimal pollution level can be achieved by providing a subsidy to the polluter. In that case, the polluter is paid to curtail pollutant discharges in accordance with the degree of willingness to pay for cleaner surroundings.

The equivalence of an environmental tax and subsidy is an important concept. Intuitively, if pollution has a social welfare cost, society should be willing to pay to stop the polluter from continuing the polluting activity. The net effect is the same as one obtained by imposing a tax on the polluter. The level of the subsidy or tax should be equal to the charge determined by the estimate of environmental damage. If we step back one level from the individual entities (i.e. polluters and society), it is evident that, on balance, whether there is a tax imposed on polluters or a subsidy given to them, the economic resources expended to achieve a given "optimal" amount of pollution reduction are approximately the same.[5]

This equivalence is referred to as Coase's Law and has become of central importance in recent developments, applying economic reasoning to legal issues.[6]

2. The polluter-pays-principle

Another concept gaining credence amongst policy-makers is the polluter-pays-principle (PPP). The convergence of the

1. Regulation continues to be the most suitable for restricting the emission of toxic chemicals and compounds.
2. US EPA, *Environmental Investments: The Costs of a Clean Environment*, Washington, D.C.(December 1990). This estimate excludes activities not directly associated with pollution control or cleanup, such as wildlife conservation and land management. The $ 100 billion estimate covers spending by private business (63%), local governments (22.5%), the Federal government (11%) and state governments (3.5%).
3. Dale Jorgenson and Peter Wilcoxen, "Impact of Environmental Legislation on US Economic Growth, Investment, and Capital Costs", from *US Environmental Policy and Economic Growth: How do we Fare?*, American Council for Capital Formation Center for Policy Research (March 1992), at 8-13.
4. See William J. Baumol and Wallace Oates, *The Theory of Environmental Policy* (Cambridge: Cambridge University Press, 1988), and Tom Tietenberg, *Environmental and Natural Resource Economics*, 2nd ed. (Chicago: Scott Foresman and Company, 1988). Both books have a good textbook treatment of the theory.
5. These costs may differ owing to transaction costs and behavioural inertia on the part of the polluter.
6. R.H. Coase, "The Problem of Social Cost", *The Journal of Law and Economics*, No. 3 (1960), at 7-44.

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INTERNATIONAL:

MARKET-BASED INCENTIVE INSTRUMENTS FOR POLLUTION CONTROL*

Glenn P. Jenkins and Ranjit Lamech

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Mr Ranjit Lamech has graduate degrees in Public Administration and Energy Engineering from Harvard and Stanford Universities respectively, and was a 1991 graduate of the Harvard International Tax Program. He was a Research Fellow with the Harvard International Tax Program during the time this study was undertaken. Mr Lamech is now a consultant for the World Bank's Energy Sector Management Assistance Programme.

The authors wish to thank the Tax and Tariff Commission, Ministry of Finance, Republic of China for its financial support to the Harvard International Tax Program which enabled us to undertake this study. Comments by the staff of the Tax and Tariff Commission on an earlier draft of this work were very helpful and were greatly appreciated. Discussions with our Harvard colleagues, Robert Stavins and Theodore Panayotou, have significantly improved our understanding of the design and operation of market-based incentives to control environmental damage. A special thanks to Ana Lucia Santos, Rachaneephan Yuktasevi and Efeng Huang who, as graduate students at Harvard, completed their thesis in this field of study, and to Mwana Lugogo, who provided key assistance in the completion of the final reports.

ABSTRACT

The use of market-based incentives (MBIs) as mechanisms for influencing pollution abatement has increased greatly in recent years. This trend reflects the realization that the integration of economic and environmental decision-making will induce the private sector to take steps to reduce their pollution emissions levels. Market-based incentive instruments may be broadly classified to include environmental taxes, investment tax incentives, tradeable permits, user charges and deposit refund systems. Until now, policy-makers worldwide have continued to place greater emphasis on the use of investment tax incentives since they seem to more effectively balance environmental considerations with concerns about industrial competitiveness. It is becoming increasingly apparent, however, that other MBIs may be more effective mechanisms for influencing pollution abatement in certain circumstances. This report reviews the theoretical foundations for idealized pollution control MBIs. It then focuses in particular on the way in which environmental taxes, deposit refund systems and tradeable pollution permits may be more suitable instruments for inducing pollution abatement behaviour. A number of international examples of the implementation of such policies are reviewed.

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II. Theoretical Foundations of MBIs
  A. The demand for MBIs
  B. The economics of MBI instruments for pollution control
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  D. The measurement problem
III. Environmental Taxes, Deposit Refund Systems and Tradeable Pollution Permits
  A. Environmental taxes
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IV. Conclusion
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I. INTRODUCTION

Assessments of the fiscal structure, operational mechanism and economic impacts of investment tax incentives for pollution control point to the challenge of designing fiscal instruments for pollution control purposes. Much of this challenge lies in designing an administratively and politically acceptable market-based instrument. This paper discusses alternative market-based instruments for pollution control.

Section I is a review of the theoretical foundations of MBI instruments. The discussion stresses the disadvantages of the traditional regulatory approaches used to control pollution and the advantages of the MBI approach. Section II describes three MBI instruments — environmental taxes, deposit refund schemes and tradeable pollution permits. Aspects of their design and administration are also presented.

* See for the first article on pollution control the October 1992 issue of the Bulletin at 483.

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BRAZIL: TAX REFORM 555 *Ana Lucia Goncalves Soares*

A tax reform, effective 1 January 1992, establishes a new indexation unit which is used for the payment of income and other federal taxes, and amends the rules governing the payment of corporate income tax by legal entities established in Brazil. This article highlights the salient features of the reform.

NETHERLANDS: TAX STATUS OF EXPATRIATES 558 *John A. Rompelman and Wim H. Kanbier*

Foreign employees temporarily transferred to the Netherlands may benefit from a special tax regime if certain conditions are met. This regime, usually referred to as the "35% ruling", was recently changed. This article reviews the history of the expatriate tax regime and discusses the conditions and features of the new ruling.

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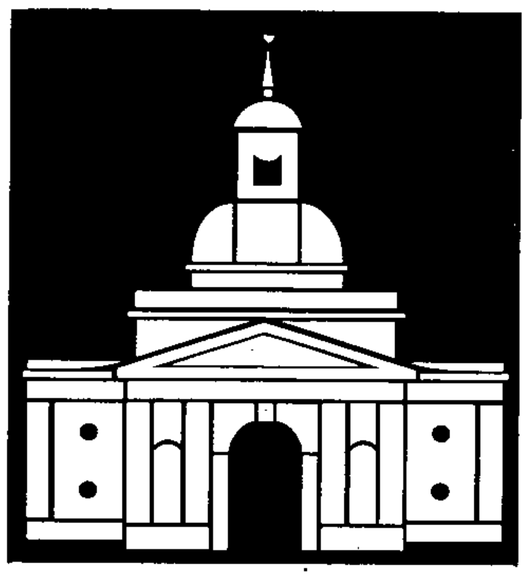

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Last month we featured Part I of this article which focused on the intent and design of investment tax incentives. Now the authors shift their discussion to alternative market-based-incentive (MBI) instruments for pollution control. The theoretical foundations of MBI instruments are reviewed, emphasizing the disadvantages of the traditional regulatory approaches used to control pollution and the advantages of the MBI approach. Three instruments – environmental taxes deposit refund schemes and tradeable pollution permits – are described, including aspects of their design and administration.

UNITED STATES: PROPOSED RULES FOR DETERMINING DEDUCTIBLE INTEREST OF A FOREIGN CORPORATION'S US TRADE OR BUSINESS — 539 — *Paul J. Biehl, Peter J. Connors and Barry Ruddell*

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VIII. QCET

Because the new regime gives a company the ability to distribute (unimputed) dividends tax-free once an election is made to become a QC, there is logically an entry price to recognize that accumulated distributable reserves from earlier years may later be released as tax-free dividends. QCET, therefore, is the tax payable by a company upon election to become a QC. It is essentially a 33 percent tax imposed on the reserves of the company at the time of the election, which upon distribution to shareholders would otherwise be taxable in their hands.[28]

QCET must be paid by the due date for payment of terminal tax for the income year in which the day immediately preceding the time at which the company became a QC falls. This means that if a 31 March balance date company becomes a QC on 1 April 1994, it must pay its QCET by 7 February 1995.

QCET does not form part of residual income tax upon which provisional tax and use of money interest is calculated.

IX. TRANSITIONAL PROVISIONS

A. *Notices of election*

Shareholder and director elections for a company to become a QC, LAQC elections and foreign loss elections take effect on the first day of a company's 1992/93 income year (the first year from which the new regime operates) if the relevant notices of election are received by the Commissioner by 31 March 1993.

B. *Concessional rate of QCET*

If a company which was incorporated before 30 November 1991 becomes a QC on the first day of its 1992/93 income year (normally 1 April 1992), its QCET can be reduced to 7.5 percent of the taxable dividend which would arise upon winding up, adjusted for the net amount of tax-exempt cash dividends and "taxable" bonus issues[29] received and paid by the company from 30 November 1990 to that first day of QC status.

This is basically an incentive (by reducing the QCET rate from 33 percent to 7.5 percent) to encourage companies that meet the criteria to come within the regime.

The adjustment for net exempt dividends received in the specified period is an anti-avoidance measure to prevent companies from retaining exempt dividends which were received after the date of first announcement of the QC code (30 November 1990) and distributing them to their own shareholders tax-free after becoming a QC. Those net dividends remain subject to the full 33 percent QCET.

As a further incentive to participate in the regime from the outset, a company incorporated before 30 November 1991 which becomes a QC on the first day of its 1992/93 income year may carry forward to that year, in accordance with the normal loss carry forward rules, 75 percent of any losses incurred by it in the 1991/92 or earlier years.

X. CONCLUSION

The QC regime was founded on the premise that businesses undertaken through small closely held companies are in effect no different from partnerships undertaking the same operations, except for the entity's legal form. Therefore, each should pay the same amount of tax. Specifically, the pre-1991 company tax law needed to be rectified to allow such companies to distribute capital gains free of tax to their shareholders and to attribute their losses to shareholders.

This review of the QC legislation has demonstrated how that objective is to be achieved using an imputation-based model, rather than the direct attribution or full integration partnership-type approach adopted in Subchapter S of the US revenue law.

However, the article also illustrates that, in attempting to attain its objectives, the QC approach still leaves small closely held companies facing complex legislation with its associated significant monetary and administrative down-time costs; in particular, the maintenance of imputation records and the need to obtain professional advice to ensure the qualifying criteria are continually met and technical difficulties are complied with.

The benefits of the legislation lie in the ability of New Zealand resident shareholders of small closely-held companies to end up with the same tax liability as if they operated their business through a partnership or as a sole trader. But the regime is essentially a domestic one. The inability of non-residents to utilize dividend imputation credits and attributed losses, and the retention of NRWT on otherwise tax-exempt dividends severely curtails the benefits of a QC to non-residents. In these circumstances, a partnership or non-corporate New Zealand joint venture structure may be a more attractive option.

This narrow focus, which deters non-residents, is unfortunate. While it is driven by revenue protection considerations, it nevertheless undermines the conceptual policy objectives of creating a tax-neutral environment in New Zealand in which business decisions can be taken without Government favour of one player over another.

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28. Numerically, QCET is calculated using the following formula:

$$a + c - b - {}^{c}/d) \times d$$

where
- a = taxable dividends if assets and liabilities were realized and the consideration was distributed upon winding up;
- b = assessable income to the company in calculating a;
- c = ICA (and FDWP account) balance accrued for tax payable and refunds owing; and
- d = resident company tax rate (33%).

29. Taxable bonus issues are included in the definition of *dividend* in Sec. 4(1)(f) and therefore fall within the Sec. 63 exemption where it applies.

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tween two companies in a 100% commonly owned group, and (ii) the company which derives the dividend is not an LAQC, and (iii) the paying company is a QC (but not an LAQC).

The loss offset and subvention payment provisions do not apply to a QC unless the loss company is also a QC.

VII. LOSSES

It is the treatment of losses that brings the regime closest to achieving the policy objective of taxing QCs in a manner similar to that of a partnership. If a QC elects to be an LAQC (where it meets the conditions set out below), its losses are attributed to the underlying shareholders in proportion to their respective effective interests in the QC in the same way as a partner carries his/her share of a partnership's loss. Therefore, any losses are carried forward at the shareholder level. The only exception to this rule is where a foreign loss election is made by each sui juris shareholder nominating that attributed foreign losses and foreign investment fund losses remain in the LAQC for carrying forward to a later income year.[26] Because these losses can only be offset against assessable income derived in future years from the same tax jurisdiction as that in which they arose, the ability for an LAQC to retain those losses, rather than pass them through to shareholders, is advantageous when it is more likely that the LAQC, instead of those shareholders, will derive future income from the relevant country. This will generally be the case given the types of companies and shareholders at which these reforms are aimed.

LAQC status permits the pass-through of losses where the following circumstances prevail:

(a) The company is a QC *at all times* in the income year.

(b) The QC has only one class of share. The shares must carry at all times in the income year the same voting rights in respect of distributions, the company's constitution, variation of capital and appointment of directors, and the same rights to dividends, assets and return of capital and share premium. In this context, Section 192 debentures (i.e. debentures with a floating rate of interest) and Section 195 debentures (i.e. debentures issued in substitution for shares) fall within the one class of share rule.[27]

This rule was imposed to avoid otherwise complex legislation to determine the allocation of losses to differing classes of shares and to reduce the opportunities for losses to be allocated, via different rights pertaining to different types of shares, to shareholders who would obtain the greatest tax advantage from them.

(c) All sui juris shareholders and directors must unanimously elect that corporate losses will pass through to shareholders. The election must be made before the beginning of the income year to which it applies, unless it is the QC's first year in which case it takes effect from the first day of that year. In many situations, it will not be practicable to predict a loss in advance of an income year necessitating the election to become an LAQC. After all, companies are normally in business to make a profit, the achievement of which may be undermined only by unforeseen adverse events late in an income year.

Given this potential election difficulty and the revocation difficulties with LAQCs noted above, it is hard to resist the conclusion that the better course would be to allow QCs to automatically also be LAQCs provided the other criteria in Section 393N were met.

If a company subsequently ceases to qualify for the loss pass-through because of a shareholder or director revocation of election, it falls out of the LAQC regime with effect from the first day of the income year in which notice of revocation was given to the Commissioner or from the first day of a later income year specified in the notice or a later income year the Commissioner considers appropriate or successfully applied for by the company.

An LAQC election is deemed to be revoked upon the death of any shareholder or disposal of the shares to a person other than an existing shareholder. The grace periods of 12 months and 63 days, respectively, apply for the lodgment of a further notice of election to preserve LAQC rank. Again, the deemed revocation takes effect from the beginning of the income year in which the revoking event arose or the first day of a later year considered appropriate by the Commissioner or applied for by the company.

(d) None of the shares have been, during the year, subject to (an) arrangement(s) for the purpose(s) of making the QC an LAQC to defeat the intent and application of the LAQC-empowering section of the Act. (The widespread view appears to be that no one really knows what this provision means!) There is also a specific anti-avoidance rule which disallows a loss attribution where no economic loss is suffered by a shareholder because a compensatory right to sell shares prevails.

Subject to the concessionary transitional provisions, prior year losses carried forward by a company upon entering the QC regime are not available for carryforward and offset against future company profits. This treatment is logical in that events which occurred prior to entering the regime are properly dealt with under the old rules with the loss attribution rules applying only from the time the election to fall within them is made.

Where a company ceases to be an LAQC, it also automatically ceases to be a QC from the first day of the following income year. This also is an anti-avoidance rule designed to prevent switching between QCs and LAQCs in alternate years to reduce provisional tax obligations. But it also imposes upon QCs which elect to be LAQCs additional constraints (e.g. the restriction to one class of share) which if (inadvertently) broken will jeopardize their QC status. The consequences of this will be dire if, for example, a new class of shares was issued and the company continued to pay exempt dividends to shareholders in the belief that it was still a QC.

26. Attributed foreign losses and foreign investment fund losses are losses of controlled foreign companies and foreign investment funds which are allocated to New Zealand resident owners under the international tax rules in Secs. 245G and 245R of the Act.

27. See the definition of *share* in Sec. 2 of the Act.

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company represent family trusts (perhaps established for the specific purpose of providing income for the beneficiaries' future education and well-being) the beneficiaries of which are infants, there will not yet be any sui juris beneficiaries. Consequently, in these circumstances, the section permits the trustee (or any other natural person) to personally assume joint and several liability for the company's tax payments in proportion to the trustee's interest in the QC.

However, given the fiduciary obligation placed upon trustees, prudence would suggest that trustee shareholders would be extremely cautious in electing to be personally liable for a share of the company's tax obligations unless the trustee was also a director, in which case he/she would at least be aware of the company's affairs, and/or he/she obtained an indemnity from the (other) directors.

From the viewpoint of a beneficiary of a purely discretionary trust, there is likely to be a reluctance to accept personal liability for the company's tax if, at the time he/she is required to commit him/herself, it is not known whether any distribution will even be obtained from the trust.

V. TAXATION OF DIVIDENDS FROM A QC

Where a QC which maintains a dividend imputation credit account ("ICA") or an FDWP account pays a cash dividend to any shareholder, it must attach imputation and FDWP credits to that dividend equal to the *lesser* of:

(a) the maximum imputation or FDWP credits allowed, i.e. $^{33}/_{67}$ of the dividend paid; or

(b)

$$\text{ICA (or FDWP account) balance at 31 March each year} \times \frac{\text{Amount of dividend (before attachment of credits)}}{\text{Total cash dividends and taxable bonus issues (before attachment of credits)}}$$

This rule effectively requires the maximum imputation and FDWP credits to be attached to dividends paid and when the maximum cannot be attained because sufficient credits are not available in the ICA or FDWP account, alternative (b) prorates the ICA and FDWP account balances across all dividend payments made during the year. This prevents the use of QCs to stream imputation and FDWP credits to shareholders who can benefit most from them.

Imputation credits must still be attached to dividends paid to non-resident shareholders and are, therefore, wasted because non-resident shareholders cannot claim a credit for them against their New Zealand tax liability[24] nor, for most jurisdictions, against their home country tax liability.

To the extent to which a dividend is not fully imputed, it is exempt from income tax in the shareholder's hands.

The fully imputed component of the dividend payment is determined by the following formula:

$$\frac{\text{Imputation (and FDWP) credits deemed attached to dividends}}{\text{Resident company tax rate (33\%)}}$$

For example, assume a company makes a profit of NZ$ 100 and, because of (say) losses carried forward, it pays corporate tax of NZ$ 20 so that it has an ICA balance of NZ$ 20. It then pays one cash dividend of NZ$ 80. Under alternative (b) above, it must attach the NZ$ 20 ICA balance to the NZ$ 80 dividend paid, it being the *lesser* of:

(i) $^{33}/_{67}$ x NZ$ 80 = NZ$ 39.40; and

(ii) 20 x $^{80}/_{80}$ = NZ$ 20.

The exempt portion of the dividend is the excess of the NZ$ 80 paid over the fully imputed gross dividend, i.e. $^{20}/_{33}$ = 60.61. Thus, the exempt portion is NZ$ 19.39, i.e. NZ$ 80 = 60.61.

Therefore, the shareholder has no net tax to pay, determined as follows:

	NZ$	*NZ$*
Taxable gross dividend		60.61
Less Tax thereon (33%)	20.00	
Less Imputation credit	(20.00)	–
Net after-tax dividend		60.61
Add Exempt dividend		19.39
Total after-tax dividend		80.00

Interest deductions

A shareholder who incurs interest expenditure on money borrowed to acquire shares in a QC is not permitted a deduction to the extent of the amount of any non-cash dividends (excluding taxable bonus issues) that the shareholder derives from the QC during the income year. This prohibition is based on the proposition that such non-cash dividends are tax-exempt in the recipient's hands and, consequently, no deduction should be permitted for costs which may lead to their provision. However, this constraint has inequitable consequences for a shareholder who is not also an employee because the denial of the interest deduction is not directly related to the provision of the non-cash benefit. In these circumstances, the company will be denied a deduction for all costs related to the provision of the benefit *and* the shareholder will also be denied a deduction (at least part of) his/her interest expense. Hence, deductions are rejected twice in respect of the one benefit.

VI. TAXATION OF QCs

The intercorporate dividend exemption which is to apply to a wholly owned group of New Zealand resident companies[25] does not apply to a company which has been a QC at any time before the dividend was derived by it, unless (i) the dividend was derived from a foreign company (in which case it is subject to an FDWP deduction by the New Zealand recipient company) or the dividend is paid before 1 April 1993 be-

24. Non-resident shareholders of New Zealand companies are subject to non-resident withholding tax on dividends, which is a final tax. The dividends are not included in the non-resident shareholder's assessable income in New Zealand. Since it is the tax on assessable income from which imputation credits are deducted, non-resident shareholders obtain no credit for tax paid at the corporate level by the New Zealand companies in which they invest.

25. See Sec. 63(2K) in clause 7 of the Bill.

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Where a shareholder revokes his/her election that the company be a QC, a 63-day grace period (extendible on application to the Commissioner) allows a substitute shareholder to so elect, thus enabling the company to continuously maintain its QC status. The 63-day period also applies where new elections are required by virtue of a deemed revocation. Further, the death of a shareholder will not terminate QC status if the company would have remained a QC but for that death and the new shareholder(s) make a shareholder election within 12 months of the date of death (or such extended period as the Commissioner may, on application, allow). The (extendible) 12-month period is designed to provide sufficient time for the transmission of the shares to beneficiaries under the deceased's will or intestacy and the resultant elections.

To become an LAQC, a separate election must also be made by all sui juris shareholders and directors.[20] Under Section 393O(1), such an election may be unilaterally revoked by any one of the sui juris shareholders or directors. In this situation, there is no grace period for any other person to make the LAQC election, in order to maintain the company's LAQC status. Prima facie, the revocation takes effect retrospectively, i.e. on the first day of the income year in which the notice was given to the Commissioner and the company.[21] To mitigate the revocation by an aggrieved shareholder or director, the company would have to rely on the Commissioner's discretion under Section 393O(1)(c)(ii) to defer the date on which the notice of revocation takes effect. However, even if the Commissioner exercised his discretion favourably, this approach only offers relief in a timing sense.

This issue is a particularly pertinent one because a shareholder's or director's revocation of his/her election that a QC be an LAQC results in loss of *both* the company's LAQC and QC statti.[22] To ensure the provisions could not be used by disgruntled shareholders or directors to undermine a company's LAQC and QC positions, it would seem more appropriate to include a 63-day grace period rule similar to Section 393F(2)(a) into the LAQC provisions, assuming Parliament is entrenched in the view that elections to become LAQCs are necessary at all.

If a company ceases to comply with any of the QC criteria, it loses its QC status from the beginning of the income year in which non-compliance arose. However, if the Commissioner considers that rule unduly harsh or inappropriate, he may, after taking account of the relevant circumstances, defer cessation of QC status until the first day of a later income year provided he is satisfied that the company did not know nor could have reasonably been expected to have known that it would cease to be a QC because it was reasonably expected that (i) a substitute election would have been obtained within the grace periods, or (ii) the NZ$ 10,000 foreign non-dividend income threshold would not be breached, or (iii) QC dividend income derived by a trustee shareholder would have been distributed as beneficiary income.

G. *Personal liability of sui juris shareholders*

Each sui juris shareholder must also elect to be personally liable for his/her share of a QC's tax obligations.[23] This provision was considered necessary from a revenue protection viewpoint to ensure that QC shareholders did not obtain tax-free dividends where their company had insufficient funds to meet its tax liabilities, especially where those liabilities arise ex post upon investigation. But one would have thought that such a situation would be countered by the new Section 276 of the Act which provides that, if an arrangement is entered into having the effect of rendering the company unable to satisfy its tax liability, the directors of the company at the time the arrangement was entered into are jointly and severally liable as agent for any resultant corporate tax payable. A controlling shareholder is similarly liable, subject to a statutory limit turning on the value of the shareholder's interest in the company and the value of the benefit derived from the arrangement.

Furthermore, the "solvency test" in the Companies Bill (1990) imposes an obligation on a company's directors to ensure that the company can pay its debts as they become due in the normal course of business and that the realizable value of the company's assets exceeds the present value of its liabilities (including contingent liabilities) after they authorize a distribution to shareholders. Consequently, there are already remedies available to the Commissioner under the Act and there will be further remedies under the amended Companies Act (if the amendments proceed in their present form) to address concerns about protection of the Revenue upon which the shareholder assumption of personal liability rests.

One major problem that could have arisen from the requirement that *all* sui juris shareholders elect personal liability for their respective proportions of the QC's tax liability is that a disgruntled shareholder could undermine the QC status of a company by merely not so electing or revoking his/her election. Consequently, minority shareholders are excluded from this requirement where majority shareholders, i.e. those shareholders holding a 50 percent or more interest in the company, elect to be personally or, if more than one majority shareholder, joint and severally liable for the company's tax liability in place of any shareholders with less than a 50 percent interest in the company.

Nevertheless, even with a benchmark shareholding interest of less than 50 percent for a minority shareholder, some mischievous situations will not be addressed by the legislation. Suppose an estranged spouse held exactly 50 percent of the shares in a family company. He/she could refuse to elect that a family company become a QC and, for example, thwart an otherwise tax-free capital distribution from the company at least partially for the benefit of the matrimonial partner.

Section 393D(2) requires a trustee shareholder *and* at least one sui juris beneficiary (being a natural person) to assume personal liability. Where trustee shareholders in a family

20. See Sec. 393N(c)(i).
21. See Sec. 393O(1)(a).
22. See Secs. 393R and 393O(1)(c)(i).
23. The share is measured by the shareholder's "effective interest" which, in most circumstances, will be determined by the person's voting interest in the QC. Where that voting interest varies throughout the year, a weighted average is taken over the whole year. See Secs. 393A(2)(b) and 8C for the statutory definition of *voting interest*.

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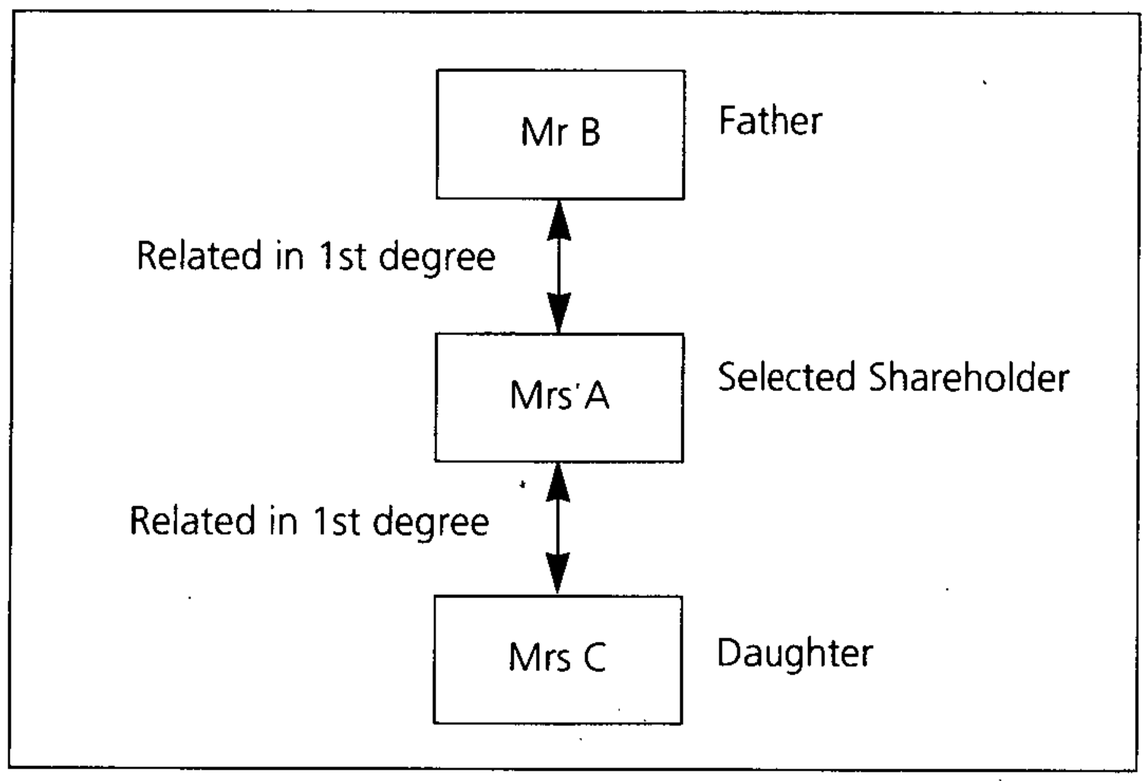
tion within the first degree of relationship are treated as a single shareholder. This narrows down the number for the purpose of the shareholder count test. For example, if the shareholders in a company are Mrs A, her father (Mr B) and Mrs A's daughter (Mrs C), all three are treated as a single shareholder because both Mr B and Mrs C are connected to Mrs A in the first degree (see Figure, below).

FIRST DEGREE OF RELATIONSHIP



Deemed Single Shareholder

This deeming provision operates even if the first degree test is broken by death or marriage dissolution so long as the parties (the surviving shareholders, in the case of death) remain shareholders in QC. Therefore, in the above example, if Mrs A died, Mr B and Mrs C would still be treated as one single shareholder, notwithstanding that they are connected only in the second degree of relationship, until they relinquish their shareholdings.

A shareholder who is a trustee is not taken into account in the shareholder count test. Instead, the number of shareholders is deemed to be the *greater* of the number of:

- persons who have derived beneficiary income from the trust in the form of dividends from a QC since 1 April 1992; or
- persons (other than the trustee) who make a shareholder election.[14]

It should be noted that the maximum shareholder test applies continuously throughout the life of a QC. This means that not only must changes in shareholding be closely monitored to ensure that the threshold is not exceeded, but also income beneficiaries deriving dividends each year under a trust must be observed. This is particularly important because the allocation of dividend income to an additional beneficiary may result in the maximum number of shareholders being exceeded. This possibility could effectively transfer the power to determine or terminate QC status to a trustee shareholder which, in certain (perhaps antagonistic) circumstances, may be inequitable vis-à-vis other shareholders of the QC.

E. *Foreign-sourced income*

The restriction that no more than NZ$ 10,000 non-dividend income be sourced outside New Zealand was founded on the premise that "non-resident companies could bypass the (New Zealand residence and FDWP) rules by establishing New Zealand resident status at the outset in order to distribute their foreign-sourced retained earnings free of tax as qualifying company..."[15] This reasoning is not at all clear. If a non-resident company became a New Zealand tax resident, like any other New Zealand resident company, it must pay QCET upon entering the QC regime. Foreign-sourced retained earnings would be subject to tax at that point and therefore do not totally escape tax even though they can be distributed later without any further impost.

F. *Shareholder and director elections*

The new law requires that all directors and sui juris shareholders unanimously agree that their company becomes a QC.

A director's election takes effect on the first day of the income year following that in which the notice of election is received by the Commissioner or on the first day of a later year specified in the notice. However, in the case of new companies, the election takes effect on the first day of the company's first income year. Although the directors' election to become a QC must be unanimous, it may be revoked by a simple resolution of directors. That revocation takes effect on the later of the beginning of the income year in which notice is received by the Commissioner or the beginning of a later income year specified in the notice.

A shareholder's election takes effect on the first day of the company's income year following that in which the Commissioner received the notice of election or, if specified in the notice, the first day of a later income year.

A shareholder election can be revoked by:

(1) any shareholder notifying the company and the Commissioner accordingly; or
(2) the death of the shareholder; or
(3) the disposal of all the shareholder's shares unless disposed of to an existing shareholder for whom a valid election is already in effect;[16] or
(4) a beneficiary of a trust, for whom both the trustee and a natural person have assumed liability under Sections 393D(2) and (3), becoming sui juris;[17] or
(5) a minority shareholder, in respect of whom a majority shareholder has made an election and assumed liability under Section 393D(3), increasing his/her effective interest in the QC to 50 percent or more;[18] or
(6) a majority shareholder's effective interest falling below 50 percent.[19]

Such deemed revocations take effect on the first day of the income year in which the event giving rise to the revocation occurs.

14. See under *Shareholder and Director Elections*.
15. *Supra*, note 1 at 24.
16. See clause 30 of the Bill which amends Sec. 393E(2)(b) to this effect.
17. See under *Personal Liability of Sui Juris Shareholders*.
18. *Id.*
19. *Id.*

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IV. REQUIREMENTS OF THE NEW LEGISLATION

The criteria to obtain and retain QC status are specified in Section 393B of the Act. These tests, which are applied for each income year, are discussed below.

A. *Qualifying shareholders*

At any time during an income year, each shareholder in a QC must be either:

- a natural person; or
- another QC; or
- a trustee of a trust which allocates all of its cash dividends and taxable bonus issues from QCs to beneficiaries as beneficiary income. This means that income of that type cannot be accumulated by, and taxed as income of, the trustee. As an anti-avoidance measure, the beneficiaries entitled to that income cannot include other trustees or non-QCs.

B. *Corporate residence*

A QC must not be a foreign company at any time during the income year.[8]

From a non-resident's viewpoint, this effectively means that a New Zealand subsidiary company must be incorporated if QC status is to be attained.[9]

The Committee's justification for the requirement that a QC be a New Zealand resident company was to ensure that the foreign dividend withholding payment ("FDWP") regime is not debilitated.[10] If non-resident companies could be QCs, such dividends could flow through the company and be distributed to underlying shareholders without the imposition of any withholding tax.

The retention of the Section 63 intercorporate dividend exemption in the Bill, in respect of dividend transactions within a wholly owned group, appears to justify (at least in the New Zealand Government's view) the continuation of the FDWP regime.

The Committee also considered that, on tax administration grounds, allowing non-residents to be QCs would lead to policing difficulties in relation to the qualifying criteria.

C. *Non-resident shareholders*

Although a QC itself must be a New Zealand resident, it may have non-resident shareholders. However, dividends paid by a QC to non-resident shareholders remain subject to non-resident withholding tax ("NRWT").[11] This can have a substantial effect on the New Zealand tax liability. Assume, for example, that a business having an owner resident in the United Kingdom derived NZ$ 100 of business income from New Zealand. If the business was undertaken through a QC, the ultimate New Zealand tax impost would be 43 percent, calculated as follows:

	NZ$
Business income	100
Less Company tax (33%)	(33)*
Gross exempt dividend	67
Less NRWT (15%)	(10)*
Net dividend remitted	57
* Total tax	43

Conversely, if the business was New Zealand-owned, the tax impost would be 33 percent, viz.:[12]

	NZ$	*NZ$*
Business income		100
Less Company tax (33%)		(33)
Gross dividend		67
Tax thereon (33%)	33	
Less Imputation credit (fully imputed)	(33)	
Net tax payable by shareholder		Nil
After-tax dividend		67

The final tax liabilities of non-resident shareholders will turn on the extent to which they are able to claim in their home countries a credit for tax paid on foreign-sourced income. However, it is by no means assured that such a credit will meet the New Zealand tax imposed on the income remitted overseas and, indeed, a credit will not generally be available for the underlying company tax paid in New Zealand.

Conversely, and logically, there are no restrictions on the ability of a loss attributing qualifying company ("LAQC") to attribute the relevant share of its losses to a non-resident shareholder.[13] Although this is beneficial to non-residents insofar as they fall within the New Zealand tax jurisdiction, the LAQC losses so attributed would not generally be expected to reduce the non-residents' tax liabilities in their home jurisdiction.

D. *Maximum number of shareholders*

The legislation imposes a (somewhat arbitrary) limit of five on the number of shareholders in a QC on the basis that, by definition, a closely held company has a small number of shareholders.

In applying the maximum shareholder test, there must be a trace-through of corporate shareholders to the ultimate non-corporate shareholders. This clearly has the effect of broadening the number of shareholders. On the other hand, all shareholders who are connected by blood, marriage or adop-

8. A *foreign company* is defined in Sec. 63 to mean either a company which is not resident in New Zealand or, if it is resident in New Zealand, it is treated as being a non-resident in terms of the relevant double tax agreement. Corporate residence tests for tax purposes are set out in Sec. 241(6) of the Act.
9. But see under *Non-Resident Shareholders* to appreciate that the advantages in these circumstances are more apparent than real.
10. A New Zealand resident company which receives dividends from a foreign company must deduct FDWPs from those dividends at the time the dividend is paid to it. It is effectively a withholding tax for which the shareholders of the New Zealand company are given credit when taxable distributions are made to them.
11. *Supra*, note 1 at 32.
12. Assuming that either the corporate or top personal marginal tax rate applies.
13. Refer to *Losses* for a discussion of LAQCs.

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(4) In the case of a trustee shareholder, dividends derived by the trustee must vest in beneficiaries as beneficiary income.
(5) Each sui juris shareholder (i.e. a shareholder of full age and capacity) must elect to be personally liable for his/her share of the tax payable by the company should the company default in meeting its liability. At least one sui juris beneficiary of a shareholding trust must accept liability along with the trustee.
(6) The company must be resident in New Zealand.
(7) Non-dividend income not sourced in New Zealand must not exceed NZ$ 10,000 per year.
(8) The company cannot be a unit trust.

Losses incurred by a QC may pass through to its shareholders under certain specified circumstances.

In-kind benefits obtained by shareholder-employees are subject to fringe benefit tax and the costs of providing the benefits are deductible. Expenditure in respect of such benefits derived by non-employee shareholders is not deductible because the benefits constitute dividends to those shareholders. Interest incurred to acquire shares in a QC is deductible only to the extent to which it exceeds the value of any in-kind benefits provided to the shareholder.

A transitional concessionary 7.5 percent tax is imposed essentially on the reserves of companies incorporated before 30 November 1991 and which become Qcs on the first day of their 1992/93 income year. The tax rate is 33 percent for companies falling outside that criterion. This tax is known as the *qualifying company election tax* ("QCET"). The reserves subject to QCET can subsequently be distributed tax-free. They would otherwise have been taxable in shareholders' hands.

III. REASONS FOR INTRODUCING THE REGIME

The conceptual basis behind taxing closely held companies in a manner different from other companies is that, in substance, their operations are no different than those of partnerships or sole traders.

Of the 140,000 companies registered in New Zealand in 1991, it has been estimated that two thirds had no more than five shareholders.[4]

Anecdotal evidence suggests that these companies tend to be small family entities (akin to the US "Mom and Pop" stores) which undertake their business in the legal form of a company in order to obtain the advantage of limited liability (at least to a large extent in the public domain since shareholder and other personal guarantees tend to expunge that advantage in a corporate borrowing context) and to facilitate the issue of debt securities, particularly debentures. Aside from these two primary considerations, the relevant business could otherwise equally be undertaken outside the legal corporate structure.

However, the disadvantages that have accrued to such companies have grown considerably as tax reform in New Zealand has continued. The law governing the taxation of distributions from companies (particularly the legislation describing the constituents of a *dividend* for tax purposes) has become so complex that closely held companies must now incur considerable compliance costs (relative to their size) in order to determine their correct tax liability.

Moreover, the tax treatment itself differs between such a business undertaken in partnership or by a sole trader and that undertaken by a company. A principal inconsistency is the treatment of capital gains arising from the disposal of business assets. Under New Zealand law which does not tax capital profits, such gains fall outside the income tax net if the assets are disposed of by a sole trader or partnership entity, i.e. the gain is derived tax-free by the sole trader or partner, but, although the same gain is tax-free to a company which disposes of the asset, it is taxable as a dividend to the shareholder when the company distributes the gain to him/her.[5]

Also, losses incurred by a sole trader or partnership are able to be directly offset against the owners' other assessable income in the year in which the losses are incurred. But losses incurred by a company are quarantined within that company. They are unable to be transferred to the shareholders for offset against their other income. The company must carry its losses forward to future income years (subject to certain share ownership continuity tests)[6] when they may be deducted from assessable income in those years. At best, the company may offset its losses against assessable income derived by other companies in the same group of companies (again subject to stringent ownership tests)[7] in the year the losses were incurred. In relation to closely held companies the corporate group situation arises relatively infrequently. Therefore, because company losses cannot be immediately offset against a shareholder's other income, whereas they can in the partnership situation, there is a significant tax timing disadvantage if an incorporated legal entity is adopted. This may become a permanent disadvantage if the company never turns in a taxable profit. It is for these reasons that the partnership entity is often utilized at the outset of a business undertaking (where potential losses are anticipated) with the intention of incorporation after that initial loss-making phase has passed.

The New Zealand Government's well-iterated policy position is that the tax system should be neutral in the context of business decisionmaking, i.e. there should be a "level playing field" in the way different legal entities, which in substance undertake the same business, must be taxed. Hence, the new legislation is based on the premise that the manner in which different businesses are taxed should not differ because the legal form of their undertaking is different. This is simply a specific business application of an historical tenet of taxation, i.e. horizontal equity between taxpayers.

4. A. Valabh, R. Congreve, L. McKay, R. McLeod and T. Robinson, *The Taxation of Distributions from Companies – Final Report*, Report of the Consultative Committee on the Taxation of Income from Capital (Wellington: Government Print July 1991).
5. See Secs. 4(1)(a) and 4A(1)(c) of the Act.
6. See Sec. 188.
7. See Secs. 191 and 191A.

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NEW ZEALAND:

TAXATION OF CLOSELY HELD COMPANIES: THE NEW ZEALAND MODEL

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I. INTRODUCTION

The New Zealand Income Tax Amendment Act (No. 2) 1992 incorporates into the Income Tax Act 1976 ("the Act") the legislation[1] for the taxation of "closely held" companies in New Zealand. The law is presently subject to some proposed, and relatively minor, amendments in the Tax Reform Bill (No. 5) 1992 ("the Bill") which, at the time of writing, was before the Parliamentary Finance and Expenditure Select Committee.

The legislation emerged from initial proposals by the Consultative Committee on the Taxation of Income from Capital ("the Committee"). In its report,[2] the Committee postulated that "closely held companies are effectively substitutes for partnerships and sole traders"[3] in the sense that a very small number of shareholders of small companies are virtually synonymous with the company they own.

Based on this classification of companies, the Committee created the concept of a *qualifying company* ("QC"), being a closely held company which meets specified criteria enabling it to elect to be taxed in a manner vaguely comparable to that of a partnership. But the full integration approach adopted in the United States has not been transposed to New Zealand. Rather, a novel method, based on the dividend imputation system, was developed. It involves making corporate distributions effectively tax-free in shareholders' hands by attaching full imputation credits to those distributions where the company has paid tax (which distributions are taxable in the shareholders' hands) and rendering all other distributions tax-exempt to the shareholder, thus ensuring that corporate income is ultimately taxed at the shareholders' marginal tax rates.

II. FEATURES OF THE QC REGIME

Briefly, the main features of the regime are set out below:

A QC must distribute fully imputed taxable dividends and, to the extent that dividends are not fully imputed, they are exempt dividends. This means that a shareholder recipient will incur no tax liability on the dividend distributions he/she derives because either he/she obtains at least a full imputation credit in respect of taxable dividends derived (assuming the corporate tax rate applied in determining the imputation credits does not exceed the maximum personal tax rate) or the dividends are simply exempt. To the extent that there is an insufficient credit balance in the company's dividend imputation credit account to enable dividends to be fully imputed, the dividend distribution is exempt from tax in shareholders' hands.

To fall within this concessionary regime, a company must meet the following criteria:

(1) All shareholders and directors must unanimously agree that their company becomes a QC.
(2) The company must have no more than five shareholders. Shareholders related to the first degree are treated as one shareholder. All beneficiaries of a trust who have derived dividend income from a company during its life as a QC are deemed to be shareholders. There are provisions to trace through to ultimate non-corporate shareholders.
(3) Corporate shareholders themselves must be QCs.

1. Secs. 393-393T of the Act.
2. A. Valabh, R. Congreve, L. McKay, R. McLeod and T. Robinson, *The Taxation of Distributions from Companies*, Report of the Consultative Committee on the Taxation of Income from Capital (Wellington: Government Print, November 1990).
3. *Id.* at 12.

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First, the proposal is not based on sound economic analysis. Under the proposal, a foreign-controlled corporation is required to report a minimum taxable income from related-party transactions without any reference to the functions it performs, assets it utilizes or risk it incurs. Thus, the proposal does not seek to allocate to the foreign-controlled corporation an amount of income determined by reference to the value added by the foreign-controlled corporation to the specific transaction under review. Rather, as a surrogate for a true economic analysis, the proposal requires that the foreign-controlled corporation earn a minimum amount of income based on a formula determined by reference to a book income industry average.

Second, the proposal is not based on sound tax policy. The proposal computes minimum taxable income by reference to a percentage of the gross receipts derived by a foreign-controlled corporation. To impose US tax on a formulary basis only on foreign-controlled corporations and without reference to whether the recipient has derived net income does not reflect good tax policy and may be subject to a constitutional challenge.

The minimum taxable income standard of the proposal also is not consistent with the arm's length standard. It does not clearly reflect income as it does not allocate the appropriate amount of income from the controlled transaction among the participants to the transaction by reference to the value that each such participant adds to the transaction. In addition, the proposal may not clearly reflect income because it could cause income to be subject to US tax in situations where the multinational enterprise on a consolidated basis suffers a loss.

Third, the proposal is likely to be viewed by US treaty partners as violating US bilateral income treaty obligations on the basis that a formulary approach is inconsistent with the arm's length standard, causes income not attributable to a US permanent establishment to be subject to US tax and is inconsistent with the non-discrimination provisions of our treaties.[3] In this latter regard, the repeal of deferral for US-controlled foreign corporations will not cause all US operations to be treated similarly. There still will be a different standard for determining the profits of a foreign-controlled US corporation from the standard that will apply in determining the profits of a US-controlled US corporation.

It is possible that if the proposal were enacted in its current form that some foreign countries could seek to retaliate against US multinationals doing business within their borders. Retaliation would be detrimental to US controlled corporations and would be contrary to other objectives of the bill. In that regard, the United Kingdom has already lodged a strong protest against the provisions contained in the bill that are discriminatory against foreign residents, charging that passage of the bill could lead to pressure on the British government to institute retaliatory measures.

Finally, it is this commentator's view that the proposal, if enacted, would exacerbate substantially the already difficult problem the IRS already faces in auditing multinational transactions. Under the proposal, the IRS would first have to determine the applicable industry profit percentage. This might not be an easy task, particularly if the data sufficient to compute the applicable profit percentage is not readily available. Even if the data were available, the IRS seemingly would be engaged in additional audit activities. Under the proposal, it would appear that the IRS first would have to determine whether the foreign-controlled corporation satisfied the minimum taxable income requirement, and even if it did, then the IRS next would have to determine whether under the general arm's length rules, the foreign-controlled corporation should have reported additional income. Moreover, it is not clear how the IRS would be able to process all the requests for qualified Section 482 agreements that are likely to be filed.

3. The 1979 Report by the OECD on Transfer Pricing and Multinational Enterprises endorsed the arm's length standard and explicitly rejected formulary approaches for allocating profits between related enterprises as "necessarily arbitrary". The arbitrariness of the proposal is evidenced by the fact that it is based on a book income industry average that may have no relevance to the actual amount of income that should be allocated to the foreign-controlled corporation and most likely will result in the foreign-controlled corporation having income subject to US taxation that is either understated or overstated.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

OCTOBER 1992

Taxplanning in Europa, Maastricht (the Netherlands), 9 October (Dutch):
Rijksuniversiteit Limburg, Vakgroep Belastingrecht, PO Box 616, 6200 MD Maastricht, Tel.: (0)43-883148.

46th Congress of the International Fiscal Association, Cancún (Mexico), 11-16 October (English, French, German, Spanish), main subjects: Transfer pricing in the absence of comparable market prices and Tax consequences of international acquisitions and business combinations.
Congress Secretariat: Mundus Tours de México, Paseo de la Reforma No. 379 – 7° piso, Colonia Cuauhtémoc, 06500 México D.F., Tel.: 5 5255250, Fax: 5 5256306.

Tax Efficient Corporate Organisation, Training Course, Paris (France), 21-23 October (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX (United Kingdom), Tel.: 71-7798601, Fax: 71-7798599.

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retary of the Treasury ("Secretary") will prescribe the applicable industry profit percentage for each "category of business activities". Business activities generally will be categorized by reference to the three digit classification of the Standard Industrial Classification Code (SIC Code), although the Secretary in appropriate cases may prescribe an aggregation of two or more three-digit classifications or a classification system other than the SIC Code. Thus, for example, where appropriate, the Secretary may distinguish between two types of businesses that fall into the same three-digit SIC Code and prescribe separate applicable profit percentages for each.

The bill provides that the proposal will not apply in the following two circumstances:

(1) If the foreign-controlled corporation has entered into a "qualified Section 482 agreement" with the IRS *prior* to the time it files its tax return for the taxable year that covers *all* related party transactions in any category of business activities of the foreign-controlled corporation. The IRS is granted sole discretion to enter into an agreement if it determines that such agreement will result in a clear reflection of the taxable income of the foreign-controlled corporation from that category of business activities to which the agreement relates. (It is contemplated that the procedure for negotiating and entering into these agreements will be similar to those relating to advance pricing agreements.)

Though the bill contemplates that it will be necessary generally for the agreement to be in effect when the return for the year is filed, the IRS will have the flexibility in its sole discretion to accept a foreign-controlled corporation's pricing methodology for an earlier taxable year even though a qualified Section 482 agreement has not been entered into for that prior year.

(2) The IRS may waive the minimum taxable income requirement even in the absence of a qualified Section 482 agreement if it finds in its sole discretion that application of the requirement would be inequitable. This could arise in the case of a casualty or disaster, e.g. from a fire, theft, flood, earthquake, war or riot, which would make application of the general minimum taxable income rule inequitable.

The JCT Explanation states that the IRS' discretion to waive the minimum taxable income requirement would be extremely narrowly drawn and would not extend to situations where losses are due to poor business judgment. Under the JCT Explanation, the IRS would not be permitted to waive the minimum taxable income requirement of a foreign-controlled corporation on the basis that the foreign multinational is generating a worldwide consolidated loss since it still may be appropriate to allocate a normal profit to a foreign-controlled corporation with respect to, for example, the US distributorship activities.

There are no other exceptions provided in the bill.

The JCT Explanation states that "it is believed that the bill does not violate treaties" because all US operations would be treated similarly. The rationale for this conclusion is that since the bill terminates deferral for US-controlled foreign corporations, there will no longer be the opportunity to shift profits to such corporations; likewise, the shifting of what would otherwise be the normal profits of a foreign-controlled corporation to foreign affiliates on the basis of intercompany pricing would no longer shelter that income unless it were established to the satisfaction of the IRS that this would produce a fair result. Thus, similarity would be achieved in this way according to the JCT Explanation.

The JCT Explanation also adds that the proposal is consistent with the business profits and associated enterprises articles of treaties. In that regard, it indicates that imputation of a minimum profit as is provided in the bill is a *prima facie* reasonable manner of computing the income attributable to the permanent establishment or enterprise, especially in view of the fact that the amount required is chosen on the basis of a fraction of the domestic industry average.

Notwithstanding this expression that the proposal is compatible with the US treaty network, the discussion in the JCT Explanation concludes that "if, despite the belief expressed above, it is ultimately determined that this provision of the bill violates a treaty obligation of the United States, it is intended that the provisions of the bill will nevertheless apply".

COMMENTS

The proposal emanates from the perception (which to date has not been substantiated) that foreign-controlled corporations do not pay their fair share of US tax, and it is the most recent attempt to raise additional revenue from foreign-controlled corporations.[2] In 1990 Chairman Rostenkowski initially had suggested a 50/50 pricing presumption. Under that proposal, a foreign-controlled corporation would have been treated as deriving taxable income from the sale of property acquired from a foreign affiliate of an amount not less than 50 percent of the combined taxable income resulting from the sale of such property by the foreign-controlled corporation and any related party, unless the foreign-controlled corporation could prove otherwise to the satisfaction of the IRS.

The proposal is a variation of Rostenkowski's approach since it, too, mandates that foreign-controlled corporations report a certain minimum taxable income, as determined by reference to a formula. Nothing in the proposal, however, suggests that the IRS would be precluded from asserting in appropriate cases that the foreign-controlled corporation should earn a greater amount of income under the general rules of Section 482. Moreover, the proposal would not appear to permit the foreign-controlled corporation to substantiate the arm's length nature of its transfer pricing by reference to the general rules of Section 482, other than through obtaining a qualified Section 482 agreement. Thus, in contrast to the earlier Rostenkowski proposal, the current formulary approach could not be rebutted.

The proposal is subject to numerous criticisms.

2. There are two other bills pending before the House Ways and Means Committee that would impose an alternative minimum tax to remedy perceived Section 482 enforcement problems against foreign-controlled corporations.

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UNITED STATES:

THE FOREIGN INCOME TAX RATIONALIZATION AND SIMPLIFICATION ACT:

A BRIEF ANALYSIS OF THE MINIMUM TAXABLE INCOME TRANSFER PRICING APPROACH FOR FOREIGN-CONTROLLED CORPORATIONS

Alan W. Granwell

INTRODUCTION

On 27 May 1992 Chairman Rostenkowski and Representative Gradison of the House Ways and Means Committee introduced the Foreign Income Tax Rationalization and Simplification Act of 1992 (H.R. 5270 ("the bill")). The bill, if enacted, would make important changes to the tax treatment of US companies operating abroad and of foreign companies and individuals with business or investments in the United States. While many of the provisions of the bill affecting US multinational corporations are favourable, others affecting US and foreign persons are intended to be major revenue raisers and are controversial. The sponsors of the bill recognize that many of the bill's proposals are controversial; they view the bill as a "good faith effort" to identify revenue raising provisions for public discussion.

One of the most controversial provisions of the bill is the proposal to require that a minimum amount of taxable income be reported by certain foreign-owned US corporations and US branches of foreign corporations, that engage in substantial transactions with foreign related parties; this provision ("the proposal") would be effective for taxable years beginning after 31 December 1992.

This article will describe the proposal[1] and comment on its implications.

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A graduate of Middlebury College, the Boston University School of Law (J.D., 1968, LL.M in taxation, 1969), and the New York University School of Law (LL.M., 1976), Mr Granwell also served as an adjunct assistant professor of law at the New York University School of Law Graduate Tax Program.

Mr Granwell is a frequent lecturer on international taxation and he has written numerous articles on subjects involving international taxation.

DESCRIPTION OF PROPOSAL

Under Section 304 of the bill, Section 482 of the US Internal Revenue Code ("the Code") would be amended. A special transfer pricing rule would apply to US corporations that are at least 25-percent owned by a foreign person, and to US branches of foreign corporations (collectively, "foreign-controlled corporations"), that have substantial transactions with foreign related persons. Under the proposal, the taxable income of the foreign-controlled corporation from any line of business would have to be no less than 75 percent of the amount determined by applying an "industry profit percentage" to the taxpayer's gross receipts from that line of business. Alternatively, the foreign-controlled corporation could enter into an agreement with the Internal Revenue Service (IRS) concerning intercompany pricing of related party transactions.

In order to subject to the proposal, a US corporation must be 25-percent owned under the Section 6038A rules of the Code or be a foreign-controlled foreign corporation subject to US net basis taxation on its business income. A foreign-controlled corporation has "substantial foreign related person transactions" for any taxable year if the aggregate amount involved in transactions with foreign related persons (as determined under Section 482) during such taxable year exceeds the lesser of US$ 2 million or ten percent of the gross income of the foreign-controlled corporation for such taxable year. In that case, the minimum taxable income requirement would appear to apply to *all* of the foreign-controlled corporation's transactions.

The "applicable industry profit percentage" is pretax financial book income divided by gross receipts and represents an estimate of an average earnings rate. The Sec-

1. Additional details relating to the proposal are contained in an explanation of the bill prepared by the staff of the Joint Committee on Taxation ("the JCT Explanation"). In addition, the bill required the Treasury Department to conduct a study of issues related to transfer pricing rules and the proper taxation of foreign persons doing business in the United States. The study is to include an examination of the effectiveness of provisions contained in the bill, issues related to unitary method of taxation and compliance issues including the advisability of providing additional confidentiality for information provided by US corporations for use in formulating third-party comparable information. Due date for the study is 1 January 1994.

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Next month we will feature Part II of this article, which looks at alternative market-based instruments for pollution control.

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non-pollution control operation contributing only to process efficiency. Should this expenditure also be eligible for a tax preference?

The dilemma for a legal draftsman is whether to be explicit and risk leaving out potentially beneficial technologies or provide a broad definition and risk tax abuse, with an associated revenue loss.

Taiwan uses a fairly broad definition. Japan, on the other hand, uses a detailed listing of equipment eligible for special preferences. The classification promulgated by the Japanese Ministry of Finance Notification is based largely on equipment, rather than processes. The types of anti-pollution machinery and equipment for which tax preferences are allowed include the following:[58]

(1) equipment for the disposal of waste oil from ships (including oil separators, incinerators, and other accessories),
(2) desulphurization equipment (including hydrogenating desulphurizers of hydrocarbon oil, etc),
(3) sewage treatment systems (including attachments to equipment or structures such as conveyors, measuring instruments, automatic regulators, etc.),
(4) smoke treatment facilities (including ventilators, heat exchangers, transformers, etc.),
(5) malodorous substance treatment systems (including exhaust pipes, gas coolers, dust collectors, air compressors, etc.),
(6) noise control systems (including silencers, sound arresters, forging machines, etc.), and
(7) industrial waste disposal facilities (including incinerators, devices to make hydrocarbon oil form waste plastics, etc.).

There are no fixed formulae that could eliminate abuse. The trade-off a tax department must make is between maintaining a technical staff to audit incentive claims and providing a detailed (but never up to date) current list of equipment and processes.

IV. CONCLUSION

Tax incentives designed to promote investments in pollution control equipment have been the dominant form of fiscal instrument to combat pollution used by countries worldwide. As we have shown, these incentives may or may not assist in the long-run improvement of environmental quality. Furthermore, if not properly designed, such tax incentives can create distortions in the choice of technology and length of asset life, leading to the selection of those that are both economically and environmentally inefficient. Recognizing the limitations of using such indirect methods to combat environmental damage, many of the countries in Asia, Europe and North America are considering other forms of market-based incentives that more clearly target the desired environmental objectives and that provide direct subsidies or taxes to achieve them. It is in this area that the important innovations in policy design are now occurring.

58. Notification No. 69, Table 1, 29 May 1973; Sangyo to Kogai (Industry and Pollution).

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Among the countries that have provided extensive tax incentives for R&D in the area of environmental protection is the United Kingdom. R&D has been specifically singled out for preferential treatment, at the exclusion of all other tax preferences for investments in pollution control equipment.

4. Deductibility of future period costs

Many industries face the problem of matching future reclamation costs (incurred after the income-earning process has ended) with current income. Reclamation and abandonment problems have been recognized, if not completely resolved, in nuclear power generation and offshore oil and gas operations. A perfect example is the problem faced by mining companies needing to deduct reclamation costs incurred after the mine has run out of ore.

It is imperative, both for encouraging industrial activity and protecting the environment, that such costs and legal responsibilities be explicitly clarified. Tax treatment is closely related because of issues about whether these costs should be considered expenses and how they should be timed.

Tax preferences enter the picture in cases where these costs can place an unacceptable burden and force closure. Under these circumstances, the government may wish to help the firm create a reserve designed to meet these future period costs.

Arguments against providing a means of matching anticipated future costs with current year income and profits are that future costs are unascertainable because they are contingent.[53]

It is necessary to determine how to decide whether such future reclamation and shut-down costs should be made deductible. The Canadian Income Tax Act prescribes three tests:

(i) Is a liability that will require the expenditure of funds in the future an "expense"? It is necessary to first ascertain whether the liability is current, future or contingent in order to answer this question. We must then determine whether the amount of the expense is determinable or just an estimate.

(ii) If such a liability can be viewed as an expense, was it incurred "for the purpose of gaining or producing income"?

(iii) If such a liability can be viewed as an expense, is a deduction prohibited because it is an expense "on account of capital"? (This test tries to establish whether there are any "enduring benefits" or "lasting advantages" to the taxpayer.)

5. Capacity to absorb tax preferences by firm size

Tax incentives are not uniformly neutral with respect to firm size. There are two explanations for this phenomenon. It has been noted that most firms do not really conduct the investment profitability calculations needed in order to make full use of the available incentives. However, larger firms seem more likely to do so.[54] The implication is that large firms may absorb incentive benefits more completely and thus become still larger.[55] The chief benefit may be assumed to be the lower aggregate cost of capital.

The second explanation is essentially an issue of cash flow, or more specifically, the presence (or absence) of taxable income. Larger firms, with their multiplicity of activities having different project vintages and cash-flow profiles, are well-positioned to utilize tax preferences by consolidating their income. Small firms have less flexibility in this regard. Consequently, they are often unable to consume their allowable tax credits and deductions. This problem is very similar to the one between start-up enterprises and older firms. A retrogressive solution to the problem would be to restrict tax benefits to individual operations, i.e. ring-fencing of investment activities. The more progressive approach would provide some appropriate means for the complete utilization of tax preferences.

6. Defining a pollution control investment

To ensure that the incentives provided are accessible only to those investments intended for preferential treatment, clear and unambiguous definitions are necessary to ease the administrative burden and curtail abuse. In the case of Taiwan, the legislation uses the terms "pollution control equipment" and "pollution control technologies".

"Pollution control equipment" is defined as any equipment that handles, inspects or tests pollution or scrap created during the process of production or operation in order to meet the standards or prescriptions of environmental protection. Eligible items include the equipment and related civil facilities for air pollution control, water pollution control, treatment of scrap, and environment inspection and testing.[56] "Pollution control technology" includes any patent rights or technological know-how that is required to be used in conjunction with the equipment mentioned above.[57]

Problems of definition

Definition becomes an issue in tax design when coverage is selective. It is a problem not specific to the treatment of pollution control equipment or technologies, but equally applicable to selective taxation in any context. If pollution control hardware and technology are homogenous and have only a single use (i.e. pollution control), the classification or definition exercise is greatly simplified. However, there are numerous types of equipment and processes, some of which can be used for other non-pollution control tasks and this serves to complicate matters.

For example, a mechanical screen designed to prevent solid contaminants from entering a water body can rightly be considered as pollution-reducing. The same screen may, however, also be used to remove solid debris from entering the plant's cooling system or other auxiliaries. This constitutes a

53. *Supra* note 49, at 10:3.
54. *Supra* note 34, at 52.
55. Eric W. Kierans, *Contribution of the Tax System to Canada's Unemployment and Ownership Problems*, Canadian Perspectives in Economics (Toronto: Collier-Macmillan Inc., 1972).
56. International Bureau of Fiscal Documentation, *Taxation and Investment in Asia and the Pacific*, Supplement No. 87 (November 1991), at 58a.
57. *Id.*

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Second, from a government perspective, granting an incentive whose benefits cannot be fully realized will decrease the level of tax expenditure items on the budget. It is, therefore, possible that revenue collections would not be reduced much by the granting of such incentives. Politically, however, the objective of encouraging an optimal level of social investment in pollution control equipment is normatively achieved.

(a) *Carry-over provisions*

Provisions to carry over unused tax preferences enhance the incentive to invest in pollution control equipment. These provisions usually allow a firm with unused tax credits and/or deductions to utilize them in future years. In most investment cash profiles, the likelihood of substantial positive cash flows in the initial years is small. Even if there are significant positive cash flows in the initial years, other deductions for "normal" depreciation and interest expenses can considerably reduce the value of the investment incentive.

Most countries allow unused tax preferences to be carried forward for a specified number of years. Taiwan, for example, permits a four-year carry-over period. Singapore, as an extreme example, permits unused tax incentive allowances to be carried forward indefinitely.

(b) *Transfer of unused tax preferences*

In some cases, an enterprise may be unable to utilize all its tax preferences within the specified carry-over period. More importantly, the longer an unused tax preference is carried forward the lower its value. Therefore, even if countries have a carry-over provision, there will still be a bias against new investments.

If the investing entity were allowed to sell or transfer its unused tax preferences to another entity that was able to use the deductions/credits currently, it stands to gain the full value of the tax preference. Alternately, the government could provide a cash refund for the unused tax preferences. However, this could be administratively difficult or undesirable due to revenue constraints. Canada and the United Kingdom use refund mechanisms for R&D tax incentives.

It is interesting to note that studies have found direct refundability to be more efficient than mechanisms to facilitate the transfer of unused tax preferences. Evidence of this was found in Canada, where flow-through shares were used as a form of tax-based financing for corporations in the natural resource sector. These shares were "sold" as tax preferences to investors who could use them to reduce their taxes payable.

For the efficient transfer of unused preferences between the entity issuing the flow-through shares and the investor who can use the tax preferences, the net revenue cost to the government should be the same as the net benefit received by the issuing entity. It was found that for every dollar of revenue foregone by the government in offering the tax preference, the enterprise received approximately 40 cents, owing to inefficiencies in the flow-through arrangement's transfer of the unused preferences.[51]

An example of a system whereby tax preferences could be sold to other non-related entities previously available in the United States was repealed in 1983. The allowance was directed to firms that had no taxable income in the early years. It was called the "safe harbour" scheme, and operated through a leasing arrangement.[52] Firms without taxable income could sell their depreciation allowances and investment tax credits to corporations with taxable income.

3. *Providing incentives for pollution control research*

To further the objective of environmental protection, some countries have decided to provide incentives for R&D in the area. It is possible to extend the debate and argue that tax incentives should be provided exclusively for R&D activities in pollution control, and not for equipment installation in production facilities. We will now briefly outline the issues and problems concerning tax incentives for R&D.

Innovative activities in the R&D of pollution control equipment entail financial risks for the parent entity. Funds diverted towards basic R&D activities have traditionally been accorded various incentives, ranging from deductions, tax credits and direct subsidies to a host of other incentives. Support for these incentives has been predicated on the grounds that such tax expenditure items do indeed yield benefits in excess of the present value of the budgetary costs. Since these incentives reduce the effective cost of capital faced by the firm or entity, they can also be thought of as a way for the government to share in the financial risk of the research activity.

There is a belief that private firms would carry out insufficient research activity from a social perspective if they did not expect to capture enough of the benefits for themselves. It is, therefore, argued that this presents a clear case for public subsidies. R&D incentives have been the topic of intense policy and legislative debate.

From the policy angle, while there are clear reasons for public support, it is not entirely clear that tax incentives are the appropriate subsidy mechanism. Government support of basic and applied research at research institutes and universities may be the better investment. In addition, it would ensure that the knowledge generated would become a true non-exclusive public good available to everybody. Tax incentives merely subsidize the cost of private research, thereby reducing the final public benefit of the expenditure.

However, the legislative problems with R&D tax incentives are of greater direct concern. Most of these problems lie in the definition of what constitutes R&D in the context of profit-making taxable entities. Since one of the reasons for considering R&D tax incentives is to encourage welfare-enhancing activities that would not have been carried out otherwise, a good definition should distinguish between these activities. In other words, R&D that would be conducted as part of routine business development should be separated from that which is sincerely done for the purpose of advancing scientific relations or technologies.

51. Glenn P. Jenkins, "Tax Shelter Finance: How Efficient Is It?", in *Policy Options for the Treatment of Tax Losses in Canada*, The Clarkson Gordon Foundation (1991), at 7:3-7:41.
52. Provisions of the Economic Recovery Tax Act (ERTA) of 1981, Public Law No. 97-34, 95 Stat. 172 (1981), US Internal Revenue Code.

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to a rejection of the basis on which the optimal total pollution load was determined when formulating environmental protection regulation.

Strictly, an acceptable pollution load must be determined before an appropriate incentive can be designed to eventually achieve this goal. A tax incentive, however, distorts the relative price signals otherwise provided by economic instruments that may reduce pollution and may in fact be counterproductive. In fact, a recent study in Canada suggests that the removal of subsidies may be a more effective way to reduce pollution levels, particularly in those sectors most favoured by government subsidies.[50] This was found to be the case for subsidized sectors like mining and primary metals processing.

Finally, tax incentives can reduce the variance between firms in the costs of curbing pollution, thereby reducing the effectiveness of other economic instruments such as tradeable permits. For example, wider variances in costs ensure the development of markets for tradeable permits because they generate a stronger incentive to trade. Subsidies can reduce the absolute, and in some cases, the relative difference, in costs and cause potential trading opportunities to be depressed.

C. *Improving the effectiveness and efficiency of investment incentives*

The criteria outlined in Part B may be used to determine the weaknesses and other inconsistencies of investment tax incentives. Though the incentives may be appropriate for promoting non-pollution-related objectives, their relevance to pollution abatement and control is gradually diminishing. As noted earlier, tax incentives for pollution control equipment achieve multiple policy objectives, and therefore continue to be used.

An examination of the structural differences in incentive design reveal these multiple objectives. Although the incentives can be grouped under the broad headings of accelerated depreciation, investment credits and expensing, differences in accounting procedures and eligibility requirements, as well as conditionality clauses, exist.

Some of the differences legislated include:

- Differentiation between imported and domestically supplied pollution control equipment, evidenced in Korea and Taiwan.
- Differentiation based on plant age, as is the case in Canada.
- Differentiation based on administrative and accounting procedures adopted, such as the use of blue returns in Japan.
- Differentiation based on the type of technology, i.e. the provision of greater incentives to use advanced or pioneering processes or equipment, which is illustrated by Taiwan, Korea, the Netherlands and Canada.

In a few cases, these distinctions have helped improve the environmental cost effectiveness and economic efficiency of the tax incentives. This sub-section analyses a few mechanisms and structural aspects of tax incentive design that could enhance their efficacy. A comparative perspective is used wherever possible.

1. Qualifying eligibility based on plant age

This eligibility clause has been used in Canada to restrict the tax incentive to older production facilities.

Pollution abatement costs vary greatly based on plant location, process used and plant age. An efficient pollution control incentive will account for these differences. The cost of installing pollution control equipment in older plants and facilities usually has a much larger impact on operational cost than the installation of similar equipment in newer facilities. Often, this implies requiring newer (i.e. more modern) plants to make greater emission reductions, while older facilities with expensive control options may make fewer reductions.

In effect, the marginal cost of achieving a given level of pollution abatement through investments in control equipment is lower for newer facilities and higher for older facilities.

There will be older facilities, however, whose pollution burdens place unacceptable costs on society. The authorities are then left with no choice but to close the plant, risking unemployment. Alternatively, the reduction of emission levels may be required of all plants in order to meet minimum ambient standards. Under these circumstances, the case for providing some assistance to older facilities could be made.

Canada has targeted the incentive, or subsidy, to the older plants, making accelerated capital cost recovery available to facilities commissioned before 1974. (See Section I for a description of the Canadian accelerated depreciation allowances).

2. Impact on new investments

There is a notion that new investments do not really stand to gain from a variety of tax incentives. There is a very large tax benefit to existing (or older) facilities that have positive cash flows when they claim deductions or credits on new investments on pollution control equipment. These benefits on new investments are not attractive incentives for those investors who expect to suffer losses in the initial years after making an investment. In other words, tax deductions and exemptions are of benefit mainly to those who have an operational enterprise with a positive tax liability. For start-up enterprises, this is rarely the case.

Even in cases where the enterprise is likely to be immediately profitable, it will often be unable to utilize all the investment incentives offered. A barrier to innovation is introduced as a result of favouring owners of old capital over new entrepreneurs.

To make investment tax credits and capital cost allowances equally attractive to new enterprises who do not foresee taxable income for a few years after start-up, provisions for treating unclaimed tax preferences are necessary. These could include carry-over of unused preferences, and provisions to transfer unused preferences to unconnected entities.

There are two perspectives on the issue. First, there is the argument for eliminating the bias against new investments.

50. Brian Hull and Antoine St-Pierre, *The Market and the Environment*, The Conference Board of Canada, Ottawa (1990), at 19.

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its associated cost on economic growth rates. It is argued that investments in pollution control devices crowd out investments for capital accumulation, thereby further reducing the rate of economic growth.[45] In an effort to determine the impact of non-productive pollution control investments, models have been developed that were designed to plot the transition path of the US economy after investment requirements for pollution control were eliminated. Results indicate that in the long run, real GNP would rise by a maximum of about 1.29 percent, the exchange rate would appreciate by 0.462 percent, consumption would increase by 0.489 percent, and capital stock would rise by 2.266 percent as a direct result of the drop in the price of investment goods.[46]

Though these numbers seem to indicate substantial economic opportunities foregone as a consequence of the costs of pollution control, the real issue is whether the growth in income and consumption would be consistent with environmental protection.

2. Efficiency of investment incentives

A *more* efficient tax system is described as one that interferes *less* with the market's allocation of resources. With reference to tax instruments for environmental protection, two guidelines of system design must be adhered to. First, and most directly relevant, is the balancing of social costs and benefits, which focuses on the use of the tax system to counteract negative externalities. These "externalities" if left unaffected by economic policy will result in a suboptimal (or inefficient) allocation of resources. The most efficient incentives are those which relate most directly to the activity being encouraged. To conform to this guideline, the incentives should be applied only to new, additional or marginal activities. The reasoning behind this principle is that any activity being carried out in the absence of an incentive, clearly does not need it to bring about that activity. If the incentive is nevertheless granted, it will be redundant or inframarginal and will amount to a windfall for the recipient.[47]

The second guideline for assessing tax system efficiency is the principle of neutrality. Under the given conditions of selective tax preferences, the most comprehensive definition is the one stated earlier by Harberger; a neutral tax incentive is one that does not induce new "covered" investment with low rates of social yield, while failing to induce other "covered" investments with higher rates of social yield.[48] ("Covered" investments refer to those which are eligible for the tax preference under the tax code.)

To illustrate further, let us consider a preferred group of assets, i.e. one covered by the tax incentive. Suppose that in the absence of a tax incentive, corporate investments at the margin typically yielded a 20 percent rate of return gross-of-tax and a ten percent rate net-of-tax. The introduction of a tax incentive would cause more investments to become "interesting" from the private standpoint. Neutrality within the preferred category requires that an investment stimulus make all investments with gross-of-tax above a critical level (for example 18 percent) acceptable, while not encouraging any with gross-tax yields that are less than that level. Making the incentive more generous would admit all investments with gross-of-tax yields of, say 15 percent or more, but none with yields of less than 15 percent. For each level of stimulus, neutrality requires some rate of social return that will tend to encourage all independent investment projects meeting that rate to be privately accepted, while discouraging the private acceptance of projects failing to meet it.

Tax incentives that affect the net-of-tax return for all investments at an *equal rate* have the property of reducing the critical level of expected marginal productivity in a very orderly manner. Under such an incentive regime, it would be possible for the government to have a normal tax administration in which the gross-of-tax rate of return was 20 percent per annum, a "preferred" category in which this rate was 16 percent per year, and a "super-preferred" category in which the cut-off rate was 10 percent per annum.

Each such category should be free from cases in which the incentive structure leads to the acceptance of an inferior alternative (for example with a 14 percent rate of return in the 16 percent per year category), while other alternatives covered by the same category are rejected, even though they have a higher (e.g. 17 percent) rate of return.

3. Policy implications of the evaluative criteria

The ability to justify the use of an investment incentive for pollution control equipment on the basis of these evaluative criteria suffers from three major problems.

First, there is an implicit divergence from the polluter-pays-principle, which is fast becoming a dominant determinant in using economic instruments. While there are political reasons for providing a hidden tax expenditure subsidy through a general tax incentive rather than an outright cash subsidy, the fundamental issue is that polluting activities are being subsidized without affecting pollutant levels.

More specifically, the use of investment incentives indicates a lack of focus on the broader issues of environmental protection. Allowing deductions for environmental expenses in the absence of a policy agenda to deal with specific environmental problems is much like trying to fit a square peg into a round hole.[49]

Second, focusing on the measurement of tax incentive effectiveness and efficiency actually distracts attention from the central task of determining the socially optimal level of pollution reduction. The use of an investment incentive amounts

45. Dale Jorgenson and Peter Wilcoxen, "Impact of Environmental Legislation on US Economic Growth, Investment, and Capital Costs", from *US Environmental Policy and Economic Growth: How do we Fare?*, monograph by the American Council for Capital Formation Center for Policy Research, Washington D.C. (March 1992), at 13.
46. *Id.*, at 16-19.
47. Dan Usher, "The Economics of Tax Incentives to Encourage Investment in Less Developed Countries", *Journal of Development Economics* (June 1977), at 117.
48. *Supra* note 33, at 299.
49. Robin J. Macknight, *Square Pegs and Round Holes: Environmental Cost Under the Income Tax Act*, Canadian Tax Foundation, Conference Report 1990, at 10:2.

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For example, in paper pulp production, additional upstream pulp processing to remove lignin can be used. The more lignin removed upstream, the less chlorine needed to bleach the pulp. A reduction in the chlorine requirement greatly reduces downstream water treatment and toxic discharges. Since the upstream ventures may not be eligible for the investment incentive, there could be a bias towards using the older process, requiring more water treatment and causing more pollution.

It is difficult to measure the extent of this bias. Nevertheless, it should remain in perspective during any analysis of tax incentives for pollution control.

1. Cost effectiveness of investment incentives for pollution control

Cost-effective utilization of investment incentives for pollution control requires that the marginal cost of the abatement effort be less than or equal to the marginal benefit derived from the reduction. The principles of cost-benefit analysis form the analytical foundations of these criteria.

A general investment tax incentive for pollution control equipment does not differentiate between the marginal control costs of various pollution sources. Expressed differently, a general incentive tacitly assumes that marginal control costs are the same across all sectors.

Costs can be broadly defined to include direct costs, such as investment costs undertaken. Additionally, there are indirect welfare costs resulting from the economic costs of raising tax revenues and/or borrowing to compensate for the foregone revenue.

Benefits include the value attributed to improved environmental quality. Since pollution control requirements are perceived as having negative impacts on industrial competitiveness and other macroeconomic indicators, improvements in these variables may also be included.

To facilitate an accurate comparison, however, all costs and benefits should be attributed to the specific investment tax incentives for pollution control. In practice this may be difficult. Direct costs are easy to estimate because they are equal to the investment expenditures undertaken. On the other hand, the direct benefits and the indirect effects from improved environmental quality are more difficult to determine. First, the benefits are often intangible, necessitating the use of various techniques designed to assign monetary values to environmental quality. Second, measurements of the economic impact on other sectors require simplifying assumptions that may make the analytic reasoning rather tenuous. Third, the data required may be unavailable, and even if available it may be not be accurate enough to draw useful policy conclusions.

Three classes of benefits have the related measurement problems explained below.

(a) *Measuring marginal improvements in environmental quality*

Emission reductions may be a result of the prescribed standards and regulations laid down by the environmental protection agency and may not be a direct consequence of the tax incentives provided.

For a tax incentive to cause incremental pollution reduction beyond levels mandated by regulation, there would have to be firms investing in "excessive" pollution control equipment.[42] For this to be true, the present value of the tax incentive on the investment would have to be higher than the present value of the expenditure on equipment. This seems unlikely for two reasons:

- Pollution control investments do not generate any income for the enterprise since no firm is likely to invest in facilities whose marginal financial cost will be above the marginal tax benefit, unless legally required to. In order for pollution control investments in excess of the legal requirements to be attractive, the incentive would have to provide a subsidy in excess of, or at least equal to, the equipment cost.
- There is no non-financial incentive for the firm to internalize the costs of environmental degradation that are legally external to it.

(b) *Measuring directly attributable improvements in the terms of trade*

Investment incentives for pollution control are at times justified as mechanisms to counter the adverse impact on international competitiveness due to the increasing costs of environmental compliance. By extension, one could search for benefits manifested in the form of an incremental improvement in the terms of trade.

In one study that used a partial equilibrium framework to measure the impact of marginal changes in industrial pollution abatement costs on the US balance of trade in general, and its balance of trade with Canada in particular, the following conclusions were reached:[43]

- The impacts were found to be negative for most industries. They grow with trade volume and are small relative to domestic consumption.
- Some evidence was found that pollution control programmes have changed the US comparative advantage such that a greater number of high-abatement-cost goods are imported and more low-abatement-cost goods are exported.

The above results are not unexpected since they emphasize the inefficiency of "regulatory" pollution control schemes rather than support the use of investment tax incentives. An earlier study in the United States also pointed out that air pollution abatement costs could be reduced 40 to 90 percent if a more efficient regulatory scheme were employed.[44]

(c) *Measuring improvements in economic growth rates*

Investment incentives have also been rationalized as necessary for reducing the impact of environmental regulation and

42. The word "excessive" is used because such behaviour runs counter to rational profit-maximization.
43. H. David Robinson, *Industrial Pollution Abatement: The Impact on Balance of Trade*, Canadian Economics Association (1988), at 187-199.
44. US General Accounting Office, *A Market Approach to Air Pollution Control Could Reduce Compliance Costs Without Jeopardizing Clean Air Goals* (1982).

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across all investments eligible for the tax credit, thereby promoting neutrality.

Of the countries reviewed, Korea, the Netherlands, Canada and Taiwan offer investment tax credits. The rates range from 3 to 20 percent. In the case of Taiwan, the rates are moderated by a limitation that restricts the credit to only half the tax due. None of the schemes in these countries will be neutral across all classes of eligible investments.

III. EVALUATION OF INVESTMENT TAX INCENTIVES FOR POLLUTION CONTROL

Part B of this section analyses the criteria of cost effectiveness and efficiency used to evaluate MBI instruments. These two criteria are by no means exclusive or comprehensive. However, informed policy-making requires that they be dominant. To provide a wider perspective and enhance the scope of the analysis, some of the criticisms directed at tax incentives for pollution control are discussed in Part A. Part C examines certain structural issues of tax incentive design and legislation that can enhance the effectiveness and efficiency of tax incentive instruments for pollution abatement.

A. *Criticisms of investment tax incentives for pollution control*

Even though tax incentives do influence behaviour, there is criticism concerning their inclusion in the family of MBIs. Investment tax incentives do not conform to the tenet of influencing environmentally superior choices that is mandated by an inflexible and exacting definition of MBIs. These incentives have sometimes been termed "pseudo-incentives".[40] Quoting directly:

> Other common instruments, such as tax write-offs, accelerated depreciation, low-interest loans or outright subsidies for the adoption of "clean" production technologies, or the construction of waste treatment facilities are similarly inefficient and ineffective even though they can pass as economic incentives; it is the wrong kind of incentive. They do not make waste reduction or waste treatment any more profitable; they simply subsidize the producers and consumers of the products of these industries. Waste treatment is not always the most efficient means of reducing wastes; in many cases changing production processes, the type and quality of raw materials or the rate of output is more efficient. ....Tax breaks, credits, depreciation allowances, and subsidies are a drain on the government budget and a disincentive to industries which might have otherwise developed more efficient methods for reducing emissions.[41]

This criticism is not completely accurate since there may be reasons for governments to provide an investment subsidy via a tax incentive for pollution abatement. For example:

- Even though pollution standards may be mandated by regulation, they may not be well enforced. Under these conditions, the government may decide to encourage the purchase of necessary pollution control equipment by offering tax incentives.
- Older plants and production facilities may find it financially debilitating to install pollution control equipment. Without the financial assistance to do so, these plants may be forced to close down, resulting in unemployment. The government may find the benefit of contributing such a subsidy greater than the cost of providing the tax incentive.

Finally, the fact that tax incentives are effective subsidies has come under criticism. These subsidies have sometimes been confused with a subsidy-to-pollute, therefore generating a myth that polluters would find it attractive to cause more pollution. In reality, investment incentives are used in conjunction with environmental regulation that expressly specifies acceptable pollutant levels. Therefore, the subsidy is for equipment purchase, not the generation of more pollution.

B. *Criteria to evaluate investment tax incentives*

If tax incentives are broadly applicable to all investments, their evaluation is greatly simplified. The advantage of a generalized evaluation model that treats all investments similarly (i.e. assuming that tax incentives are available to all classes of assets) is that no distinctions need to be made regarding the physical characteristics of the investment project. However, incentives for pollution control investments by definition target a selective class of assets. Consequently, they do not directly lend themselves to such a general analysis.

In order to proceed with a meaningful evaluation, the following words of caution are in order:

Focus on intra-industry investment distortions

Narrowly defined investment incentives are aimed at inducing investments in certain technologies and industry groups, i.e. certain sectors are preferred over others. In a pure economic sense, most narrowly defined incentives create distortions, since alternate investment choices are being influenced by the tax system. It is only in cases where an externality is being offset that an investment incentive would correct for a distortion. With incentives being available for certain explicitly stated activities, it is evident that tax policy is being used as an instrument to meet other policy objectives.

These distortions between the investments undertaken in preferred areas and those in other industrial activities must be accepted. Tax incentives should, however, not influence choices within the same preferred category. It is important that the ranking of projects within the same sector not be changed by the incentives.

Presence of perverse incentives

Perverse incentives in the context of environmental protection refer to situations where the tax factor results in investment decisions that are incrementally more polluting. In most of the countries surveyed, incentives for pollution control are available principally for equipment purchases. This creates a bias against the adoption of cleaner production processes that minimize the need for pollution control equipment. Thus, despite encouraging the installation of control equipment to achieve an aggregate reduction in pollution levels, the same incentives could act as a barrier to long-term emission reductions.

40. Theodore Panayotou, *Economic Incentives in Environmental Management and their Relevance to Developing Countries* (Paris: OECD, 1991), at 96-97.
41. *Id.*

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TABLE 3

COMPARISON OF TWO INVESTMENT PROJECTS: Each with 30% tax credit

	YEAR 0	1	2	3	4
PRIVATELY ACCEPTABLE					
Gross-of-tax cash flow	–1500	450	450	450	
Tax credit at 30%	450	0	0	0	
Depreciation	0	500	500	500	
Taxable income	0	–50	–50	–50	
Tax at 50%	0	–25	–25	–25	
Private cash flow	–1050	475	475	475	
Internal rate of return:	social, –5%; private, 17%				
Net present value:	private NPV at 10% is 131				

	YEAR 0	1	2	3	...	infinity
PRIVATELY UNACCEPTABLE						
Gross-of-tax cash flow	–1500	135	135	135	....	135
Tax credit at 30%	450	0	0	0	....	0
Taxable income	0	135	135	135	....	135
Tax at 50%	0	–67.5	–67.5	–67.5	....	–67.5
Private cash flow	–1050	67.5	67.5	67.5	....	67.5
Internal rate of return:	social, 9%; private, 6.4%					
Net present value:	private NPV at 10% is –375					

of the tax credit, everybody would rush to buy 90-day bonds. No one would buy 1-year bonds, let alone perpetuities, since a subsidy on the purchase price of an asset is biased in favour of short-lived assets. This occurs because the subsidy covers not only the present value of net return, but the present value of depreciation (amortization in the case of bonds) of the asset as well.

The problem with this non-neutrality would be manifest in a scenario where a project with an unacceptable social rate of return, i.e. having a gross-of-tax return below a socially acceptable hurdle rate, but having a privately acceptable net-of-tax return would be favoured over one whose social rate of return is acceptable.

An illustration of socially sub-optimal project choices is shown in Table 3, where two projects with different asset lives have been compared. In both cases, a 30 percent investment tax credit has been made available.

Even though the first project has a negative social return, it clears the private hurdle rate, while the second project, despite providing a high social return, will not be privately chosen. Such distortions created by investment tax credits force one to question the logic of providing government subsidies for projects that have a detrimental social impact.

In the context of environmental protection, therefore, it is possible to choose an environmentally inferior project over one that is environmentally friendlier. Under this scenario, the objective of the pollution control incentive is not realized.

(b) *Neutral investment tax credits*

An investment tax credit subsidizes the purchase price of an asset. At the beginning of our discussion of investment incentives, it was shown that the purchase price or value of the asset is equal to PVY+PVD, i.e. the gross-of-depreciation flow of benefits attributable to the asset. If r is the rate at which the investment credit is provided, the investing entity gains r(PVY+PVD).

For the incentive to be neutral across all investment classes (within a given industry group), the tax incentive should ensure that all assets with equal present values of net earnings (PVY) carry an equal tax burden. For an investment tax credit to be neutral, therefore, the ratio of PVD to PVY should be the same for all investments, i.e. PVD/PVY should be equal for all investments.

However, since PVD depends on the service life of the asset, there will be a marked preference for shorter asset lives over longer ones.

Nevertheless, it is possible to structure a neutral scheme of investment tax credits.[39] To do so would require that the credit be granted on net, rather than gross, investment for the year. In other words, the credit should equal r(PVY). This satisfies the requirement that incentives be provided at an *equal rate*

39. From a talk by Arnold C. Harberger, *Tax Incentives in a Capital Theory Context*, at the Latin American Meetings of the Econometric Society, San Jose, Costa Rica (August 1988).
The original idea is attributed to Cary Brown.

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(i) *Immediate expensing (cost write-off)*

This is also called Musgrave neutrality, after Richard Musgrave, who first showed that allowing the full expensing of investment outlays and the subsequent full taxation of the gross income stream results in an effective tax rate of zero. Hence, the immediate expensing of the purchase value of an asset ensures the same effective rate of tax on all investments.[36] Full and immediate expensing results in a totally neutral income tax with respect to different economic lives and differently shaped time profiles of net benefits.

Expensing allows for the instantaneous depreciation of assets at the moment of purchase. Since nothing is left to depreciate in the future, it pays the same rate of tax on net income in each period.

Though none of the countries we reviewed have an immediate expensing provision in place, there is a bill pending in the Netherlands to have such a law adopted.

(ii) *Partial expensing with economic depreciation of the remainder*

This scheme is also called Harberger-Bradford neutrality. Under the scheme, a portion of the asset cost is immediately expensed, while the remainder is depreciated over the life of the asset as a fraction of the true economic depreciation. This fraction is equal to the percentage that was not expensed initially.

Some of the countries reviewed have allowed partial expensing for pollution control investments, with normal depreciation deductions taken for the remainder. This should not be confused with Harberger-Bradford neutrality. However, it does reduce the extent of distortion between asset choices, while allowing the investor to benefit from a postponement of the tax liability. This method is being used in Japan, Germany and France.

Japan	25 percent initial allowance, remainder to be depreciated normally, i.e. ordinary depreciation in tax code.
Germany	60 percent initial allowance, remainder at 10 percent until full amortization.
France	50 percent initial allowance, remainder at 10 to 20 percent straight-line.

2. Investment tax credit

The investment credit is similar to accelerated depreciation in that it reduces the present value of tax liability, but it has a different mechanism. The investment credit involves not merely a tax postponement, but an outright tax reduction as well.

Disagreements exist concerning the design and structure of investment tax credits. Nevertheless, it is worth noting that in ranking various incentives, such as accelerated depreciation, investment credits and reduced nominal tax rates, there is virtual unanimity that the investment credit will produce the most new investment per dollar of revenue foregone.[37]

The Netherlands is an example of a country where the superiority of investment tax credits over accelerated depreciation has been recognized. This is evident from the fact that accelerated depreciation and other tax allowances in the previous code were replaced with investment tax credits.

Uniformly applicable investment tax credits are in some ways fiscal substitutes for investment stimulants that should normally be accomplished through monetary policy. However, monetary stimulants may not always result in business investment. The argument might, therefore, be made in favour of directed investment tax incentives.[38]

In most cases, the tax credit is given as a percentage of the purchase price of the assets. Credits are not usually refundable, i.e. they can be claimed only against a positive tax liability. To facilitate a more equitable treatment of those with and without taxable profits, credit carry-over and transfer schemes may be provided. Canada, for example, has experimented with refundable R&D credits.

These schemes have an important impact on the effective utility of legislated investment credits. Investment tax credits reduce the amount of financing required by reducing the acquisition cost of capital assets, and hence the overall cost of capital. For accounting purposes, the depreciable base of the asset can either be maintained at the original purchase price or adjusted for the tax credit.

Many variations of the relationship of the credit to the depreciable base exist. In 1983, the Canadian system of investment tax credits reduced the accounting base by the full tax credit value, while in the United States the basis was reduced by only half the credit. Korea, on the other hand, does not reduce the depreciable base of the asset by the value of the credit.

Irrespective of the final depreciable base available to the firm, an investment tax credit translates into a cash subsidy proportional to the size of the investment in the qualifying asset.

(a) *Distortions created by investment tax credits*

The investment tax credit works in favour of short-lived assets. This is in contrast to accelerated depreciation, which favours the long-term fixed investment.

A simple exercise using government bonds as illustration gives a striking example of why tax credits perpetuate this bias. Assume that a government passed a law granting a subsidy of seven percent of the purchase price to everybody buying a newly issued government obligation. Suppose that the available government obligations were perpetuities, 20-year bonds, 1-year bonds and 90-day bonds.

If the interest rate were one percent per month, the bonds would have a yield of ten percent every 90 days. As a result

36. Richard Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw Hill, 1959), at 343.
37. Testimony by Eisner and Jorgenson in the US Senate Report, *Joint Seminars Encouraging Capital Formation Through the Tax Code* (Washington, D.C.: US Government Printing Office, 1975).
38. Martin Feldstein, "Inflation, Capital Taxation, and Monetary Policy", in Robert E. Hall, ed. *Inflation: Causes and Effects* (Chicago: University of Chicago Press, 1982), at 153-67.

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TABLE 2

COMPARISON OF TWO INVESTMENT PROJECTS: Depreciation over half the normal life

	YEAR 0	1	2	3	4	5	6
PRIVATELY UNACCEPTABLE							
Gross-of-tax cash flow	–1200	490	450	400	200	140	100
Depreciation	0	400	400	400	0	0	0
Taxable income	0	90	50	0	200	140	100
Tax at 50%	0	–45	–25	0	–100	–70	–50
Private cash flow	–1200	445	425	400	100	70	50
Internal rate of return:		social, 17.2%; private, 9.8%					
Net present value:		private NPV at 10% is –3.6					

	YEAR 0	1	2	3	...	20	21	...	40
PRIVATELY ACCEPTABLE									
Gross-of-tax cash flow	–1200	205	205	205	...	205	205	...	205
Depreciation	0	60	60	60	...	60	0	...	0
Taxable income	0	145	145	145	...	145	205	...	205
Tax at 50%	0	–73	–73	–73	...	–73	–103	...	–103
Private cash flow	–1200	133	133	133	...	133	103	...	103
Internal rate of return:		social, 17%; private, 10.5%							
Net present value:		private NPV at 10% is 55.5							

cally) before it has been completely worn down (i.e. depreciates physically).

(d) *Typical cases of non-neutral accelerated depreciation*

Most accelerated depreciation mechanisms are non-neutral. Though this might seem to be a rather sweeping statement, after having shown how difficult it is to measure economic depreciation, this should not be surprising. There exist certain mechanisms whereby accelerated cost recovery can be achieved neutrally. Before we examine these neutral accelerated depreciation mechanisms, we will discuss typical methods of providing non-neutral accelerated depreciation. These are:

Case 1. Depreciating assets in a specified number of years, regardless of their true economic life.

Case 2. Allowing assets of different economic depreciation patterns to be depreciated according to a specified method (e.g. exponentially).

Case 3. Depreciating assets in a specified fraction of time (e.g. twice as fast as dictated by true economic depreciation).

The accelerated depreciation provisions of the Taiwanese Statute for Upgrading Industry is a variation of case 3 above. In Taiwan, depreciation for certain specified assets, including pollution control equipment may be accelerated by up to half the number of years of normal service life.

This particular incentive leads to a general shortening of depreciation periods without distorting the ordinal ranking of asset lives. More specifically, long-lived assets end up with longer depreciation periods than do short-lived assets. The result achieved by cutting the depreciable life of assets in half appears to distort the process of project selection significantly less than many of the alternative schemes of accelerated depreciation.[35]

Nonetheless, it is still possible to find examples that violate the criterion of neutrality. For illustration, we take a pair of projects with 6-year and 40-year *normal* lifetimes respectively. (See Table 2.) We allow the assets to be depreciated over half the normal life of the projects. While the comparison may seem exaggerated, the fundamental effects of the interferences are easily and quickly underscored. Let us also assume a ten-percent private after-tax discount rate.

The project with a 6-year lifetime will be rejected since it has a private after-tax return of only 9.8 percent, despite its high social return of 17.2 percent. On the other hand, the project with a 40-year lifetime will be accepted privately, despite the fact that its social rate of return is 17 percent, because its private after-tax return is 10.5 percent. The non-neutrality results in the first project with a social return of 17 percent being rejected and the project with the lower social return being accepted.

(e) *Can accelerated depreciation be made neutral?*

Accelerated depreciation allows full capital cost recovery over a period that is less than the life of the asset.

It is still possible to achieve neutrality when using accelerated cost recovery as the appropriate tax policy for a particular class of investments. The neutrality criterion will remain inviolate if the following two methods are used.

35. *Supra* note 33, at 303-304.

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The asset will diminish in value due to wear and tear over the years of usage. This reduction in value is recognized by tax authorities, who permit a tax depreciation deduction. Tax depreciation must, however, be distinguished from the actual or true reduction in value resulting from the asset's being utilized. This true reduction in value is referred to as *economic depreciation*, the present value of which is represented by PVD.

For perfect tax neutrality, assets with equal present values of net earnings (PVY) should carry an equal tax burden. In other words, investments with the same present value of net earnings should have the same present value of tax liability.

1. Accelerated depreciation

Capital asset depreciation is a cost of doing business. The tax law recognizes this by permitting investors to recover their cost of capital investment. Other costs of doing business, such as wages, materials, etc., are deducted currently, i.e. when the payments are made. Depreciation deductions for capital cost recovery, on the other hand, are made over many years.

Under accelerated depreciation, purchasers of depreciable assets are accorded tax benefits, permitting them larger deductions in the initial years of asset operation. The total units of deductions available for accelerated depreciation are the same as under a normal depreciation regime. The incentive is derived from the postponement of the tax liability.

For example, if a company pays $ 100 less in tax in year 1 as a result of accelerated depreciation, even if it has to pay $ 100 more in tax in year 2, it is still ahead – if only by the return it earns as a result of having the $ 100 to use for another year.

(a) *Impact on effective tax rate*

The effective tax rate governs the investor's decision concerning the attractiveness of the investment incentive in question. The effective rate of tax depends on both the nominal rate and the rate at which depreciation is permitted. The faster the depreciation rate, the lower the effective rate of tax.

When considering an investment, the investor weighs the present value of its net-of-tax income stream against the cost of the asset. The present value of net income equals the present value of the income stream before tax minus the present value of tax payments. The present value of tax payments may be viewed as equal to the present value of the taxes on the gross income stream (Y+D) minus the present value of tax savings due to depreciation. The present value of tax savings due to depreciation will be larger when more rapid depreciation is allowed. Accelerated depreciation thus reduces the effective rate of tax by postponing the due date of the tax liability.

For the tax incentive to be neutral between two assets, it should result in the same effective tax rate – other factors being equal.

The benefits of accelerated depreciation are also manifest in other forms better appreciated by accountants and financiers:

- A postponed tax liability is a virtual interest-free loan from the Treasury to the firm. This reduces the costs of financing and acquiring new capital, hence improving a firm's cash flow. The characterization of deferred taxes as merely equivalent to an interest-free loan overlooks some of their other advantages. These are best expressed in a statement by Richard Bird,[34] "Who would refuse an interest-free loan available without any strings at all, without having to ask anyone for it, without having to put up any security, and without even having to pay it back unless profits are made in the future?"
- The faster recovery of investment costs reduces recovery risks in the long run.

(b) *Distortions generated by accelerated depreciation*

Accelerated depreciation changes the ranking of projects depending upon the useful life of the assets. The principal distortion is that accelerated depreciation is more attractive to investors in long-lived assets. The gain from early deductions are larger because the postponed tax payments can be delayed for a longer period when the asset has a longer life.

For example, consider an asset that has a 20-year life and another with a 5-year life. In both cases, depreciation is permitted over two years. For an investor holding the 20-year asset, the reduction in tax liability that occurs in the first two years is recovered in nominal value over 18 years, whereas for a 5-year asset it is recovered over the following three years of the asset's life. Consequently, it is evident that 20-year assets will be preferred over shorter-lived assets.

In the case of pollution control investments, this could influence the choice of technologies selected for a particular abatement task. Countries where marked preferences for long-lived assets could exist are Singapore (all assets depreciated in three years), and Germany (60 percent initial expense allowed).

(c) *Neutral depreciation*

A neutral depreciation allowance is one where assets with the same present value of net income streams carry an equal tax burden. This will be achieved if the net income stream being taxed each year is equal to the gross income flow less the actual diminution in asset value. This is the case where tax depreciation is charged in line with economic depreciation.

If the allowable depreciation equals economic depreciation, taxation will reduce the value of the net income stream by the statutory (nominal) rate of tax. In this case, the effective rate of tax will equal the nominal tax rate irrespective of the length of asset life.

Unfortunately, economic depreciation is a theoretical concept that in practice cannot be easily applied. Capital assets do not wear out evenly, which makes it difficult to predict their actual reduction in value (economic depreciation). Further, equipment often becomes obsolete (i.e. depreciates economi-

34. Richard M. Bird, *Tax Incentives for Investment: The State of the Art*, The Canadian Tax Foundation, Canadian Tax Paper No. 64 (November 1980), at 19.

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Policy-makers worldwide continue to use these investment tax preferences since they seem to balance environmental considerations with concerns about industrial competitiveness. Additionally, tax incentives are often politically expedient ways of providing "hidden" government subsidies for select activities. Tax concessions, or *tax expenditures* as they are often termed, have a major political advantage over direct cash subsidies since they are usually concealed and are not reported as individual items on the budget.

B. *The environmental impact of investment incentives for pollution control*

Investment tax incentives for pollution control equipment and technologies do not promote the active pursuit of pollution reduction, which is the desired goal. In other words, even though an investment tax incentive may be provided for purchases of specific pollution abatement hardware, the pollution control investment may only induce more of the polluting activity (i.e. manufacture or production of goods and services).

Entities invest in pollution control assets only because they are required to do so by law, i.e. environmental regulation. Pollution control equipment represent non-productive assets since they do not produce any income for the investing entity. If investments in pollution control assets are viewed as independent projects, negative net present values equal to the purchase price plus the discounted sum of the annual operating expenses and allocable overheads are obtained. An investment tax incentive for the same pollution control asset only improves the net present value by the present value of the incentive; the overall net present value continues to be negative.

When examining an investment incentive for pollution control and the accompanying environmental legislation, it is important to determine whether or not there is a net increase in pollution as a result of the incentive. Not all forms of environmental regulation will result in a net increase in pollution when combined with an investment incentive. We will examine two cases to illustrate this point.

Pure Technology Standard. This standard requires a firm to install a specific technology depending on the production process in question. For example, all power plants may be required to install flue-gas desulphurizers and precipitators of a specified efficiency.

In this case, all the investment incentive for pollution control does is lower the overall cost of the investment in productive plant and equipment. Since investors cannot operate their productive assets unless pollution control equipment is installed, they view the cost of the equipment as part of the total investment package.

There is no incentive to reduce pollution because all the firm has to do is install certain specified equipment for each level of production. In essence, the investment incentive only subsidizes the value of the entire investment.

In this case, more pollution is created than would be produced without the incentive. In other words, there is an increase in pollution at the margin, resulting in a "net increase" in pollution.

Performance Standard. Under this standard, the firm is allowed considerable latitude in the choice of methods by which pollution abatement may be achieved. For example, the standard may set a limit on the maximum allowable units of pollutant per unit time, while remaining neutral with respect to the means by which the firm should reach this goal.

Hence, the firm is able to compute an approximate marginal cost and benefit of polluting based on its options, i.e. use no abatement and produce very little of the pollution-causing product (steel or electricity) or use a variety of pollution control technologies that allow production to be increased. Under both options, pollution must be kept within mandated limits.

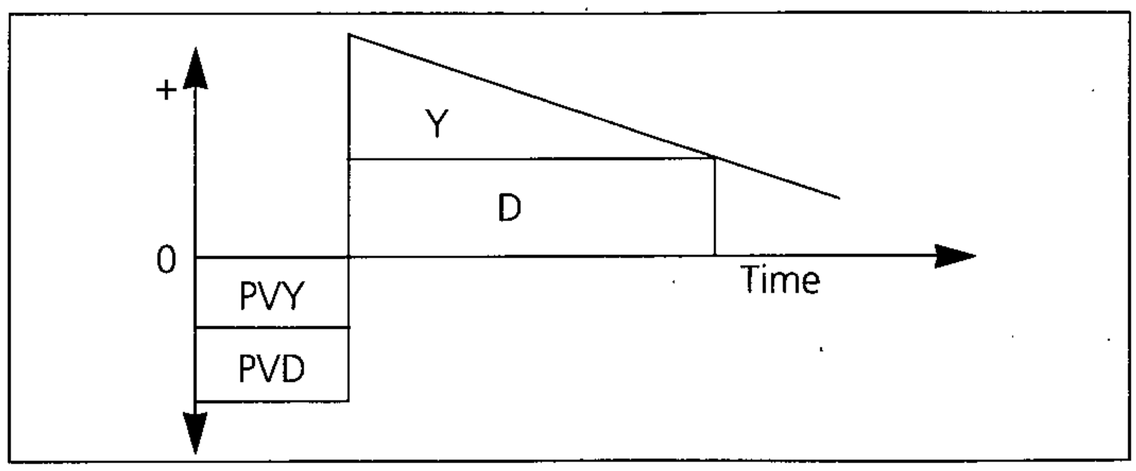
There is no incentive to reduce pollution, but neither is there an incentive to pollute more. The investment incentive reduces the marginal cost of abatement without permitting any marginal increase in pollution.

C. *Neutrality of investment tax incentives*

Since tax incentives influence behaviour, it is important that they result in optimal investment choices – financially, economically and by extension, environmentally. In the case of investments to control pollution, a tax incentive that is not neutral will distort the choice of technology used. Such distortions will increase the overall economic cost of pollution control. Neutrality is one measure of the behavioural impact of tax incentives.

A *neutral tax incentive* is one that does not induce new "covered" investment with low rates of social yield, while failing to induce other covered investments with higher rates of social yield.[33] ("Covered" investments refer to those which are eligible for the tax preference as per the tax code.)

A depreciable income-producing asset generates a positive gross-of-depreciation income stream of earnings (Y+D) arising from the utilization of the asset, the present value of which can be represented as PVY+PVD, where PVY is the present value of the net income stream and PVD is the present value of depreciation. The following figure provides a graphical representation of an investment profile.



The gross-of-depreciation income stream is also equal to the market price of the asset.

33. Arnold C. Harberger, "Tax Neutrality in Investment Incentives", from *The Economics of Taxation*, Henry Aaron and Michael Boskin eds., The Brookings Institution, Studies of Government Finance (1980), at 299.

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apply to the Minister of Environment for approval to depreciate this property at an accelerated rate.[32] The three types of operations are:

- operations carried on before 1974 at a site in Canada,
- operations carried on in Canada at a plant that was under construction prior to 1974, (a plant is deemed to have been under construction if an agreement to build it was signed before 1974), and
- operations carried on through the employment of movable equipment in Canada prior to 1974. (The ITA also allows taxpayers who lease pollution control equipment to persons carrying on eligible operations and taxpayers who are in the business of reducing pollution from eligible operations to write off their investments at the same accelerated rates.)

The ITA does not contain comparable provisions for post-1973 operations. Thus, the class of taxpayers who are eligible to benefit from the programme becomes smaller every time pre-1974 operations are permanently discontinued. There are, however, no restrictions on the number of pollution control properties and no limits on expenditures that may be approved by the Minister of the Environment.

Qualified and approved water pollution control equipment falls into Class 24 of Canada's CCA system, while qualified and approved air pollution control equipment falls into Class 27 of Canada's CCA system. In both of these cases, properties acquired after 12 November 1981 may be depreciated by claiming a maximum CCA of 25 percent in the year of acquisition, 50 percent in the second year of ownership and 25 percent in the third year. Thus, a depreciable property that was acquired primarily for the purpose of preventing, reducing or eliminating water or air pollution from eligible pre-1974 operations can usually be written off over three years.

Although not designed for environmental purposes, both Quebec and Ontario offer investment tax credits (ITCs) for the purchase of manufacturing and processing machinery. These may include pollution abatement and control equipment. The general investment tax credit applicable in most regions of Canada was eliminated for 1989 and subsequent years. The current ITC provisions are intended to stimulate new investment over a wide range of commercial activity, with special treatment given to certain taxpayers and regions and specific types of investment. Actual investment tax credits are taken against the cost of certain assets and expenditures and vary depending upon the taxpayer, activity, region and year involved.

The 1991 Quebec Budget made environmental technology innovation projects eligible for special R&D incentives, including a refundable tax credit. Ontario also provides income tax incentives for investments in manufacturing, processing and pollution control equipment.

J. *The United States*

Pollution control investments are not accorded special incentives under the US income tax statute. Limited investment credits for the purchase of certain depreciable property were made unavailable for assets placed in service after 1985. The depreciation of plant and equipment is based on the 1981 Accelerated Cost Recovery System (ACRS) and the Modified ACRS, which went into effect in 1986. The cost of property acquired after 31 December 1986 is recovered over a 3, 5, 7, 10, 15 or 20-year period, depending on the type of property. Cost recovery methods and periods are the same for both new and used property.

Property classes are chosen by broad process unit characteristics. This means that all equipment in a particular plant, except for structural buildings, will be given a single classification. There is no distinction between machinery and equipment used for pollution control and that used for other purposes.

II. AN ANALYSIS OF INVESTMENT TAX INCENTIVES

The tax incentives for pollution control available in several of the leading industrialized and newly industrialized countries can be categorized in a few broad classes. Most common of these incentives are provisions for accelerated depreciation and investment tax credits. In order to determine the cost effectiveness of such provisions, we need to consider the criteria that should be used in evaluating or designing incentives for the control of pollution and environmental damage.

A. *Background*

Investment tax incentives are specific tax preferences directed towards the purchase of capital goods and services. Besides furthering environmental objectives, these incentives have been used to promote employment, output, investment, productivity, international competitiveness, research and technological progress.

Most investment tax incentives that operate through the corporate tax mechanism are based on the purchase price of capital assets. Although incentive utilization may be conditioned on positive net profits and other arbitrary percentage limitations, the basis for these tax incentives is in effect the cost of the asset purchased.

One major distinction between tax preferences for pollution control and tax preferences for other purposes is that the equipment investments that enable pollution incentives to be utilized are usually not voluntary. In the case of a general investment tax incentive, the investing entity is free to choose whether to make a given investment or not. However, in the case of investment incentives for pollution control, the installation of pollution abatement hardware is often necessary to comply with regulatory standards and permitting procedures.

Operationally, however, and in terms of cash-flow impacts, investment tax incentives for pollution control are no different from incentives to invest in other plant and equipment.

32. See the Department of National Revenue's Interpretation, Bulletin IT-336R, published in Volume 8, Canadian Tax Reporter, Information Circulars & Interpretation Bulletins, 1985, 33, at 399-401-4.

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The basis of depreciation is the cost of acquisition or manufacturing. Immovable assets can as a rule be depreciated only by using the straight-line method. On the other hand, in the case of movable fixed assets, straight-line, three-times declining balance and the production basis methods are permitted. Where the declining balance method is used, the rate may not exceed 30 percent.[24] The generally accepted straight-line rate for machinery is 10 to 12 percent.

Accelerated depreciation is allowed for personal and immovable assets serving the purposes of environmental protection (air pollution, water pollution, noise protection, etc). There is an initial allowance of 60 percent, followed by an annual depreciation rate of 10 percent until full amortization.[25]

One interesting feature of the German law is the stipulation of a qualification clause in order for pollution control equipment to be eligible for accelerated depreciation. Eligibility is based on the percentage of equipment that is intended for pollution abatement. Qualifying equipment is defined as that which serves more than 70 percent for the purpose of reducing air, water or noise pollution.

According to current legislation, accelerated depreciation for anti-pollution equipment is available only for assets acquired or produced before 31 December 1991.[26]

There are no investment tax credits in Germany.

G. *The Netherlands*

The Netherlands allows the taxpayer to choose any suitable method of depreciation, provided it is in accordance with generally accepted accounting principles and "sound business practice". Once a method is chosen, it must be used consistently. For each different kind of asset, a different method may be adopted. Straight-line depreciation is commonly used by taxpayers and generally accepted by the tax administration. Machinery and equipment are generally depreciated at rates ranging from 10 to 20 percent.

Accelerated depreciation and investment allowances that were permitted by an earlier law have been replaced by investment tax credits. Credits ranging from 3 to 15 percent, depending on the type of asset, are available for investments in pollution control, or so-called "investments for implementing environmental policies".[27]

Environmentally beneficial products or techniques are eligible for grants and loans to assist in their manufacture or implementation. Financial aid can also be obtained for certain projects promoting the development, application and demonstration of environmentally sound projects. These projects should include the development of new machinery, systems or techniques which have the effect of reducing or eliminating pollution.[28]

A law has been proposed that would permit the immediate and full expensing of investments in assets that may contribute to a cleaner environment. Under this law, the pollution control asset would be fully written off as an expense in the year in which it was purchased. The bill is still pending.[29]

H. *The United Kingdom*

There are no investment incentives for installing pollution control equipment in production facilities in the United Kingdom. The only anti-pollution expenditure that is eligible for a deduction is the cost incurred when closing down an oilfield (or part of a field) in order to minimize the environmental impact. This deduction is allowable only against a capital gains tax liability.[30]

The UK tax code is fairly generous as regards tax incentives for the research and development (R&D) of pollution control technologies and equipment. In order to support research in environmental protection products and technologies, the following two provisions have been made available:

1. Tax credit for environmental R&D

In 1988, the Department of the Environment set up the Environmental Protection Technology Scheme. Under the scheme, the government may provide up to 50 percent of the cost of industrial research projects aimed at improving environmental standards.

2. Immediate expensing of R&D capital expenditures

Companies making capital expenditures on scientific research (not necessarily in the field of pollution control) are eligible for a capital allowance equal to 100 percent. Another condition for this tax relief is that the company must be carrying on, or about to commence, trade related to the expenditure.[31]

I. *Canada*

Incentives within the income tax system generally reduce both the provincial and federal taxes payable. Ontario, Quebec and Alberta, the three provinces which do not participate in the federal/provincial corporate tax collection agreements, follow the federal government's treatment of pollution control equipment for capital cost allowance (CCA) purposes.

In general, the Canadian system of CCAs operates on a pool basis, with separate classes provided for various types of property acquired for the purpose of earning income. The capital cost of each asset is added to the appropriate pool or class. Each class is then reduced by the specific capital allowance permitted.

Under Canada's Income Tax Act (ITA), a taxpayer who has acquired an *unused* depreciable property primarily for the purposes of "preventing, reducing, or eliminating [water or air] pollution" from one of three types of operations can

24. EStG. Sec. 7(2).
25. EStG. Sec. 7(d).
26. EStG., as repromulgated 7 September 1990; see Bundesgesetzblatt I (BGBL, Official Law Gazette of the Federal Republic of Germany), at 1898, Sec. 7d.
27. International Bureau of Fiscal Documentation, *The Taxation of Companies in Europe, Netherlands* – 53, Corporate Income Tax, Supplement No. 95 (February 1991).
28. Price Waterhouse, *Doing Business in the Netherlands* (December 1990), at 32.
29. *Supra*, note 27.
30. Oil Taxation Act, Chapter 22, Art. 3, 1975.
31. Capital Allowances Act, Chapter 1, Arts. 137 and 138, 1990.

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If the residual period after depreciation is less than one year, it is not counted, i.e. full depreciation will be completed in the earlier period.[18]

2. Investment tax credit

Available investment tax credits range from 5 to 20 percent of the investment on equipment or technologies used for production automation, pollution control, personnel training or the establishment of international brand names. There must be a minimum investment of NT$ 600,000 in the particular taxable year. The total amount of credit allowed in a given year is limited to 50 percent of the corporate income tax payable in that year. If the credit exceeds the mandated limitation, it may be carried over for a period of four years.

According to the Enforcement Rules of the SUI, the credit is graduated as follows:
- 20 percent for pollution control equipment procured domestically,
- 15 percent for pollution control equipment procured abroad, and
- 5 percent for pollution control technologies procured either domestically or abroad.

These credits are available only for funds spent on pollution control equipment or technologies within five years from the effective date of the statute.

3. Share-purchase tax credits

Investors holding registered shares in "important technological industries" (which may include firms engaged in the development and production of pollution control equipment) for a period of more than two years can credit up to 20 percent of the price paid for the acquisition of such stocks against their income tax. If the share-purchase credit is greater than the tax payable, the balance of the creditable amount can be carried over for a period of four years.

4. Tax exemption on retained earnings

The SUI allows a corporation to retain undistributed earnings (also called retained profits) up to twice its accumulated paid-up capital, which is exempt from the ten percent profit-seeking enterprise income tax if the funds are used for certain specified purposes.[19] Such purposes include:
- purchasing various classes of products, including pollution control equipment,
- repaying loans borrowed for the purpose of purchasing the aforesaid equipment, and
- investing in certain important industries specified by the government.[20]

According to the ITL, if the accumulated retained profits of a company exceed one half of the total paid-up capital in a year, in the following business year the company must distribute the accumulated retained earnings in the form of dividends to its shareholders.[21] Undistributed accumulated profits in excess of half of the total paid-up capital in a year can be included in the taxable income of the shareholder if there is no stock distribution. The local tax administration will compute the distributable profits (above the 50 percent of paid-up capital limit) allocable to each shareholder, and levy a ten percent profit-seeking enterprise income tax on each shareholder for the current taxable year.[22]

5. Tax deferral on stock dividends

If a registered stock dividend is newly issued by a corporate enterprise from its undistributed earnings for certain approved purposes (see 4 above), the tax on the stock dividends is deferred until the shares are sold. These dividends may be in the form of bonus share issues or may result from the paying company's capitalization of retained earnings. Neither of these stock dividends will be included in the consolidated income of the corporate shareholder.[23]

E. *France*

The general guidelines concerning tax incentives are contained in the Code général des impôts (the general tax code). Both straight-line and declining balance depreciation are available. However, straight-line depreciation is usually used for most plant and machinery. Since there are no official rates, acceptable rates of depreciation under the straight-line method are normally consistent with rates used by business and industry. Rates for machinery range from 10 to 20 percent. Depreciation must correspond to the useful life customarily associated with a particular activity, although an administrative tolerance of 20 percent is allowed.

Accelerated depreciation is available for certain assets, including pollution control equipment. Immovable installations for the purification of water and air can be depreciated by 50 percent straight-line in the first year.

The French law has a number of investment incentives, such as regional tax concessions and grants. None are specifically slated for investments in pollution control equipment. However, some will definitely reduce the effective burden of environmental regulation. The number of possible tax preference outcomes vary by industry, location and product characteristics and are difficult to predict with any certainty.

F. *Germany*

The German Income Tax Law, Einkommensteuergesetz (EStG), provides accelerated depreciation or initial expensing provisions for assets used for pollution control.

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18. SUI Art. 5.
19. The retained earnings is the amount of profit-seeking income determined by the administration after deducting:
- the profit-seeking enterprise tax amount in the taxable year,
- previous losses,
- dividends to be distributed upon resolution of the shareholders' meeting,
- legal reserve funds set aside according to company law,
- bonuses paid to directors and employees, and
- other items permitted by the Ministry of Finance.

International Bureau of Fiscal Documentation, *Taxation in Asia and the Pacific, Taiwan*, Supplement No. 81 (May 1991).
20. The list of eligible products and designated industries are specified by the Executive Yuan, with a revision option every two years.
21. ITA Art. 76-1.
22. ITL Art. 88.
23. SUI Art. 16.

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- carry losses over five years and back one,
- establish certain special tax incentive reserve accounts and take certain tax incentive deductions and credits, and
- use accelerated depreciation or initial depreciation with respect to certain assets.

B. *Korea*

The Corporation Tax Law (CTL) in Korea provides the basic operative guidelines for income reporting and taxation. The Tax Exemption and Reduction Control Law (TERCL)[7] provides tax incentives and regulates those specified in 22 other statutes, such as the Income Tax Law, the Value-Added Tax Law, the Local Tax Law and the CTL itself. There are two provisions within the TERCL which directly and indirectly provide incentives for pollution control.

There is a direct investment tax credit of three percent (or ten percent for equipment made in Korea) of the value of the investment. This credit is restricted to those resident or domestic corporations investing in one of the following:[8]

- facilities for increasing productivity,
- energy-saving facilities,
- anti-pollution facilities,
- facilities for preventing industrial hazards, and
- other specified facilities.

More indirectly, there is a choice between accelerated depreciation and investment credits for persons who start a business using new technology patented in Korea or developed by institutions designated through consultations between the Ministry of Finance and the Ministry of Science and Technology.[9] Investors have a choice between:

- an investment credit at the rate of three percent (or ten percent in the case of machinery made in Korea) of the value of the investment in new assets, or
- taking a depreciation of 30 percent (50 percent in the case of machinery manufactured in Korea) of the asset's acquisition price in the fiscal year of acquisition.

We call this incentive provision "indirect" only because the law does not specifically list pollution control investments as being approved new technology. However, the statute is broad enough to permit the inclusion of pollution control technologies. Since pollution control equipment is often considered to be part of manufacturing equipment, it qualifies for the incentive, particularly when its purchase costs are combined with process-modification costs.

Three methods for depreciating assets are defined in the CTL:[10] (i) the straight-line method, (ii) the declining-balance method and (iii) the unit-of-production method. Only one of the first two can be selected by taxpayers for the depreciation of tangible fixed assets – pollution control equipment will fall under this category. Intangible fixed assets must use the straight-line method. The unit-of-production method is available only to depreciate mineral rights.

C. *Singapore*

While providing a number of incentives for certain explicitly favoured activities, the government provides no preferences whatsoever for environmental protection investments. Singapore provides a number of other incentives, such as investment credits, tax holidays and concessionary tax rates – none of which are available for environmental protection purposes. In brief, Singapore's investment objectives and strategies focus upon the incorporation of high technology for manufacturing, trade, tourism, transport, communications and "brain services". The latter includes computer, financial, medical and consulting services.

Notwithstanding the absence of preferences for pollution control investments, the depreciation provisions are generous. All categories of taxpayers who are carrying on a trade, business or profession can choose to depreciate all classes of plant and equipment, except motor vehicles, in three years following the year of purchase.[11]

To facilitate the absorption of depreciation allowances, unused allowances may be carried forward indefinitely or set off against future profits.[12] In the case of companies, the same continuity-of-ownership test applicable for losses must be met in order to carry over depreciation allowances.[13] The Minister may dispense with the test if satisfied that the change of ownership is not for the purpose of deriving any tax benefit or obtaining a tax advantage.[14]

D. *Taiwan*

Investments in pollution control equipment and energy-saving devices were first accorded special treatment in 1970, when the existing Statute for Encouraging Industry (SEI) was extended. Current investment incentive provisions are contained in the Statute for Upgrading Industry (SUI).[15]

Investment tax incentives for pollution control allowed by the SUI include accelerated depreciation, investment tax credits, share-purchase tax credits, tax exemption on retained earnings and tax deferral on stock dividends.

1. Accelerated depreciation

Under the earlier SEI, investments in pollution control equipment could be depreciated over a period of two years (straight line).[16] The present SUI allows the depreciation of certified investments to be accelerated by up to half the number of years of normal service life, as specified in the Income Tax Law (ITL). Although the law is not explicitly drafted to include pollution control equipment, the wording is sufficiently broad to technically include such investments. It states:

> Based on the requirements for adjustment of industrial structure and improvement of scale of operations and methods of production, depreciation of the machinery and equipment of specifically designated industries may be accelerated by one half the number of years of service life of fixed assets as prescribed in the income tax law.[17]

7. Law No. 1723 of 1965.
8. TERCL Arts. 71 and 18(1).
9. TERCL Art. 18 and TERCL-Executive Decree, Art. 15.
10. CTL Art. 56.
11. The Income Tax Act (ITA) Art. 19A.
12. ITA (Cap. 134) Sec. 23(1).
13. *Id.*, Sec. 23(3).
14. *Id.*, Sec. 23(2A).
15. Statute for Upgrading Industry (SUI), promulgated on 29 December 1990, by Presidential Decree. It is effective from 1 January 1991 until 30 June 1998.
16. 1990 ITL Art. 51.
17. *Taxation in the Republic of China*, Ministry of Finance (1991).

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TABLE 1

COUNTRY	TYPE OF INCENTIVE	DETAILS
JAPAN	Special Depreciation (Expensing) for pollution control equipment. No Investment Tax Credit.	25% initial allowance is permitted. The remainder of investment cost is depreciated normally.
KOREA	Investment Tax Credit for pollution control equipment. Accelerated Depreciation or Investment Credit, for new technologies.	3% for imported equipment. 10% for domestic equipment. 30% for imported equipment. 50% for domestic equipment. Investment credit same as above.
SINGAPORE	No special incentives.	Three-year depreciation available for all plant and equipment.
TAIWAN	Accelerated Depreciation. Investment Tax Credits.	Depreciation over half of the life of the assets. 5% to 20% depending on the type of asset.
FRANCE	Accelerated Depreciation for pollution control equipment. Regional tax concessions and grants are available.	50% initial allowance, remainder at 10 to 20% straight-line.
GERMANY	Accelerated Depreciation. No Investment Tax Credit.	60% initial allowance, rest at 10% until full amortization.
NETHERLANDS	Investment Tax Credit for any environmental protection investment. Grants and Loans to assist research and development projects.	3% to 15% depending on the type of asset.
UNITED KINGDOM	No special incentives for installing pollution control equipment.	
CANADA	Accelerated Depreciation for pollution control investments on plants commissioned before 1974. Investment Credits for certain activities which can include expenditures on pollution control assets.	3-year straight-line 25%—50%—25% vs. normal declining balance depreciation, 20% to 25%. Depends on taxpayer, activity, region and year involved.
UNITED STATES	No special incentives for installing pollution control equipment.	

ed based on the shorter life, and the excess of depreciation (as computed over the depreciation actually deducted during those years) may be currently expensed.

3. Special accelerated (initial) depreciation[5]

Under the "special initial depreciation" method, a certain percentage of the acquisition costs of eligible assets may be deducted once during the year when the assets are first placed in use. Examples of the amount of the special initial depreciation allowed are as follows:[6]

- qualified facilities to prevent pollution: 25 percent of acquisition cost,
- qualified plants equipped with special anti-pollution devices and qualified energy-efficient plants: 18 percent of acquisition cost, and
- certain energy-saving machinery: 18 percent of acquisition cost.

The special initial depreciation may be accounted for in the normal way by reducing the book value of the assets, thus decreasing the amount of depreciation in future years. Alternatively, these amounts may be credited to a special depreciation reserve account, in which case book value is not reduced and ordinary depreciation may be taken on the basis of the higher value.

The above accounting option allows an investor to choose between immediate partial expensing and the use of normal depreciation. This enables the investor to select a scheme that more closely matches the investor's cash flow.

Eligibility for the special accelerated depreciation benefits is conditioned upon a corporation filing a so-called blue return. The blue return was originally established to encourage the use of standardized accounting procedures. Corporations which apply for the privilege of filing a blue return and agree to use a standard bookkeeping system are eligible for very substantial tax benefits. They may:

5. Law No. 26, 31 March 1957, as last amended by Law No. 15, 31 March 1990. Cabinet Order No. 43, 31 March 1957, as last amended by Cabinet Order No. 93, 31 March 1990.
6. Special Tax Measures Law (STML) Art. 43.

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native actions, hence influencing the decisions and behaviour of individuals, firms and governments, so that environmentally superior alternatives are chosen. In short, MBIs use market forces to integrate economic and environmental decision-making.

The use of MBIs saves economic resources because decision-makers are made aware, through prices, of the environmental implications of their choices.

Fiscal instruments for environmental protection are a subset of MBI mechanisms. Though not always in conformance with ideal market-incentive approaches, a wide variety of pure fiscal (or tax) incentives may be used to influence pollution abatement. The structure of income taxes, including tax rates, the definition of the tax base, the relation between corporate and personal taxes and loss treatment provisions, can affect pollution control. In the case of indirect taxes, differential tax rates on products or inputs may have the effect of influencing pollution, e.g. higher excises on oil products may cause more polluting coal to be used.

This report is focused on those fiscal instruments for environmental protection whose design philosophy explicitly incorporates an environmental agenda. A limited, but comprehensive, list would contain:

- tax incentives for investment in pollution control equipment and technologies,
- specific taxes on goods and inputs based on environmental externalities, and
- user charges that account for the true social value of the amenity or service involved.

This study discusses the intent and design of investment tax incentives, and their economic and environmental impact. It is organized as follows:

Section I provides a taxonomy of investment tax incentives for pollution control used by selected industrialized countries in Asia, Europe and North America. Section II reviews the theory of tax incentive instruments. The purpose is to create a framework for identifying structural weaknesses and negative behavioural influences. Section III introduces the criteria that may be used to evaluate tax incentives and uses a comparative methodology to suggest structural and legislative modifications of tax incentives that may enhance their effectiveness and promote efficiency.

I. TAXONOMY OF INVESTMENT TAX INCENTIVES FOR POLLUTION CONTROL

Possible incentives that can be extended through the tax system are differentiated by the nature of the base for tax benefit determination, the timing of the benefits from such incentives and the conditionality attached to their use. A taxonomy of tax incentives used for pollution control may be developed by examining tax laws and regulations in the industrialized nations of Asia, Europe and North America. In particular, the incentive tax laws of the following countries have been examined: Japan, Korea, Singapore, Taiwan, France, Germany, the Netherlands, the United Kingdom, Canada and the United States.

While there are important differences in accounting and tax benefit accrual, a general list of the specific incentives encountered are: accelerated depreciation, investment tax credits, partial expensing and tax exemptions/deferrals.

Table 1 summarizes the basic structure of investment tax incentives for pollution control in these nations.

A. *Japan*

The basic provisions dealing with national taxes on individuals and corporations are to be found in a series of statutes covering both specific and general topics. For corporations, the basic statute is the Corporate Tax Law (CTL), which is supplemented by Cabinet Orders and Ministerial Ordinances issued pursuant to each.

A combination of depreciation and expensing incentives are provided for certain eligible assets, which include pollution control investments. The interplay of ordinary depreciation, and the so-called "initial depreciation provision" (which is essentially a partial expensing allowance), in addition to an obsolescence clause for shortening useful asset lives, results in an attractive investment tax incentive for pollution control equipment.

No investment tax credits are provided under the Japanese CTL.

1. Ordinary depreciation

Most assets eligible for ordinary depreciation may be depreciated using the straight-line method, the declining balance method or any other method specifically approved by the relevant regional tax bureau. For accounting purposes, a corporation may treat ordinary depreciation charges as a reduction in the book value of the asset or as a credit to an ordinary depreciation reserve account.[1] Depreciation, as entered on the books of the company, may be deducted for tax purposes and may be charged against profits, up to the limits established by law.[2] Depreciation entered on the books in excess of the statutory limits may not be deducted currently, but may be carried over and, taken together with subsequent book depreciation, deducted up to the statutory limits in subsequent years.[3]

A ministerial ordinance stipulates that machinery used for pollution control should have a useful life span of seven years. Specially constructed structures, such as towers, reinforced concrete buildings, chimneys over 70 metres high, etc., have varying useful life spans, ranging from 10 to 30 years.[4]

2. Shortening of useful life due to obsolescence

Upon application to the tax authorities, the useful life of an asset may be shortened on grounds of functional obsolescence. Depreciation for the previous years may be recomput-

1. Report of Ministry of Finance Committee on Business Accounting Principles, as amended, 30 August 1974, Note 17.
2. CTL Arts. 31 and 32.
3. CTL Basic Circular Sec. 7-5-1.
4. Tables 6 and 7, *Ministerial Ordinance Concerning the Useful Life of Depreciable Assets*, Ministry of Finance Ordinance No. 15, 31 March 1965, as last amended by Ordinance No. 17, 31 March 1990.

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INTERNATIONAL:

FISCAL POLICIES TO CONTROL POLLUTION: INTERNATIONAL EXPERIENCE

Glenn P. Jenkins and Ranjit Lamech

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Mr Ranjit Lamech *has graduate degrees in Public Administration and Energy Engineering from Harvard and Stanford Universities respectively, and was a 1991 graduate of the Harvard International Tax Program. He was a Research Fellow with the Harvard International Tax Program during the time this study was undertaken. Mr. Lamech is now a consultant for the World Bank's Energy Sector Management Assistance Programme.*

The authors wish to thank the Tax and Tariff Commission, Ministry of Finance, Republic of China for its financial support to the Harvard International Tax Program which enabled us to undertake this study. Comments by the staff of the Tax and Tariff Commission on an earlier draft of this work were very helpful and were greatly appreciated. Discussions with our Harvard colleagues, Robert Stavins and Theodore Panayotou, have significantly improved our understanding of the design and operation of market-based incentives to control environmental damage. A special thanks to Ana Lucia Santos, Rachaneephan Yuktasevi and Efeng Huang who, as graduate students at Harvard, completed their thesis in this field of study, and to Mwana Lugogo, who provided key assistance in the completion of the final reports.

ABSTRACT

Over the past few decades, the environmental policy debate has evolved to recognize the utility of influencing pollution abatement by using market forces that integrate economic and environmental decision-making. Market-based incentive (MBI) instruments may be broadly classified to include environmental taxes, investment tax incentives, tradeable permits, user charges and deposit refund systems. Investment tax credits have been the preferred fiscal instruments for pollution control because they seem to balance environmental considerations with concerns about industrial competitiveness. Their use, however, may not have the desired effect of reducing pollution and may, in certain circumstances, increase emissions levels. The taxes are also sometimes seen as subsidies in disguise. This report is a comparative analysis of the fiscal instruments used by countries in Asia, Europe and North America, whose design philosophy explicitly incorporates an environmental agenda. In particular, it discusses the intent and design of investment tax incentives, presenting a review of the basic theoretical framework necessary for understanding how they function. In addition, it outlines a set of criteria that may be used to evaluate their economic and environmental impact and describes possible legislative and structural revisions that may enhance their effectiveness and promote their efficiency.

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INTRODUCTION

Over the past few decades, the environmental policy debate has evolved to recognize the importance of market-based incentives (MBIs) as instruments for encouraging pollution abatement. Market-based incentive instruments can be broadly classified to include a combination of environmental taxes, investment tax incentives, tradeable permits, user charges and deposit-refund systems.

The level of interest in using MBIs to reduce environmental damage has increased greatly in recent years. An MBI affects the estimates of costs and benefits of alter-

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To provide for an equitable application of global methodology, the countries adopting such methodology would have to maintain a consistency of approach to accounting concepts and principles which underlie profit determination in income tax systems based on the net income standard. Currently, due to variations from nation to nation in:

- treatment of certain significant types of expenditures (e.g. R&D, depreciation, handling of intangible property, amortization of goodwill, etc.);
- methods for translation of foreign currency and treatment of resulting foreign currency gains and losses;
- permissible accounting periods and methods;
- reserve requirements;
- realization rules.

It would be a practicable impossibility to develop a worldwide consolidated profit (with respect to application of a comprehensive global method) or to develop an appropriate combined taxable income (with respect to the apportionment of a revenue stream between two or more national affiliates) which would be acceptable to either revenue authorities or taxpayers. To do so would entail the harmonization of relevant rules, as noted above, or an internationally agreed upon regime involving consolidating or combining adjustments in order to eliminate the impact of international variations.

In addition to harmonizing accounting principles, global methodologies would further require consistency among the nations adopting such methodologies with respect to the apportionment factors selected.

With this by way of background, i.e. the need for harmonization of economic policies, accounting principles and standards and tax structures, it becomes easy to visualize how extraordinarily difficult it would be for national fiscal administrations or taxpayers to resort to global methodologies under the existing facts and circumstances of today's global environment, without the harmonization noted above. Not only would such an effort be the epitome of complexity, but it would be extremely costly, in terms of time and administrative expense, to be achieved (if it could even be achieved). Perhaps it could be said that the fiscal administrations of the sophisticated countries might be better equipped to cope with the complexity of using global methods, but even this is problematical. Countries which do not have such well-developed administrative machinery would have a clear disadvantage, which could have significant implications for third-world countries. But no tax administration (or taxpayer) would have an easy time implementing the apportionment processes inherent in employing a global methodology.

IV. APPLICATION OF GLOBAL METHODOLOGIES IN EXCEPTIONAL CASES

Having set forth the objections to the use of global methodologies, it is important to note that, in certain very special and exceptional circumstances, there may be some instances where it would be appropriate to use an allocation method. For example, there may be instances where commonly controlled units around the world join in the conduct of a 24-hour trade in certain financial products and agree to pool costs, position and credit risk, and income, sharing resultant profit on an agreed basis. If a taxpayer decides to follow this approach, and the profit sharing agreement corresponds to what would have been agreed on an arm's length basis, then it should be accepted for tax purposes. In general, even in a supposed 24-hour trading situation, the above example would not be typical. The established arm's length rules, taking account of market prices and the business unit where the trading risk and expertise reside, are the appropriate test in such situations.

We would also like to comment on a point made at the end of paragraph 14 of the OECD report that some regard to the total group profits of an MNE may be helpful "as a check on the assessment of the arm's length price or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available". We believe that such an approach should be only very exceptionally resorted to and then only if the countries involved can obtain the appropriate data as well as agree to a common ground so as to eliminate any possibility of double taxation. Any reference to the total group profit of an MNE should be based exclusively on the basis of publicly available information.

V. CONCLUSIONS

Global methods rarely reflect economic reality, as their implementation often relies on arbitrary apportionment factors rather than on actual economic conditions in the countries and contractual agreements between the parties. Often the application of global methodology involves substituting the commercial judgement of the tax examiner (for the purpose of determining tax liabilities) for that of the enterprise at the time when the transaction was concluded, contrary to the recommendations of the OECD Report.

Global methods cause unequal tax treatment between domestic independent enterprises and local affiliates of MNEs because, as noted above, by departing from real world consideration in favour of arbitrary apportionments, the results of a local MNE affiliate – following such adjustment – are bound to differ from those of an independent enterprise whose results are necessarily dictated by market conditions.

Global methods would seriously increase, rather than reduce, the likelihood of double taxation unless all countries applied such methods and did so in accordance with precisely uniform rules and concepts therefor. On the contrary, countries which refuse to accept global methodology would apply tax determination rules without regard to the rules in other countries.

Global methods tend to be highly complex and hence difficult to understand and to apply in practice, and expensive to administer – for both tax administrations and taxpayers alike.

In conclusion, BIAC believes that what was said in the OECD report about "global" methods remains equally valid today. In our view the weight of the evidence and prevailing opinions clearly discredits the use of global methodologies except in the very circumscribed circumstances laid out in the preceding section.

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trary to the recommendations of the OECD report and cannot be accepted for either tax or general business purposes.

B. *Artificial profit shifting*

Paragraph 14 of the OECD report on transfer pricing comments further:

> "They [global methods] are all however to some degree arbitrary."
>
> "...and inherently running the risk of allocating profits to an entity which is in truth making losses (or possible the contrary)."
>
> "While the widest range of such information [i.e. information about the total activities of an MNE] may be available to the tax authorities in the country of the parent company in a group even those tax authorities will be limited to some extent on the information which they can compile."
>
> "Even if the information were available, however, the varied activities of any MNE and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere."

Some of the main purposes of the arm's length test is to prevent profit shifting by companies. A basic objection to the use of global methods is that it will result in profit shifting by the authorities, whichever application of global methodology is involved, i.e. apportionment of the total profit of an MNE group among all the affiliates or apportionment of a revenue stream between two affiliates within an MNE group, for the many reasons set out in paragraph 14 of the OECD Report.

To take a particular example, the variation between differing approaches to social welfare may cause serious distortions. In some countries, the responsibility for social welfare may be borne substantially by the government, while in others, employers may have the major responsibility therefor. Or, as another example, some countries (e.g. developing countries) have much lower prevailing wage scales than the industrialized countries. Both of these examples demonstrate how the use of comparative cost data, unadjusted for these environmental differences between nations, could, if used as an apportionment factor (either alone or in combination with other factors) create distortions leading to misallocations of profit. In this connection, it should be noted that, in the case of low production cost countries (i.e. the third world countries), the use of global methodology can actually discourage inward investment, since apportioning global profit will automatically favour wealthier countries because of higher prevailing prices and costs, where the factors would tilt the balance by apportioning a disproportionate share of the profit to the industrialized countries. This has been a major complaint against using worldwide reporting under a unitary taxation system.

To employ a global methodology to determine the profit of one or more (or all) affiliates within an MNE group would of necessity entail the adoption of an approach designed to eliminate arbitrariness as much as possible. This means that a detailed analysis of the functions within the MNE and each of its affiliates is necessary, for either of the extreme applications of global methodology. Such an analysis must include, for each group member, consideration of commercial and legal risks, determination of value added, analysis of the relative number of personnel, consideration of whether the relevant affiliate is a strategic business unit or an unproductive entity, the performance of R&D, and countless other aspects of their business. It would be entirely unrealistic to suppose that any global methodology could achieve in a working form the degree of sophistication to account for all these factors in such a way as to produce the same level and distribution of taxation as would arise if the transactions in question had been between independent parties (see D. below).

C. *Double taxation*

On the very important matter of avoiding double taxation, paragraph 14 of the OECD report on transfer pricing comments:

> "The use of such alternatives to the arm's length principle is incompatible with Articles 7 and 9 of the OECD Model Double Taxation Convention."
>
> "Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their uncoordinated use by the tax authorities of several countries would involve the danger that, overall, the MNE affected would suffer double taxation of its profits."

In order to avoid any risks of double taxation using the global methodology, fiscal authorities around the world choosing to employ global methodologies would have to apply consistent procedures and regulations which, of course, would require appropriate national legislative and, perhaps, constitutional authorization. Such a system, involving multilateral coordination, which would need to include a clearing system to ensure that double taxation did not occur on worldwide basis, is clearly so utopian in concept as to lack any credible chance of being created, even over the long term.

We should point out that a government of a country whose tax revenues are declining because its economy is in a recessionary state (albeit only temporarily) might be inclined to use a global methodology to artificially apportion greater profitability to its tax jurisdiction than is warranted by the facts and circumstances. This is a further example of the risk of double taxation where global methodologies are sanctioned.

D. *Acceptance and simplicity*

The OECD report on transfer pricing states as follows (p. 14):

> "To allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various different stages of manufacturing transportation, marketing and so on."
>
> "Nor would the information necessary for such an assessment be readily or, in many cases, available to all."
>
> "The need would be for full information about the total activities of the whole MNE."
>
> "Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group's worldwide activities."

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ing whether, as between related companies, the arm's length test is met and, in some countries, is a direct obligation of companies under commercial law. (The same approach, incidentally, is included in the new US proposed regulations.) Before 1930, the League of Nations adopted a Model Agreement for Avoidance of Double Taxation, incorporating the arm's length principle, which was then followed by the various member states.

The United States adopted the arm's length standard in 1935. At that time, the US Treasury added the following language to the Treas. Reg. 86, Art. 45-1(b) (currently contained in Reg. Sec. 1.482 -1(b)(1):

> "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

In 1979, the OECD Committee on Fiscal Affairs issued its report on "Transfer Pricing and Multinational Enterprises". The OECD report summarized the basic concept behind the arm's length principle, and how it had been adopted by the OECD members in practice. Today the report has become an authoritative treatise for guidance on the determination of intra-group prices for tax purposes.

The OECD report discusses "global" methods (paragraph 14), expressing clear disapproval of these methods (with one minor exception to be noted below). The report states that the usage of global methods is tantamount to abandoning the arm's length approach, and is incompatible with Articles 7 and 9 of the OECD Model Double Taxation Convention.

II. CRITERIA FOR TAX STANDARDS

A standard, such as the arm's length principle, is crucial for ensuring that, within an MNE group, transfer prices attaching to all types of intercompany transactions are established at levels which do not distort companies' tax liabilities by shifting profits from one company to another company in a different jurisdiction. Equally, if applied consistently by all countries, such a common standard protects companies from double taxation. It should be noted that the various revenue authorities around the world also need such a standard to facilitate their examinations of the members within the MNE group.

BIAC believes that such a standard should:

- respect market conditions, by reflecting economic reality;
- result in comparable taxation between independent and controlled taxpayers involved in similar transactions and located in the same (or similar) geographic locations;
- ensure that neither double taxation nor artificial profit shifting occur;
- be widely accepted by governments as well as by taxpayers;
- be readily adoptable for application in a world with different tax and accounting systems;
- be easy to comprehend and practicable to apply.

BIAC believes that the arm's length standard meets these criteria, and, therefore, it should not be replaced by another standard, in whole or in part, unless such other standard better achieves these objectives. We have not as yet found such a better standard.

III. CAN GLOBAL METHODS MEET THESE CRITERIA?

In order to determine whether a global methodology approach would be a better, or even an adequate, alternative to the arm's length standard, it is necessary to judge the effectiveness of such an approach in meeting the criteria noted above.

A. *Economic reality and comparable taxation*

Paragraph 14 of the OECD Report addresses "global" methods from a number of standpoints. It includes the following:

> "Such [global] methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises..."
>
> "...and tending to ignore the management's own allocation of resources."
>
> "...producing an allocation of profits which may bear no sound relationship to the economic facts..."
>
> "For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process...Nor does it follow that labour costs are the same for the same labour in different countries, or that profits are necessarily related to any simple combination of such factors."

In the situation where a global methodology is applied to the overall group profits of an MNE, there would be a natural tendency on the part of the revenue authorities in the home country to assume that every affiliate in the group is strongly dependent on the parent company or the group as a whole, thus resulting in the attribution of an artificially high profit for the group parent. Such an artificial allocation of profits by tax authorities under this approach, particularly if also accepted by the various host country authorities, would result in the measure of taxable profits in home and host jurisdictions completely unrelated to actual performance therein.

In the more limited scenario, where global methodologies are used to apportion profit on a cross-border stream of transactions between two affiliates, the factors chosen by which to apportion profit are apt to be arbitrary, without any consideration given to the variations in economic circumstances between the two countries. The result is bound to be distorted.

In either scenario, i.e. the broader or narrower application of global methodology, the distortion created by the arbitrary and artificial profit apportionment would naturally result in tax burdens totally out of line with tax burdens suffered by local enterprises without international affiliations, in the home and host countries alike, creating a competitive disadvantage (or advantage, as the case may be) and particular difficulties, for example, in the case of companies with minority shareholders or which are subject to statutory employee participation (as in Germany).

What global methodology does is to provide the tax authorities with an administrative tool which would allow them to ignore valid intercompany agreements on arm's length terms, reflecting the proper commercial judgements and expertise of the parties exercised without the benefit of hindsight and to substitute their own commercial judgement, applied on a retrospective basis, for that of the enterprise. Such a result is con-

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INTERNATIONAL:

INTERNATIONAL GLOBAL METHODS – A CRITICAL VIEW

Business and Industry Advisory Committee

INTRODUCTION

We understand that there is a growing interest, on the part of certain revenue authorities, to use what has been referred to as global methods in the enforcement and administration of their tax laws in the area of transfer pricing (e.g. specifically noted in the case of the US regulations under Section 6038A of the US Internal Revenue Code). Such global methodology would ostensibly be substituted for the long standing use of the traditional "arm's length" principle applied on a transactional basis. This paper has been prepared by the Business and Industry Advisory Committee (BIAC) to the OECD to present its views to the OECD's Committee on Fiscal Affairs on the problems that will arise in attempting to apply global methods in the taxation of multinational enterprises (MNEs), particularly as related to the determination of transfer prices. The following analysis does not deal with the new US proposed regulations under Section 482 of the US Internal Revenue Code, a critical review of which will be undertaken at a later date.

Before attempting to compare global methods with the internationally accepted arm's length standard, it is necessary to define both terms. The arm's length standard is essentially a fair market value standard applied on a transactional basis, with due regard to the functions of the parties. It requires that a transfer price in a transaction between two related parties reflect the amount that would have been agreed upon between two unrelated parties under the same or similar circumstances.

On the other hand, global or allocation methodology does not look to the valuation of transactions as they occur, but rather looks to an allocation and apportionment among two or more affiliated group members of the profits resulting from such transactions. At the one extreme, this methodology may be used to determine the taxable profit of local entities by apportioning the worldwide profit of an MNE group, including all the individual affiliates subject to taxation in various countries, according to a predetermined formula. This application of global methodology is rarely, if ever, seen in practice. At the other end of the spectrum, the application of a global methodology may be limited in scope to the apportionment of the profit arising from a stream of cross-border transactions (e.g. sales of goods) between two affiliates within an MNE group. It is this latter, more limited form of usage of global methodology that is appearing on the scene in various countries, particularly in the United States (as noted above by the reference to Section 6038A).

*The **Business and Industry Advisory Committee** to the OECD (BIAC) was constituted in March 1962 as an independent organization officially recognized by the OECD as being representative of business and industry. Therefore, BIAC, an organization whose members include the industrial and employers' organizations of the 24 OECD Member Countries, is representative of the private sector in the industrialized world.*

The BIAC Committee on Taxation and Fiscal Policy, a multinational group of private sector tax specialists, has met with the OECD Committee on Fiscal Affairs and its Working Groups to discuss various issues in the tax field.

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I. HISTORY OF THE ARM'S LENGTH STANDARD

Every member nation of the OECD has adopted the arm's length principle as the basic conceptual standard for determining transfer prices on transactions between and/or among affiliates within an MNE group. This approach has also been accepted by revenue authorities virtually throughout the world as a proper standard to apply when reviewing intercompany transfer pricing structures during revenue examinations. In a number of European countries, the arm's length standard is directly associated with the concept of the "prudent businessman", i.e. one who exhibits intelligence, sophistication and conscientiousness in conducting the affairs of his company. This prudent business man's approach acts as a yardstick in assess-

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NEW ZEALAND: TAXATION OF CLOSELY HELD COMPANIES: THE NEW ZEALAND MODEL 506 *Kevin Holmes*

A 1992 amendment to the New Zealand Income Tax Act incorporates legislation for the taxation of closely held companies in New Zealand. A "qualifying company" regime was founded on the premise that business undertaken through small closely held companies are in effect no different from partnerships undertaking the same operations, except for the entity's legal form – consequently, each should pay the same amount of tax. This article reviews the qualifying company legislation and illustrates the benefits and pitfalls associated with the new provisions.

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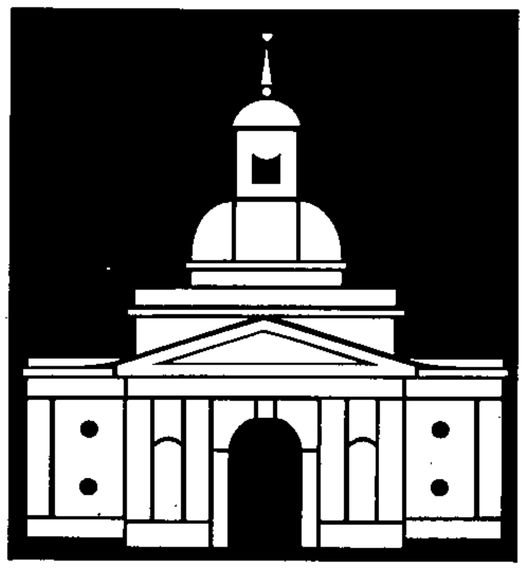

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The Business and Industry Advisory Committee (BIAC) to the OECD recently prepared this paper to present its views to the OECD Committee on Fiscal Affairs on the problems that will arise in attempting to apply global methods in the taxation of multinational enterprises, particularly as related to the determining of transfer prices.

INTERNATIONAL: FISCAL POLICIES TO CONTROL POLLUTION: INTERNATIONAL EXPERIENCE — 483 *Glenn P. Jenkins and Ranjit Lamech*

The environmental policy debate has evolved over the past few decades to recognize the importance of market-based incentives (MBIs) as instruments for encouraging pollution abatement. MBIs can be broadly classified to include a combination of environmental taxes, investment tax incentives, tradeable permits, user charges and deposit refund systems. This article – the first of two parts – discusses the intent and design of investment tax incentives, and their economic and environmental impact. A taxonomy of investment tax incentives for pollution control used by a number of Asian, European and North American countries is provided, followed by a review of the theory of tax incentive instruments. Criteria are then introduced to evaluate tax incentives and a comparative methodology is used to suggest structural and legislative modifications of tax incentives that may enhance their effectiveness and promote efficiency.

UNITED STATES: THE FOREIGN INCOME TAX RATIONALIZATION AND SIMPLIFICATION ACT: A BRIEF ANALYSIS OF THE MINIMUM TAXABLE INCOME TRANSFER PRICING APPROACH FOR FOREIGN-CONTROLLED CORPORATIONS — 503 *Alan W. Granwell*

The Foreign Income Tax Rationalization and Simplification Act was introduced on 27 May 1992. If enacted the bill would make important changes to the tax treatment of US companies operating abroad and of foreign companies and individuals with business or investment in the United States. One of the most controversial aspects of the bill is the proposal to require that a minimum amount of taxable income be reported by certain foreign-controlled US corporations and US branches of foreign corporations. This article describes the proposal and comments on its implications.

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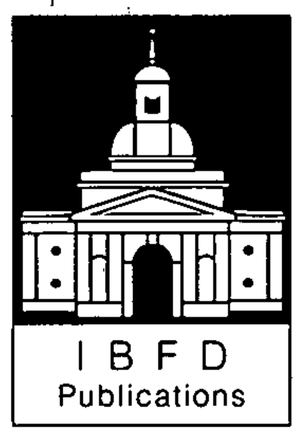

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the 1990s as Argentina becomes the first country to attempt to implement a form of cash-flow taxation. Conceptually, there is little to complain about the tax (except that it comes very close to the already existing VAT in most countries). Its problems lie, however, in administrative difficulties since it can be relatively easily avoided through transfer pricing and the like. Also, foreign investors may not find this tax to be deductible against the corporate income tax that they have to pay in their home countries. Thus, unless the developed countries make a concerted and simultaneous effort in the area of cash-flow taxation, it is unlikely to be successful in the developing country environment.

Third, a preoccupation among tax economists has been the relative lack of success in taxing the financial sector either through its income or in the form of the consumption of services that it provides. For example, during periods of high inflation, the financial sector may reap windfall profits. To capture this source of revenue, a tax on short-term interest-bearing assets can be considered, but its incidence – whether on banks or consumers – remains unclear. Or, in order to compensate for the difficulty of taxing the financial sector under the VAT, a tax on bank debits, that is, on checks, has been debated. While such a tax would imply a burden on financial intermediation, no clear solution has yet emerged. There is general agreement, however, that the financial sector needs to be tapped for tax revenue. This will remain on the agenda of tax reformers in the 1990s.

Fourth, countries have generally neglected the area of property taxation even as the issue of fiscal responsibility at lower levels of government has assumed greater importance. The pressure to narrow fiscal deficits and pursue much needed stabilization policies will oblige this much pampered area of taxation to be brought out for closer examination and be made subject to greater and appropriate levies. There are immediate possibilities for improving the revenue impact from property taxation through consistent and frequent reassessment of property values based on existing information. It is hoped, therefore, that property taxation will be an area of renewed attention during the 1990s.

Fifth, growing environmental awareness across the world has brought the plausible role of environment taxes to control pollution to the forefront of tax policymaking. Latin American countries will have to contend increasingly with environmental taxes in the 1990s. At the beginning, their coverage and scope would albeit have to remain modest, and revenues would need to be earmarked for environmental protection in order to earn the confidence of the taxpayers that the revenues are being used toward the specific objective for which the taxes are imposed. Also clearly defined tax bases would have to be identified such as gasoline, factory emissions and forestry companies. Realistic tax structures and practical proxy measures for emissions measurement would have to be used. These methods should be quite applicable in most Latin American countries.

Sixth, difficulties have been faced in implementing the conceptually correct global tax structures – in which all sources of income are treated equally for tax purposes – based on declarations. This has tended to move taxation methods to withholding systems – at least as minimum payments – while retaining the overall global structures. It is likely that during the 1990s, withholding will become more acceptable if further experience reveals that the withholding mechanism approaches the intention of global taxation more successfully than systems that are based on compulsory declarations but are supported by limited administrative capacity.

Finally, the 1990s are certain to witness major tax harmonization efforts among Latin American countries such as among MERCOSUL and the Andean Pact, and perhaps among even larger country groups. These efforts are likely to be in the areas of capital income taxes, double taxation on the personal income tax base, customs tariffs, as well as the VAT. The models that are already available are those in operation or are being discussed among the EC, North American, or CIS states, in various areas of taxation with international ramifications.

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III. SUMMARY AND CONCLUSION

This paper reviewed the experience of Latin American countries with respect to tax reform and revenue performance for the decade of the 1980s. It also discussed selected tax reform issues that are likely to be in the forefront of Latin American debate and discussion during the 1990s. Several important conclusions have emerged from this review. They are summarized in this section.

A. *Trends of the 1980s*

An interesting finding regarding tax reform in the 1980s is that steeply progressive rate structures of income and property taxes – which were conceptually optimal from the point of view of equity and stabilization objectives, but were practically unimplementable – were demolished. Instead, broad-based, low-rate taxes on domestic consumption such as the VAT were emphasized, more for their administrative ease based on a self-monitoring feature, as well as for their relative dependability for revenue. Also, it came increasingly to be realized that fundamental tax reform can take many years to be fully implemented and effectively constituted an aggregation of many annual discretionary changes.

The actual experiences of Latin American countries between 1980 and 1991 bear witness to the above-mentioned overall premise. The number of countries that operated a VAT increased from eight to 15. The objective of maintaining a simple tax structure resulted in nine countries having a uniform VAT rate. Countries that attached other objectives than revenue – such as regional development or redistribution – to the VAT, used a multiple-rate VAT. To enhance its revenue-raising feature, countries continually attempted to expand the VAT revenue base. In addition to the VAT, almost all countries imposed excise taxes at different and higher rates, typically on petroleum products, tobacco products, alcoholic and non-alcoholic beverages, automobiles and gambling. Many countries, however, continued with much longer lists of excisable commodities.

Direct taxation at highly progressive rates was de-emphasized. The top marginal personal income tax rate fell from 48 percent on average to 35 percent. The overall structure of rates was scaled down. The number of rates was reduced. The average exemption level was also increased from about half of per capita GDP to one and a half times per capita GDP.

Many countries reduced the corporate income tax rate, the average falling from about 44 percent to about 36 percent, even though many countries continue to maintain progressive rate structures. The top marginal personal income tax rate approached the main corporate income tax rate. Foreign companies continue to be subjected to withholding taxes, mainly in the form of surcharges. However, the surcharges have fallen, on average, from 17 percent to 11 percent. Also, the number of countries that treat foreign and domestic capital equally increased from three to six.

In order to assess the movements in the tax-to-GDP ratios of Latin American countries during the 1980s, they were divided into three (equal) groups: high-tax countries (around 20 percent and above), low-tax countries (around 10 percent and below) and medium-tax countries (10-20 percent). One conclusion that emerges is that major tax reform is neither always carried out with the revenue objective nor does it necessarily push a country to the high-tax ratio group. Similarly, a country with a high tax burden does not always represent one that has undertaken fundamental tax reform. Nevertheless, countries that have undertaken tax reform – for example, Argentina, Bolivia and Mexico – in general experienced a greater revenue gain in terms of GDP over the decade, as compared to the revenue gain in the overall sample. An exception was Chile which experienced a fall in its tax-to-GDP ratio as it transferred its social security system to the private sector and reduced its VAT rate. In most instances, however, the revenue gain still left the countries in the original country groupings to which they had belonged at the beginning of the decade.

For the sample as a whole, the tax-to-GDP ratio increased by one percentage point. Income and social security taxes each remained stagnant at around three percent of GDP, while domestic consumption taxes increased, on average, from five to six percent of GDP. The reliance on international trade taxes declined only slightly, by one-half percent of GDP, reflecting no clear pattern in their use within the sample. Property tax revenue continued to remain insignificant, usually below one-half percent of GDP.

B. *Issues for the 1990s*

Given the experience of the 1980s, many new issues have emerged for consideration during the 1990s. Many of the new concerns reflect a preoccupation that the role of direct taxation has slipped even as reform in the consumption tax area has progressed.

First, there is an increasing realization that few – mainly large, and foreign – corporations pay the corporate income tax. A minimum contribution to the corporate income tax should be made by other corporations. A judicious application of a minimum tax could also help contain the growth of the underground economy if, for example, the tax is applied to persons engaged in business who are subject to the individual tax. While many Latin American countries already use some form of taxation of assets, few use it as a minimum contribution to the income tax. Others have it on the books, but revenue tends to be minimal. More countries need to carefully design and implement a minimum gross assets tax in order to raise the revenue-raising capacity of the income tax. Mexico has successfully applied this minimum tax to both corporate and individual income taxes. It can serve as a model to other countries in the formulation of a good minimum tax based on gross assets. Other bases for a minimum tax such as net worth or physical assets can also be contemplated; but their bases tend to be narrow and, consequently, their rates need to be higher.

Second, a concern regarding the corporate income tax has been that it has tended to become a complex tax, ridden with incentives, subject to ambiguous interpretation and difficult to administer. Some tax economists have recommended its replacement by a cash-flow tax. This tax will be debated in

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amount and kind of waste; marketable techniques (trading of emission permits); regulations; and taxes. Environmental taxes and charges have been commonly used in Europe. France, Germany and the Netherlands have all been using systems of charges on water pollutants for some time, and revenues are usually earmarked for improving environmental quality, for covering administrative expenses for water quality management and to subsidize related projects. Charges are related to a wide range of variables including expected volume and concentration of use, size of municipality, desired level of treatment and state of equipment.

Developing countries will be expected to embrace wide-ranging revenue systems aimed at environmental protection. In developed countries, the pollution problem can often be successfully addressed at a local or state level. In developing countries, this may not always be adequate, and greater central government regulation – even implementation – may be necessary. Pollution taxes ideally require continuous monitoring and measurement of waste discharges. The challenge, therefore, is how a realistic, yet behaviour-affecting system of environmental protection might be devised for Latin American countries. A new form of tax, the carbon tax, levied on the carbon emissions of vehicles may be practicable.[27]

Some general policy prescriptions may be made, based on the experience of developed countries. First, the coverage and scope of pollution taxes have to be limited at the beginning, while an education campaign for industry and the taxpaying public is mounted. Second, earmarking of environmental tax revenue for environmental protection purposes could be expected to generate greater cooperation from taxpayers. Third, specific targets will have to be identified for the levy of taxes such as gasoline (over and above its being subjected to excise taxation), factory emissions, forestry companies and establishments harvesting the sea. Fourth, in order to make the system feasible, proxy measures for emissions – estimates of sulfur emissions from knowledge of sulfur content of the fuel – and average (rather than a marginal scale) rates of taxes will have to be used.

F. *Increasing role of withholding taxes*

If the 1960s and 1970s firmed up the conceptual basis of taxation in the Haig-Simon tradition, the late 1980s (with continuation in the 1990s) began to question the feasibility and some of the administrative implications of the tax structures that emerged from purist concepts of equity, efficiency and stabilization as objectives. Those objectives based on equal tax treatment of equals (horizontal equity) and unequal treatment of unequals (vertical equity) as well as of neutral treatment of different economic activities, generally led to the basis of global taxation with a progressive rate structure. All sources of income were to be grouped together, that is, globalized, and taxed under the same rate schedule, assuring equity as well as stabilization over the business cycle.

In its implementation, global taxation had to relegate to self-declaration many sources of income. Even after the tax collection process, auditing turned out to be cumbersome and often infeasible. Slowly, withholding taxes (at source) at low rates began to be introduced. Though not final taxes (whose rates were higher), withholding taxes assured a minimum tax contribution from income sources such as wages and interest.

A further stage has arrived in which withholding taxes are being levied at higher rates and as final taxes, mainly for administrative reasons. Conceptually correct global taxation seems to have given way to a more administratively feasible means of taxing all major sources of income. The opinion seems to be forming that withholding taxes are able to subject all sources of income – such as wages, interest, dividends and payments to small suppliers – to taxation, at least in a minimum way, while several sources of income are liable to escape taxation altogether, if taxes were applied on a global basis. In that sense withholding, rather than the declarations method (which is more difficult to control), is increasingly seen as being more able to approach the objective of global taxation. All indications are that the 1990s will experience greater use of withholding as a form of final taxation for an increasing number of sources of income.

G. *Tax harmonization*

Various aspects of tax harmonization are being contemplated in the European Community (EC), the North American countries as well as the newly founded CIS, whether they be in the area of customs tariffs, corporate income tax, relief from double taxation on the personal income tax or a harmonized VAT. In the same vein, these issues are likely to appear as important elements in Latin American tax reform in the 1990s.

Growing economic integration within the EC, for example, has increased the need to harmonize capital income taxes as capital becomes more and more mobile. Harmonization has to be based on a common tax base and a statutory minimum tax rate.[28] Indeed, all indications are that an EC-wide corporate tax may be in the offing.[29] Similarly, the integration of personal and corporate taxes for the alleviation of the problem of double taxation within a harmonized tax system is a major issue in the EC.[30] Currently, free trade agreements are being designed among Canada, Mexico and the United States. Finally, harmonization of the VAT, based on the "origin principle" of taxation – the tax is levied in the state of origin, that is, production – is being proposed for trade among EC countries. Finally, the CIS states are attempting to harmonize most aspects of their tax systems – the corporate income tax, the VAT, as well as customs duties.

Thus, much progress has already occurred in many areas of harmonization across the world. Comparable issues are likely to be very important in the 1990s for MERCOSUL, the Andean Pact and other groupings among the Latin American countries. Perhaps a wider area of economic cooperation, free of barriers, would be debated and created, after the models being developed in other parts of the world.

27. See Oates (1988), for a discussion of the feasibility of a similar sulfur emissions tax.
28. See Tanzi and Bovenberg (1990) on this issue.
29. See item under European Community news in *Tax Notes International*, Vol. 4, No. 13 (March 1992).
30. See de la Fuente and Gardner (1990) on this issue.

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The combination of the financial regulatory structure and the incentives promoted by an inflationary environment result in increased profits for financial institutions. In an inflationary context, individuals will seek to keep any monetary assets that they decide to hold in shorter-term maturities and will increase the share of real assets in their portfolios. To achieve the latter objective, individuals will raise their level of borrowing. Short-term deposit rates react slowly to rising rates of inflation due to institutional or regulatory reasons, whereas lending rates are often more responsive to market conditions. This widening interest rate spread, between deposit and lending rates, combined with buoyant demand for short-term financing enables the financial institutions to earn significant profits. In such an environment, short-term interest-bearing assets might be taxed, but the incidence of the tax could very well fall on depositors rather than on banks. Thus, it is likely to be a poor proxy for the target tax base, namely the rising earnings of financial institutions. Though the need for financial sector taxation during high inflation is clear, an appropriate form of taxation needs to tax earnings rather than deposits. In a low-inflation environment, taxing short-term interest-bearing assets would result in a shift to longer-term deposits. Therefore, while this alternative does not retain much merit, other means of taxing the incomes of the financial sector must be sought.

Apart from the issue of financial sector incomes, there is also the need to tax the consumption of financial services just as any other service is taxed through the VAT. Given the definitional problems of including the financial sector in the VAT base, a substitute tax with a very low rate could be imposed on bank debits as was tried out, but revoked, in Argentina. If it is defined as a tax on transactions rather than on money balances, its yield would not vary with inflation. Its popularity among a selected group of economists has been manifest, for example, recently in Brazil which has been coping with high inflation. Further, conceptually the tax could be seen as an excise tax on a service, since the use of checks and credit cards offers greater safety and convenience than does cash or barter. The real danger seems to lie in high tax rates. If the tax rate increases to high levels, irreparable damages to the banking system could take place and alternative inefficient clearing mechanisms might appear. In conclusion, taxation of the financial sector, and especially financial services, is one area that will merit greater attention in the agenda of tax reformers in the 1990s.

D. *Taxation of property*

One of the most remarkable facts about the Latin American experience is the relatively low use of property taxation. While this is perhaps true of most developing countries, it is also true that selected Asian countries have recently begun using this tax or are in the process of undertaking reform in this area.[26] Latin American countries – especially those in which fiscal federalism and associated tax assignment issues are important – can be successful in expenditure sharing with lower levels of government only if property taxes – placed under local jurisdictions – are realistically legislated and earnestly implemented.

What needs to be addressed is whether improvements in property taxation solely comprise a long-term issue as is usually proffered as an argument in most tax reform packages. While cadastral surveys are lacking in some Latin American countries, many others already have them, at least for the urban areas. The answer, therefore, is that property taxation is not just a long-term issue. Countries with urban cadastral surveys can implement the tax seriously by realistically updating the assessed values of properties, for example, using a construction sector price index. Countries that do not even have an urban cadastral survey are few. They could start with the capital city and extend it to smaller cities. Surveys can be based on property values in entire blocks of cities and towns, and a very low tax applied to ensure minimization of overtaxing. As far as rural properties are concerned, again property registrations tend to exist in many countries. A strong political will and guidance through regulation at the federal level could underline the beginning of serious implementation by lower levels of government. To conclude, given the prevalence of the need to curtail fiscal deficits and the continuing existence of this large untapped tax base – urban and rural property – property taxation will remain on the 1990s tax reform agenda.

E. *Pollution and environment taxes*

A wide variety of environment taxes has been discussed in theory and applied in practice for quite some time in developed countries. The question is, to what extent they are relevant for middle-income Latin American countries. The answer is that given the rapid pace at which environmental awareness has grown across the world in the last few years, Latin American countries cannot stay far behind on this issue. It will, therefore, comprise an important item of discussion as well as implementation during the 1990s. Given the novelty of this tax, it represents what Tanzi (1988) aptly describes, "tax innovation, I mean the 'discovery' of new taxes" (p. 270).

The competitive market provides a set of incentives for producers to produce at the least cost (reflecting the use of scarce resources) the goods that consumers want. Usually the price of the product that emerges from the market reflects its social cost. There are cases such as environmental depletion – pollution of fresh air, natural forest and sea resource depletion – where social costs may not get fully reflected in the market price because clean air, green forests, and water resources have a low opportunity cost of use for the firms using them. This leads to their uneconomic use and to justified governmental intervention in the form of a custom-tailored price (a tax, a fee/charge) on polluting emissions, or a policy determined ceiling on the quantity of pollution (marketable permits, emissions trading).

Several forms of environmental instruments have been debated and utilized in the context of developed countries such as command-and- control techniques that directly control the

26. See Tanzi and Shome (1992). Taiwan Province of China has successfully implemented a tax on the increases in property values. Singapore and Korea have also made recent progress in this area.

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The minimum assets tax base can be defined such that no additional information to the corporate income tax is required. Thus, the base would be: inventories, plus accounts receivable and deposits (i.e. financial assets excluding shares), plus fixed assets adjusted for accumulated depreciation (at normal rates) and for inflation, minus liabilities with domestic non-financial companies.[20]

It may be worthwhile pointing out some important factors in the design and implementation of the minimum gross assets tax that have become apparent with the Mexican experience. In order to stabilize tax revenue through a business cycle, Mexico allows a complete carryforward and carrybackward of the income taxes and minimum assets tax for a period of six years.[21] Also, all values are inflation adjusted. In order to avoid double taxation, Mexico allows the value of shares and investments in other firms to be deductible from the tax base. Mexico exempts firms that are liquidating. New business activities, mergers and corporate reorganizations are exempt for two years. There is a strong need for precise regulation. For example, inventory valuation, treatment of losses in accounts receivables and the general basis for monetary correction need careful regulation, as do write-offs, amortization and depreciation allowances.

A minimum tax based on net worth does not have the same revenue-raising capacity as one based on gross assets. Also, since smaller firms tend to have lower debt-equity ratios, the distribution of tax burdens between small and large firms is biased against small firms in the case of a net worth tax. In general, firms can reduce their tax liability by increasing their debt-equity ratio. Perhaps a better tax base is physical or fixed assets.[22] However, here too the tax base is narrow and there are significant differences in the ownership of physical assets by type of business. Expanding the base to include all assets reduces the heterogeneity in asset ownership to some extent. Finally, given its simplicity of measurement, a minimum tax based on gross receipts has been used more commonly in African countries. Latin American countries seem to be moving in the direction of assets as the base. Perhaps both bases – gross assets and gross receipts – whichever yields the greater revenue, could be used as a design for a minimum tax.[23] To conclude, the 1990s should experience a greater use of the concept of a minimum contribution as a means to stabilize revenues from the income taxes.

B. *Cash-flow tax*

There is a growing realization that the corporate income tax is subject to problems of definition, base erosion as well as conceptual confusion, reducing it to a tax that is hardly based on income. Therefore, a small, yet perhaps expanding, group of tax economists are proposing that the basis of corporate taxation – which they feel is in general only linked precariously to income – be switched to its cash-flow. They offer many arguments in favour of the cash-flow tax that will be examined below. Argentina has proposed legislation to Congress on a modified cash-flow tax. It is very likely that other Latin American countries would do likewise during the 1990s, in the hope that tax would perform better than the income tax revenues which have remained stagnant. However, the cash-flow tax is also beset with major problems, especially those pertaining to tax administration. These must also be considered.[24]

As a concept, the cash-flow tax is simple. The tax base is real transactions: (all receipts)-(current plus capital expenditures) per period. In contrast, ideally the corporate income tax base should be: (sales receipts from goods and services, financial incomes and accrued capital gains)-(wages, economic depreciation, inventory costs and real interest) which is much more difficult to measure. In cash-flow taxation, measurement problems essentially disappear since the concept of economic costing is not used; for example, there is no role for capital gains and depreciation as legal concepts.

However, the cash-flow tax is associated with a number of problems, including: an uneven tax profile caused by immediate capital expending; tax arbitrage, through transfer pricing among affiliates which tends to affect the taxation of the financial sector; transitional problems as a result of eliminating interest deductions, leading to windfall losses for indebted firms; and, last but not least, the fact that the cash-flow tax is not creditable against the corporate income tax payable by foreign investors in their home countries, which might make it impractical at this time.[25]

C. *Taxation of the financial sector*

As indicated above, the financial system is difficult to tax on conceptual and definitional grounds. Yet, it remains a potentially large tax base that should be captured. The 1990s are likely to see concerted efforts being made in the direction of taxing the financial sector adequately. These efforts will probably be intensified if the financial sector makes large profits, untapped for tax purposes, perhaps because of high inflation. Indeed, experience has revealed that those "transitional" inflationary periods might actually continue for considerably long periods.

20. The financial system is left out of the base, since most financial assets are corporate liabilities which are used to finance corporate gross assets. Taxing the financial sector would, therefore, comprise double taxation. Also, since banks usually have normal profits of 1-1.5% of gross assets, a minimum assets tax of 1.5% would probably represent a higher than 100% tax. In Argentina, however, a similar tax that is being contemplated includes the financial sector in its base, taxing 50% of gross assets. Further, inter-company liabilities are not deductible, implying double taxation.
Real estate owned by businesses should be included in the tax base since it should not raise the nominal burden of taxation in these assets (since it is deductible from the income tax).
For a comprehensive discussion of a historical perspective, and appropriate base and rate structure of the gross assets tax as a minimum income tax rather than as a final tax, see Sadka and Tanzi (1992).
21. For details regarding the intricacies of this unique feature in the Mexican tax, see McLees (1991).
22. Sadka and Tanzi (1992) argue in favour of fixed assets as the taxable base since other assets such as "cash balances, accounts receivable, inventories and other current assets are not inherent in the production process, nor do they constitute an integral part of the real economic nature of the firm's activity" (p. 10).
23. I owe this point of possibly combining the two bases to my colleague, Mr. Carlos Silvani.
24. For a comprehensive coverage, see Mintz and Seade (1991).
25. See, for example, Abbin, Gordon and Renfroe (1985) for the main considerations affecting mainstream thinking on the issue in the United States.

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C. Low-Tax Countries

	Bolivia		Guatemala		Nicaragua		Paraguay		Peru	
	1984	1990	1980	1989	1980	1990	1980	1990	1980	1990
General Government of which:	4.5	7.9	10.6	na	na	8.1	10.4	na	22.1	na
Central Government	2.9	6.6	10.1	7.8	20.1	8.1	10.1	10.4	18.9	7.9
Corporate income tax	0.0	0.6	0.9	1.4	1.8	1.5	1.6	1.5	5.0	0.6
Personal income and payroll tax			0.4	0.3			0.2		1.0	
Social security tax	1.0	1.1	1.3	0.0	2.0	1.0	1.4	1.5	2.2	–
Property tax	0.0	0.9	0.1	0.2	1.4	0.3	0.7	1.1	0.7	0.6
Goods and services taxes	1.9	4.4	3.0	2.2	8.6	3.3	2.0	3.9	7.6	5.2
VAT, sales tax	(0)	(2.2)	(1.5)	(1.2)	(2.2)	(0.9)	(0.6)	(0.8)	(5.7)	na
Excises	(1.9)	(2.2)	(1.2)	(0.8)	(3.6)	(2.3)	(1.2)	(1.9)	(1.8)	na
Trade taxes	1.0	0.9	3.4	3.2	5.8	1.5	2.7	2.4	5.6	1.5
Other taxes	0.6	–	1.5	0.5	0.5	0.5	1.8	–	–	–

Source: Government Finance Statistics, IMF; and IMF staff estimates.

countries that carried out VAT reform were represented by even greater gains in revenue generation from goods and services taxes.[17] (4) While there is a small – half percentage point of GDP – decline in the trade tax-to-GDP ratio, no clear pattern emerges, some countries having increased, and others decreased, their use of customs duties. A fifth general conclusion might be added: property tax revenue in terms of GDP has remained insignificant, usually less than half percent of GDP.

II. SELECTED TAX REFORM ISSUES FOR THE 1990S[18]

The introduction and reform (where it already exists) of VAT have been a mainstay of tax reform of the 1980s. While selected concerns with the VAT, such as the difficulty in taxing the financial sector, remain, a greater preoccupation has been the slipping away of the role of direct taxation even as VAT reform progresses. The design of new features in direct taxation, as well as a practical means of bringing the financial sector into the tax net, should comprise important issues for tax reform in the 1990s. Also, focus of the 1990s debates will almost certainly be on issues emanating from the feasibility of tax administration, rather than from the point of view of designing a theoretically correct tax structure. Thus, for example, withholding is likely to be emphasized more as an administrative mechanism. A discussion of some of these issues is the objective of this section.[19]

A. *Minimum contribution to the corporate income tax*

It is likely that, during the 1990s, more countries will opt for a tax that would be simple to administer and yet would make a minimum contribution to the corporate income tax. Currently, the corporate income tax is mostly collected from a few large – often foreign – companies. Most companies do not pay income tax. There is a growing feeling among tax experts that all companies should be made to pay a minimum tax. The calculation of the minimum contribution may be based on gross assets, net worth, physical assets or gross receipts. The tax rate would depend upon the tax base used (as well as the need for revenue, of course).

In Section I, it was pointed out that three Latin American countries currently operate a minimum corporate tax while several others have similar taxes additional to the corporate income tax. Mexico has been a pioneer in the minimum assets tax and makes it applicable also to individuals who are engaged in business and are taxpayers under the income tax, in order to avoid tax arbitrage.

Simplicity is an attractive feature of the minimum gross assets tax. The income tax law needs to be modified in a straightforward manner by incorporating a feature indicating that tax due cannot be lower than an amount defined by the assets tax criterion; or a new assets tax can be created that is creditable against the income tax. The payment mechanism of the tax is also not complicated. All businesses could pay a percentage of gross assets per year; the income tax already paid can be credited against this tax. Thus, if the income tax is higher or equal to the minimum assets tax, no additional payment is required.

17. Even for European countries, the introduction of the VAT has had a positive impact on the tax ratio. See Nellor (1987).
18. For another view of selected tax reform issues for the 1990s, see Bagchi (1991).
19. For a slightly different stance on tax policy issues for the 1990s, see Khalilzadeh-Shirazi and Shah (1991).

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TABLE 8

Tax GDP Ratios: Cross-Country Comparison

A. High-Tax Countries

	Argentina		Brazil		Chile		Costa Rica		Jamaica		Uruguay	
	1980	1991	1980	1990/91	1981	1990	1980	1990	1980	1989	1980	1989
General Government of which:	21.4	22.5	22.0	24.1	25.9	23.1	17.1	21.1	na	na	na	na
Central Government	14.3	12.0	17.4	8.6	25.3	–	16.8	19.7	27.0	26.8	21.0	21.2
Corporate income tax	3.6	1.5	3.0	1.7	2.5	6.6	0.0	0.6	4.5	11.5	1.8	0.9
Personal income and payroll tax		0.1		2.2	2.7		2.4	1.7	5.5		0.5	0.7
Social security tax	3.6	4.3	6.1	5.0	4.1	1.9	5.1	6.6	1.0	–	5.2	6.5
Property tax	–	1.1	–	0.3	0.0	0.1	0.4	0.4	0.5	0.3	0.8	1.1
Goods and services taxes	7.1	10.4	10.6	12.3	12.6	11.5	5.6	6.5	13.9	9.6	9.6	9.9
VAT, sales tax	na	na	na	na	(11.1)	(8.9)	(1.7)	(3.0)	(5.8)	na	(3.8)	(3.0)
Excises	na	na	na	na	(1.4)	(2.6)	(3.8)	(3.1)	(7.2)	na	(3.8)	(3.0)
Trade taxes	–	1.1	1.5	0.4	1.7	2.8	3.4	5.3	0.9	5.4	2.1	0.9
Other taxes	–	4.0	0.8	2.2	1.7	0.2	0.2	–	0.7	–	1.0	1.2

B. Medium-Tax Countries

	Colombia		Dominican Rep		Ecuador		Mexico		Panama		Venezuela	
	1980	1990	1980	1988	1980	1990	1980	1989	1980	1989	1980	1989
General Government of which:	12.3	14.2	11.2	na	na	na	17.2	18.8	20.3	16.3	na	na
Central Government	10.3	11.7	11.1	13.0	12.3	16.0	14.3	15.7	19.9	15.7	22.2	15.4
Corporate income tax	1.7	1.8	2.0	1.7	4.4	8.3	3.2	2.9	5.8	3.2	17.1	10.7
Personal income and payroll tax	1.8	1.8	0.8	1.3	1.3	1.0	2.5	2.7			0.9	1.6
Social security tax	1.4	1.6	0.5	0.6	0.0	0.0	2.1	2.2	5.7	6.0	1.2	0.6
Property tax	0.3	0.3	0.1	0.1	0.1	0.2	0.3	na	0.5	0.3	0.1	0.1
Goods and services taxes	3.9	3.6	3.1	2.8	2.2	3.5	4.5	5.9	4.5	3.9	1.1	0.8
VAT, sales tax	(2.5)	(2.8)	(0.6)	(0.7)	(1.5)	(2.8)	(2.5)	(3.5)	(1.9)	(1.2)	(–)	(–)
Excises	(1.4)	(0.7)	(2.5)	(2.1)	(0.7)	(0.6)	(1.1)	(2.4)	(2.0)	(1.8)	(1.0)	(0.8)
Trade taxes	2.5	1.9	4.4	5.9	3.9	2.3	4.2	1.0	2.8	1.8	1.8	1.6
Other taxes	0.7	3.2	0.3	0.6	0.4	0.7	0.4	4.1	1.0	1.1	–	–

note that no clear pattern seems to emerge regarding the movement in the revenue to GDP ratio of trade taxes.

In sum, the following conclusions may be made from the movements in tax-to-GDP ratios during the 1980s. (1) The sample countries as a whole increased their tax-to-GDP ratio by about one percentage point, while countries that carried out tax reform during the decade experienced a greater increase.[15] An important exception is Chile which, while carrying out fundamental tax reform, decreased its VAT rate and transferred much of the social security system to the private sector. (2) There has been a shift of emphasis toward taxes on goods and services from direct taxes: while income and social security tax revenue hovered around three percent of GDP, those from goods and services taxes increased by almost one percent of GDP, from five to six percent.[16] (3) The

15. Chile, Nicaragua and Peru are excluded from the sample calculations.
16. Jamaica was excluded as mentioned above. Including it reduces the strength of the conclusion, but not the conclusion itself.

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TABLE 7

Taxes on Domestic Consumption: Rates, 1980 and 1991

(Percent of tax base)

Country	1980		1991	
	Sales tax	Value-added tax	Sales tax	Value-added tax
Argentina	–	16	–	18
Bolivia	2,10	–	–	10
Brazil	–	central: 8, 10	–	10, 15
		state: 12, 16		7, 17, 20
	municipal: 5		5	
Chile	–	20	–	18
Colombia	–	6, 15, 35	–	6, 10, 35
Costa Rica	–	8	–	10
Dominican Republic	–	–	–	6
Ecuador	5	–	–	10
El Salvador	5[1]	–	5[1]	–[1]
Guatemala	2	–	–	7
Honduras	–	–	–	7, 10
Mexico	–	10	–	6, 15, 20
Nicaragua	8	–	–	10, 15, 25
Panama	–	–	–	5
Paraguay	3, 5, 10	--	4, 8, 14	–
Peru	–	6, 22, 42	–	12
Uruguay	–	8, 18	–	12, 21
Venezuela	–	–	–	–

Source: Secondary, published sources such as publications of tax summaries by Price Waterhouse, Coopers and Lybrand, International Bureau of Fiscal Documentation, *International Financial Statistics* (*IFS*) of the IMF, and other similar sources.
1. Currently, the turnover tax with a commonly applied rate of 5% continues to be applied. A VAT legislation for a 15% VAT rate is pending in Congress.

to the private sector; and to some extent, a reduction in the VAT rate from 20 percent to 18 percent. Yet it remains in the high-tax ratio group. Two countries, Nicaragua and Peru, fell from the high- to the low-tax ratio group reflecting major structural economic policy changes. In general, however, countries have tended to remain within their own groupings.

It is clear that tax reform is not necessarily carried out with a revenue objective. The effect of tax reform on the tax-to-GDP ratio is that major tax reforms do not necessarily push a country to the high-tax ratio group. Nor does a country with a high tax burden reflect that it is the result of fundamental tax reform. Various types of experiences seem to have emerged. For example, Colombia, Ecuador and Mexico have been experimenting with tax reform; their tax-to-GDP ratios remain within the medium range. Argentina, Brazil and Costa Rica have been debating tax reform, especially since the mid-1980s. They have only been able to introduce partial reform, in small steps, rather than any wide-ranging fundamental tax reform. Yet, over the decade, their tax ratios have remained in the high range. Finally, Bolivia, which simplified its tax structure considerably, remains within the low range. Nevertheless, a common experience of all the above-mentioned countries that have been attempting to reform their tax structures is that their tax-to-GDP ratios have increased by two to four percentage points, usually maintaining them within their overall band of tax ratios.[11] The revenue impact, just as the reform measures themselves, seems to take hold relatively slowly over time.

Comparisons regarding changes in the overall tax burden, as well as of its distribution among different taxes, may be of some relevance to assess the impact of the tax reform process. Leaving out Nicaragua and Peru, whose declines in tax-to-GDP ratios over the decade could be interpreted as exogenous; Chile, whose changes mainly reflect social security reform; as well as Venezuela, whose revenue dependence primarily on oil makes its experience non-comparable with those of the others in the sample, it is seen that the overall tax-to-GDP ratio increased by one percentage point – from about 16 percent of GDP to about 17 percent – over the decade. This result pertains to a sample of 13 countries in some of which the ratio increased and, in the others, it decreased. Of course, as indicated above, those countries in which some form of tax reform was in progress experienced greater success in terms of revenue generation.

The shift in emphasis from income and payroll taxes to taxes on goods and services for the revenue objective is also verifiable from the sample. Leaving Jamaica out because its trend was markedly opposite,[12] reveals that for the remaining 12 countries, the income tax ratio to GDP stagnated at just above three percent, and the ratio of social security taxes to GDP just below three percent during the 1980s; while reliance on goods and services taxes increased by almost a one percentage point from about five to six percent of GDP.[13] Also interesting is the fact that those countries that introduced or cleaned up their VAT structures, such as Argentina, Bolivia and Mexico, gained even more.

Finally, the reliance on international trade taxes – mainly customs duties – decreased slightly by less than one-half percentage point of GDP, from 2.7 percent to 2.3 percent, reflecting that some countries increased, while others decreased their reliance on trade taxes without, however, any major change in any of the sample countries.[14] It is, therefore, interesting to

11. Of course, it must be kept in mind that public expenditure requirements are a major determinant of the increase in tax revenue as a formal objective of tax reform. Nevertheless, most tax reform studies undertaken in different countries recommend measures, the revenue impact of which lies in a similar 2-4 percentage point range.
12. Jamaica's dependence on income taxes increased while that on goods and services taxes decreased significantly.
13. Even including Jamaica indicates an increase in the dependence on goods and services taxes by a half percentage point of GDP (to 6%), while the income tax-to-GDP ratio remained stable at just below 4%. The impact of including Jamaica in the sample on the social security tax ratio is negligible.
14. Jamaica moved significantly in the direction opposite to the trend. Including it in the sample results in there being no change in the trade tax-to-GDP ratio during the 1980s for the sample of 13 countries.

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TABLE 6

Withholding Taxes on Foreign Remittances, 1980 and 1991

(Percent of remittances)

Country	1980	1991
Argentina	28.5	20
Bolivia	30	–
Brazil	25	17
Chile	7.4	–
Colombia	20	19
Costa Rica	15	15
Dominican Republic	21	21
Ecuador	25	–
El Salvador	–	11.4
Guatemala	10	12.5
Honduras	15	15
Mexico	21	–
Nicaragua	–	20
Panama	–	–
Paraguay	10	10
Peru	30	10
Uruguay	20	–
Venezuela	20	20
Simple average	16.6	10.6

Source: Secondary, published sources such as publications of tax summaries by Price Waterhouse, Coopers and Lybrand, International Bureau of Fiscal Documentation, *International Financial Statistics* (*IFS*) of the IMF, and other similar sources.

El Salvador, Nicaragua and Panama – treated foreign investors the same as domestic investors. In 1991, the simple average of surcharges on foreign remittances had fallen to 10.6 percent. The high tax surcharges are now around 20 percent, with Argentina, Colombia, the Dominican Republic and Venezuela applying them. The number of countries that treat foreign capital the same way as domestic capital increased from three to six.

3. Value-added type taxes

There is a clear tendency among Latin American countries to adopt a VAT. In 1980, eight of the 18 countries in the sample had some form of VAT based on the credit principle (Table 7). In 1991, 15 countries had legislated a VAT. Countries such as Bolivia, Ecuador, Guatemala and Nicaragua switched from a sales tax to a VAT. Other countries which had previously no sales tax, such as the Dominican Republic and Panama, introduced a VAT-type tax with some form of credit mechanism. One country, El Salvador, has sent VAT legislation to Congress.

Of the 15 countries that had a VAT in 1991, nine had a uniform tax rate. A uniform VAT rate is easier to administer than a multiple-rate structure. Other countries such as Brazil, Colombia, Honduras, Mexico, Nicaragua, Paraguay and Uruguay are trying to use the VAT for other objectives than revenue raising, such as for income redistribution or regional development. For this, they use multiple tax rates. Typically, food and essentials are taxed at low rates or at a zero rate; normal goods are taxed at an intermediate "general" rate; and luxuries are taxed at a higher rate. Also commodities destined for backward or border areas may be taxed at a lower rate. Compared to a uniform rate VAT, a multiple tax rate has higher monitoring costs and possibly leads to the loss of some tax revenue because of greater administrative difficulties.

Reform is also being undertaken to broaden the VAT base, in order to raise the tax's revenue-raising capacity, since many of the older VAT systems have suffered significant base erosion over the years. Success in this respect certainly depends on political will, but it would not be wrong to generalize that the VAT is being increasingly used as a revenue raiser across Latin America through continuing attempts to broaden the base. The VAT base is, in general, complemented with a few excises, typically on gasoline and other petroleum products, tobacco products, alcoholic as well as non-alcoholic beverages, automobiles and gambling. Some countries, however, continue to have a much longer list of excisable items.

Before concluding this section, it may be worthwhile drawing the reader's attention to Bolivia, the country that clearly stands out as having achieved a major simplification of the tax structure. It removed the exemption level from the personal income tax and imposed a flat ten percent tax. It abolished the corporate income tax, replacing it with a three percent net worth tax.[8] Foreign enterprises are treated the same way as domestic enterprises for tax purposes. The capital gains tax was abolished. It introduced a flat ten percent VAT.

C. *Performance in terms of tax-to-GDP ratios*

Table 8 presents tax-to-GDP ratios of general (or, where not available, central) government for the sample countries.[9] If the countries are grouped into high-tax (around 20 percent tax-to-GDP ratio and above), low-tax (around 10 percent and below) and medium-tax countries (10-20 percent range), the sample is about equally divided. Currently, there are six high-tax ratio countries: Argentina, Brazil, Chile, Costa Rica, Jamaica and Uruguay; and five low-tax ratio countries: Bolivia, Guatemala, Nicaragua, Paraguay and Peru. The remaining six countries have tax ratios within the 10-20 percent range: Colombia, the Dominican Republic, Ecuador, Mexico, Panama and Venezuela.[10]

Exclusive examination of current tax-to-GDP ratios is not enough, however, to draw conclusions on the nature of revenue performance. Some countries have undergone significant changes in their tax ratios. For example, with a simplification of the tax structure and a significant fall in inflation, Bolivia almost doubled its tax ratio, but it still remains among the countries with the lowest tax burdens. On the other hand, Chile's tax ratio fell slightly, reflecting, mainly, a shift of a major segment of the public social security system

8. The debate over the efficacy of completely removing a tax based on corporate income is not yet over among tax economists, while a minimum contribution calculated on some other base is encouraged. More will be discussed on this topic in the next section.

9. Comparable dates for Honduras were not available.

10. Much of Venezuela's revenue derives from the oil sector, indicated by high corporate sector revenue.

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TABLE 4

Treatment of Capital Gains, 1980 and 1991

(Percent of capital gains)

Country	1980	1991
Argentina	15[1]	Normal[2]
Bolivia	Normal	Exempt
Brazil	Normal	Normal
Chile	Normal	Normal
Colombia	Normal	Normal
Costa Rica	Normal	Exempt
Dominican Republic	Exempt	Exempt
Ecuador	8[1]	Normal
El Salvador	6.8-21.5[1]	5-15[1]
Guatemala	Normal	Normal
Honduras	Normal	Normal
Mexico	Normal	Normal
Nicaragua	Exempt	1-15[1]
Panama	2% of price	2% of price
Paraguay	5[1]	5[1]
Peru	Normal	Normal
Uruguay	Normal	Normal
Venezuela	Normal	Normal

Source: Secondary, published sources such as publications of tax summaries by Price Waterhouse, Coopers and Lybrand, International Bureau of Fiscal Documentation, *International Financial Statistics* (*IFS*) of the IMF, and other similar sources.
1. Less than normal corporate tax rate.
2. "Normal" throughout the table indicates that the prevailing income tax rate is applicable.

exemption. Others, like Argentina and Ecuador, have switched in the opposite direction: from taxation of capital gains at reduced rates towards taxation as normal profits.

There is a slow yet steady movement toward requiring a minimum contribution toward the corporate income tax. A few of the countries in the sample have introduced a minimum contribution requirement (Table 5).

Argentina and Mexico calculate this minimum contribution as a percent on gross assets. Other countries, such as Colombia, calculate this minimum contribution as a percentage of net worth. Bolivia has completely replaced the corporate income tax by a tax on net worth. Some countries like Ecuador, El Salvador and Uruguay have a tax on net worth or assets but not necessarily as a minimum contribution to the corporate tax. Others such as Costa Rica or Paraguay legislate taxes on fixed assets or real estate[6] in addition to normal income taxes.

In sum, in 1991, three countries out of 18 sample countries had a gross assets or net worth tax that was used as a minimum corporate tax, while nine countries had some type of tax on assets or net worth that was applicable in addition to the normal corporate income tax. One country (Bolivia) replaced its corporate income tax by a net worth tax. Five countries did not have this kind of tax.

Most sample countries continue to apply withholding taxes on foreign remittances. Within the context of the host country, such withholding should not necessarily represent an

TABLE 5

Net Worth or Assets Tax, 1980 and 1991

(In percent)

Country	1980	1991
Argentina	1.5% net worth[1]	1% on assets[1]
Bolivia	–	3% net worth
Brazil	–	–
Chile	–	–
Colombia	3.2% net worth[1]	7% net worth[1]
Costa Rica	0.3-1.05% fixed assets	0.36-1.17% fixed assets
Dominican Republic	–	–
Ecuador	0.16% on assets	0.15% net worth
El Salvador	0.1-1.4% net worth	0.9-2% on assets
Guatemala	0.3-0.8% real estate[2]	0.3-0.9% real estate[2]
Honduras	–	–
Mexico	–	2% on assets[1]
Nicaragua	1% on real estate[2]	1-3% net worth
Panama	–	1% net worth[3]
Paraguay	1% on real estate[2]	1% on real estate[2]
Peru	–	1.5-3% net worth[4]
Uruguay	4.5% net worth	2% net worth[5]
Venezuela	–	–

Source: Secondary, published sources such as publications of tax summaries by Price Waterhouse, Coopers and Lybrand, International Bureau of Fiscal Documentation, *International Financial Statistics* (*IFS*) of the IMF, and other similar sources.
1. Minimum corporate income tax; can be credited against normal corporate tax. In Mexico, the income tax can be credited against the gross assets tax in order to avoid the foreign investors' problem of crediting against tax liability in the home country.
2. The base is real estate. The tax, however, is conceived not as a property tax but as an additional corporate tax.
3. This tax has the form of a license to do business. The maximum tax amount is US$ 20,000 per year.
4. Only half the liabilities can be deducted from the tax base. Thus, it is a hybrid of gross assets and net worth tax.
5. Though it is called a net worth tax, in effect, it is a gross assets tax since liabilities can no longer be deducted.

additional tax burden on the foreign investor vis-à-vis the domestic investor if the host country has a "classical" system in which no deduction is allowed for dividends from the personal income tax, that is, there is double taxation. However, looking at the problem from the point of view of the foreign investor and his tax liabilities in the home country, if there are tax treaties between the home and host countries, or if the host country's withholding tax rate is higher than the foreign investor's average tax rate at home, the withholding tax is likely to affect the investor's decision to invest abroad. Although the average withholding tax rate has been diminishing over the years for the sample, the withholding tax is still prevalent.[7] Normally, this additional tax is placed as surcharges on remittances. In 1980, the average tax surcharge on remittances was 16.6 percent (Table 6). The high tax surcharge countries were Argentina and Bolivia, with surcharges of 28.5 percent and 30 percent, respectively. On the other end of the spectrum, only three countries out of 18 –

6. As opposed to a municipal property tax.
7. For a comprehensive treatment of the effect of tax policy on foreign investment, see Tax Policy Division, IMF (1990).

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Ecuador, Mexico, Peru and Venezuela. Bolivia has reformed its personal income tax rate to the most simple scheme: just a flat rate of ten percent.[5] Only two countries have marginal tax rates of over 50 percent for personal income in 1991: the Dominican Republic and Panama. In these two cases, the tax structure remained almost the same as in 1979. All countries that reformed the personal income tax in the past decade scaled downward the overall structure of rates. On average, the high marginal income tax rate of the personal income tax has tended to approach the corporate income tax rate (which will be discussed below).

There is a tendency for the personal exemption level to rise among Latin American countries (Table 2). Between 1979 and 1991, the average exemption level rose from less than half of per capita GDP to greater than one and a half times per capita GDP. On the other hand, the upper income bracket has been going down. During the same period, the average upper income bracket fell from about 110 times per capita GDP to about 89 times per capita GDP.

TABLE 2

Personal Income Tax: Exemption Level and Upper Income Bracket, 1979 and 1991

(Multiples of per capita GDP)

	1979		1991	
	Exemption level	Upper income	Exemption level	Upper income
Argentina	0.70	70.0	4.7	394.2
Bolivia	0.12	8.4	–	(Flat rate tax)
Brazil	0.67	10.3	1.16	2.8
Chile	0.50	13.3	2.26	22.6
Colombia	0.36	6.8	0.41	25.3
Costa Rica	0.20	13.9	2.85	5.3
Dominican Republic	–	6.9	0.17	74.3
Ecuador	0.24	72.0	2.87	35.8
El Salvador	–	51.6	2.34	32.5
Guatemala	–	487.5	2.34	31.7
Honduras	–	402.3	6.87	686.8
Mexico	–	21.9	0.18	11.7
Nicaragua	–	36.4	–	9.9
Panama	0.52	103.2	0.49	97.8
Paraguay	Exempt	Exempt	–	3.6
Peru	0.08	13.5	–	53.1
Uruguay	Exempt	Exempt	Exempt	Exempt
Venezuela	1.09	434.4	1.96	27.8
Simple average	0.45	109.5	1.62	89.1

Source: Secondary, published sources such as publications of tax summaries by Price Waterhouse, Coopers and Lybrand, International Bureau of Fiscal Documentation, *International Financial Statistics* (*IFS*) of the IMF, and other similar sources.

2. Corporate income tax

In the last decade, many Latin American countries have reduced the corporate income tax rate. The simple average of tax rates has diminished from about 44 percent in 1980 to 36 percent in 1991 (Table 3). Of the 18 countries in the sample, eight countries reduced the corporate tax rate between 1980 and 1991, five countries increased the tax rate (though the increases have mainly been small), one country replaced the corporate income tax by a net worth tax and the rest maintained the tax rates. In 1980, most sample countries had progressive corporate income tax rates. Of the sample, 11 countries had progressive tax rates and seven countries had uniform rates in 1980. This proportion remained essentially the same in 1991 despite the realization that a uniform rate is easier to control than a progressive rate. However, the number of tax rates seems to have fallen.

TABLE 3

Corporate Income Tax: Rates and Structure, 1980 and 1991

(Percent of taxable profits)

Country	1980	1991
Argentina	33	20
Bolivia	30	[1]
Brazil	35	42.95-51.7
Chile	48.57	15
Colombia	40	30
Costa Rica	5-45	30
Dominican Republic	15-43	12.3-49.4
Ecuador	20	25-36
El Salvador	15.5-43	10-30
Guatemala	33.8-52.8	12-34
Honduras	3-40	15-40.3
Mexico	5-42	35
Nicaragua	6-50	40-50
Panama	20-50	20-50
Paraguay	25-30	25-35
Peru	20-55	30
Uruguay	25	30
Venezuela	18-50	15-50
Simple average [2]	43.5	36.3

Source: Secondary, published sources such as publications of tax summaries by Price Waterhouse, Coopers and Lybrand, International Bureau of Fiscal Documentation, *International Financial Statistics* (*IFS*) of the IMF, and other similar sources.

1. Bolivia replaced the corporate income tax by a 3% tax on net worth.
2. For countries having progressive rates, the upper tax rate was used.

The treatment of capital gains has also not changed in that 11 countries (though not the same ones) continue to treat capital gains as normal profits within the overall corporate tax structure (Table 4). The number of countries that exempt capital gains or tax them at lower rates, likewise, continues to be similar. However, some changes in particular countries have, of course, taken place. For example, Bolivia and Costa Rica have changed capital gains treatment from normal taxation to

5. In effect, the Bolivian tax is not an income tax, but a tax on savings since the taxpayer can deduct all VAT paid (on consumption items) against this tax.

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infant capital markets might call for reduced tax rates for retained profits and dividends of registered firms. Nationalized segments of the corporate financial sector may operate with other than pure efficiency or profit objectives. These factors, even while resulting in the rate of growth of corporate profits to fall short of GDP growth, are unlikely to be reconsidered or modified by the legislature solely with the objective of revenue generation in mind. Finally, a high proportion of corporate tax revenue has historically been collected from a relatively small number of companies. Even as the incomes of companies increase, revenue from the increased tax base does not necessarily increase at the same rate. The cause could be tax evasion or tax avoidance, reflecting the ability of larger firms to use transfer pricing mechanisms, to make more advantageous use of tax incentive laws, and the like.

Historically, developing countries depended heavily on international trade taxes for tax revenue. The rate of growth of revenue from import duties is partly affected by the structure of tariffs and partly by the industrial strategy of the country. As the share of manufacturing in GDP increases, the ratio of imports of intermediate goods to those of finished products tends to increase. As a result, the share of lower-rated to higher-rated imports goes up, arresting the growth of import duty revenues. As industries have matured, discretionary action reducing the rates of nominal protection has been introduced in many instances. These and other factors have tended to narrow the reliance on international trade taxes during the 1980s in many countries, even though some countries continue to rely on customs duties as a relatively easily administrable source of revenue.

The taxes that have comprised the major focus of attention as a revenue source are those on domestic consumption of goods and services, namely value-added type taxes, coupled with selected excises. Experience has demonstrated that they are relatively easy to administer since the VAT is, to a great extent, "self-monitoring"; also, a production-based excise system could be based on simple administrative mechanisms. In practical terms, their elasticity[3] can also be high despite their structures not being based on progressive rates. For example, the consumption of, and therefore revenue from, excisable items such as petroleum and beverages, could be expected to grow faster than GDP if the tax rates were ad valorem. Also, if the VAT exempts unprocessed foods and basic necessities, its elasticity should be high. Under the VAT, because the credit principle – tax paid on output is net of the taxes paid on inputs – operates, there is less likelihood of tax evasion and avoidance (except at the last retail stage). Elastic or not, administrative feasibility, revenue productivity and the hope of lowering economic distortions have rendered domestic consumption taxes a mainstay of tax reform in much of the cross-country tax reform experience of the 1980s.

B. *Trends in legislative changes in tax policy*

How are the above discussed premises reflected in the actual tax reform experience of the 1980s? In this section a summary of the major tax policy changes of the 1980s is presented with a focus on Latin America.[4]

1. Personal income tax

In the last decade, there has been a clear tendency toward lower rates of taxation on the individual. Taking a representative sample of 18 Latin American countries for 1979-80 and 1990-91, it is apparent that they have undertaken reforms that resulted in lower marginal tax rates for the high income brackets (Table 1). Some of the reforms may have been inspired by the objective of reducing disincentive effects of the high tax rates. Others may have been inspired by more practical considerations of reducing the incentives to tax evasion. It is also perhaps true that tax reform in the United States and Canada provided some guidance to that in Latin America. In 1979 the simple average of the high-income marginal tax rate was 48 percent. By 1991, the rate had reduced to 35 percent.

TABLE 1

Personal Income Tax: Rates, 1979 and 1991

(Percent of taxable income)

Country	1979	1991[1]
Argentina	7-45	6-30
Bolivia	7-48	10% flat rate
Brazil	5-55	10-25
Chile	3.5-60	5-50
Colombia	10-56	5-30
Costa Rica	5-50	10-25
Dominican Republic	5-72	3-70
Ecuador	10-50	10-25
El Salvador	10-60	10-50
Guatemala	40.75-58	4-34
Honduras	3-40	9-40
Mexico	3-55	3-35
Nicaragua	6-50	6-60
Panama	2.5-56	3.5-56
Paraguay	Exempt	5-30
Peru	5-56	8-37
Uruguay	Exempt	Exempt
Venezuela	4.5-45	10-30
Simple average	7.1-48.1	6.5-35.4

Source: Secondary, published sources such as publications of tax summaries by Price Waterhouse, Coopers and Lybrand, International Bureau of Fiscal Documentation, *International Financial Statistics (IFS)* of the IMF, and other similar sources.

1. Most are 1990 laws. As such, they should be applicable to 1991 incomes. However, some of the laws may have changed since then.

Most countries have abandoned complex tax schedules with a great number of tax rates, in favour of a small number of tax brackets. This is the case of Argentina, Brazil, Costa Rica,

3. Elasticity of a tax can be defined as its automatic revenue response to GDP growth and, especially, to growth in economic activity in particular sectors.

4. A comparison of some of the actual country experiences over the 1980s with the type of tax policy recommendations made by the Fund during that period may be attempted by referring to Gandhi (1987) and Tanzi (1990), who discuss, in their papers, the thrust of IMF tax policy recommendations. It is interesting that a close similarity emerges between the type of recommendations made and the actual tax policy reforms carried out.

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bases; (3) a more neutral approach to the taxation of capital – including the treatment of debt and equity financing; and (4) changes in the interaction between taxes on personal income and corporate income to make more neutral the decision to retain or distribute profits. These propositions, together with other experiences in tax policy during the last decade, will be discussed in Section I of this paper as a background to specific issues in tax reform that are likely to be important during the 1990s. The discussion makes particular reference to Latin America.

The main reforms of the 1980s have left some obvious gaps in their scope and coverage, with concomitant revenue implications. For example, the movement away from heavy reliance on income taxes, albeit resulting from a sluggishness in direct tax revenue, is making tax policy experts think increasingly of a minimum income tax contribution by taxpayers. Such a contribution could take the form of a low-rate tax on gross assets, net worth, physical assets or gross receipts. Second, there is the belief by a considerable number of tax economists that the typical corporate tax structure – with the inclusion of inflation adjustment, incentives and other factors – has become very complicated; that its base bears little resemblance to income; and that it results in distortionary economic effects. Therefore, corporate taxation should be simplified by substituting the profits tax with a tax on the cash flow of enterprises. Third, there is a continuing difficulty in including the financial sector in the taxable base, whether by income tax or VAT and economists perceive an implied need for taxing this sector through some other means. Fourth, the virtual failure to tax property is giving rise to a growing awareness that greater effort must be made to tax property if the devolution of fiscal responsibility to lower levels of government is to be considered a matter of importance, and if the traditional assignment of the taxation of property to those levels of government are to remain in place. Fifth, as environmental awareness increases across the world, taxes with the objective of preservation of the environment should assume importance. Sixth, experience increasingly demonstrates that there is an increasing interdependence between tax policy and tax administration. Withholding as an administrative mechanism may be better able to bring different sources of income into the tax net than a theoretically well-defined but impractical global income tax structure based on a compulsory – but not administrable – declarations method. Seventh, as regional tax harmonization proceeds in Europe, North America and the newly founded Commonwealth of Independent States (CIS) of the ex-Soviet Union, Latin American countries will also face tax harmonization and international compatibility of direct tax structures – and even overall tax structures – as an issue to be reckoned with. These are selected tax policy concerns – some shared with developed countries (e.g. taxation of the financial sector) and some with developing countries (e.g. increasing use of withholding) – that will affect many middle-income Latin American countries during the 1990s. These possible directions for tax policy reform for the 1990s for Latin American countries are the focus of discussion in Section II.[1] Section III provides a brief summary and concluding remarks.

I. TAX POLICY TRENDS OF THE 1980S

A. *The choice of particular taxes*

Two factors seem to have affected the choice of particular taxes as the major revenue generators during the 1980s. First, a growing conservative attitude reflected through a position opposing high levels and steeply progressive rate structures of taxes helped move the emphasis from income taxes to consumption-based taxes. Tanzi (1988), for example, points out, "While the present conservative trend has slowed down the growth in the level of taxation in many countries,...[it] has had a greater impact on the structure of tax systems than on the levels of taxation" (p. 271). The Latin American experience examined in the next section could be significantly explained by this observation.

Second, practical and structural constraints that operated with respect to particular taxes had an effect on the choice of taxes that were given an important (or less important) role in the reform process.[2] The diminution in the roles of the personal and corporate income taxes can be seen in this light. In the case of the personal income tax, reformers have found it difficult to tax adequately those sources of income other than wages and salaries. As far as the latter are concerned, their growth is likely to be constrained to below the inflation rate, for example, during periods when a country has embarked on a stabilization programme comprising demand management policies. Thus, the base of the tax cannot be expected to grow with gross domestic product (GDP) because of the stance of macroeconomic policy. Also, in the case of the personal income tax, personal and family allowances, and the spectrum of exemptions and deductions for education, life insurance, provident fund and savings, mortgage interest, charity, medical expenses and the like, are subject to political decisions, and often result in adjustments higher than the consumer price index (CPI). Such measures might admittedly be taken to provide incentives at the top and equity at the bottom, but they certainly have a negative influence on revenue. In addition, growing difficulties with tax administration as economies have become more complex and factors of production more mobile, increasingly have tended to move the 1980s tax reform experience away from focusing on the personal income tax.

Raising corporate income tax revenue can also face several constraints. A progressive corporate income tax structure has little conceptual basis and, if imposed at high levels, is likely not to be internationally competitive. In a developing country, in particular, the manufacturing sector is often the leading growth sector which receives various and substantial tax incentives. Significant portions of the public corporate sector may fail to generate taxable profits. The encouragement of

1. In addition, the 1990s will have to address selected continuing concerns of the 1980s. These include: the restructuring of customs tariffs to reduce protection and improve international competitiveness of traded goods; the restructuring of social security systems (including taxes) to match revenues with an increasingly heavy benefits burden; and the need for vigilance to ensure that the tax system is not riddled with multiple objectives such as redistribution, differential regional or sectoral development and the like.

2. For a qualitative assessment of tax reform in Argentina, Bolivia, Colombia and Mexico, see Bird (1992).

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TRENDS AND FUTURE DIRECTIONS IN TAX POLICY REFORM: A LATIN AMERICAN PERSPECTIVE

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SUMMARY

This paper reviews the Latin American experience with tax reform during the 1980s. It also discusses selected tax reform issues likely to be in the forefront of Latin American debate and discussion during the 1990s.

Fundamental tax reform can take many years to be fully implemented, and it effectively constitutes an aggregation of many annual discretionary changes. On the whole, tax reform in the 1980s de-emphasized steeply progressive rate structures of income and property taxes that were conceptually optimal from the point of view of equity and stabilization objectives but were difficult to administer. It emphasized, instead, broadly based, low-rate taxes on domestic consumption, such as the value added tax (VAT), for their administrative ease based on a self-monitoring feature, as well as for their ability to raise revenue (as seen in terms of their ratios to GDP).

Between 1980 and 1991, the number of countries that operated a VAT increased to 15 from eight; they usually supplemented the VAT with a list of excisable items. The top marginal personal income tax rate in these countries fell from 48 percent on average to 35 percent. The average exemption level increased from about half of per capita GDP to one and a half times per capita GDP. The average corporate income tax rate fell to 36 percent from 44 percent, even though many countries continue to maintain progressive rate structures. The top marginal personal income tax rate approached the corporate income tax rate. Withholding taxes on foreign companies fell, on average, to 11 percent from 17 percent.

The tax-to-GDP ratio across countries has increased by one percentage point, on average, since the 1980s. However, tax reform is not always carried out with a revenue objective nor does it necessarily push a country to a significantly higher tax-to-GDP ratio. Similarly, a country with a high tax burden does not always represent one that has undertaken fundamental tax reform. Nevertheless, countries that have undertaken tax reform have, in general, experienced a greater revenue gain in terms of GDP than the overall sample of countries. Consumption tax revenue has increased in terms of GDP in reforming countries, while income and social security taxes have remained stagnant. Reliance on international trade taxes has declined slightly – with wide variations across countries – while property tax revenue has remained insignificant.

Latin America has pioneered many ideas in tax reform over the past decades and is likely to introduce and debate new ideas during the 1990s. These are likely to include a minimum income tax; alternative forms of corporate taxation, such as a cash-flow tax or an assets tax; ways of capturing bases that are difficult to tax, such as financial intermediation and property; environmentally-oriented taxes; the extension of withholding as a taxing mechanism; and tax harmonization across countries.

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INTRODUCTION

There is a widely held view that tax reform efforts in the 1980s have established certain new trends that include: (1) changes in the relative use of different taxes, specifically greater dependence on the value-added type taxes; (2) reduction of individual and corporate income tax rates pari passu with an effort to expand their

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withheld must be remitted to the tax collection office within the first 17 days of the month following that in which the payment was due.

B. *Withholding on remuneration*

In general, the withholding obligation exists for all types of remuneration paid to an employee, as well as benefits paid on his behalf that do not qualify as tax-free fringe benefits. This withholding must be computed on monthly income. Payment of such withholdings are due within the first 17 days of the following month. This withholding tax is an advance payment on account of the annual tax due by employees.

C. *State and local taxes*

The principal taxes payable by corporations and permanent establishments of residents abroad operating in Mexico are those levied by the federal government. State and municipal governments have more limited powers, and are not authorized to levy general corporate income taxes. Some states tax employers on salaries and professional fees paid by them.

The principal local taxes are taxes on real property, salaries and the acquisition of real property.

D. *Turnover or sales taxes/value added tax (VAT)*

A value added tax at the general rate of ten percent is payable on the sale of goods and the rendering of services, rents and imports of goods and services.

The principal activities exempt from VAT include sales of land, books, credit instruments (except for interest charged on credit cards), residential construction, financial and medical services, education and rentals of residential property.

Taxes paid by corporations on their purchases of goods and services may be credited against their liability to tax on their taxable transactions. VAT must be charged to all customers, including the government and its agencies. Excess credits can be refunded or offset against future payments.

A zero rate is applicable to the export of goods and certain services; sales to in-bond processing companies or to companies solely engaged in the export of goods; and the sale of certain basic food, agricultural goods, services and rentals. This means that no VAT is payable, although amounts paid on the purchase of goods and services can be recovered through a credit against the entity's VAT liability or by direct refund.

E. *Employees' profit sharing*

As of the second year of operations, every business having employees is required to distribute a portion of its annual profits among its employees, regardless of its form of organization. The amount distributable to employees in most cases is ten percent of taxable income, adjusted to eliminate income or deductions that relate to the effects of inflation and increased by domestic dividend income.

As of 1992, payment of profit sharing, reduced by exempt salaries and fringe benefits, may be deducted in arriving at taxable income.

F. *Tax on assets*

This tax, which actually represents a minimum tax, is payable at the rate of two percent on the average value of the assets, reduced by certain liabilities, of corporations and branches or permanent establishments of non-residents.

The income tax can be credited against the current year two percent tax on assets. If the former exceeds the latter, the excess may be recovered from the two percent tax effectively paid in the five prior periods.

The minimum tax on assets is not payable by entities in the financial sector, during the pre-operative period, during the first two years of operation or during liquidation, provided the liquidation process does not exceed two years.

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Taxpayers with gross income in excess of Ps$ 5.8 billion, or whose assets are worth more than Ps$ 11.7 billion, or who employ 300 or more workers in each month of the calendar year are required to engage an independent public accountant to carry out an annual tax audit. The auditor's report must be filed by 31 July following the year end.

Penalties for failure to comply with these provisions range from Ps$ 39.7 million to Ps$ 119 million. Other taxpayers may also elect to file an auditor's report. One of the advantages of filing an auditor's report is that any tax authority review is conducted through the public accountant who issues the report rather than on the taxpayer's premises.

In addition to the auditor's report, basic financial statements and footnote disclosures, the tax report must contain the following:

- a special report signed by the auditor, stating that all federal tax obligations have been complied with.[1]
- detailed analysis of income and expense accounts included in the statement of income;
- details of amounts subject to federal taxes and dues, either by withholding or payable by the company, and including social security taxes and housing fund contribution, sworn to by the chief financial officer;
- reconciliation of taxable and accounting income;
- reconciliation of revenue included in the income statement and that included in the income tax return and in the value added tax return;
- details of federal taxes payable at year-end, stating the date and place of payment.

This report requires extensive work both on the part of the auditor and company personnel.

B. *Record keeping requirements*

As from 1992, corporate taxpayers must keep their books and records for ten years rather than five. The new rule will be phased in over a period of four years.

C. *Statue of limitations for examination of returns*

The right of the tax authorities to review and assess additional taxes for any tax year expires five years after the taxes were due or after the tax return, including any amended return, was filed.

A special ten-year statute of limitations applies where the taxpayer failed to apply for an identification number, failed to keep accounting records or to retain the books for the requisite period of time, or failed to file a tax return.

XI. APPEAL PROCEDURES

A. *Appeals against assessments*

In order to challenge a tax assessment, a taxpayer may lodge an appeal with either the Treasury Department or the Federal Tax Court. A taxpayer has 45 working days from the time an assessment is issued to file an appeal. The appeal must be filed in writing and must state fully and in detail the grounds for the objection, along with any evidence.

If, during the review that gave rise to the tax assessment, the taxpayer had a reasonable opportunity to present evidence, only evidence submitted within the period of review is accepted in the appeal. If the taxpayer's evidence does not relate to each of the items in controversy, it is not accepted.

An appeal must be decided within four months from the time the appeal was filed.

Collection of tax is suspended upon the taxpayer's request during an appeal if a guarantee is provided for the amount of taxes involved and any surcharges thereon.

B. *Court and legal recourse available to taxpayer*

If an unfavourable decision is issued at the administrative level, the taxpayer has 45 working days from the time he is notified of the decision to file an appeal with the Federal Tax Court. Tax suits are handled by attorneys, usually with assistance from accountants who act as expert witnesses in accounting matters.

The Federal Tax Court decision may be appealed to the circuit court, and the latter decision may be appealed to the Supreme Court.

C. *Competent authority relief under tax treaties*

Mexico has signed tax treaties with Canada, France and Italy. The Canada treaty entered into force on 11 May 1992, and is generally effective as from 1 January 1992. The France and Italy treaties have not yet entered into force. Treaties with Spain and Switzerland have recently been initialled. Mexico is currently negotiating comprehensive double taxation treaties and exchange of tax information agreements with the United States and several European countries.

XII. OTHER TAX COMPLIANCE CONCERNS

A. *Withholding tax procedures*

In many cases, a corporation making payments is required to withhold and remit to the Treasury Department an amount of income tax on behalf of the recipient. This requirement must be complied with for the payment in question to be allowed as a deduction. The company is jointly responsible with the recipient for the payment of tax that should be withheld. In the event of failure to withhold, the company is subject to an inflation-factor revision of tax, interest on late payment and fines.

Companies making payments to foreign corporations or individuals must withhold and pay the relevant income tax. Such withholdings are deemed to be final payments, and the foreign taxpayer has no further obligations. The withholdings are payable at the time the payment to the recipient is due, regardless of whether payment is actually made, and the tax

1. Even though the amount of omitted taxes might not be considered material for accounting purposes, the amount must still be disclosed.

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thereafter the approval of the Treasury Department is required to revoke the option to consolidate.

C. *Where to file*

A corporation must file its tax returns with the tax collection office corresponding to its domicile; however, as from 1991, banks are authorized to receive tax returns.

III. PROCEDURES FOR EXTENDING TIME LIMIT FOR FILING RETURNS

Neither the Income Tax Law nor its regulations contain any provisions allowing for the extension of the time for filing tax returns. However, the Federal Tax Code provides that the Executive Power, at its discretion, may extend the due date for payment by means of a general ruling, which may be granted in emergencies resulting from special economic situations or natural disasters, such as floods and earthquakes, etc.

IV. ESTIMATED TAX RETURNS

Corporate taxpayers are required to make monthly estimated income tax payments by the 17th day of the following month, on the basis of their estimated taxable income to the end of the previous month. The estimated tax is computed by applying the ratio of taxable/gross income of the previous year to the current year's gross income. If no earnings were reported in the prior year, the ratio for the last profitable year (going back no further than five years) should be used.

Taxpayers whose income in the prior period did not reach Ps. 2,000 million must make quarterly estimated income tax payments by the 17th day of April, July, October and January of the following year.

An adjustment of the estimated income tax payments must be made with the July payment, based on the actual taxable income for the first six months.

Special procedures are provided for obtaining authorization to waive or reduce the amount of monthly estimated payments.

Estimates are not required during the first year of operation of a business.

The Mexican tax system levies a two percent "minimum tax on assets" designed to supplement the federal income tax. In conjunction with the monthly income tax estimates, taxpayers are also required to make estimates of this tax. The amount of such estimates is arrived at by dividing by 12 the preceding year's tax on assets liability, updated for inflation, and multiplied by the number of month(s) elapsed during the year. The tax on assets is considered a minimum tax, and an amount equivalent to the income tax payable is allowed as a credit against the two percent tax on assets.

V. ASSESSMENTS

The Mexican tax system is a self-assessment system based on annual tax returns, which are subject to audit by the Treasury Department. An assessment may result from a review of a taxpayer's returns.

VI. CLAIM FOR REFUND PROCEDURES

If the monthly estimated payments exceed the annual tax liability, the overpayment revised by inflation factors may be offset against subsequent income tax payments, including withholding tax payments, or a refund may be obtained. The period for claiming a tax refund expires after five years.

VII. PROCEDURES FOR OBTAINING DOUBLE TAX RELIEF

The Income Tax Law allows resident corporations a limited foreign tax credit. These corporations may credit against their Mexican income tax liability the amount of foreign income taxes paid on their foreign-source income, provided such income is subject to domestic income tax.

The foreign tax credit is limited to the amount obtained by applying the effective Mexican tax rate to the foreign-source taxable income. The current corporate income tax rate is 35 percent.

VIII. COMPANY LAW FILING REQUIREMENTS FOR NON-RESIDENTS

Mexican subsidiaries of foreign corporations and permanent establishments of non-residents are subject to the same filing requirements as any other Mexican corporation.

IX. INTEREST AND PENALTIES

Late tax and penalty payments will be revised by inflation factors from their due date to the actual date of payment. For any taxes and penalties payable before 1990, December 1989 will be the earliest month for inflation-factor revision purposes.

Interest for late payment may not be imposed for a period exceeding ten years. Interest is computed from the date the tax should have been paid on the revised amount of omitted taxes. The rate for 1992 is 1.5 percent per month.

Payments of omitted tax made at the request of the tax authorities are not considered voluntary, and penalties may be assessed up to the amount of the revised omitted tax in addition to the interest. For 1992 only, the period in which interest on voluntary payments is computed is limited to one year.

As from 1 January 1992, interest payments for late filing are deductible for income tax purposes. Penalties and the amounts arising from the inflation-factor revision of taxes are not deductible in arriving at taxable income.

X. EXAMINATIONS

A. *Audit procedures*

The Treasury Department is authorized to review any return, including an amended one. For this purpose the tax authorities may audit the taxpayer's operations or the operations of third parties which involve the taxpayer.

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CORPORATE TAX COMPLICANCE PROCEDURES

KPMG Cárdenas Dosal Nieto Astiazarán y Cia, S.C., Mexico

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I. INTRODUCTION

Over the last few years, the Mexican tax system has seen major amendments. Until 1986 the Mexican income tax law only took into account certain effects of inflation. However, as of 1987 provisions were included to recognize such effects in a practical, integrated manner, so that the law takes into account the effects of inflation on corporations' monetary positions, the depreciation of fixed assets revised by inflation factors and the deduction of inventory purchases.

The corporate tax rate has been gradually reduced from 42 to 35 percent.

Other objectives of the amendments include recovery of revenue collection which was eroded by inflation (under 19 percent in 1991), and to make the Mexican tax system competitive with the tax systems of Mexico's most important trading and investment partners.

II. REPORTING REQUIREMENTS AND TIME LIMITS FOR FILING RETURNS

A. *Reporting requirements*

Taxable entities include resident corporations, permanent establishments and fixed bases of operations of foreign corporations, and all entities other than associations specifically designated as non-profit organizations. Entities subject to the corporate income tax are taxed on their worldwide income of whatever nature, unless specifically exempt. All foreign-source income, without exception, of a Mexican corporation is subject to tax. Permanent establishments or fixed bases of operations of foreign corporations are subject to tax only on income attributable to their activities in Mexico, whether foreign or Mexican sourced.

Non-resident corporations are taxed only on their Mexican-source income, although under certain circumstances, non-residents may be considered to have a permanent establishment or a fixed base for income tax purposes.

The Federal Tax Code provides that corporations are considered to be residents of Mexico if their principal office is established there, and that without proof to the contrary, companies incorporated in Mexico are considered to be Mexican residents.

Taxable corporations residing in Mexico are required to apply for an identification number in the Federal Taxpayers' Registry within one month from the date of incorporation. Failure to obtain a taxpayer identification number leads to the imposition of penalties, which under certain circumstances might give rise to criminal actions.

B. *Time limit for filing returns and due date for payment*

Corporate taxpayers are required to use the calendar year for tax purposes, and must file an annual income tax return within three months of the year-end and pay any balance of tax shown as due at that time.

If certain requirements are complied with, local holding companies may file consolidated tax returns. In order to consolidate for tax purposes, the holding company must obtain prior authorization from the Treasury Department. Once authorization is granted, the election becomes compulsory for the following five fiscal years, and

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subject to Mexican income tax. The credit is limited to the lower of the effective rate of Mexican tax or the foreign tax paid on the income.

Until recently Mexico was not a party to any double taxation treaties. However, this policy has changed – a treaty with Canada recently entered into force, treaties with France and Italy have been signed but are not yet in force, and treaties with Spain and Switzerland have been initialled.[5]

J. *Non-residents*

A non-resident individual who works in Mexico for over 183 days in a 12-month period will be subject to tax on income earned in Mexico when paid by a non-resident company. The current rules allow for an exemption of tax for the income earned from January to June 1992, and effective 1 July 1992, the income will be subjected to tax at a graduated rate with the first $ 10,000 of income exempt, the next $ 70,000 income subject to a 15 percent rate and the income exceeding $ 80,000 subject to a 30 percent rate.

On the other hand, when a non-resident individual is paid by a Mexican company, the withholding tax rate is 30 percent of the gross salary.

III. OTHER TAXES AND LEVIES

A. *Social security levies*

Foreigners who work in Mexico for Mexican employers are subject to Mexican social security contributions. These are based on total wages, excluding overtime, up to a maximum of ten times the general minimum wage in Mexico City (Ps. 13,330 per day). The employer must pay the entire cost of insurance for occupational risks and diseases at a percentage of the total employer and employee contribution toward old age benefits. Such costs vary from five to 125 percent depending upon the risk classification to which a company is assigned.

Contributions liable by the employee amount to approximately Ps. 2,400,000.

B. *Local taxes*

There are local taxes imposed on income of the individuals in Mexico, in certain areas, but these are usually covered by the Mexican employers.

C. *Inheritance and gift taxes*

Mexico does not levy inheritance or gift taxes.

5. For a discussion of Mexico's treaties see, in this issue, Francisco G.L. Diaz, "Mexican Policy on Tax Treaty Negotiations".

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and sport activities and other activities of similar nature are social welfare benefits which are not subject to tax. However, excessive benefits may be regarded as taxable income.

D. *Expatriate concessions*

The Mexican income tax law does not contain any incentives or special reliefs, except a limited foreign tax credit on income derived from foreign sources, for resident expatriates working locally.

E. *Salary earned from working abroad*

There are no tax provisions on this subject. However, if foreign income tax is paid on such foreign-source earned income, a limited foreign tax credit is available.

F. *Taxation of investment income and capital gains*

Worldwide investment income, including dividends and interest, is subject to Mexican tax at ordinary graduated tax rates.

The income tax on dividends is paid by the Mexican company at 35 percent of 1.54 times the dividend paid to the individual. No tax is applied to dividends paid to individuals when the dividend is paid from the "net of tax profit account".

Interest income is taxable and interest on Mexican bank deposits is subject to 21 percent withholding tax at source which is considered as a final tax payment. Other types of interest are taxable when filing the annual tax return.

In general, profit from the sale or transfer of property is taxed as income; however, certain exemptions are available.

The gain from the sale of a taxpayer's personal residence is non-taxable if the individual lived in the residence for at least two years prior to the sale, as are the following events:
- transfer of ownership by reason of death or donation;
- gains on the sale of securites when the transaction is carried out through the Mexican stock exhange;
- profits on sales of personal property up to an annual amount not exceeding three times the yearly general minimum wage.

When securities are transferred outside the Mexican stock exchange, the acquisition may be adjusted by inflation indexes based on the holding period. The updated cost will be increased or decreased by the updated tax profits or losses and dividends paid during the holding period.

G. *Tax returns and compliance*

The taxpayer is normally required to file a tax return by 30 April of the following year. A penalty of 1.5 percent monthly, in the form of interest, is imposed for late payment on the tax adjusted for inflation, for a maximum of ten years.

Late filing penalties are imposed when omitted tax is paid at the tax authorities' request.

H. *Termination of residence*

The taxpayer is not required to file an annual return upon termination of Mexican residence, and withholdings and/or estimated payments effected are considered as final tax payments.

I. *Tax calculation*

1. Tax rates

Employers must make monthly income tax withholdings on compensation paid to their employees which are levied on a progressive scale, up to 35 percent. This tax scale is modified quarterly by the Treasury Department to adjust for inflation. The annual tax rate scale is a combination of the four quarterly tables.

In the case of split payroll arrangements, the portion of the compensation received directly from abroad is subject to monthly estimated tax payments. These payments are due on or before the 17th day of the month following that in which the compensation was received, using the monthly graduated rate scale.

Individuals may apply a credit against monthly withholdings, estimates and the annual payments, equivalent to ten percent of the minimum wage for the period to which the payments relate and a subsidy, using a prescribed table. This subsidy is also modified quarterly to adjust for inflation. The annual subsidy table is a combination of the four quarterly tables.

2. General deductions against income

In arriving at taxable income certain deductions are allowed:
- 30 days of minimum wage for annual bonus;
- 15 days of minimum wage for profit sharing;
- 15 days of minimum wage for vacation pay;
- unlimited medical and dental fees and hospital expenses paid in Mexico by the expatriate or for his dependents, not reimbursed by insurance;
- funeral expenses paid in Mexico but limited to the annual minimum wage;
- authorized donations;
- itemized deductions (with certain adjustments) relating to rental income.

Apart from the above deductions, resident individuals are also entitled to exclude from taxable income those contributions paid by their employers to retirement funds specifically designated as such by the Treasury Department under the newly-established Retirement Savings System. The maximum allowable contribution is presently Ps. 30,000,000 in each calendar year.[4]

3. Relief for foreign taxes

Mexican residents are entitled to credit income tax paid abroad on foreign-source income, provided this income is

4. It is rare, however, for contributions to be paid into such funds on behalf of a foreign expatriate as he would normally have a retirement plan with his employer in the home country.

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TAXATION OF EXPATRIATES

KPMG Cárdenas Dosal Nieto Astiazarán y Cia, S.C., Mexico

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I. INTRODUCTION

Individuals resident in Mexico are subject to income tax on their worldwide income. Non-residents are subject to tax only on Mexican-source income, irrespective of the location of the payor.

II. INCOME TAX

A. *Residency rules*

An individual is considered a Mexican resident for income tax purposes when he establishes his place of abode in Mexico, unless he spends more than 183 days out of Mexico during a calendar year, and also has evidence of having acquired residence for tax purposes in another country.

B. *Taxable compensation*

All types of remuneration and benefits received by a foreign employee for services rendered in Mexico constitute taxable income, regardless of where paid. Typical items of expatriate compensation are fully taxable unless otherwise indicated below:

- reimbursement of foreign and/or home country taxes;[1]
- school tuition reimbursements;
- cost of living allowances and expatriation premiums for working in Mexico;
- employer contribution to rent and the imputed value of housing provided directly by the employer;[2]
- company car;
- stock option plans, when granted, have no tax consequences. When exercised, in the event that the tax authorities carry out an appraisal of the stock value which establishes that there is a difference of more than ten percent between this appraisal and the option price, such difference will be considered as taxable income for the individual;
- contributions made by employers to employees' savings funds qualify as a social welfare benefit when granted to all employees. The income from the funds is not taxable provided a number of requirements are complied with.[3]

C. *Tax-exempt income*

The employee's transportation costs incurred for a business trip which has also been combined with home leave is non-taxable. However, the employee's family transportation costs are taxable.

Moving expense reimbursements which are claimed as a business expense are non-taxable for the individual, but relocation allowances of unsubstantiated expenses are taxable.

Certain deferred compensation schemes may result in non-taxable compensation, provided they are not recognized by a foreign employer as a liability payable to the individual.

Social welfare benefits granted to all employees, such as group life and medical insurance, disability subsidies, educational scholarships, day care centres, cultural

1. Hypothetical taxes charged to the employee would be offset against this income to determine the net taxable.
2. Hypothetical housing charged to the employee would be offset against this income to determine the net taxable.
3. Special rules also apply to thrift/savings plans and retirement schemes.

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1. Taxable persons

The assets tax is levied on resident companies, branches and other PEs in Mexico, and to prevent tax arbitrage, on individuals who engage in business activities or whose assets are used for business activities by a third party. Institutions in the financial sector and companies in the pre-operation stage, the first two years of operation or liquidation are exempt from the assets tax.

2. Taxable property

The fact that the tax is not imposed on *profits* but rather on a resident taxpayer's gross business assets is somewhat controversial. In the case of non-residents with a PE in Mexico and taxpayers granting the use of their assets to third parties, the tax is only levied on the net worth attributable to the PE or the assets, respectively.

3. Tax base and rate

The tax base is the annual average value of assets, less the annual average value of liabilities (in Mexican pesos) to resident enterprises.[28] Highly detailed rules govern the computation of the average value of assets, and once this value is ascertained a flat two percent tax is applied.

4. Tax credit

A taxpayer's income tax liability may be credited against the assets tax liability of the same tax period. If the creditable income tax exceeds the liability to assets tax, the taxpayer may obtain a refund not greater than the excess or the assets tax paid in the preceding five years, whichever is lower.

5. Advance payment and final assessment

Taxpayers are required to make monthly advance payments of the assets tax. The assets tax return is filed with the income tax return, i.e. in the case of companies within three months of the end of the taxable period, and for individuals between February and April of the year following the tax year.

B. *Individual net wealth tax*

There is no net wealth tax on individuals, although as discussed above individuals carrying on business activities in Mexico are subject to the assets tax.

C. *Real property tax*

The municipalities have jurisdiction over the taxation of real property. Rates vary from place to place and according to whether the property is located in a rural or urban area. Business enterprises may be exempt from property tax if the property is used for business activities.

D. *Inheritance and gift tax*

There is no inheritance or gift tax levied in Mexico.[29]

28. Except for liabilities to institutions in the financial sector.
29. Certain gifts, however, are subject to income tax. For example, gifts made to a Mexican resident which in the aggregate exceed three times the annual minimum salary for the economic zone in which the recipient lives must be included in the taxable income of the donee. Gifts to non-residents of Mexican situs immovable property, shares or capital participations are subject to tax at a flat rate of 20% of the officially appraised value of the property.

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Export duties are levied on a few items; however, most goods manufactured in Mexico and sold abroad are not taxed.

Excise duties are levied at varying rates on specified goods and services, such as alcoholic beverages, tobacco products, gasoline and brokerage and similar services. The rates range from 20 to 135.87 percent (depending on the product or service).

3. Real estate acquisition tax [21]

Although the real property acquisition tax is in principle a federal tax, it is not payable in states which have brought their local tax in line with the federal tax, i.e. in such cases only the state tax will be payable. The tax is levied on the acquisition (by purchase, gift, inheritance, contribution to an association or company) of immovable property. Property acquired by the federal, state or municipal government for public purposes and property acquired by Mexican political parties for their own use are exempt from this tax.

The tax base is the acquisition price, as adjusted by a formula based on the monthly national consumer price index. The rate of the real property acquisition tax is six percent for 1992, four percent for 1993, and two percent from 1994.

4. Transfers of shares

The transfer of shares is not subject to any form of transfer tax.

B. *Special charges*

1. Social security charges

Employers and employees alike are required to contribute to the social security system, which is used to fund medical care and insurance for occupational hazards, retirement, limited unemployment benefits for disability, maternity leave and old age. The employer pays its own share as well as the employee's share by withholding the contribution from the salary. The premiums are based on the employees' daily wages up to a maximum amount.

2. Profit sharing

Most companies in Mexico are required to share profits with their employees. The profit sharing obligation applies to enterprises that produce or distribute goods, and to individuals or entities liable to income tax in respect of income derived from independent personal services, interest, rent, etc. Newly-formed enterprises are exempt from the profit-sharing obligation during the first year of operation, and newly-formed enterprises engaged in the manufacture of a new product are exempt for the first two years of operation.

Directors, general managers, and seasonal and other temporary workers (who have worked less than 60 days during the year) are not entitled to share in the profits. Other employees are entitled to a share based on the number of days worked and the salaries received during the year.

The share is currently ten percent of taxable income, as determined under the ITL. Mexican-source dividends are subject to the profit-sharing requirement. Prior year's losses may not be deducted when computing the profit sharing obligation. The profit sharing is partially deductible in the year of payment.[22] Employees who work for individuals rendering independent personal services or deriving interest or rents from real estate may not receive more than the equivalent of one month's salary.

3. Payroll taxes

Employers are required to make a number of contributions based on payroll. The federal government levies a payroll tax on the total amount of remuneration paid to employees at a flat rate of two percent. The states impose a similar tax at rates of between one and two percent. Employers must also pay a one percent tax on the total amount of wages and salaries paid each month. This tax – which is not withheld from wages or salaries – is used to maintain the Mexican education system. Finally, the federal Labour Law mandates that employers contribute an amount equal to five percent of an employee's daily wage to the National Housing Fund.

4. Retirement insurance fund

A compulsory retirement insurance scheme came into effect on 1 May 1992.[23] Under the scheme employers are required to make an initial contribution equal to eight percent of salaries by a certain date,[24] and another contribution of two percent of salaries. The fund is registered in the name of each individual employee, and he is entitled to make additional contributions to the fund. The fund may be withdrawn upon retirement or death.[25]

V. OTHER TAXES

A. *Assets tax* [26]

An annual minimum tax on assets is payable with the income tax as from the 1990 year of assessment. An inflationary environment affords companies the opportunity of declaring substantial losses to carry forward, thus reducing the tax payable. The assets tax was introduced to counter this practice.[27] The tax is designed to improve the equity and efficiency of the system and to ensure collection of income tax because enterprises which file a tax return showing no income tax liability must now pay at least a minimum tax.

21. This tax replaced the stamp tax in 1980.
22. The deduction is equal to the profit sharing obligation less salaries and other payments made to employees, which were deducted by the payor and not taxed in the hands of the recipient.
23. Law of 22 February 1992, published in the Official Gazette of 24 February 1992.
24. The contribution was due on 29 May 1992 for employers with more than 100 employees, and on 1 July 1992 for employers with less than 100 employees.
25. Contributions to the scheme as well as interest earned are exempt income for the employee until withdrawn.
Additional contributions made by the employee are deductible for income tax purposes provided the deduction does not exceed two percent of his salary.
26. For a discussion of this tax, see John A. McLees, "Fine Tuning the Mexico Assets Tax", Vol. 3 *Tax Notes International* (February 1991), at 117.
27. Argentina also imposes a minimum tax on gross assets, and such a tax is also being considered in a number of other Latin American countries.
For a discussion of the tax on gross assets, see Efraim Sadka and Vito Tanzi, "A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation", International Monetary Fund Working Paper, WP/92/16 (1992).

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- gains derived from the sale of a personal residence if the individual lived in the residence for at least two years prior to the sale;
- gains derived from the sale of certain securities quoted on the Mexican stock exchange;
- interest on publicly-issued bonds and securities whose terms exceed one year;
- interest on debts and bonds issued by international credit institutions (if the Mexican government is a member) and national credit institutions.

G. *Relief from tax*

See II.G. above for treaties.

Foreign tax paid by resident individuals on foreign-source income may be deducted from the income tax payable in Mexico so long as the income is subject to Mexican income tax. The credit is limited to the amount of income tax that would be payable in Mexico if the income were derived from Mexican sources.

H. *Assessment and tax rates*

Although the withholding tax system is the primary method of collecting taxes from individuals, the self-assessment system also plays a role. The tax year is the calendar year. Resident individuals are required to file an income tax return for the previous year, and remit any tax due. The filing deadline is 30 April of the year following the tax year. Penalties may be imposed for late filings or failure to file.

Individuals deriving business income are required to make advance monthly payments, and an additional prepayment in July. Taxpayers whose receipts do not exceed Ps. 2,000 million in the preceding tax year make their advance payments within the first 17 days of April, July, October and January, as do individuals deriving income from independent personal services.

The personal income tax is levied according to a graduated scale of rates, the maximum rate being 35 percent. Employment income is subject to withholding of tax at source, at the same graduated rates, which is creditable against the taxpayer's final tax liability. Resident individuals rendering independent personal services are subject to a ten percent withholding tax, which is also creditable against the individual's liability to advance payments.

I. *Non-resident withholding tax*

Non-resident individuals with a PE or fixed base in Mexico are taxed on all income attributable to the PE or fixed base at the corporate rate, i.e. 35 percent, and are subject to the same income tax rules as resident individuals.

Non-resident employees of foreign corporations or non-resident persons rendering independent personal services in Mexico are subject to graduated rates of withholding tax on payments received for such services.[19] As from 1 July 1992, the first $ 10,000 is exempt from tax, the next $ 70,000 is subject to a withholding tax of 15 percent, and any amount exceeding $ 80,000 is subject to a 30 percent rate.

Mexican-source income derived directly by non-resident individuals (i.e. not through a PE or fixed base in Mexico) is subject to withholding tax at the following rates:
- 21 percent of gross receipts derived from the leasing of movable or immovable property;
- 20 percent of gross receipts on gains from the transfer of shares or immovable property; and
- dividends, interest and royalties are subject to the same rules as apply to non-resident companies (see above).

IV. INDIRECT TAXES

Indirect taxes in Mexico are comprised of a number of taxes on transactions (VAT, customs and excise duties, the real property acquisition tax), and special charges on businesses (social security charges, profit sharing, payroll taxes and retirement insurance).

A. *Taxes on transactions*

1. Value added tax (VAT)

The VAT came into effect in 1980, replacing a tax on gross receipts. The tax is levied at the federal level. The VAT applies to all individuals and companies (whether or not foreign) which carry out taxable activities in Mexico. Taxable activities include the sale or leasing of goods, the provision of independent services and the importation of goods and services.

The taxable base is the total price charged for goods or services (including interest on consumer and credit card debt); for imported goods VAT is calculated on the value of the goods for customs purposes increased by any import-related charges. VAT is computed by crediting taxes paid on purchases against tax liabilities arising from sales.

Under the recent amendments the number of VAT rates was reduced to two: a basic rate of ten percent and a zero rate for certain basic necessities.[20]

Advance payments of VAT must be made on a monthly basis. Taxpayers must submit their payments by the 17th day of each month. A final tax return must be filed at the end of each fiscal year and any balance due must be paid at that time.

2. Customs and excise duties

Customs duties are levied on most imported goods on an ad valorem basis. The General Tariff Law provides for rates up to 20 percent, although the average tariff rate is about 11 percent.

19. In order to be subject to this withholding tax the payments must be made by a foreign corporation, the services may not be performed in connection with a PE of the foreign corporation, and the non-resident must work at least 183 days in a 12-month period in Mexico. It should be noted, however, that the 183-day requirement may be satisfied in *any* 12-month period, i.e. it need not be a calendar year. If these requirements are not satisfied the non-resident is subject to a withholding tax of 30 percent of gross receipts, unless the non-resident works for less than 183 days in which case the income is exempt.
For a discussion of the non-resident withholding tax, see John A. McLees and Ignacio Reyes, "Mexican Taxation of Income from Services Performed in Mexico", *Tax Notes International* (1 June 1992), at 1127.
20. Note, however, that the 6% reduced rate (temporarily suspended) will again be applicable as from 1 January 1993.

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form of cash, kind, debt claims or inflationary gains. Business income derived by individuals is normally taxed separately at the corporate rate, i.e. 35 percent.

Income is divided into ten categories under the ITL for purposes of computation and withholding tax:

1. *Employment income*
Employment income comprises income derived from the rendering of dependent personal services, such as wages, salaries, certain fringe benefits, amounts received as severance pay and amounts under the profit-sharing obligation (discussed below). Fees and other remuneration earned by resident directors are treated as employment income.

2. *Income from independent personal services*
Income from independent personal services encompasses all income from the rendering of independent personal services not covered under "employment income", i.e. income earned by professionals, independent contractors, etc.

3. *Income from business activities*
Individuals who engage in commercial, industrial or agricultural activities are taxed as business entities (at the corporate rate of 35 percent), and the ITL contains a separate set of rules governing the computation of income from this source. Individuals deriving income from business activities are required to maintain an account similar to the company "net of tax profit account" which represents earnings which have been subject to tax and which are therefore available for withdrawal.

4. *Capital gains*
There is no separate capital gains tax, but capital gains realized by resident individuals from the transfer of movable or immovable property and securities are subject to income tax at special rates (however, for exemptions, see below).

5. *Dividends*
Domestic-source dividends paid to resident individuals are exempt from income tax in the hands of the recipient if paid out of distributable profits, but subject to a final tax of 35 percent (to be paid by the distributing company) if paid out of profits which have not been subject to tax.

6. *Interest income*
Some interest income paid to individuals is exempt (see below); other interest is subject to a final withholding tax of 21 percent, or 35 percent in the case of interest paid on special savings accounts. The 35 percent tax is creditable against final tax liability.

7. *Income from the acquisition of goods*
Income from the acquisition of goods includes, inter alia, income from the discovery of treasure and acquisition of goods at a cost less than their actual value.

8. *Rental income*
Rental income from immovable property is taxable.

9. *Income from prizes*

10. *Other income*
The following items are treated as "other income": certain exchange gains and interest, foreign-source dividends paid to resident individuals, copyright income received by an individual other than the author and distributions made by non-profit organizations. This income is included in a resident taxpayer's total income and taxed at the regular rates.

D. *Deductions*

Individuals are granted a number of personal deductions in computing taxable income. For example, an individual taxpayer may deduct unlimited medical, dental and hospital expenses incurred for himself or his dependents, funeral expenses and certain donations to authorized institutions.[17] Resident individuals may also deduct amounts deposited into savings accounts, payments made to Mexican pension plans, shares acquired in investment companies[18] and contributions to the retirement insurance scheme (up to two percent of a portion of the employee's salary but not exceeding ten minimum salaries).

Individuals deriving income from independent personal services are entitled to deduct expenses incurred to obtain the income.

E. *Tax credits*

An individual is entitled to a non-refundable credit equal to ten percent of the general minimum wage, as well as a credit, known as the "fiscal subsidy", against his income tax liability. The fiscal subsidy is calculated on the basis of the taxpayer's taxable income and tax liability, taking the aggregate of a fixed amount and a certain percentage of the marginal tax.

F. *Exempt income*

The following income is exempt from income tax:
- amounts received for disability;
- certain social security benefits;
- fringe benefits granted to employees who earn the minimum wage, provided the benefits do not exceed limits established by labour law;
- certain employee benefits, such as a portion of overtime, work on Sundays, severance or retirement pay;
- contributions to the retirement insurance scheme, until withdrawn (see below);
- inheritances;
- gifts between spouses or members of the immediate family;

17. The rule set forth in note 7 *supra* also applies to individuals. For individuals deriving business income the amount of the gift that may be deducted may not exceed 20% of business net profits before the deduction of losses from previous periods.
18. The aggregate of eligible deposits, premiums and acquisitions may not exceed 30 million pesos during the year.

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lion at the time the fraud was committed or three to nine years if the amount at issue exceeds Ps. 30 million.

J. *Non-resident withholding tax*

Mexican-source income derived directly by non-residents (i.e. not through a PE in Mexico) is subject to withholding tax at rates varying according to the type of income. Such tax is generally a final tax.

1. Dividends

Dividends and profits distributed to non-resident parents or head offices by subsidiaries or branches in Mexico are exempt from income tax if paid out of profits which have already been subject to corporate tax (see above). However, if dividends are paid out of profits which have not been subject to income tax they are subject to a final tax of 35 percent.[13]

2. Interest

Interest payments to non-residents are subject to a withholding tax at rates ranging from 15 to 35 percent, depending on the type of interest and creditor; for example, a withholding tax of 15 percent is applied on interest paid to financial institutions, 21 percent on interest to suppliers and 35 percent on other payments.

3. Royalties

Royalty payments to non-residents for copyrights, technical assistance and transfer of technology are subject to a withholding tax of 15 percent. Royalties for patents, trade marks and advertising are subject to a 35 percent withholding tax.[14]

K. *Branches*

Branches and other PEs of non-residents are generally treated as separate entities, and income derived by such entities which is attributable to the PE is subject to corporate income tax at the ordinary rate applicable to Mexican corporations, i.e. currently 35 percent.

Branches are required to maintain a "remittance account", which is similar to the "net of tax profit account" maintained by resident companies. Profits out of this account remitted abroad to the head office are exempt from tax – profits remitted from other sources are subject to a final tax of 35 percent.

L. *Groups of companies*

Consolidated returns may be filed by groups of companies. Once an election to consolidate is made it may not be revoked for five years; thereafter revocation requires the prior approval of the Ministry of Finance.

A number of requirements must be fulfilled before companies are eligible for consolidation. First, the controlling company must make the election and receive authorization from the Ministry of Finance. Second, the group must be comprised of a resident controlling company and at least one controlled company, which must either be resident in Mexico or resident in a country with which Mexico has concluded a tax information exchange agreement. A controlling company is a company which owns, directly or indirectly, more than 50 percent of the voting shares in a controlled company.[15] Finally, the financial statements of the group must be submitted to an independent auditor.

The consolidated taxable profit is determined by combining the net profits and losses of all members in the group and making adjustments for certain intragroup transactions.

The controlling company must file a consolidated tax return for the group within four months of the end of the taxable period. The group tax liability is calculated at the rate of 35 percent. Advance payments and additional prepayments may be credited against the tax liability and the balance, if any, must be paid by the controlling company or refunded by the Treasury as the case may be. In addition, each member of the group must file its own income tax return and pay income tax separately under ordinary rules. That portion of the tax assessed by the controlled company which proportionately corresponds to the controlling company's holding in the controlled company is given to the controlling company and the remainder paid to the Treasury.

III. INDIVIDUAL TAXATION

A. *Overview*

The personal income tax is levied on resident individuals deriving income in cash, in kind or credit, and non-resident individuals carrying on a business in Mexico through a PE or fixed base to the extent that income is attributable to that PE or fixed base,[16] and on income otherwise arising from Mexican sources. A resident is taxable on his worldwide income from all sources, although he is entitled to a foreign tax credit in respect of foreign-source income; a non-resident is taxable only on income deriving from Mexican sources.

B. *Residence*

An individual is considered a resident if he has established his permanent home in Mexico or if he is present in the country for more than 183 days in a calendar year.

C. *Taxable income*

The taxable income of an individual is calculated on the total income from all sources (for resident taxpayers) less deductions and allowances. Income is taxable whether it is in the

13. The tax is not formally withheld from the payment to the non-resident but rather the onus is on the distributing company to pay the tax within 30 days of distribution.
14. Royalties are also subject to VAT, which is paid by the resident recipient of the service.
15. Indirect holding can be through a company resident in Mexico or a company resident in a country with which Mexico has a tax information exchange agreement.
16. The Tax Reform Law of 1992 extended the scope of Mexican taxation to non-residents with a fixed base in Mexico with respect to income attributable to the fixed base.

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companies,[10] VAT and excise tax shifted to other persons, and surpluses arising from the revaluation of assets and capital to reflect inflation.

G. *Relief from tax*

At the time of writing Mexico has signed three comprehensive double taxation treaties (Canada, France and Italy), initialled treaties with Spain and Switzerland, and is actively engaged in negotiations with a number of other countries.[11] Foreign companies operating in Mexico must therefore rely on unilateral relief provisions available in their country of residence to obtain relief from double taxation.

All income of a resident company derived from foreign sources is included in taxable income and a credit is granted for the foreign income tax paid on that income so long as the income is subject to Mexican income tax. The amount of the credit is limited to the amount of Mexican tax that would have been payable on the foreign income, i.e. 35 percent.

A credit for underlying tax is also available. A resident company receiving dividends or profits from a non-resident company is entitled to a credit for the tax paid by the non-resident company on profits out of which the dividends or profits were paid, provided the Mexican company owns at least ten percent of the registered capital of the paying company.

Taxpayers who are unable to utilize the full foreign tax credit in a particular tax year may carry it forward for five years.

H. *Dividends and distributions*

Mexican companies are statutorily required to maintain a special account known as the "net of tax profit account".[12] Essentially this account represents profits which have already been subject to corporate tax (including dividends received from a Mexican company) and which are available for distribution. When dividends are paid out of this account the dividends are exempt from tax. Dividends which are paid out of profits which have not already been taxed, however, are subject to a 35 percent final tax which is payable by the distributing company.

Dividends received by resident companies from foreign sources must be included in the taxable income of the company, although the foreign tax paid on the dividend may be credited against the Mexican company's liability to income tax (see above).

I. *Assessment and collection*

The tax year is the calendar year. Mexico operates a self-assessment system under which companies are required to file an annual income tax return. The tax authorities have the right to review the return and give the taxpayer's affairs a detailed examination in the course of an audit.

1. Advance payment

Companies are required to make monthly income tax prepayments by the 17th day of the following month in relation to their estimated net profits derived to the end of the previous month. If the income in the preceding year did not exceed Ps. 2,000 million, the advance payments are to be made on a quarterly basis, by the 17th day of April, July, October and January. Additionally, a prepayment of tax must be made with the July payment, based on the actual taxable income for the first six months of the taxable period.

2. Final return

Corporate tax must be computed and paid by the taxpayer, i.e. the taxpayer must file an annual income tax return which sets out the taxable profits, tax liability, net profits and the amount of profit sharing. The tax return must be filed within three months following the end of the taxable period, and any balances of tax due must be paid at that time.

In addition, in February of each year companies engaged in business activities are required to report on transactions entered into during the previous calendar year with their 50 principal clients and 50 principal suppliers. These taxpayers must also provide data on persons from whom they have withheld income tax at source or to whom they have distributed dividends.

3. Estimated income

The tax authorities may estimate a taxpayer's net income in the following cases: if the taxpayer obstructs the tax authorities; fails to file an income tax return; fails to produce accounting books, documents or records; fails to comply with obligations relating to valuation of inventory; or fails to maintain proper accounting records.

4. Interest and penalties

An interest charge is imposed when tax is unpaid at the due date for payment. The current rate of interest is 1.5 percent per month, calculated on the amount of tax in arrears, as adjusted for inflation, for each month (or part thereof) that the tax is unpaid starting with the date the taxes were due.

Penalties (as adjusted for inflation) may be imposed as follows:

- where the ommission is a result of a computational error: 10 to 20 percent of the omitted tax;
- failure to make advance payment of tax: 20 percent of the amount;
- where the omission is a result of a tax offence: 50 to 100 percent of the adjusted tax.

The penalty for tax fraud is imprisonment from three months to six years if the amount at issue does not exceed Ps. 30 mil-

10. However, these amounts must be included in income subject to profit sharing and may be subject to a final tax.
11. The Canada treaty entered into force on 11 May 1992, and is generally effective as from 1 January 1992. For a discussion of the Mexico–Canada treaty, see Jinyan Li, "The New Canada-Mexico Tax Treaty", 45 *Bulletin for International Fiscal Documentation* (November 1991), at 523.
The France and Italy treaties have not yet entered into force.
Mexico is currently negotiating treaties with several European countries and the United States.
12. The "Cuenta de Utilidad Fiscal Neta" is comprised of profits not just net of tax but also after deduction of profit sharing and certain non-deductible expenses.

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In addition to the corporate income tax, resident companies are liable to an annual two percent tax on the value of assets used in the enterprise, and are also required to share ten percent of their annual profits with employees.

B. *Residence*

A company is resident in Mexico if it is incorporated there or if its principal administration is carried out in Mexico. A resident company is subject to tax on its worldwide income. A non-resident company is any company not falling within the definition of resident company. A non-resident company with a PE in Mexico is taxed on the income attributable to the PE as well as income arising from Mexican sources.[6] A non-resident company without a PE in Mexico is taxed only on Mexican-source income.

C. *Taxable income*

The taxable income of companies is gross income minus allowable costs and business expenses, and net losses incurred in other periods.

Resident companies are taxed on income received in cash or in kind, income from services, debt claims and inflationary gains, at a flat rate of 35 percent. Foreign dividends received by resident companies are included in taxable income, although a direct and an underlying tax credit against the Mexican tax liability may be available. Mexican-source dividends are not included in the recipient's taxable income although they must be taken into account in computing employee profit shares. Interest income paid to resident companies is subject to a withholding tax of 20 percent which is treated as an advance payment. Royalties and income from immovable property are generally included in gross receipts and are subject to corporate income tax at the normal rate. There is no separate tax on capital gains. Capital gains form part of the taxable income for income tax purposes.

Non-resident companies with a PE in Mexico are taxed on their income from business activities carried out by or attributable to the PE, and are subject to tax at the rate applicable to resident companies, i.e. 35 percent.

D. *Deductions*

As a general rule only expenses which are absolutely necessary for the company business are deductible. Expenditure must be supported by documentary evidence which is prepared in accordance with the provisions of the tax law.

Deductions are specifically allowed for the following:
(1) Personnel costs, such as salaries paid to employees, retirement pension plans and social security contributions.
(2) Fees or bonuses paid to administrators, examiners, directors, general managers or members of the board of directors (but limited to prescribed amounts).
(3) Rent of business premises.
(4) Pre-incorporation expenses (deductible in the year incurred).
(5) Royalties which qualify as business expenses.
(6) Bad debts – deductible immediately if the taxpayer proves the debt will be impossible to collect; otherwise when the statute of limitations has expired.
(7) Donations actually made to certain organizations.[7]
(8) Repairs to fixed assets.[8]
(9) Insurance and bond premiums paid to Mexican institutions in accordance with Mexican law.
(10) R&D expenses under certain conditions.
(11) Depreciation and amortization: the cost of investments in fixed assets and intangible property may only be deducted through annual depreciation or amortization charges.[9] The straight-line method is the only method permitted in Mexico. Fixed assets (with the exception of land) which are acquired to carry out the business of the company and which are not for resale may be depreciated at maximum rates set by law depending on the estimated useful lives of the assets. The depreciable value is the total amount expended on the asset, including the cost price, freight, handling charges, commissions, fees, customs duties and taxes (except VAT).

E. *Losses*

Operating losses may be carried forward and set off against taxable profits of the subsequent five years. Operating losses incurred as from the taxable year 1991 which cannot be deducted from the taxable profits of the subsequent five years, may be deducted in the next five-year period if the results of the tax year in which the loss was incurred shows both a net loss and an accounting loss. Losses may not be carried back.

F. *Exempt income*

The ITL allows very few exemptions from corporate taxation, namely premiums which are charged for the issuance of new shares, investment income of certain approved pension plans, dividends and profits received from other resident

6. The Tax Reform Law of 1992, published in the Official Gazette of 20 December 1991 and effective as from 1 January 1992, amended the rules governing PEs by expanding the circumstances in which a PE is deemed to exist. ITL Art. 2 now provides that a PE arises where an individual or legal entity acting on behalf of a non-resident (even if the individual or legal entity does not maintain a place of business in Mexico):
- has and exercises authority to conclude contracts in the name of the non-resident;
- has a stock of goods or merchandise out of which he makes deliveries on behalf of the non-resident;
- assumes risks on behalf of the non-resident;
- acts under the general control or according to detailed instructions of the non-resident;
- carries on activities which belong economically to the non-resident if he does not have the authority to act independently in respect of such activities;
- is remunerated regardless of the result of his activities.

7. According to the Law of 14 July 1992, as from 1 January 1993, gifts to the federal, state or municipal goverments by corporate taxpayers will be deductible if they comply with certain requirements established by the Ministry of Finance. In addition, gifts to charitable organizations authorized by law and certain civil companies or associations may also be deducted. The amount of the gift that may be deducted in a tax year may not exceed 20% of net profits before deduction of the gift. Gifts made in a loss period may be deducted in the following period.

8. Repairs to fixed assets are deductible when made to keep the assets in operation. However, if the expenditure adds to the value or improves the assets, it must be deducted via depreciation allowances.

9. However, companies which acquire new fixed assets may choose to take an investment allowance in certain circumstances.

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THE TAXATION OF COMPANIES AND INDIVIDUALS IN MEXICO[1]

Susan M. Lyons

Ms Lyons is a research associate of the IBFD and editor of the Bulletin.

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I. GENERAL

Taxes are levied at the federal and local (state and municipality) level in Mexico. According to the Mexican Constitution certain specific taxing powers are granted to the federal government, although the federal government may delegate these powers to the states. The states retain full sovereignty except to the extent that the Constitution grants exclusive jurisdiction to the federal government or specifically precludes the states from exercising taxing powers.[2] The municipalities generally have the power to levy taxes on immovable property.

Federal taxes such as income tax (both corporate and personal), value added tax, import and export taxes and the real estate acquisition tax are Mexico's principal source of revenue.

The Mexican income tax was first introduced in 1921 under a system of schedular taxation. The schedular approach was partially abandoned in 1964 in favour of a global system for enterprises and individuals whose income exceeded a certain amount. Individuals with income below the amount remained under the schedular system, as did certain types of income, such as dividends and interest.

The current Income Tax Law (ITL) was enacted in 1980 and has been subject to a number of amendments, the most recent in 1992.[3] The ITL is comprised of several titles: general provisions, business companies, non-profit organizations, individuals, non-residents deriving Mexican-source income, tax incentives and transitional mechanisms for the income tax on business activities.

This article profiles the major aspects of the Mexican tax system as it pertains to companies and individuals.

II. CORPORATE TAXATION

A. *Overview*

Corporate income tax is levied on all "legal entities",[4] which includes corporations, limited liability companies, foreign corporations with a permanent establishment (PE) in Mexico and partnerships.[5] Non-profit organizations, and common and fixed income investment companies are not considered taxable persons for corporate income tax purposes, although the partners or members of such organizations are liable to tax on income received from the organizations.

Generally speaking, corporate earnings are taxed only once at the corporate level. However, if corporate distributions are made out of profits which have not been subject to corporate income tax, a final withholding tax equal to the corporate tax rate (35 percent) is imposed on the distribution.

1. For detailed information on the Mexican tax system, see *Taxation in Latin America*, Chapter Mexico (Amsterdam: IBFD, 1991).
2. The states are precluded from imposing inter-state customs duties.
3. This article includes reform measures up to and including the Law of 14 July 1992.
4. For the sake of convenience, the term "companies" will henceforth be used to refer to legal entities.
5. A partnership in Mexico is generally not treated as fiscally transparent but rather as having its own legal personality distinct from the partners, and for tax purposes is treated the same as a corporation.

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possible that the Mexican tax authorities may at some point require that processing fees charged by maquiladoras include more realistic mark-ups.

In the case of "commuters" (i.e. individuals who live in the United States and commute every day to Mexico to work in maquiladoras), their salaries will now be taxed in Mexico even if they are paid by non-Mexican companies.[5]

IX. INFLATION ADJUSTMENTS

Of the three countries in North America, Mexico is the only one with a comprehensive system of inflation adjustments for income tax purposes. This system was adopted during the time that Mexico was suffering from a "Latin American type rate of inflation".

It is conceivable that Mexico, as part of the process to make its tax system more comparable to the systems in the United States and Canada, might at some point eliminate its inflation adjustments particularly if its stabilization policies continue to move in the right direction. Furthermore, if the inflation rate is significantly reduced, the effect of the adjustments on the computation of taxable income will diminish and, as a result, may no longer be needed.

In their present form, the inflation adjustments may in some cases produce rather unusual results. For example, a Mexican company with a liability denominated in US dollars may have a net addition to income if the "inflationary component" exceeds the sum of the interest and exchange loss of the loan.

X. PROFIT SHARING CONTRIBUTION WITH EMPLOYEES

The ten percent profit sharing with employees constitutes a significant expense for many Mexican corporations. Because a proper deduction for this expense is not allowed, the statutory corporate tax rate is grossly misleading. Furthermore, since intercompany dividends are not exempt from the profit sharing, it limits significantly the flexibility to set up multi-tier corporate structures.

Effective 1 January 1992, the profit sharing contribution is allowed as a deduction to the extent that it exceeds the amount of non-taxable benefits paid to employees. In most cases, the deductible portion of the contribution is minimal or non-existent. Nevertheless, this amendment may constitute a first step in the process towards making the profit sharing contribution to employees fully deductible.

XI. US POSSESSIONS

In the EC, multinational companies may set up manufacturing and certain other operations in Ireland, where they only pay a ten percent corporate income tax, in order to sell to other EC countries, thus enjoying full benefits from the elimination of custom duties and tariff barriers.

It is possible that US possessions, primarily Puerto Rico and the Virgin Islands which also offer significant tax incentives for manufacturing operations and certain services, may play a role in North America similar to the one played by Ireland in the EC. These possessions may become more competitive if the trend towards increased taxation of maquiladoras continues. In that case, multinational companies may look more favourably at Puerto Rico and the US Virgin Islands as possible locations to establish manufacturing or assembly operations for the North American market.

XII. VALUE ADDED TAX (VAT)

The VAT is particularly suitable for a free trade region. It is utilized by all countries in the EC and, in many respects, it lends itself better to tax harmonization than the income tax. The VAT is a major source of revenues for both Canada and Mexico. Chronic budget deficits and the implementation of NAFTA may, in the medium term, become powerful reasons for the United States also to adopt a VAT.

XIII. CONCLUSION

As multinational corporations assess the possible impact of NAFTA and develop their strategic plans to operate effectively in North America, full attention will have to be devoted to the tax rules in the three countries, not only as they exist today but as they are adjusted as a result of NAFTA.

5. The tax is effective as from 1 July 1992.

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Until these disparities are corrected by income tax treaties, there will be an incentive to move income from US or Canadian companies to Mexican affiliates.
- If affiliates in one of the countries incurs losses, it will normally be beneficial to try to set up transfer pricing policies that would permit a rapid utilization of those losses.
- Particularly in the United States, companies with excess foreign tax credits will have a strong incentive to maximize foreign-source income by increasing prices of exports as well as intercompany charges such as interest, royalties and technical assistance fees.

In the case of Mexico, prior to 1991, licensing agreements entered into by Mexican companies with foreign licensors, (related and unrelated) had to be registered and approved by the National Registry of Transfers of Technology (NRTT). This registration and approval process was extremely important to foreign licensors as the NRTT generally dictated the maximum royalty rate that could be paid under the agreement. In addition, registration of the agreement with the NRTT was necessary for the Mexican company to claim a deduction for Mexican income tax purposes. The NRTT was abolished in the 1991 Law for the Promotion and Protection of Industrial Property. Therefore licensing agreements no longer need to be registered or approved by the NRTT. Instead, related parties may now freely determine the terms of their agreements. Furthermore, the Mexican Income Tax Law was amended in December 1991 to provide that registration of a licensing agreement is no longer necessary for the royalty to be a deductible tax expense for the Mexican corporation.

Prior to these changes, it was quite common, particularly for US corporations, to charge to their affiliates in Mexico the royalty rates approved by the NRTT. These rates were usually lower than the rates that they charged for the same intangibles to, say, European affiliates which were based on arm's length standards. In cases where the US Internal Revenue Service questioned this practice, the US companies were able to elect "blocked income" on the theory that they were not permitted by the Mexican government to charge any higher rates. This possibility is no longer available since the Mexican restrictions have been eliminated. As a result, and because of some of the planning considerations discussed above, many US corporations are reviewing their existing licensing agreements with their Mexican subsidiaries in order to increase the applicable royalty rates. In that process, they are encountering two conflicts. On the one hand, US transfer pricing rules require that charges to Mexican affiliates be raised to market levels. On the other hand, recently enacted Mexican transfer pricing rules give the Mexican Secretaría de Hacienda y Crédito Público authority to make adjustments if the charges to the Mexican affiliates are excessive. In many instances, it will be advisable for US companies in this position to undertake economic studies to determine true arm's length royalty rates which could be supported if challenged by either the US or the Mexican tax authorities.

Although less common, a similar situation arises in the case of Canadian companies licensing intangibles to Mexican affiliates.

Transfer pricing disputes among the NAFTA countries will be referred to the "competent authorities" under the terms of the US–Canada treaty, under the Mexico–Canada treaty, and presumably under the treaty Mexico is negotiating with the United States. Typically this procedure is not very effective for a number of reasons. First, it tends to be lengthy. Second, the authorities are not necessarily entitled to participate throughout the entire process. It is therefore possible that at some future date the North American countries may negotiate a transfer pricing convention modeled on the one adopted by the EC. This convention provides that an arbitration commission will be established to render an opinion on transfer pricing disputes which are referred to it if the competent tax authorities cannot reach agreement. The commission will be comprised of two representatives from the competent authorities of the countries concerned plus an even number of "independent persons of standing" and a chairman who will also be an "independent person of standing". The competent authorities are not required to implement the decision of the arbitration commission unless they are unable to agree on an alternative method of eliminating the double taxation situation at issue. The taxpayer is entitled to be represented at the commission hearings.

VIII. MAQUILADORAS

The maquiladora programme will in all likelihood undergo significant changes. For example, in a future North America region without trade barriers, it would be a bit incongruous for a maquiladora to be restricted from selling in its own country the products that it manufactures or assembles.

In fact, the Mexican government is already making significant changes to the tax treatment of maquiladoras. Initially, the programme's main objective was to generate employment. Raising tax revenues from maquiladoras was not a high priority and maquiladoras were typically allowed to operate basically on a break-even basis and pay only nominal corporate income taxes, if any. This situation, however, is changing and there is presently a clear trend towards treating maquiladoras for tax purposes the same way as any other regular Mexican corporation.

For example, maquiladoras are subject to the two percent minimum tax on the assets. The Mexican corporate income tax is creditable against the tax on assets. US-owned maquiladoras, therefore, have already been under pressure to increase their levels of taxable income in order to replace a non-creditable tax for a creditable tax.

Presently, inventory items processed and machinery and equipment used by maquiladoras are largely exempt from the tax on assets. However, for the last two or three years, the Mexican government has been sending strong signals that this exemption may be terminated. If so, US corporations with maquiladora operations will have to reconsider their original planning considerations since otherwise they will incur a significant non-creditable tax.

The recently enacted transfer pricing rules in Mexico do not provide any exception for maquiladoras. It is therefore quite

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Table II

Selected tax rates

Paid by/Received by	Canada (in %)	Mexico (in %)	United States (in %)	Treaty country outside North America (in %)
Combined tax rates on distributed earnings				
Canada	-	39 to 59	39 to 51	39 to 54
Mexico	39	-	39	N/A
United States	46 to 53	58 to 64	-	43 to 51
Withholding tax on royalties				
Canada	-	15	10	10 to 25
Mexico	15	-	15[1]	N/A
United States	10	30	-	0
Withholding tax on interest				
Canada	-	15	15	10 to 25
Mexico	15[2]	-	35[3]	N/A
United States	15	30	-	0

1. 35% on royalties for the use of patents, trade names and advertising.
2. Reduced to zero in certain cases.
3. Reduced to zero, 15% or 21% in certain cases.

tute a significant disincentive to the free flow of funds within North America.

In the case of Mexico particularly, the withholding tax on interest significantly increases the cost of financing business operations with borrowed funds from affiliates or financial institutions in other countries. Even Canada's extensive treaty network does not usually eliminate withholding taxes on interest.

It has become apparent that the level of the withholding tax on interest is one of the thorniest issues in the ongoing negotiations between Mexico and the United States. Part of the reason is that this tax constitutes a significant source of revenue for the Mexican government.

Withholding taxes have been largely eliminated on interest payments among EC countries and, for that matter, between EC countries and the United States. It would be somewhat illogical, therefore, to adopt a free trade agreement in North America without correcting the present levels of taxation on interest payments within the region. Presumably this problem will be reduced through the implementation of income tax treaties.

Furthermore, in addition to the impact that income tax treaties will have in this area, unilateral action may be taken by NAFTA countries. For example, in March 1992, Mexico eliminated the withholding tax on interest paid by Mexican borrowers to pensions funds in other countries pursuant to certain criteria.

VI. CONSOLIDATED TAX RETURNS

The so called EC "losses directive" provides that member states must make arrangements to enable their enterprises to take into account losses incurred by permanent establishments, and by at least 75 percent-owned subsidiaries in other member states. If adopted by the member states, these rules will become effective on 1 January 1993. In this area, both Mexico and the United States are ahead of the EC since both countries already allow corporate groups that meet certain requirements to file consolidated tax returns in cross-border situations. For many years, the "contiguous country election" of Section of 1504(d) of the US Internal Revenue Code has allowed US corporations to include in their consolidated tax returns wholly owned subsidiaries in Canada or Mexico that were formed for the purpose of "complying with the laws of such country as to title and operation of property". In the case of Mexico, the rules are even more liberal in allowing the inclusion of certain non-Mexican subsidiaries in Mexican consolidated tax returns.

Canada, on the other hand, presently does not allow consolidation even among Canadian affiliated groups.

Obviously the rules on consolidation allow utilization of losses on a cross-border basis, at least for now, between the United States and Mexico. More importantly, in some cases they may facilitate the introduction of debt to an affiliated group in another country in the region in a way that could result in a reduction of the overall tax burden for the group.

VII. TRANSFER PRICING

If, as expected, NAFTA results in higher levels of trade, technology and financial flows within North America, transfer pricing will become a much more important issue within the region than it is today.

As multinational corporations plan the expansion of their activities in North America, they will encounter many reasons to optimize transfer pricing policies in order to minimize their overall tax burdens. Examples include the following:

- While not substantial, there are (as indicated above) certain differences between the corporate rates of the three NAFTA countries, particularly when US state and local taxes and Canadian provincial taxes are taken into account. These differences constitute an incentive to shift income towards the locations with the lower rates.
- The differences become significantly larger when one looks at the relative levels of taxation that the countries in North America presently impose on distributed earnings.

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Although not necessarily in the immediate future, it is possible that the three NAFTA countries could further liberalize the tax rules applicable to corporate reorganizations within the region.

III. CORPORATE TAX RATES AND WITHHOLDING TAXES ON DIVIDENDS

The levels of income taxation in Canada, Mexico and the United States are other important factors that should be considered when making strategic planning decisions. Such decisions include where to establish manufacturing, distribution and retail facilities as well as determining transfer pricing policies. As indicated above, it is important not only to look at existing rates but also at possible changes the countries may adopt as a result of NAFTA.

As shown in Table I, the combined corporate rates in the three countries are not that far apart. In fact, depending on the particular province in Canada or state in the United States, the applicable rates can be quite similar. For this reason it is unlikely that the conclusion of NAFTA will put pressure on any of the three countries to alter those rates.

Table I

Corporate tax rates

	Statutory	Effective*
Canada	38%	32% to 46%
Mexico	35%	39%
United States	34%	40% to 48%

* Includes state and local taxes in the case of the United States and provincial taxes in Canada. In the case of Mexico, the effective rate reflects the effect of the 10% profit sharing contribution to employees which in most cases is not deductible.

The recent tax developments in the EC do not indicate a clear trend towards an equalization of corporate tax rates. Actually, in 1991 the United Kingdom, which is at the lower end of the scale, reduced its corporate rate from 35 to 33 percent while Germany, which is at the higher end, adopted a 3.75 percent surtax.

The situation is rather different with respect to the relative levels of taxation on distributed earnings. Mexico presently imposes the lowest tax among the three countries in North America primarily because dividends are not subject to any withholding tax so long as they are paid out of earnings that have been subject to normal corporate income tax (i.e. dividends paid out of the so-called "Cuenta de Utilidad Fiscal Neta" or "CUFIN"). This aspect is magnified by the fact that Mexico presently has no treaty in effect with the United States. In this regard, while a dividend paid by a Mexican corporation to a US shareholder is free from withholding tax, a dividend paid by a US corporation to a Mexican shareholder is subject to a 30 percent withholding tax. Today, therefore, the United States offers much more favourable treatment to European corporations which can receive dividends from US subsidiaries, generally at a withholding tax rate of five percent, than to its perspective trading partner south of the border.

The treaty with Canada[4] provides for a lower ten percent withholding tax on dividends paid by a Canadian corporation to a Mexican affiliate. While Canada presently does not have any treaty that provides for withholding tax rates on dividends lower than ten percent, it is negotiating with the United States a possible reduction to five percent. It is reasonable to expect, therefore, that if NAFTA is adopted, a similar reduction may be included in the Mexico/Canada treaty.

An interesting question is whether Canada and the United States will, at some point, follow the lead of the EC and completely eliminate withholding taxes on dividends paid to parent companies regardless of the country in North America in which they are incorporated. While at this point there does not seem to be a strong push in that direction, it is conceivable that this step could be taken in the medium term as the economies of the NAFTA countries become more integrated than they are today. Otherwise, the existence of Canadian and US withholding taxes on dividends paid to Mexican parent companies may cause Mexico to rethink the appropriateness of its existing dividend withholding exemption.

IV. WITHHOLDING TAXES ON ROYALTIES AND TECHNICAL ASSISTANCE FEES

As shown in Table II, present levels of withholding taxes on royalties or technical assistance fees are not very conducive to the free flow of technology among the three North American countries – an aspect that seems contrary to the spirit of NAFTA. It is, therefore, logical to expect significant changes in this area as a result of the recent income tax treaty with Canada and the treaty being negotiated between Mexico and the United States.

In its present form, the Mexico–Canada treaty, which reduces the withholding tax on most types of royalties and technical assistance fees to 15 percent, does not seem to go far enough. In fact, it does not appear very logical for Canada to impose a ten percent withholding tax on royalties paid to a US licensor which is lower than the rate that it would impose if the licensor were in Mexico.

In this sense, it would also seem within the realm of logical expectations that the NAFTA countries might at some point follow the example of the EC tax directives and abolish in most situations withholding taxes on royalties and technical assistance fee payments between companies incorporated in the region. If this does not happen, the United States, for example, will provide a more favourable treatment to European companies which can receive these types of payments free from US withholding taxes, than to its NAFTA trading partners.

V. WITHHOLDING TAX ON INTEREST

As with the case of transfers of technology, Table II shows that the present levels of withholding taxes on interest consti-

4. A comprehensive double taxation agreement with Canada came into effect on 11 May 1992, and is generally effective as from 1 January 1992.

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TAX CONSIDERATIONS FOR MULTINATIONAL COMPANIES RESULTING FROM THE NORTH AMERICAN FREE TRADE AGREEMENT[1]

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I. INTRODUCTION

Tax considerations constitute a crucial aspect of the strategic planning that companies are conducting in contemplation of the North American Free Trade Agreement (NAFTA).[2] In this sense, it is important not only to take into account tax rules as they exist today, but also to try to anticipate the impact that the implementation of NAFTA will have on the Canadian, Mexican and US tax systems.

This article discusses the type of changes that may occur in the tax area as a result of NAFTA. As part of the analysis, some lessons are drawn from the tax developments that are taking place in the European Community (EC) in connection with Europe 1992.

II. CORPORATE RESTRUCTURING

As a result of the EC's trend towards a single market, many multinational corporations have restructured or are contemplating the possibility of restructuring their European operations in order to:

- select appropriate locations to establish manufacturing facilities;
- centralize functions such as manufacturing, distribution, warehousing, packaging, administration, management, etc.;
- take advantage of tax reductions such as the elimination of withholding taxes (e.g. the possible use of European holding companies); and
- reduce the impact of custom duties.

Corporate reorganizations, particularly on a cross-border basis, usually present significant obstacles from a tax point of view. In many cases it is not possible to carry out such reorganizations on a tax-free basis. In the EC, the so-called "mergers, acquisitions and divisions directive" constitutes an important development aimed at facilitating corporate restructuring within the Community. Once adopted by the member countries, the directive will provide tax relief for many forms of cross-border reorganizations.

Corporate restructurings in North America require an analysis of the applicable rules on a country-by-country basis. The United States, and to a lesser extent Canada, have had for many years very detailed provisions laying out the ground rules for these types of reorganizations. Within the limits imposed by those rules, many types of restructuring may be conducted largely on a tax-free basis. Others, however, such as the "outbound transfer" of certain assets (e.g. inventory, certain intangibles, etc.), are taxable in the United States.

Presumably in an effort to harmonize its tax system with the systems of Canada and the United States and to facilitate corporate reorganizations, Mexico adopted a set of rules allowing tax-free mergers and spin-offs.[3] In broad terms, the requirements imposed by the new rules to qualify for tax-free treatment follow the principles of the US Internal Revenue Code.

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II. Corporate Restructuring
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VIII. Maquiladoras
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X. Profit Sharing Contribution with Employees
XI. US Possessions
XII. Value Added Tax (VAT)
XIII. Conclusion

1. This paper is based on a presentation made by the author at the 1992 Annual Meeting of the US branch of IFA in Houston, Texas.
2. For a discussion of the NAFTA, see David A. Gantz and Kevin Lara, "The North American Free Trade Agreement and Current US Trade Policy in Latin America", 45 *Bulletin for International Fiscal Documentation* (July/August 1991), at 368, and in this issue at 424.
3. The new rules are effective 1 January 1992.

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adverse finding may result in suspension of the binational panel process, with reciprocal suspension of benefits.

The NAFTA provides for "safeguard" provisions which permit the reintroduction of trade controls when a party's industry is seriously injured by increasing imports, during a transition period. Where safeguards are imposed under the GATT "Escape Clause" on a global basis, NAFTA industries may not be included unless their exports to the NAFTA party bringing the action constitute a substantial share of the imports and contribute to serious injury.

N. *Dispute settlement*

In addition to the special mechanisms for investment disputes, environmental issues and trade cases, the NAFTA will create a bi-national or tri-national mechanism to settle disagreements arising under the agreement. This is a three step mechanism similar in many respects to Chapter 18 of the FTA. It provides first for consultations, then for submission to the Trade Commission (comprised of the three ministers of trade), and if the matter is still not resolved, for binding arbitration.

The NAFTA also encourages settlement of commercial disputes between private parties through established mechanisms for conciliation and arbitration. The Trade Commission will designate a special committee to review and report on dispute settlement issues in the three countries.

O. *Environmental protection*

Serious concerns in the United States particularly as to whether a NAFTA would cause a degradation in the border environment, along with the fear that lack of enforcement of environmental and health standards in Mexico would give Mexico an unfair advantage in attracting US, Canadian and other foreign investment, have resulted in certain agreed steps to encourage protection of the environment and placate opponents of the NAFTA in the United States. The NAFTA will maintain existing US environmental, health and safety standards, and allow any government to impose new environmental standards on investment, so long as it is done on a non-discriminatory basis. State and local jurisdictions will be permitted to maintain or establish tougher standards, which may be applied against NAFTA imports as long as this is done on a non-discriminatory basis.

The NAFTA preserves the rights of the parties to enforce international treaty obligations, such as those which protect endangered species and against ozone-depleting chemicals or the improper disposal of hazardous wastes. The lowering of environmental standards to attract investment is specifically renounced.

The NAFTA will include a special dispute resolution mechanism for environmental and health related disputes, with the ability to call outside experts to testify.

While this chapter is unique, perhaps revolutionary, for a trade agreement, it is being criticized by environmental groups for not going far enough to assure that Mexico promptly upgrades its enforcement of environmental and health standards.

P. *Other provisions*

The NAFTA will also include sections dealing with sanitary and phytosanitary measures, technical standards, competition policy, temporary entry of business visitors (but not immigration generally), general exceptions and institutional arrangements as well as final provisions for entry into force.

III. CONCLUSION

Once the complete text of the NAFTA becomes available in early September, it will be possible to assess the impact of the agreement for individual industries and firms, and to begin to develop strategies for taking advantage of NAFTA benefits, and minimizing any adverse effects. While this may be a difficult process given the anticipated length of the agreement and its annexes, few firms participating in the North American market will be able to ignore this fundamental restructuring of what may soon be the world's most lucrative market.

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the strong dependency of its industry on third country yarns, but was ultimately mollified through the use of tariff-rate quota provisions allowing the entry during a transition period of some products that do not meet the full origin requirements.

I. *Financial and other services*

This is another area where the United States must be considered successful in facilitating the expansion of some of its most important financial service industries. Under the NAFTA, Mexico will end its restrictions on banks and insurance companies by 1 January 2000, and on brokerage firms within ten years, so that wholly-owned subsidiaries may be established, which will be subject to non-discriminatory treatment. (Mexico felt that with its recent re-privatization of banks, the newly private banks needed a period of protection from the full brunt of US and Canadian bank competition.) These provisions will apply to third country financial institutions with a substantial US presence.

In the first year, US banks may own eight percent of the Mexican banking industry, rising to 15 percent after seven years, and then disappearing. The US securities industry would be permitted an initial ten percent interest, rising in increments to 20 percent over the following six years, to 30 percent over the ensuing four years, with all restrictions eliminated thereafter.

Existing US and Canadian insurance joint venturers in Mexico will be able to acquire 100 percent ownership by 1996; new entrants may obtain a majority interest by 1998.

The NAFTA covers cargo reinsurance, but is silent on other cross-border financial services.

More generally, a series of principles, including national treatment and elimination of local office requirements, will apply to many cross-border services, with various exceptions yet to be established. (Air transport and telephone services are among the expected exceptions.) Discussions are to continue on reciprocal licensing of foreign legal consultants and engineers; all citizenship requirements for licensing are to be abolished.

J. *Transportation*

US trucking firms, which are currently barred from carrying cargo into Mexico, will be permitted to carry international cargo into the Mexican states contiguous to the United States by 1995, and to the rest of Mexico by 1 January 2000. Full reciprocal access for trucking firms will be permitted after six years. After ten years, US interests may own Mexican truck carriers involved in international service; domestic carriers will remain protected indefinitely. For a brief phase-in period, Mexican trucking firms will enjoy their current monopoly on maquiladora-related transport. Safety and regulatory standards will be harmonized over three years.

The United States and Mexico will allow charter and tour bus operations in the cross-border market, with full access to follow in all three countries three years later.

US railroads will be able to serve Mexico generally. US investment will be permitted in land-side port services.

The extent of US participation in Mexico's transportation system may well be one of the most significant reciprocal benefits of the agreement, as neither Mexico nor the United States will be able to enjoy the anticipated increases in trade unless transportation of goods into, out of and within Mexico is greatly improved.

K. *Intellectual property*

The NAFTA broadens existing Mexican protection of patents, copyrights, trade marks and service marks. Virtually all types of inventions will receive patent protection, including process patents for pharmaceutical products and agricultural chemicals. Mexico will protect foreign registered patents for 20 years, comply with Berne Convention requirements, and protect goods that are currently under development.

US drug companies will be permitted to bid for contracts to supply Mexican government-owned hospitals. Canadian compulsory licensing requirements, long a source of contention with US pharmaceutical product manufacturers, will be eliminated.

The NAFTA will include detailed enforcement procedures available to individuals and companies in the three jurisdictions.

L. *Telecommunications*

While the NAFTA does not cover the operation and provision of telecommunications transport networks, it requires that such networks and services are to be provided on reasonable and non-discriminatory terms, allowing US or Canadian firms to provide such services as voice mail or packet-switching. Other chapters will open the Mexican market for telecommunications equipment and services provided by US and Canadian suppliers.

M. *Anti-dumping, countervailing duties and safeguards*

The NAFTA, like the FTA, requires no changes in the substantive provisions of US or Canadian antidumping or countervailing duty laws, but requires consultation if any party subsequently changes its rules. Like the FTA, the NAFTA provides a mechanism through which independent binational panels may review the determinations by individual country agencies. As a condition for acceptance by the United States of this mechanism, Mexico has effectively agreed to complete revise its procedures for handling these cases, which have long been criticized for their lack of transparency and absence of procedural due process. Many observers believe that the trade action appeal mechanism will be of principal benefit to US firms that are subject to antidumping actions, rather than the reverse.

A "special committee" is created to safeguard the panel process where, *inter alia*, a country (Mexico) has failed to provide an opportunity for judicial review of a disputed administrative determination by an independent national court. An

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sale contracts. Southwestern US electric producers have sought the right to "wheel" excess IPP power for sales to other customers in Mexico, or for export to the United States. Under the agreements, this will apparently be possible only when the power is first sold to CFE.

Certain energy provisions of the FTA will continue to be applicable between the United States and Canada. Significantly, Mexico, unlike Canada, is *not* required to supply energy to the United States when energy shortages arise, as is required of Canada under the FTA.

E. *Government procurement*

US and Canadian firms are principally interested in procurement by Pemex and CFE, a market estimated to be worth $ 11 billion annually, on a non-discriminatory basis through transparent bid and evaluation procedures. Ultimately, Mexico agreed that federal government procurement, including Pemex and CFE procurement, would be open to US and Canadian firms subject to certain minimum threshold levels.[14] In one of the major achievements by US negotiators, 50 percent of Pemex and CFE procurement above the threshold levels will be open immediately to foreign bidding, rising to 70 percent over eight years and 100 percent after ten years.

F. *Investment*

The investment chapter will codify as part of an international agreement the various investment reforms Mexico has achieved over the past five years, with some additions. It represents major achievements on behalf of US and Canadian investors.

Mexico will drop export performance requirements and domestic content rules, and generally provide US and Canadian firms with national treatment. "NAFTA investors" that will enjoy the benefits of the agreement are all enterprises incorporated and with substantial business activities in a NAFTA country, regardless of the nationality of the persons that own or control the enterprises, except for Canada which will apparently continue to apply a nationality of ultimate parent criterion. Thus, in the future, European or Asian firms with an operating US affiliate may prefer to establish any Mexican projects as the subsidiary of its US company.

The NAFTA provides generally for national treatment of foreign investment; provincial and local subdivisions are required to provide foreign investors with treatment comparable to that provided to national investors outside the provincial or local jurisdiction. Free convertibility of currency and protection against expropriation are also afforded, along with international arbitration of investment disputes between investors and host governments.[15]

Canada is permitted to maintain its investment review mechanism, as liberalized in the FTA, and the United States will continue to apply the "Exon-Florio" screening to investments with possible national security implications. Mexico will also continue to screen investments above $ 25 million. All three countries are compiling lists of sectors in which investment will continue to be restricted to nationals.

G. *Agriculture*

Agriculture was the single area where the three countries could not agree on common provisions. As a result, Mexico will conclude separate bilateral agreements on agriculture with the United States and Canada. For the United States and Canada, the FTA provisions on agriculture will generally continue to apply, a result which will make many US agricultural interests, particularly US wheat growers, very unhappy. The United States convinced Mexico – its third largest agricultural market – to eliminate its import licensing system covering about 25 percent of US agricultural exports upon the entry into force of the agreement. In some instances, these are converted to "tariff-rate" quotas or simple tariffs for a transitional period.

Tariffs on agricultural products representing approximately 50 percent of US-Mexican agricultural trade will be eliminated immediately, and most other agricultural tariffs will be phased out within five years. In the US agreement, some sensitive crops such as sugar, orange juice concentrate, broccoli, tomatoes, asparagus, cauliflower and onions, and Mexican corn, dairy products and edible beans, will be subject to free trade only after 15 years. (Canada will continue to protect its sugar, poultry and egg, and dairy sectors.)

The impact of the long tariff phaseout period is softened by a carefully negotiated list of tariff-rate quotas, which will permit increasing quantities of these sensitive products to be imported with zero or low duties beginning with the entry into force of the agreement. Special safeguard provisions will apply for the first ten years when imports of a particular product reach a previously-specified "trigger" level.

H. *Textiles and apparel*

Given the highly protectionist nature of the global textile market, the textile provisions appear to be among the most successful of the NAFTA. Mexico agreed to halve its tariffs on textiles and apparel immediately, with the balance to be phased out over five years. US textile quotas on Canadian and Mexican products will be phased out within ten years, and each country is given an increased quota for textile and apparel shipments to the United States over the first five years of the agreement. Safeguards allowing temporary reimposition of import controls for surging imports are included.

Tough textile rules of origin are incorporated in the accord. To qualify for the benefits of the agreement, most apparel must be made from yarn spun in North America, or from fiber produced in North America, a provision designed to discourage third country investment in Mexican garment assembly industries. Canada initially opposed this provision given

14. For federal agencies, the rules apply for purchases of over $ 50,000 for goods and services; for construction, for projects valued at over $ 6.5 million. For federal government enterprises, such as Pemex and CFE, the limits are $ 250,000 and $ 8 million, respectively. The threshold of $ 25,000 in the FTA will continue to apply as between the United States and Canada.

15. This is in some respects a remarkable concession by Mexico, long a leading proponent of the "Calvo Clause", a doctrine that holds that such disputes between foreign investors and the state must be resolved exclusively by national courts.

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that do not qualify will be subject to each of the parties' existing rules of origin, e.g. the "substantial transformation" rule will continue to be applicable in the United States for exports from Mexico and Canada that do not qualify for preferential treatment under the NAFTA.)

With the FTA, the change in tariff category that normally confers origin under the Harmonized Tariff System was insufficient to qualify for preferential treatment. With many products, minimum US or Canadian value added was also required. For example, for a colour television receiver, the manufacturer was required to demonstrate that 50 percent of the materials plus the "direct cost of processing" were of US or Canadian origin. The percentage rules have proved difficult and controversial to implement, and confusing and unpredictable for exporters, particularly where the country sources for parts and components shifted from an FTA country to a third country, or vice versa. Except for autos and auto parts (see below), and a few other particularly sensitive items, the NAFTA greatly reduces the number of such percentage-of-local-content rules, and instead relies largely on specified changes in tariff category, or in a few instances on component-specific rules.[10]

As in the FTA, the NAFTA will provide for the elimination of duty "drawback" and similar programmes that provide for the remission of duties on parts and components incorporated in products that are later exported.[11] The FTA originally would have eliminated duty drawback in five years; the period has been extended for two additional years under the NAFTA. The NAFTA, responding to both Canadian and Mexican concerns, provides for a seven year grace period, with a few significant exceptions.[12]

Where drawback is eliminated but the product remains subject to import duties within the NAFTA, the "double taxation" of both the finished product and the components by the respective governments will be reduced or eliminated. It is anticipated that the government that would ordinarily impose duties on the imported components (e.g. Mexico) will allow partial drawback tied to the amount of import duties paid by the completed product upon entry to the destination country (e.g. the United States), with the manufacturer receiving the lesser of the duty assessed on the finished product or the duties assessed on the importation of the third country source components.

C. *Automobiles*

The auto sector rules of origin proved to be the most difficult sector of the NAFTA to negotiate. The resulting NAFTA auto provisions substantially modify the US/Canada bilateral arrangements that have been in effect in one form or another since 1965. They also reflect increasing concern that third country firms will establish Mexican facilities and "flood" the US market with vehicles incorporating relatively low local value added. For a vehicle to be considered of North American origin and subject to the preferential tariff benefits, 62.5 percent of the value must be North American.[13] In a shift from the FTA, value is determined by tracing parts and sub-components (including parts incorporated in subassemblies such as engines) to their respective countries of origin (the "net cost" approach).

The automobile section will also require Mexico to phase out its current "trade balancing" and "local content" restrictions tying sales in the Mexican domestic market to exports and to Mexican content, over ten years. Mexican tariffs on autos and light trucks are reduced by 50 percent immediately, with the balance to be eliminated in five years for light trucks and ten years for passenger automobiles. Duties on auto parts will be eliminated within five years or ten years.

Nothing in the agreed provisions appears likely to prevent Mexico from gradually becoming the country of choice for manufacturing motor vehicles for the North American market, although the NAFTA should to some extent encourage continued sourcing of some major parts and components from the United States and, to a lesser extent, Canada rather than from third countries.

D. *Energy*

US efforts to persuade Mexico to open Mexico's petroleum industry to participation and investment by US firms appear to have been largely unsuccessful. Mexico maintains its constitutionally-based state monopoly on ownership and exploitation of petroleum and natural gas resources (including refining), as well as on sales and distribution. However, US and Canadian oil field service companies will be permitted to conclude bonus contracts with Pemex, the state-owned petroleum monopoly, which will reward efficient production, and US and Canadian investment will be permitted in 14 of 19 key petrochemical sectors. (See also the applicability of government procurement provisions to Pemex, discussed in part E, below.)

Also, US marketers of natural gas, while still confined to the use of Pemex facilities, will be permitted to negotiate supply agreements directly with suppliers and end users in Mexico. The details of Pemex' role, including any veto power over contracts, had not been worked out at the time of this writing.

Mexico has agreed to permit independent electrical power producers ("IPPs") to establish facilities in Mexico to serve their own or other private consumer needs. The Mexican government electrical energy entity, CFE, will retain its monopoly on transportation of electric power, but private US entities will have the right to negotiate power purchase and

10. For example, a colour television with a screen size of more than 13 inches is considered to be of NAFTA origin only if the color picture tube (a major component representing 30-50 percent of the value) is of North American origin. A computer enjoys the NAFTA benefits only if the "motherboard" is of North American origin. Efforts of display screen producers to impose a rule which would have required the display as well to be of North American origin were defeated.

11. Where there is no internal tariff, drawback is said to give a non-local manufacturer an advantage. For example, if a factory in Mexico builds a telephone for sale in the United States, the manufacturer would normally receive a remission of Mexican duties from the Mexican government for any components imported from third countries. If a US manufacturer of telephones in San Diego imports the same components from the same third country to manufacture the telephones in the United States for sale in the United States, that US producer receives no US remission of the duties on the components.

12. Autos and auto parts, and colour picture tubes, among others, are subject to special, more stringent rules.

13. For Canada, the 50 percent rule under the FTA will continue to apply for a four-year transition period, and there are several company-specific exceptions, such as a GM-Isuzu joint venture in Ontario.

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Third, the NAFTA negotiations reflect the obvious fact that Canada and the United States are highly developed countries with per capita GNP in excess of $ 20,000 while Mexico, despite healthy economic growth over the past five years, remains a developing country, with per capita GNP of only $ 3,280, and wages of 10-15 percent of those prevalent for manufacturing jobs in the United States and Canada. At the same time, the agreement amply demonstrates that negotiating positions on many issues were determined by factors other than level of economic development. For example, Canada, whose economy is highly dependent on imported parts and components, was frequently at odds with the United States, which is less dependent, and with Mexico, which is currently highly dependent but expects the NAFTA to make it less so. Yet, Canada and Mexico share the objectives and concerns of capital importing countries still occasionally wary of US economic might, and the NAFTA to some extent reflects these concerns.

Finally, the NAFTA inevitably reflects a series of compromises among different national interests and interest groups. It seems evident, for example, that Mexico's desire to interpret its constitutional prohibition against private ownership and exploitation of petroleum resources broadly, involved trade-offs in other areas, such as agricultural trade, government procurement and investment. A few of the more obvious "winners" and "losers" are noted below; in other instances, the truth will be known only when the full text is available.

Ratification will be a difficult and time-consuming process, except in Mexico. The FTA in Canada is currently favoured by only 30 percent of the public; it and the NAFTA are opposed by the powerful provincial governments of Ontario and British Columbia. In the United States, the presidential election and election year politics have to some extent hastened the completion of the negotiations because of the Bush Administration's perception that the NAFTA will benefit its re-election efforts as a mechanism designed to stimulate job and economic growth.[6] Strong opposition in the United States by organized labour and some environmental groups remains. Yet the NAFTA is far from a strictly partisan issue. Governor Clinton has indicated his general support for the NAFTA, conditional on satisfactory environmental safeguards and assistance to cushion the impact of anticipated short-term US job losses. Also, much of the Democratic leadership of the Congress, including Senate Finance Committee Chairman Lloyd Bentsen of Texas and House Ways and Means Committee Trade Subcommittee Chairman Sam Gibbons of Florida, have indicated their support for the NAFTA.

Under these circumstances, there is reason to hope that the NAFTA will not become a divisive election issue, and to believe that whoever is elected president in November, the agreement is still likely to be ratified by the US Congress in 1993. However, the US Trade Representative's assessment that the ratification process can be completed in eight months (by the end of April 1993)[7] may well be overly optimistic.

II. SUMMARY OF KEY PROVISIONS

The coverage of the NAFTA is in some respects broader than the FTA and will provide a more detailed framework for implementation. In this summary, we review the highlights, including some of the provisions that can be expected to have a major impact on specific industries.[8]

A. *Tariff reduction*

The NAFTA is first of all a free trade agreement. The parties have agreed to eliminate all internal tariffs within no more than 15 years. (Tariffs on trade between the United States and Canada are being phased out over five and ten year schedules ending in 1988. The NAFTA does not alter these schedules for trade between the United States and Canada.)

There are four schedules under the NAFTA, which had not been released as of this writing. As with the FTA, tariffs on most items are eliminated immediately (schedule "A"), over five years ("B") or over ten years ("C"). The US Government asserts that approximately 65 percent of total US industrial and agricultural exports to Mexico in the aggregate, will be duty-free immediately upon entry into force of the agreement or within five years thereafter. For example, the "immediate" list includes computers, telecommunications products, aerospace equipment and medical products.

Unlike the FTA, however, a few select products are subject to a 15 year phase-out ("C+").[9] Unlike the FTA, where most duties were progressively phased out over five or ten years, in the NAFTA many Mexican duties are halved immediately, with only the balance subject to a phase-out, and some US duties are subject to an accelerated phase-out in the first or early years.

Mexico as a developing nation is currently eligible for GSP tariff benefits from the United States and GPT from Canada, and approximately 12 percent of Mexico's exports by volume to the United States benefit from GSP. Such benefits are "bound" under the NAFTA; Mexico will not lose GSP or GPT benefits on articles that currently enjoy duty free entry.

In general, the NAFTA does not affect the external tariffs of the three nations. However, there are several exceptions. For example, Mexico has agreed to lower its relatively high external tariff on computers (20 percent) to the 3.9 percent rate applied by the United States and Canada. The United States hopes that this change will discourage wholesale shifting of computer production to Mexico.

B. *Rules of origin and duty drawback*

As in the FTA, the NAFTA will contain detailed rules of origin, indicating the circumstances under which each will be eligible for the NAFTA preferential tariff benefits. (Articles

6. See White House, Statement of the President, 12 August 1992, at 1.
7. *American Metal Market*, 13 August 1992, at 16.
8. In preparing this summary, we have relied on conversations with various members of the US and Mexican negotiating teams, the summary text and other materials distributed by the US government concerning the agreement, and on the excellent reporting of the agreement in the *Journal of Commerce* and *Inside U.S. Trade*.
9. The longer term phaseout of tariffs benefits the United States as well as Mexico, applying, *inter alia*, to US imports of various import sensitive fruits, vegetables and other agricultural products, inexpensive glassware, rubber footwear and ceramic tiles.

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A Preliminary Assessment of the North American Free Trade Agreement

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After 14 months of intense and difficult negotiations, the United States, Mexico and Canada completed in mid-August the negotiation of a North American Free Trade Agreement ("NAFTA"). When the NAFTA enters into force – probably as scheduled on 1 January 1994 – it will establish a free trade area with more than 365 million persons[1] and a gross national product of $ 6.5 trillion.[2] Its complex and detailed provisions will necessarily impact on the operations of virtually all firms that do business in or export goods or services to North America.

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I. INTRODUCTION

While all of the essential provisions of the NAFTA have been agreed upon, the agreed text has not been released as of this writing, much legal drafting remains, and a complete text is not expected to be available before early September. Also, implementing legislation will be required in each of the three jurisdictions, requiring an additional complex drafting process that has barely begun.[3] The documentation that has been released by the three governments, along with the statements of various government officials, permits an analysis of the NAFTA's major features, but the details – critical to determining the precise impact of the NAFTA on individual firms and industries – remain uncertain in many instances. Hopefully, this preliminary analysis will provide a starting point for more extensive inquiries as to specific issues.

For those unfamiliar with the process to date, or with the United States-Canada Free Trade Agreement ("FTA") that entered into force on 1 January 1989, some general comments are in order. First, the United States and Mexico, as well as the United States and Canada,[4] are already major trading partners. US exports to Mexico have increased from $ 12 billion worth in 1986 to an estimated $ 44 billion in 1992, and Mexico can reasonably be expected to replace Japan as the United States' second largest market (Canada is first) by 1993 or 1994, regardless of the entry into force of the NAFTA. The United States is Mexico's largest market; Mexico's 1991 exports to the United States amounted to $ 31.24 billion, with imports of approximately $ 33.33 billion.

The economic growth of Mexico, preferably with but even without the NAFTA, promises great benefits to US exporters as the buying power of Mexico's 88 million persons increases. Moreover, a combination of Mexico's favourable investment climate and low wage rates, and the United States' generally low tariffs (averaging approximately four percent *ad valorem)*, virtually assure a continuing migration of labour-intensive industry from the United States and Canada to Mexico, even without the additional incentives of the NAFTA.

Secondly, the NAFTA is designed in part to "lock in" the benefits enjoyed by the United States and Canada as a result of the Mexican reforms over the past six years that have drastically lowered tariffs and opened the country to foreign investment and trade. It does not simply establish new rules. For example, Mexico's reduction of its tariffs from the 50 percent level to an average of approximately 10 percent in 1992 is not "bound" under GATT rules, and could unilaterally be raised in the absence of an international agreement that prohibits such increases. Similarly, Mexico locks in the existing benefits of the GSP programme[5] – from which other newly industrialized countries such as South Korea, Taiwan, Singapore and Hong Kong have been recently "graduated" – and assures that other trade-related concessions will be codified as international obligations of the United States.

1. 255 million Americans, 27 million Canadians and 88 million Mexicans.
2. US$ 5.67 trillion for the United States, US$ 570 billion for Canada, and US$ 284 billion for Mexico. (International Monetary Fund.)
3. In the United States, for example, under the "Fast Track" procedures, 19 U.S.C. §2112 (1988), the unsigned agreement must be presented to the Congress 90 calendar days before the agreement may be signed by the President. The 90 day period is designed in part to permit the Executive Branch and Congress, working together, to prepare draft implementing legislation. The Bush Administration is expected to send the agreement to Congress by mid-September.
4. In 1991, US exports to Canada amounted to $ 85.22 billion, 20.2 percent of total US exports. US imports from Canada amounted to $ 91.3 billion, or 18.7 percent of US exports. US Department of Commerce.
5. Under the "Generalized System of Preferences" or "GSP", 19 U.S.C. §2461 et seq., the United States provides duty-free entry to a long list of articles produced in developing countries, including Mexico. Canada provides similar benefits ("GPT").

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6. Incorporation of the Temporary Investment Trust for activities which do not allow majority foreign investment

For certain activities which under Articles 4 and 5 of the FIL do not allow 100 percent foreign participation, such as domestic air and maritime transportation, gas distribution, exploitation and use of minerals, secondary petrochemicals, manufacture of automotive components, among others, the Regulations developed a scheme of acquisition for foreigners, through the Temporary Investment Trust. Now foreigners may indirectly acquire control of existing Mexican firms engaged in these activities, or incorporate their own companies if they carry out new investments that will reflect in the export levels, or invest sufficiently in an established enterprise that is having economic difficulties with the objective of bringing it up to exportation standards. The NFIC will approve those proposals that qualify. Under the Temporary Investment Trust, the foreign investor will own indirectly such shares for a 20-year term.

VI. RESULTS AND PERSPECTIVES ON FOREIGN INVESTMENT IN MEXICO

With proven effective economic policies, a simpler and more accessible framework and a new attitude towards investment from government and investors, Mexico is ready to double, in six years, what it did not accumulate throughout its history. The objective is to reach US$ 48 billion in foreign direct investment starting at US$ 24 billion in 1988 when President Salinas took office. Today the administration is barely US$ 4 billion short of its objective.

Foreign investment has arrived primarily from the United States which presently represents 62.5 percent of the total foreign participation in the country. Following is Germany with 5.8 percent, the United Kingdom with 5.7 percent, Switzerland with 4.6 percent, Japan with 4.4 percent, France with 4.2 percent, Spain with 2.1 percent, and other nations represent 10.7 percent.[3]

Investment is primarily located in the service sector which occupies 42.3 percent of the accumulated foreign investment in the country. The commercial sector stands out at 28.8 percent and the industrial sector represents 28.5 percent of total foreign investment in Mexico. The trend for 1992 is an increase in the industrial sector which represents 57.5 percent of total foreign investment in 1992.

The administration is still expecting a larger influx of foreign investment and steps are being taken in that direction. The range of economic areas open to foreign investors has been broadened to represent 90 percent of the GNP (excluding oil extraction), and the possibility of opening more activities to foreign investment is being analysed.

Efforts have been made for foreign investment to complement domestic investment. Current legislation and the administration itself ensure security in investments for long-term planning. Foreign investment is now a permanent source of finance for Mexico in accordance with international trends. We invite all prospect investors to come and explore the possibilities of investing in the new place of opportunity: MEXICO. [4]

3. An interesting trend is Switzerland's investment for 1992 which was equivalent to 14.6% of total foreign investment in Mexico, while investment from the United States is currently at a low of 41.6% of the year's (January to March) total foreign investment.

4. For further assistance or to inquire about Mexico's opportunities, contact Mr. Fernando Heftye Etienne or Mr. Jorge Amigo Castañeda at telephone numbers (525) 540.1490, 282.5375, 540.2768 or at the following address: Blvd. Manuel Avila Camacho Nº 1, Desp. 1101, Col. Chapultepec Polanco, Mexico D.F., C.P. 11000, Mexico.

IFA NEWS

BRITISH BRANCH

The first meeting of the 1992/93 season will be held on Thursday, 1 October. The meeting will be to discuss the National Reports for the 1993 Congress in Florence. The subjects to be discussed are "Intrepretation of Double Taxation Conventions" and "Non-Discrimination Rules in International Taxation".

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1. Expeditious procedures in the Regulations that allow foreigners to own up to 100 percent of a Mexican corporation

Except for those activities enumerated in Articles 4 and 5 of the FIL, projects in most sectors may have up to 100 percent foreign ownership. Previously the NFIC reviewed all investments which exceeded 49 percent foreign participation. Now the Regulations establish a procedure which makes the authorization to incorporate in Mexico, with a majority foreign interest, automatic, so the investment project need not go through a screening process to commence operations. Six prerequisites must be met, however, in order to be exempt from the approval requirement.

The conditions are as follows:
(1) *Preference for small and medium-sized businesses:* the fixed assets of the new Mexican company during the preoperative period must not exceed the amount established periodically by the Ministry of Commerce and Industrial Development (currently US$ 100 million);
(2) *Foreign funds*: the activities of the new company must be funded from abroad. The investment must be of new foreign funds and not of Mexican borrowings or transfers of Mexican funds into the new business;
(3) *Location of business*: industrial activities must have company plants located outside the major industrial areas of Mexico City, Guadalajara, Jalisco, Monterrey and Nuevo Leon;
(4) *Equal cross-border flow of funds*: during the first three years of operation the company must maintain, as a minimum requirement, an accumulated balance of foreign inflows and outflows;
(5) *Creation of jobs and training*: the new company must help create jobs and establish training and development programmes;
(6) *Technologies and environmental safety*: adequate technologies must be used by the new company and the new investment should not violate the environmental regulations of the region in which the company is located.

Projects that do not meet the above criteria or which come under partial restriction because of specific industrial, sectoral or investment considerations, must obtain authorization from the NFIC. The NFIC, however, from 1989 to date, has authorized 98.4 percent of all incoming petitions.

In the case the project requires approval, the NFIC must respond within 45 working days of receipt of the petition; if no response if forwarded, automatic permission for the project is deemed to be granted.

A special regime is specified for "maquiladoras" which allows foreigners to own up to 100 percent of such companies without the need for prior approval.

2. Expeditious authorization when expanding existing activities in Mexico

Before the 1989 Foreign Investment Regulations were issued, permission was required to expand into other activities or product lines. Such authorization is no longer necessary if:

- the company expanding its activities is an active exporter or a maquiladora industry;
- the company is already controlled by foreigners, and an additional amount in fixed assets is invested (at least ten percent of the company's current assets);
- the company merges with, or acquires an existing authorized Mexican company.

3. Expeditious authorization for new establishments

In the past new establishments required the direct approval of NFIC. The Regulations, however, authorize the opening and operation of new establishments without any previous authorization if they:

- are maquiladoras or companies dedicated to exportation;
- invest at least ten percent of the net value of the fixed assets in the new establishment;
- increase the corporate paid-in capital in an amount equivalent to 20 percent of the additional investment in fixed assets;
- contribute at least a neutral (if not positive) balance of payments for the three subsequent years following the year of establishment.

4. Real Estate Trusts for foreigners to own land in "Restricted Zones"

Foreigners are allowed to own land in Mexico in all areas except in what is historically called the "restricted zone" (a strip of land running 100 kilometers along the borders and 50 kilometers along the coast of the Mexican territory). The Regulations make it easier for a foreigner who plans to develop activities in the tourism or industrial sectors to indirectly own property in this zone by using the Real Estate Trust. Under the trust, a Mexican bank is the direct title holder of the land but administers the property by order of the foreign beneficiary allowing the latter to have guaranteed total control.

Under Mexican legislation, all trusts have a maximum life of 30 years. The Regulations allow the trust to be quickly renewed if the beneficiaries and trust terms remain unchanged, and if a petition for renewal is filed 180 days before expiration of the original term.

5. Investment through the stock market: Series "N" shares

The Regulations establish the "Neutral Trust" under which foreign investors may acquire shares in the stock market that previously could only be acquired by Mexican nationals.

The series "N" or neutral shares do not give the shareholder corporate rights but only pecuniary ones. Neutral shares are not considered for purposes of determining the amount and participation of foreign investors in the capital stock of issuing corporations, which implies that the acquisition of these shares is unlimited.

The foreign capital received by Mexico through investment in financial instruments with variable returns amounted to US$ 6.3 billion in 1991, a sum four times greater than that received in 1990. By 1991 total foreign investment in Mexican Stock Exchange shares amounted to US$ 18.6 billion.

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The first two chapters establish the general policy to be followed by the Mexican authorities. Chapters III and V create agencies which review, approve and register foreign investment. Chapter IV establishes rules to acquire property in restricted areas under the Mexican Constitution, and the final chapter sets forth the sanctions which may be imposed for failure to comply with the FIL.

B. *Authorities in matters concerning foreign investment*

1. National Foreign Investment Commission (NFIC)

The legislators of the FIL sought to create an independent government agency which could keep pace with the rapidly developing foreign investment policy. The NFIC, the agency created for this purpose, is comprised of several ministries, including the Ministry of Commerce and Industrial Development, the Ministry of Foreign Affairs, the Ministry of the Interior, the Ministry of Finance and Public Credit, the Ministry of Labour and the Ministry of Energy, Mines and State Industry.

The NFIC analyses and approves foreign investment projects based on specific criteria provided in Article 13 of the FIL. For approval, the NFIC primarily considers the project's effect on the foreign currency balance, its capacity to employ Mexican nationals, bring in modern technology and financial resources from abroad, and locate outside the three largest cities.

The current 1989 Regulations to the FIL limit the participation of the NFIC in a number of procedures which previously required its approval.

2. National Registry for Foreign Investment

The National Registry for Foreign Investment (NRFI), in which individuals, corporations and trusts are to be registered, not only records investment data, but it also has a monitorial and analytical role over foreign capital in Mexico. With the financial information presented annually by foreign investors to the NRFI the NFIC is able to establish its general policy towards foreign direct investment.

3. General Directorate of Foreign Investment

The General Directorate of Foreign Investment of the Secretariat of Commerce and Industrial Development is the authority that provides the final economic and legal review of investment projects approved by the NFIC. It gives the authorizations their official status. It also controls the NRFI, and is the agency in charge of inward promotion of foreign investment by recruiting joint venture proposals through contact with the State governments.

C. *Participation and control of productive activities in Mexico by foreign investment*

In Mexico certain activities are reserved to the State, still others are reserved to Mexican nationals and others are open to foreign investment.

The following activities are reserved to the State (FIL, Article 4):

- petroleum and other hydrocarbons;
- basic petrochemicals;
- exploitation of radioactive minerals and the generation of nuclear energy;
- mining in the cases established by the legislation applicable to that activity;
- electricity;
- railways; and
- telegraphic and wireless communications.

The following activities are reserved to Mexican nationals (FIL, Article 5):

- radio and television;
- urban and inter-urban automotive transportation on federal highways;
- domestic air and maritime transportation;
- exploitation of forestry resources; and
- gas distribution.

Article 5 of the FIL provides that only 40 percent foreign participation is allowed in the capital of a Mexican corporation which engages in the production of secondary petrochemicals and the manufacture of automotive components, and 34 percent foreign investment is allowed in the capital stock of a mining company engaged in the exploitation and extraction of national mineral reserves.

All other activities may have 49 percent foreign participation without any prior authorization, and up to 100 percent if authorized by the NFIC, unless otherwise provided in specific laws pertaining to the activity, or in regulations issued by the Executive Branch, such as the 1989 Regulations to the FIL.[2]

D. *The 1989 Regulations to the FIL*

The objectives of the 1989 Regulations are to attract foreign investment and to simplify procedures for foreign investors. Before the Regulations were implemented there was no legislative document to ease the complexity of procedures for authorization of formal foreign investment projects. The previous Regulations orbited around the NRFI and required considerably higher standards of information than what is required today. Now, the Regulations provide dispositions that systematize the NRFI in a more efficient fashion, and provide for a new method to obtain authorization. Petitions are simple to make because the required investment data is basic, and in some cases, may even be presented well after operations have commenced. This makes it easier on the investor and the authorities.

2. All activities are listed in the Catalogue of Economic and Productive Activities. Of 754 classes listed, approximately 586 are 100 percent open to foreign direct investment (FDI); 84 allow 100 percent FDI with the NFIC's approval; 25 allow up to 49 percent FDI; 8 allow up to 40 percent FDI; 4 allow up to 34 percent FDI; and only 47 activities are prohibited to foreign ownership or control.

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III. MEXICO'S INVESTMENT EDGE

What are the advantages of investing in Mexico today? Historically, the country's location between the Atlantic and the Pacific Oceans has placed Mexico within easy reach of Europe and the Asia Pacific region. Substantial government spending has been directed towards the creation and administration of large service ports.

Latin America, to the south, promises to be a strong commercial block in future years. A free trade agreement with Chile, a country with one of the region's most flourishing economies, was recently signed, and similar agreements are expected to follow with other countries south of Mexico.

The northern border with the United States has allowed for easier, faster access to that market, the largest in the world. Mexico is the United States' third most important trading partner, and the United States represents Mexico's most important trading partner.[1] Negotiations are currently taking place leading to the signing of a North American Free Trade Agreement, which will include Canada, the United States and Mexico, and which will eventually represent the largest economic block in the world. Once the accord is signed the participant parties will have easier access to each other's markets signifying a tremendous increase in investment flows.

Mexico is also abundant in natural resources which, in most cases, are open to total or partial exploitation by foreign investment. Recent constitutional amendments allow foreigners to participate in agricultural industries, a sector of the economy once closed to foreign direct investment.

Lower labour costs have been a positive factor in attracting foreign investment. Mexico also has a large domestic market with a population of over 80 million people of which close to half are under 24 years of age. Mexico is a country with a tremendous labour and consumer potential.

Special mechanisms such as the "maquiladora" (or in-bond) industry by which the investor imports all raw materials and then exports all or almost all of the production have proven to be very effective. Today the maquiladora industry represents the second largest earner of foreign investment for the country. In addition to the maquiladora system other mechanisms have grown to meet investors' needs and requirements.

Besides strengthening the economy, exploiting Mexico's favourable location and its natural resources, the Mexican government is committed to deregulating commercial activities in order to stimulate a healthier economy. Following the "hands-off" philosophy, the role played by the State as an economic agent has been reduced, thus allowing private investors to develop long-term strategies.

Foreigners may now freely repatriate their entire earnings from Mexico or maintain dollar accounts in Mexican banks. Deregulation also took place in the abrogation of the Transfer of Technology Law, which required the government's approval and registration of such contracts. A new intellectual property law was published in July 1991 which grants international standards of protection to patents and trade marks and further assures the foreigner of his investment.

New Regulations to the Foreign Investment Law were issued in 1989 which provide for new and easier forms of carrying out an investment. The modifications primarily consist of shorter authorization procedures (some even automatic), simplification of the information required by the investor and relaxation of the Foreign Investment Commission's criteria for approval of foreign investment projects. This framework also introduced important mechanisms and advantages that will be explained later in this article.

IV. WHAT DOES MEXICO EXPECT FROM FOREIGN INVESTORS?

Mexico expects to attract capital and technology, and to create jobs through foreign investment. Mexico has the potential of becoming a fully industrialized, economically integrated nation within an international context.

The present administration's goal is to receive US$ 24 billion in foreign investment accumulated over its six-year term. It has already reached $ 20.829 billion within the first three and a half years, which demonstrates the increasing confidence of foreign investors in the country's economy. In this regard, it is necessary to point out that Mexican private investment has also increased, helped, among other things, by the repatriation of capital. Technological advancement is expected to be seen in the long term, and objectively the administration is looking forward to creating up to one million new jobs a year.

Mexico expects foreign investment to work along with national investment, to activate the economy by increasing the demand for products made and supplied in the country and to develop better quality products for domestic and foreign consumers by increasing export levels. Mexico's economic policy welcomes foreign investment with the philosophy that it will reap long-term benefits to both the country and the investor.

V. LEGAL FRAMEWORK FOR FOREIGN INVESTMENT

Foreign investment legislation is comprised primarily of the 1973 Law to Promote Mexican Investment and Regulate Foreign Investment, the 1989 Regulations to that Law, and continuing General Resolutions of the National Commission on Foreign Investment.

A. *Organization of the Foreign Investment Law (FIL)*

The FIL is divided into six chapters:

I. Purpose of the Law;
II. Acquisition or Control of Established Business Enterprises;
III. The National Commission on Foreign Investment;
IV. Trust Regime for Border and Coastal Areas;
V. The National Registry of Foreign Investment;
VI. General Provisions.

1. Investment from the United States accounts for 63% of the Mexico's total foreign direct investment.

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THE NEW INVESTMENT OPPORTUNITY: MEXICO

Fernando Heftye Etienne

I. THE NEW BUSINESS CLIMATE IN MEXICO

Today's business climate for foreigners in Mexico is dramatically different. A change has taken place not only within government, but also amongst the investors themselves. There has been a drastic change of attitude towards foreign direct investment. Mexico has recovered economically and is now ready to offer important advantages to foreign investors.

II. MEXICO'S ECONOMIC POLICIES WORKING TOWARDS RECOVERY

Mexico's economic upgrowth is not a new phenomenon. It is not the conclusion of a set of recent and draconian measures abruptly enunciated by government administrations, but rather the result of a well thought out, internationally approved programme, steadily implemented over the past ten years. It is not unfounded that Mexico's standing in the world economy is comparatively strong, and that it will continue to improve in the coming years.

When the new economic strategy was developed, Mexico had already exhausted lines of credit and loans from international banks. The country decided to turn to the international markets for foreign direct investment as a means to fund economic development. Mexico thus took several steps in this direction to slowly retreat from its economic setback.

The first substantial step was to join the General Agreement on Tariffs and Trade (GATT) in 1985. The application of this agreement brought forth important reductions in import tariffs, which in turn helped increase direct investment influxes.

Later, other actions were taken, such as controlling government spending, renegotiating the Mexican public debt with foreign creditors and applying the "Economic Solidarity Pact" on a national scale, and the "Brady Plan" and "New Package Deal" at an international level to control inflation, reasonably reduce debt payments and increase Mexico's participation in international commerce.

The administration has also privatized a number of public industries since 1983. It is expected that from the then-existing 1,200 government firms only 290 will remain. Important privatizations have taken place such as TELMEX, a government monopoly in the telecommunications sector, SIDERMEX, the largest steel complex in the country, and the entire financial and banking sectors.

Negative trends in the public financing sectors have been redirected by these activities. Public finances in 1990 reached a surplus equal to ten percent of the gross domestic product (GDP), from a deficit of seven percent in 1981. This is an increase equivalent to 17 points within nine years, signifying a remarkable recovery.

Mexico's road to recovery is still to be completed. The government must keep applying sound economic policies, and attracting healthy foreign investment is a priority. In recent years, however, competition for investment resources has increased. Countries in Eastern Europe, Asia and Latin America have all opened – in varying degree – to foreign investment. Fortunately, Mexico is now better equipped to offer important comparative advantages to the foreign investor.

Fernando Heftye was appointed Technical Secretary of the National Foreign Investment Commission in March 1990. In this capacity he is responsible for the evaluation of all applications for direct foreign investment in Mexico which require the approval of the National Foreign Investment Commission.

Prior to his appointment, Mr. Heftye was legal Manager of Finance of Petroleos Mexicanos, the state-owned oil company.

He was Chief of Staff of the Directorate General of Foreign Investment in the Secretariat of Trade and Industry from 1984 to 1987. He was subsequently appointed Director of Legal Affairs within the same General Directorate until May 1988, when he joined Petroleos Mexicanos.

Mr. Heftye received his law degrees from the Universidad Iberamericana Law School in Mexico City and obtained his Masters Degree from Harvard Law School in 1983.

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  C. The 1989 Regulations to the FIL
VI. Results and Perspectives on Foreign Investment in Mexico

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other countries was significant, in which case the UN model was followed. These latter items are:

- For the period of operation necessary to consider a construction project a permanent establishment, six months was chosen instead of one year.
- When foreign insurance companies enter the Mexican market, they will be considered to operate through a permanent establishment so long as they insure risks or collect premiums in Mexico.

Additionally, because foreign banks in Mexico only perform complementary activities to banking and credit, they are not considered as permanent establishments for tax purposes.

Besides reducing or eliminating taxation of the same source of income by two countries, an important objective when negotiating a tax treaty should be to be able to extend to foreign firms such advantageous treatment as applies to residents in the host country. This is especially relevant in the case of Mexico because our fiscal system does not impose a double tax on profits, i.e. it does not tax dividends at the shareholder level. To extend this favourable treatment to foreign firms, Mexico asks its counterparts to give tax sparing credits to their companies operating in Mexico. The magnitude of this credit clearly depends on the tax rate on dividends in the country of residence.

In general, Mexico has followed the lines of the OECD model convention, establishing maximum withholding rates of 15 percent for dividends, interest and royalties transferred abroad. We do not tax source income for air and sea transportation and we reserve the right to tax rentals on real estate.

Currently, Mexico is engaged in an intense process of negotiating bilateral tax treaties. Up to 1991 Mexico had concluded treaties with Canada, France and Italy. The Canada treaty entered into force on 11 May 1992, and is generally effective as from 1 January 1992. The treaties with France and Italy, although signed, will probably come into effect in 1993. Treaties with Spain and Switzerland have been initialled. The countries with which negotiations are now under way at various stages are:

Belgium	Netherlands	United Kingdom
Germany	Sweden	United States

Of this group, the treaties with Belgium, Germany, Sweden, Switzerland and the United States could be signed this year.

Negotiations are planned with Chile, Ecuador, Norway and Korea for this year and we have plans to engage in negotiations with the following countries:

Barbados	Guatemala	Malaysia	Russia
Brazil	Greece	Morroco	Thailand
Costa Rica	Hungary	Poland	Uruguay
China	Japan	Romania	

Mexico believes that by signing tax treaties we are not only reducing the cost of capital for foreign firms in Mexico but also creating a more stable fiscal environment, due to the bilateral commitments assumed. Both elements should play a role in stimulating investment and economic development.

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MEXICAN POLICY ON TAX TREATY NEGOTIATIONS

Francisco Gil Diaz
Under Secretary of Revenues

The communications revolution and the liberalization of trade and financial flows have nurtured international direct investment and debt flows as well as increased trade and migration. This greater international interdependence has led to increased reliance on double taxation treaties as convenient complements to domestic tax legislation to prevent the double taxation of income and capital.

As part of the nation's modernization of its tax system, Mexico has embarked on the creation of a vast network of tax double taxation treaties to provide foreign investors with a long-term stable outlook and to enforce compliance by the exchange of information.

Notwithstanding the Mexican government's effort to negotiate tax treaties, unilateral measures have also been introduced in the last few years that reduce the fiscal burden for both Mexican and foreign firms.

The Mexican fiscal system contains provisions that eliminate the double taxation of business profits as they are received by shareholders. In fact, neither dividends nor capital gains are subject to tax as such, provided the profits that give rise to such income have been taxed at the company level. If distributions are made out of profits which have been previously taxed, no dividend tax is imposed. Capital gains are taxed after adjusting the cost of shares for the reinvestment of profits and indexed for inflation.

Mexico has taken the initiative to reduce withholding rates applicable to transfers from foreign firms in Mexico to their head office in a foreign country. With respect to the transfer of interest, the withholding tax rate could rise to as high as 42 percent in 1988; currently, we have rates of 15 percent on interest paid to financial institutions, 21 percent on interest paid to suppliers and 35 percent on other interest payments. Withholding taxes on royalties were 42 percent on patents and 21 percent on copyrights. Currently, those rates are 35 percent and 15 percent, respectively.

Foreign residents working in Mexico, who were not paid by a Mexican resident or a permanent establishment of a foreign company, were subject to tax at a flat rate of 30 percent. This has been modified so that now such foreign residents are exempt from tax for the first US $10,000 of income. The excess over $ 10,000 but below $ 80,000 is subject to a 15 percent tax and only the excess over $ 80,000 is subject to a 30 percent tax.

The reduction in the withholding tax rates for foreign residents responds to the need to facilitate the transfer of technology. Even when foreigners could obtain a tax credit in their own countries for the tax paid in Mexico, the 30 percent rate often implied a higher effective rate.

All of these measures are designed to reduce the costs of operating a business in Mexico.

The tax treaties that Mexico has been negotiating will contribute further to reducing the cost of capital, by entitling foreign firms to credit taxes paid in Mexico (which is not necessarily the case in the absence of a treaty), and facilitating such credits through reductions in withholding tax rates.

One important element we had to consider before embarking on the negotiations was the asymmetry in the flows of capital when the treaty is between a developed and a developing country. In this case there must be a tradeoff between lost revenue in the short term and increased foreign investment in the medium and long terms. We concluded that the longer term payoff will be worthwhile, particularly when account is taken of the intense international competition for capital.

To give a quantitative idea of how asymmetric our international balance sheet is, direct investment in Mexico by US residents was, up to 1990, equal to US$ 19 billion, compared to US$ 554 million direct investment by Mexicans in the United States.

While in 1990 Mexican companies paid to the United States $ 1,444 million in interest, $ 266 million in royalties, $ 435 million in dividends and $ 244 million in other payments, the transfer from the United States to Mexico amounted to only $ 15 million in interest, $ 0.3 million in royalties, $ 7 million in dividends and $ 6 million in other payments. Regarding the banking system (commercial and development), Mexico's transfers of interest to the rest of the world in 1990 amounted to $ 2,564 million, while interest received from foreign banks amounted to $ 130 million.

It is estimated that by signing a treaty with the United States, the lower withholding rates on dividends, interest and royalties transferred abroad will translate into a 40 percent reduction of revenues from foreign residents, which in 1990 represented five percent of total income tax revenues. As a percentage of GDP the loss would amount to approximately 0.10 percent, or $ 280 million in 1991. However, so long as foreign banks cannot refund the Mexican withholding tax, as is the case presently, the reduction in the Mexican withholding rate which will result from treaties, will imply lower operating costs for Mexican firms which translate into higher returns.

For the purpose of establishing the terms of the conventions, Mexico has followed the rules agreed upon by members of the OECD, except when the relevance of the imbalances with

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on tax administration was very small, there was an externality problem where the private (state) incentive to spend on increased tax collection was much lower than the social (national) incentive, giving rise to underspending and undercollecting. This was solved by giving the federal government the responsibility to collect the tax. As a result we have seen a significant increase in VAT revenues far beyond GDP growth, despite having a zero rate on food and medicines from 1989 onwards (compared to six percent before), and despite having lowered the general rate from 15 to 10 percent in the last two months of 1991. VAT revenues represented 3.9 percent of GDP in 1991, compared to 3.26 percent in 1988.

Finally, some additional simplifying measures were introduced recently. The changes are fundamentally targeted to small and medium taxpayers and consist of a drastic reduction in the number of returns, a simplification of procedures and exempting individuals from having to present their annual tax return when they have no additional tax to pay.

The changes to the Mexican tax system have produced important results some of which I would like to summarize. The number of taxpayers has increased from 13.1 million in 1988 to 17.2 million in 1991; this represents a 31.7 percent increase. However, this total includes employees as well as business activities. Considering only business activities in the same period, the increase was 90 percent.

Revenues increased despite the reduction in tax rates and the elimination of some taxes because the number of taxpayers increased, legal loopholes were closed and better enforcement and control measures were adopted. Between 1988 and 1991, revenues increased by 32.6 percent in real terms, while economic growth in that same period was 11.7 percent. Thus, the Mexican tax system has been streamlined to depend on a few but broader-based taxes and lower tax rates. Its efficiency and equity must have improved concomitantly with its ability to enhance revenues.

We believe that the legal and administrative structure resulting from the vast quantity of changes that has taken place in the past four years has placed the Mexican fiscal system in a competitive and attractive situation internationally. The extraordinary increase in private investment, both Mexican and foreign, that has taken place in the past four years, bears out this result. The surge in private investment is of course in response to the extraordinary and wide ranging economic and political reforms undertaken by President Salinas, and the new tax structure has been an adequate complement to these developments.

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The second refers to the exemption of fringe benefits which induced firms to pay on the aggregate as much as one-third of wages in that form.

In 1991 a quarterly inflationary adjustment was introduced in order to maintain the personal income tax schedule in real terms. At the same time a "fiscal subsidy" was introduced into the personal income tax schedule. It consists of a reduction in rates which is steeper for those taxpayers that receive a higher proportion of their income in the form of cash. This measure seeks to reduce the distortion built into the system to pay fringe benefits instead of cash wages.

Other taxes have also been significantly reduced. The tax on dividends was eliminated; the withholding tax on interest paid to individuals was reduced; corporate and personal income tax integration was maintained; a special tax on insurance policies was eliminated as well as the tax on mineral activities; the excise tax on telephone calls was eliminated, as well as the tax on soft-drinks; the maximum tax rate on new cars was reduced and popular models were exempted. Significant rate reductions were granted to excise duties on cigarettes, wine and alcoholic beverages. The tax on capital gains derived from the sale of residences was eliminated, and, with a four-year transition period, the maximum tax rate on real estate transfers is being reduced from ten to two percent.

Two other areas that experienced substantial changes were the so-called Minor Taxpayers Regime and the Special Basis Taxpayers. Initially these were conceived as a means to tax hard-to-tax groups, but through the years the system came to be considered as an unalienable right to a privileged treatment, such that when some of the taxpayers in these groups prospered enough to pay taxes within the general tax regime, they resisted doing so, mainly through the formation of strong lobbies.

To give an idea of the magnitude of the problem, suffice it to say that these categories, which include agriculture, transportation, the publishing industry and an important number of small and midsize taxpayers, produce 18 percent of GDP, but contributed less than one percent of the income tax.

The tax-induced patterns of investment derived from privileged tax treatment and the unfair competition that arises from differential taxation among taxpayers within an industry, represented welfare losses to the economy, not to mention unequitable taxation. Furthermore, the two special regimes broke the chain of fiscal control, facilitating fiscal evasion. At the same time, these regimes gave an incentive for firms not to grow and thus gave a "legal cover" to the informal economy.

In order to have these groups and small unincorporated firms pay a larger fraction of the total tax burden, but with the aim to simultaneously minimize the costs of the transition, a simpler tax regime was designed for them in the form of a cash-flow tax. This new regime has three advantages:

(1) there is no need to assess depreciation, make inflationary adjustments, etc.;
(2) in the case of small taxpayers, it allows a transition to the general regime since it charges taxes according to size and initiates them in the fulfilment of certain formal requirements; and
(3) it increases revenue.

It is well known that the simplification of the value added tax (VAT) began in Latin America. We have also endeavoured to broaden our tax base while eliminating myriad sales and production taxes, and lowering rates. As part of this process the VAT was subject to major changes. An important achievement was made in 1991 as the different VAT rates were unified. First, the general rate of 15 percent was reduced to ten percent while eliminating the 20 percent categories on luxury goods. At the same time, regional differences were eliminated (border regions had a six percent VAT rate). The tax base was also increased by taxing interest on financial consumer loans and on credit card loans, and by eliminating the exemption enjoyed by union stores. As a result, only two rates prevail, the general rate of ten percent and the zero rate on exports, food, agricultural suppliers and medicine.

Besides the direct changes in tax rates and in the structures of several taxes, improvements were also made at the administrative level. Several simplifying measures were implemented in respect of the filing and submitting of returns, mainly a reduction in the information required and in the number of returns. Additionally, taxpayers may now pay their taxes at any commercial bank.

Several reforms have been made to foster compliance and improve the control over taxpayers. I will only mention some of the outstanding changes. One is related to deductible expenses to determine the income tax. In most countries deductions are only allowed for those expenses that are strictly business related. In some cases, however, it is difficult to separate personal from business-related expenses. In order to control abuses arising from this situation, more precise and strict requirements must now be met for firms to deduct travel expenses such as meals and accommodations, car rentals, etc. Deductions of car-related expenses are also more regulated and limited than in the past.

Tax planning used to include the deferral of payments, because penalty interest could not be legally charged on interest, thus the real value of unpaid taxes fell over time. This problem was solved by having omitted contributions adjusted for inflation and by charging penalty interest on the reflated sum, but the maximum penalty was reduced from 150 to 100 percent and interest on late payments was lowered to one percent per month, more in accordance with the current real interest rate, and it was made a deductible expense.

Some measures were designed to have taxpayers comply more strictly with their tax payments. These include a higher frequency of audits, extension of the obligation to obtain a fiscal audit by private accountants and more requirements on the issuing of invoices. In 1991, 156,000 audits were made, 90 percent of which resulted in collections, compared to 54,000 audits and a 13 percent effectiveness rate three years before. The yield per peso spent in direct audits increased from 1.5 pesos in 1988 to 40 pesos in 1992.

A structural change in the form in which the VAT is administered was introduced in 1990. The responsibility to collect the VAT – previously a state task – was given to the federal government. Since the revenue formula implied that the incentive at the margin for the states to spend an extra peso

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TAX POLICY IN MEXICO

Pedro Aspe Armella
Secretary of Finance and Public Credit

INTRODUCTION

By organizing regular congresses, promoting publications and scientific research, and by encouraging international cooperation, the International Fiscal Association (IFA) performs a most valuable function bringing together the best minds on applied fiscal policy.

IFA has contributed substantially to understanding the consequences of different fiscal policies on economic performance. Furthermore, the IFA has encouraged a healthy exchange of ideas between countries with often different fiscal structures. The sharing of these experiences plays a role in improving tax laws and in providing an important guide for the negotiation of bilateral tax treaties.

We are honoured to have such a distinguished group of fiscal experts holding their annual meeting in Mexico. We are certain that this reunion will be most productive in the generation of ideas useful for your endeavours and in the consolidation of valuable personal relationships. I wish you a great success and a pleasant stay in this magnificent region of our country.

This meeting of the IFA represents a most timely opportunity to present Mexico's recent reforms on taxation, to sketch broadly its objectives and to mention some of its results.

RECENT TAX POLICY IN MEXICO

The key role of fiscal policy in a successful stabilization programme is well understood. Mexico has not been an exception: our recent stabilization progress has been firmly supported by a strict control of public income and expenditures. The consolidated public sector deficit has been brought down from 11 percent of gross domestic product (GDP) in 1988, to 0.8 percent in 1991. We have not registered as income the substantial proceeds from the sale of important government properties in banking, steel, etc., since we believe that such once and for all transactions should not be counted as income and that only their reduction in government interest expenditures should contribute towards greater government spending.

It was clear that an improved budgetary performance would require increased public revenues, which coupled with other macroeconomic measures, would generate the required credibility of the stabilization plan.

Following a tax modernization process started in previous administrations, the government of President Salinas has been committed to further strengthening the fiscal system while simultaneously supporting its stabilization and liberalization plans.

Thus, the main objectives of recent fiscal policy in Mexico have been:

- To substantially reduce the governments's budget deficit.
- To reduce tax rates and taxes as the number of taxpayers increases and as the tax base has been broadened, with better enforcement to combat evasion.
- To have an internationally competitive fiscal structure.
- To eliminate unnecessary required paperwork and/or required procedures in order to simplify compliance.

In what follows, I shall describe briefly changes that have taken place to achieve these objectives.

All the recent reforms, with the exception of a new tax on corporate assets, complementary with the corporate income tax (the latter is creditable against it), which is intended for control purposes, imply important tax reductions.

The corporate income tax rate was reduced gradually from 42 to 35 percent. This reduction occurred simultaneously with a decrease in the tax base as the system evolved to full indexation.

The advisability of inducing investments, but at the same time decentralizing them geographically, led to the authorization of the immediate deduction of the present value of the maximum allowed legal depreciation of new investments, except for investments in the three more congested cities. The growth of firms is also encouraged through a provision that allows the immediate expensing of purchases instead of deducting the cost of sales. This measure also simplifies inflation accounting and together with the investment-inducing scheme, aproximates our system to a cash-flow corporate income tax definition. In addition, to promote long-term investments, the period within which firms can deduct losses was extended from five to ten years.

An important device to establish a floor to fiscal evasion is the tax on corporate assets introduced in 1989. This tax does not constitute an additional burden to capital since it can be credited against the income tax. It was intended for those firms that declare zero taxable income or even losses for several consecutive years, sometimes through the manipulation of the income tax base, often through transfer pricing. The new tax also encourages efficiency, since assets with a gross annual yield below 5.7 percent have to be put to a better use or be shed.

The personal income tax rate has also experienced important reductions. The maximum rate was brought down from 55 percent in 1988 to 35 percent in 1990. But the changes in the personal income tax have gone deeper. The rate structure had two main problems. The first is that with partial adjustments to the income ranges through the inflationary years, a considerable percentage of taxpayers were taxed at the highest rate.

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Subject II, "Tax consequences of international acquisitions and business combinations", is also a topic ripe for analysis. Acquiring an existing business entity is rapidly becoming the usual way to enter a market and start doing business in a foreign country. In the European Community, cross-border acquisitions are seen as the appropriate response to meet the demands of the common market. The EC merger directive will partially ensure that such acquisitions are accomplished without adverse tax consequences. Outside the EC, however, international acquisitions often encounter formidable tax difficulties and the risk of a prohibitive tax burden for the purchaser and seller alike.

The five seminars offer a broad and important range of topics. Seminar A, "Advance ruling: practice and legality", will consider a highly significant issue in regard to planning and administration of the law. A topic with possibly far-reaching consequences is considered in Seminar B, the "Branch tax". This tax affects the fundamentals of the existing system of the international taxation of business income and the permanent establishment concept. Seminar C considers the "Tax treatment of international loans", and Seminar D considers "Consequences under tax treaties of operating through a dependent or independent agent", a topic of particular interest for purposes of treaty definitions of permanent establishment. Seminar E, "Mexican tax treaties" overviews the tax treaties of our host. Not long ago Mexico refused to sign a tax treaty. This position has radically altered, and I have no doubt that Mexico will become a prominent member of the international tax treaty network.

The Cancun social programme promises to be very exciting. The golf course is rumoured to be one of the most costly projects of its kind. The nearby archaeological sites are unrivaled, bearing witness to the Mayan civilization, one of the most ancient and important cultures in America. I hope that as many participants as possible will spend the excursion day together and end the Congress in this appropriate and pleasant way.

I welcome you to the 1992 IFA Congress in Cancun!

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in the absence of
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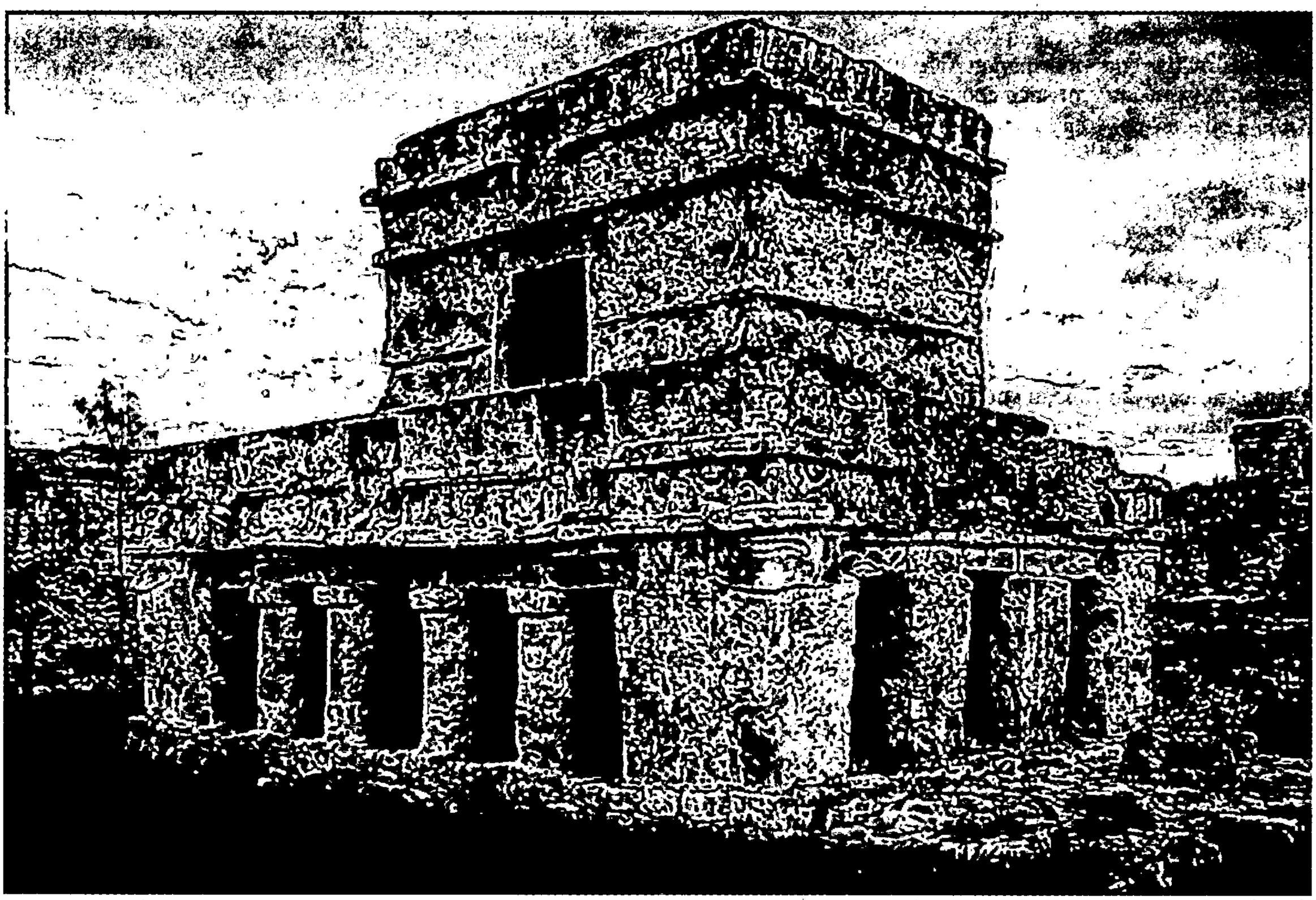
1992 IFA CONGRESS AT CANCUN



Mayan ruins at Tulum

INTRODUCTION

Karl Beusch

Cancun is once again hosting the IFA Congress! It is indeed fitting that a Mexican city was selected for the 1992 Congress -no less to celebrate the fifth centenary of the discovery of America than to pay homage to a country enjoying meteoric development. When the 1974 IFA Congress was held in Mexico for the first time, we were guests in a country with a predominantly agricultural economy. In those days Cancun was a small fishing village. As a result of remarkable and vigorous growth, Cancun has become a flourishing city of 120,000 inhabitants, boasting a highly-developed infrastructure. With its modern deluxe hotels, famous beaches and exotic surroundings, Cancun provides a magnificent venue for a successful congress.

In the first instance I would like to draw your attention to an administrative change in the organization of our Congress. For the first time, the scientific programme will be held for four days, concluding with a Gala Banquet for participants and accompanying persons. An excursion day scheduled for Friday will round out the Congress.

This year's scientific agenda offers a provocative and timely programme. Subject I is entitled "Transfer pricing in the absence of comparable market prices". Until now the arm's length principle has been generally accepted as the international standard to set transfer prices, despite the lingering presence of a number of unresolved issues, for instance where no comparable market prices are available. There have been some discernible signs of a departure from the arm's length method and a move towards profit split methods, the most recent example being the proposed matching transaction method, comparable adjustment transaction method and comparable profit method in the United States. I hope that the Congress Resolutions may make a contribution to resolving some of the difficulties which currently beset the arm's length principle.

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Tax reform in Latin America during the 1980s emphasized broad-based, low-rate consumption taxes over steeply progressive income and property taxes, primarily to simplify the tax structure and facilitate tax administration. While tax reform need not necessarily raise tax-to-GDP ratios, countries that undertook tax reform experienced a higher revenue gain in terms of GDP relative to those that did not. Tax reform issues during the 1990s will include a minimum income tax, alternative corporate taxes (cash flow tax, assets tax), capturing difficult tax bases (financial intermediation, property), environment taxes, extending withholding as a taxing mechanism and tax harmonization.

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Cayman Islands

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EUROPE

Austria

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Since the negotiable certificate is expressed in terms of tax (rather than tax allowances), it may be transferred to any category of taxpayer, notwithstanding differing tax rates.

VI. APPROVAL PROCEDURE

The beneficiation tax package is not granted automatically. Any project seeking to take advantage of these incentives must apply to a special committee appointed by the Minister of Finance, with the concurrence of the Minister of Trade and Industry and Economic Cooperation.[4] The committee has the power to:

- approve any process as a qualifying beneficiation process;
- exclude, if deemed advisable, any qualifying beneficiation process from any other type of state assistance; and
- approve or determine acceptable lead times before the particular assets of a beneficiation process are brought into use.

VII. CONCLUSION

South Africa needs to encourage major new products which add substantial value to inputs, and which are export-oriented. Conventional tax incentives are of limited value in this regard as the available tax base of most companies which might contemplate such investments would be dwarfed by the quantum of tax allowances. Furthermore, offshore companies which may now be evaluating investment in South africa simply do not have a local tax base. Finally, even where there is an adequate tax base, the long lead times inherent in major new projects create a problematic delay between the time costs are incurred and the beneficial effect of tax allowances.

The beneficiation incentives neatly overcome these problems by allowing the tax benefit to take effect in the period the expenditure is incurred, and by allowing the value of the tax benefit to be taken even where no tax base exists, by allowing the tax deductions to be transferred.

There is no doubt that this incentive is a well-designed and, more importantly, an effective measure to encourage cost-effective investment. There are a number of local projects in the pipeline which will proceed as a result of these incentives, and it behoves potential foreign investors to carefully evaluate these measures when considering new investment projects in South Africa.

4. Currently both Ministries are headed by the same individual, Mr Derek Keys, a former prominent private sector businessman.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 104-108 of the January/February 1992 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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ASIA & THE PACIFIC

Brunei Darussalam

BUSINESS PROFILES SERIES:
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IV. RELEVANCE OF MANUFACTURING ALLOWANCES

Since the beneficiation incentive is directly related to tax allowances granted to manufacturers, it is necessary to briefly discuss manufacturing allowances.

For manufacturing machinery and plant (except for mining and farming assets), straight-line depreciation is allowed at a rate of 20 percent per annum for a period of five years. The allowance commences in the year the asset is brought into use. For buildings, straight-line depreciation is allowed at a rate of five percent over a 20-year period. This allowance also commences in the year the asset is brought into use. Expenditures for pre-production interest and related finance charges must be accumulated, and are usually deductible in full when the related manufacturing assets are brought into use. The interest or finance charges must be incurred on loans utilized by the taxpayer for the acquisition, installation, erection or construction of machinery, plant, buildings or improvements used for trade purposes in the period prior to when the assets are brought into use.

V. DETAILS OF THE INCENTIVES

The incentive essentially covers two areas – accelerated tax writeoffs and transferable tax losses. Each is discussed below.

A. *Accelerated tax writeoff*

1. Machinery and plant

The incentive applies to new or unused machinery or plant which is brought into use for the first time by the taxpayer for the purposes of his trade (with the exception of mining or farming), and which is used by him for manufacturing or a similar process which qualifies as a beneficiation process. Additionally, the assets must be brought into use within a period to be determined by the committee.

If these conditions are met, the 20 percent per annum straight-line allowance is granted, but instead of the allowance commencing in the year the assets are brought into use, it is based on expenditure actually incurred. For example, if a plant costing 500 million R will take two years to erect and commission, and 300 million R is incurred in the first year, an allowance of 60 million R (20 percent of 300 million R) may be claimed in that first year.

2. Buildings

Similarly, the incentive applies to new buildings which are brought into use by the taxpayer within the prescribed period, which are wholly or primarily used by the taxpayer for the purposes of carrying on a trade (other than mining or farming), being a manufacturing or similar process, qualifying as a beneficiation process. In this case, the five percent per annum allowance is granted, and like the rule applying to machinery and plant, the allowance may be claimed in each tax year as the expenditure is incurred, even if the building has not yet been brought into use. For example, if a building costing 100 million R will take three years to erect and commission, and 40 million R is incurred in the first year, an allowance of 2 million R (five percent of 40 million R) may be claimed in the first year.

3. Pre-production interest

Interest of this nature (and related finance charges) which relates to loans incurred in financing the plant, machinery or buildings referred to above, and which is incurred before the assets are brought into use may be deducted in full as a tax allowance in the year the charges are incurred.

B. *Transferable tax losses*

By far the most significant innovation of the beneficiation package is the provision which effectively allows the monetary value of the above allowances to be realized currently, even if the investor has no initial tax base. This is achieved by allowing the tax loss to be transferred to another taxpayer.

Where the total beneficiation deductions in respect of the specified machinery, plant, building and pre-production interest exceed a taxpayer's taxable income (creating an assessed tax loss), the Commissioner of Inland Revenue may, upon application:

- disallow the relevant deductions to the extent that an assessed loss would otherwise have resulted; and
- issue a negotiable tax credit certificate to the taxpayer representing the income tax value of the disallowed expenditure (i.e. the tax rate multiplied by the expenditure).

The negotiable certificate may be sold to another taxpayer, and may then be used by the purchaser in payment of income tax (including advance payments in the form of provisional tax).

C. *Planning*

A few planning points arise from the wording of this provision. The fact that the expenditure must exceed taxable income implies that an application for a negotiable certificate may only be made once a project's tax return has been assessed by the tax authorities. It would thus be advisable to submit a tax return as soon as possible after the end of each tax year.

However, this does not mean that no advantage may be taken before assessment. Under the provisional tax rules, a taxpayer is entitled to make bona fide estimates of taxable income. Thus where one is able to predict the level of transferable tax loss in advance, and where the Commissioner indicates in advance his intention to issue a negotiable certificate, the taxpayer may reach an agreement with another company that, once the certificate is issued, it will be sold to such company. The purchaser will then be able to reduce its own provisional tax payments and pay over the tax savings (less any agreed upon margin) to the original taxpayer. The purchaser would in these circumstances probably require some form of indemnity from the taxpayer.

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SOUTH AFRICA:

TAX INCENTIVES TO ENCOURAGE VALUE-ADDED BENEFICIATION[1]

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I. INTRODUCTION

A new tax incentive (Section 37E of the Income Tax Act)[2] has been introduced in South Africa to encourage the beneficiation of raw materials and intermediate products, where such beneficiation adds substantial value. This incentive may be of substantial interest to prospective investors in South Africa, and this article summarizes the provisions, operation and implications of the new legislation.

II. COMMENCEMENT AND DURATION

The beneficiation incentive is a temporary measure, applying only to projects commenced on or after 12 September 1992 which are approved by a special committee on or before 12 September 1993. Although approval must be granted within this time frame, the benefits deriving from the incentive will apply for a longer period, as discussed below.

III. DEFINITION

The incentive only applies to defined expenditure in relation to a beneficiation process, which is any process approved by the committee, whereby any raw material or intermediate product (whether of local or imported origin) is processed to yield an intermediate or final product, if in the opinion of the committee:

- such process will add at least 35 percent in value to the sum of the cost of the material inputs plus the electricity consumed in the process, compared with the ex-factory price of the final product;
- the process will be carried out on a scale which will make it internationally competitive;
- at least 60 percent by value of the final product is exported, directly or indirectly, to countries other than Botswana, Lesotho, Namibia, Swaziland or any country which was formerly part of South Africa; and
- where imported capital goods are to be used, that appropriate use is made of relevant foreign term financing credits.

Specifically excluded from the definition of a beneficiation process are:

- mining operations;
- operations normally carried out in the course of mining operations;
- simple purification processes where the raw materials or intermediate products remain unchanged except for the removal of impurities;[3] and
- physical processes resulting merely in a change of the shape of the relevant product.

Although the incentive was originally intended to encourage the value-added beneficiation of local minerals, it is clear that the scope has been considerably broadened to include a wide range of material inputs, without regard to whether these inputs are minerals or other materials, or locally produced or imported. This is logical since the thrust of the incentive is that value-added activity is paramount, and the source and nature of inputs is immaterial.

1. "Beneficiation" is a South African tax term used to denote the further processing of raw materials or intermediate products.
2. The Taxation Laws Amendment Act 136 of 1991, promulgated on 17 July 1991.
3. An intermediate product in this context is any substance or material which is produced by any person in order to be subject to further processing by any other person.

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The effect of this provision in conjunction with the enactment of the proposed Section 8a KStG would be to treat all interest on German hybrid financing instruments (such as participating loans and silent partnerships), as well as loans exceeding a 1:1 debt-equity ratio which are granted by US persons to German companies, as dividend income subject to source-country taxation of up to 15 percent, rather than interest income, which the treaty exempts from withholding tax. Conversely, if the proposed Section 8a KStG or a similar provision is not enacted, the above treaty provision will have little impact on the tax planning of foreign shareholders of German corporations.

VII. PLANNING IMPLICATIONS

Until the German legislature enacts the proposed Section 8a KStG or a similar provision, foreign shareholders of German domestic companies remain free to finance their companies with loan financing without subjecting themselves to adverse tax consequences as long as the minimum capitalization requirements set by German company law are fulfilled. Foreign shareholders should take advantage of the current state of the law by analyzing their current or planned financing activities in light of the recent court decisions and structuring them accordingly.

Furthermore, all companies which are currently involved in tax audits where the auditors have found hidden profit distributions on the basis of thin capitalization arguments in general and the BMF decree in particular, should challenge the tax assessments arising from these findings. The current legal climate in this area virtually guarantees the success of such challenges.

However, foreign shareholders of German domestic companies should bear in mind the potential for the German legislature to enact an Section 8a KStG either in the form summarized in this article or in a similar form. Although such legislation would presumably provide a transitional period in which German companies could restructure their financial arrangements to meet the statute's provisions, such a statute could cause difficulties for shareholders who must suddenly provide large quantities of additional equity capital. Furthermore, the enactment of this provision would reduce the attractiveness of certain hybrid financing instruments, interest payments on which are dependent upon the turnover or profits of the company, since the proposed Section 8a KStG makes clear that the consideration paid on such financing instruments would, in all cases, be considered hidden profit distributions.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

SEPTEMBER 1992

Restructuring Tax Policy for Economic Growth, Johannesburg (South Africa), 17 September (English):
South African Fiscal Association/International Executive Communications, P.O. Box 91052, Auckland Park 2006, South Africa, Tel.: (11)726 6003, Fax: (11)736 1304.

Die neue europäische Umsatzsteuer (EG '93), München (Germany), 24 September (German):
Internationales Steuersaminar Zürich, c/o Bank Leu AG, z. Hd. Frau Salzberg, Postfach, CH-8022 Zürich (Switzerland), Tel.: (41)1-2192399, Fax: (41)1-2193583.

Doing business and acquisitions in Central Europe, Nijmegen (the Netherlands), 24-26 September (English):
Centrum voor Postdoctoraal Onderwijs/Bureau Symposia, P.O. Box 9049, 6500 KK Nijmegen, Tel.: (0)80 612022, Fax: (0)80 615949.

Tax Effective Management of an International Treasury, London (UK), 30 September-1 October (English):
IBC Financial Focus Ltd., IBC House, Canada Road, Byfleet, Surrey, KT 14 7JL, United Kingdom, Tel.: 71-6374383, Fax: 71-3234298.

OCTOBER 1992

First Caribbean Tax Conference, Aruba, 7-9 October (English):
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, Tel.: 20-6267726, Fax: 20-6209397.

46th Congress of the International Fiscal Association, Cancún (Mexico), 11-15 October (English, French, German, Spanish), main subjects: Transfer pricing in the absence of comparable market prices and Tax consequences of international acquisitions and business combinations.
Congress Secretariat: Mundus Tours de México, Paseo de la Reforma No. 379 – 7° piso, Colonia Cuauhtémoc, 06500 México D.F., Tel.: 5 5255250, Fax: 5 5256306.

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the interest obligation. The Court noted, however, that payment obligations remain legally effective even if they are deemed to violate the above-discussed company law provisions and therefore do lead to the satisfaction of the interest obligation and may not be recharacterized as constructive dividends based on such an argument.

However, the Court left open the question of whether this analysis could also be applied to loans which are granted by the shareholders to a company during a financial crisis and which are to be repaid only with future profits or liquidation proceeds.

4. Abuse of form

The Court also addressed the possibility of basing a hidden profit distribution determination upon the violation of the general abuse of form provisions of the German Fiscal Code (Section 42 AO). The BMF decree took the position that an abuse of form would generally be assumed if a shareholder provided loan financing although the company's equity was less than ten percent of its assets. Although not directly addressing the BMF's use of Section 42 AO as the basis for its decree, the Court pointed out that no German legal provision exists which requires a company to maintain adequate capital on behalf of its shareholders and that companies are generally free to finance their operations with loans rather than equity as long as the minimum capital requirements set by law are fulfilled.

Finally, the Court noted that the provisions of Sections 30, 31, 32a and b GmbHG do not require shareholders to provide their company with a specified amount of capital; they merely show the consequences for shareholders who decide to meet the capital needs of their company through debt financing. The Court did not, however, specifically reject the debt-equity ratio contained in the BMF decree and therefore left open the question of whether such a ratio could be used to determine the existence of an abuse of form.

B. *Supreme Tax Court opinion of 5 February 1992*[8]

In this case, a German GmbH, the shares of which were held by foreign shareholders, experienced a loss in the year under audit of 100,000 DM. The financial statements for the end of the prior year showed assets of 544,000 DM and shareholder equity of 9,000 DM. The local tax office determined, on the basis of the BMF decree, that the GmbH should have had equity capital of at least 54,400 DM (i.e. ten percent of the company's assets) and therefore deemed the difference between this amount and the actual shareholder equity of DM 9,000 as a hidden capital contribution, recharacterized the interest payments owing on the resulting amount as hidden profit distributions and assessed additional tax on that basis.

The Court, in denying the tax assessment determined by the local tax office, reaffirmed the principal that in the absence of actual bankruptcy or debt-composition proceedings only Sections 30 and 31 GmbHG may be applied to determine the existence of a hidden profit distribution and that the treatment of a shareholder loan as "capital replacing" does not lead to the reclassification of the loan as shareholder equity from either an accounting or a tax assessment perspective.

The Court also denied the assumption of an abuse of form on the basis of Section 42 AO by noting that this provision may only be applied to transactions which are purposely structured to avoid a tax law. The Court further held that, in order to apply Section 42 AO, the tax authorities must prove the existence of such a tax avoidance purpose.

Finally, the Court reiterated the findings of previous court decisions that shareholders are free to provide their companies with either equity or debt financing. The Court went beyond the opinion of 14 August 1991, however, by stating that no provision exists in the corporate income tax law which specifies that a company must maintain a certain ratio of equity to debt financing and that an express statutory rule would be necessary to create such a ratio. Through this language, the Court specifically rejected the debt-equity requirements imposed by the BMF decree.

V. ANALYSIS

As seen from the above cases, the court decisions have left open a number of important questions regarding the recharacterization of shareholder debt financing as constructive equity contributions and the related treatment of interest paid on such loans as constructive dividends. The open questions generally relate to whether the tax authorities may recharacterize as hidden profit distributions interest paid on shareholder loans which are granted to the company during a time of financial crisis.

What is clear, however, is that the debt-equity ratio set forth by the BMF decree can no longer be applied as the basis for a determination that a company's use of shareholder financing is an abuse of form within the meaning of Section 42 AO. The tax authorities may, however, still find thin capitalization and therefore hidden profit distributions in individual cases under the abuse of form provisions of Section 42 AO by proving a tax avoidance purpose.

It remains to be seen whether the German legislature will enact a statute to override the latest court decisions and whether such a statute would contain all of the provisions of the most recent Section 8a Corporate Income Tax Act proposal. As noted above, while such a provision has been included in draft amendments of the corporation tax code in the past, none has been enacted to date and the Tax Reform Act of 1992 included no such provision.

VI. IMPACT OF THE US/GERMAN DOUBLE TAXATION CONVENTION

Paragraph 5 of Article 10 (Dividends) of the US/German double taxation treaty provides that:

> income from arrangements, including debt obligations carrying the right to participate in profits . . . that is deductible in determining the profits of the payor may be taxed in the Contracting State in which it arises according to the laws of that State.

8. BFH-Urteil from 5 February 1992, DStR 15/92, at 496.

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on the first category of loans (i.e. profit-sharing or turnover-based loans) will be considered hidden profit distributions whereas, in the second category, only the interest paid on debt financing exceeding a 1:1 debt-equity ratio for the individual shareholder will be considered a constructive dividend. Furthermore, in the latter category, the interest paid on the "excess" debt financing will not be deemed to be a hidden profit distribution if the company can prove that an unrelated party would have granted a loan under the same conditions.

IV. RECENT JUDICIAL HISTORY

A. *Supreme Tax Court Opinion of 14 August 1991*[7]

This decision of the German Supreme Federal Tax Court (*Bundesfinanzhof*, hereinafter "the Court") casts doubt upon the continued application of the BMF decree. In this case, a US parent company converted accounts receivable from its German subsidiary into a long-term loan carrying a market rate of interest. The local German tax office applied the provisions of the BMF decree and reclassified the interest payments as hidden profit distributions because the share capital of the subsidiary was less than ten percent of its total assets. The tax office issued an assessment to collect the tax due on the deemed distribution. A lower tax court, in an interim proceeding, granted the taxpayer's challenge to the execution of the assessment. The Court refused the tax office's appeal and stated that interest payments made by a domestic company to its foreign shareholder can only be deemed to be hidden profit distributions in the following situations:

(1) the interest payments are unreasonable in comparison with those to which unrelated third parties would agree (i.e. the interest payments do not meet an arm's length standard);
(2) the duty to pay interest does not actually exist under the provisions of German civil law;
(3) the interest payments do not lead to a payoff of the interest obligation; or
(4) the use of debt financing must be considered an abuse of form under Section 42 AO.

The Court's application of each of these situations to the case under consideration is presented below.

1. Non-arm's length interest payments

The first situation noted above involves the application of an arm's length standard which will generally be applied in all cases involving transactions between related parties and will not be limited to loans granted to corporations by foreign shareholders. Since the loan arising from the converted accounts receivable was subject to a market rate of interest, the arm's length principle was not applied to recharacterize the interest payments as hidden profit distributions.

2. Interest obligation in violation of civil law

In regard to the second situation, the Court noted the possibility of reclassifying an interest payment on a shareholder loan as a hidden profit distribution if, under civil law, the loan obligation is deemed not to exist. This is generally assumed to be the case if the shareholder loan must be treated as a so-called "capital-replacing loan" under the provisions of Section 32a and b or Sections 30 and 31 of the Law Regarding Companies with Limited Liability (*Gesellschaft mit beschränkter Haftung Gesetz*, hereinafter GmbHG).

Article 32a and b GmbHG provides that a shareholder who grants loan financing instead of equity at a time when the company is threatened by bankruptcy or debt-composition proceedings may not claim repayment of the loan during the course of those proceedings. The German tax authorities have generally interpreted these provisions as allowing a reclassification into equity capital of any loan granted by a shareholder during a financial crisis of the company, with the reclassification continuing even after the crisis has passed. The Court held, however, that Section 32a and b can only be used to recharacterize shareholder loans into equity financing if the company actually enters bankruptcy or debt-composition proceedings and that, in the absence of such proceedings, a hidden profit distribution can only be found under the provisions of Sections 30 and 31 GmbHG.

Articles 30 and 31 GmbHG prohibit a GmbH from distributing assets to shareholders if those assets are needed to preserve the company's share capital. If such payments are nevertheless made, they must be returned to the company. Therefore, if a company's share capital has been decreased through losses and a shareholder provides loan financing instead of additional equity, such loan financing may not be repaid to the shareholder because the funds are needed to preserve the company's share capital. The German tax authorities have also interpreted these provisions as authorizing the recharacterization of a shareholder loan as equity capital.

The Court specified, however, that the treatment of a shareholder loan as "capital replacing" under the provisions of Sections 30 and 31 GmbHG does not lead to the reclassification of the loan as equity financing but rather simply provides that, in times of financial crisis, the claims of the shareholders for the repayment of loans will be subordinated to the claims of the company's unrelated creditors. The Court further noted that whether the payment of interest on shareholder loans can be treated as a return on capital must be addressed separately from the question of whether the shareholder loan itself will be treated as hidden equity capital. Therefore, even if a shareholder loan is deemed to be "capital replacing," interest paid on the loan may not automatically be treated as a hidden profit distribution.

The Court's reasoning in both of the scenarios under situation 2 leads to the conclusion that once the company's financial crisis has passed, a recharacterization of loan financing as "capital replacing" will terminate.

3. Non-satisfaction of the interest obligation

The Court also addressed whether a hidden profit distribution could be assumed in the case where the payment of interest on a shareholder loan is void as a violation of Sections 30 and 31 GmbHG and therefore does not lead to the satisfaction of

7. BFH-Beschluß from 14 August 1991, Der Betrieb 1991, at 2317.

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infusion of capital. The first case arises where the financing of the company, because of legal or economic reasons, should have been made in the form of a capital contribution. The BMF decree cites as an example of this case, the situation where a shareholder gives the company a loan but also provides a guarantee, in effect giving the loan an obligatory character to replace lacking share capital.

The second case noted in the BMF decree is where the loan agreement has been structured in such a manner that it must be deemed to be an abuse of form under Section 42 of the German Fiscal Code (*Abgabenordnung*, hereinafter AO). In the BMF's opinion, an abuse of form will generally exist where the agreement has been structured to avoid corporate income taxation and will generally be assumed in the following situations:

(1) The shareholder grants a loan to the company at the same time that the company reduces its capital in order to repay a shareholder's capital contribution and without sufficient economic reason.

(2) The shareholder grants a loan to the company although the share capital is disproportionate to the company's level of assets. Such a relationship will generally be assumed if the amount of equity capital is substantially less than the equity capital which is generally held by other companies in the same branch of industry and will particularly be found where the amount of equity capital does not exceed ten percent of the company's assets.[4]

The BMF decree also states that consideration paid for such recharacterized debt financing will be considered a hidden profit distribution. For purposes of these provisions, equity capital is defined as paid-in authorized share capital adjusted for capital and revenue reserves, retained profits or loss carryforwards and the net income or loss for the year.[5]

B. *Proposed Section 8a Corporation Tax Law*

The BMF decree was issued largely to overcome the tax administration's unsuccessful attempts to introduce thin capitalization legislation. Although a draft of such legislation was introduced as early as 1979 and as late as 1989, no thin capitalization provision has been passed to date and no such provision was included in the Tax Reform Act of 1992, which was enacted in February of this year. The following is an unofficial translation of the latest thin capitalization legislation as proposed in 1989:

Section 8a Shareholder Loan Financing[6]

(1) Consideration paid for loan financing given to a company subject to German unlimited corporate income taxation by a shareholder not entitled to the imputation system and who, at some point during the fiscal year, held a substantial interest in the company's authorized share capital, is deemed to be a hidden profit distribution,

1. if consideration has been agreed upon that is not computed as a certain percentage of the shareholder loan; or

2. to the extent that the borrowed capital, at some point during the fiscal year, exceeded that part of the company's equity capital at the end of the previous fiscal year which is equivalent to the shareholder's interest in the company's authorized or subscribed share capital, unless the company proves that an unrelated party would also have provided the loan financing upon the same conditions.

Sentence 1 is also to be applied to consideration for borrowed capital which the company has received from a person who is related to a shareholder and is not entitled to the imputation system.

(2) Equity capital is the subscribed capital less unpaid contributions plus capital reserves, revenue reserves, retained earnings and net income for the year less accumulated loss carryforwards and net losses for the year (Sections 266(3)(A) and 272 Commercial Code) as shown in the commercial balance sheet at the end of the previous fiscal year; special entries with an equity portion (Section 273 Commercial Code) are not to be included. If the company participates in the subscribed capital of another company, the company's equity capital must be reduced by the book value of that participation.

(3) A substantial participation is assumed if the shareholder holds more than 25 percent of the authorized capital of the company. This also applies if the shareholder holds more than 25 percent together with other shareholders with whom he has entered into an association for reasons of the joint administration of the participation or with other shareholders who control him, who he controls, or who are controlled together with him. A shareholder with a less than substantial participation who, alone or with other shareholders with whom he pursues similar interests, can dominantly influence the company is treated as a shareholder with a substantial participation.

This provision is drafted to apply only to those shareholders (and persons related to them) who are not entitled to the benefits of the imputation tax system (i.e. foreign shareholders and certain tax-exempt domestic shareholders). Thus, the provision applies to German stock corporations (*Aktiengesellschaften* or AGs) and corporations with limited liability (*Gesellschaften mit beschränkter Haftung* or GmbHs) which are subject to unlimited German taxation but not to representative offices, branches or permanent establishments of foreign companies. Furthermore, the provision only applies to shareholders who held a significant interest in the company at some point during the fiscal year. A substantial interest is generally defined as an interest of at least 25 percent in the authorized or subscribed share capital (whether held alone or together with related parties) but may also be found where a shareholder holds an interest of less than 25 percent if he exercises dominant control over the company (e.g. through voting rights).

The types of shareholder loans which will be recharacterized as equity financing under the latest proposed Section 8a KStG include profit-participating or turnover-based loans and fixed-interest loans which exceed the shareholder's interest in the company's equity capital, such interest being proportionate to the shareholder's interest in the company's authorized or issued share capital. Therefore, all interest paid

4. *Id.*, at 374.
5. *Id.*
6. *Gesetzentwurf des deutschen Bundestages* from 18 September 1989.

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THIN CAPITALIZATION IN GERMAN TAX LAW

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I. INTRODUCTION

The German imputation tax system, which imposes different tax rates on retained and paid-out earnings, grants domestic shareholders a tax credit for the amount of corporate income tax paid on distributed profits. Foreign shareholders are generally not entitled to this tax credit, so the imputation system creates a great deal of incentive for German companies with foreign shareholders to distribute profits in the form of interest on loans (which are deductible business expenses) rather than as dividends (which are not deductible). Foreign parent companies therefore finance their German subsidiaries as much as possible through the use of shareholder loans rather than equity capital. Since such arrangements reduce the amount of tax which the German tax authorities can collect, these authorities have developed thin capitalization rules which recharacterize shareholder loans as equity capital and the interest paid on such loans as hidden profit distributions.

The tax authorities have, however, met with a number of obstacles in this regard mainly due to the lack of clear legislative action, as will be seen below. The purpose of this article is to summarize the current legal situation regarding the classification of interest on shareholder loans as hidden profit distributions and to identify the planning implications imposed by the current situation while keeping in mind the potential for the future enactment of thin capitalization legislation by the German lawmakers. Unless and until the German legislature passes legislation to counter the recent court decisions regarding thin capitalization, the current legal situation should increase the attractiveness of hybrid financing instruments and therefore the opportunities for tax planning.

II. LEGAL PROVISIONS

German tax law generally provides that foreign persons and corporations are subject to German taxation in regard to interest income if the debtor is resident in Germany.[1] Therefore, as a general rule, German authorities are entitled to assess tax on interest paid by domestic corporations on loans provided by their foreign shareholders and parent companies.

Interest is not, however, subject to withholding tax under German tax law[2] and most, if not all, of the double taxation treaties concluded by Germany provide that interest income may only be taxed by the country in which the recipient has his residence. In principal, therefore, interest paid by a German corporation on loans provided by its foreign shareholder(s) will not be subject to withholding tax; such tax will only apply if the interest is reclassified as a hidden profit distribution. The issue which therefore arises is under what circumstances the German tax authorities may reclassify payments of interest on shareholder loans as constructive profit distributions. The current status of this issue, from both legislative and judicial perspectives, is discussed below.

III. LEGISLATIVE HISTORY

A. *Minister of Finance Administrative Decree of March 1987*[3]

In March 1987, the Federal Minister of Finance (*Bundesminister der Finanzen*, hereinafter BMF) issued an administrative decree (hereinafter the BMF decree) which specified two cases in which a shareholder loan will be reclassified as an

1. Sec. 49(1) para. 5 Einkommensteuergesetz (Income Tax Law, hereinafter "EStG").
2. Sec. 43 EStG.
3. Schreiben des Bundesministers der Finanzen betr. Verdecktes Nennkapital, Bundessteuerblatt (BStBl.) 1987, at 373.

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A. *Computation of a report to a resident business enterprise: Gross Taxable Income:*

1. Domestic Source
a. domestic-source periodic income:
(300.00) (interest) + (125.00 x 20%) (dividends)
+ (20.00) (royalties): 345.00
b. domestic-source capital gains income: – 8.00
total domestic source income (345.00) + (– 8.00) = 337.00

2. Foreign-Source Income:
(110.00) (interest) + (150.00) (dividends)
+ (4.00) (capital gains) = 264.00
Total gross taxable income: 601.00

Deductible Expenses:
1. Traceable Costs:
(8.00) (costs associated with trading royalties)
+ 5.00 (costs associated with trading
foreign equities) = 13.00

2. Deductible Untraceable Costs:
(125.00) (interest expense)[23]
+ (55.00) (general management costs) = 180.00

Total Deductible Expenses: 193.00

Net Taxable Income:
(601.00) – (193.00) = 408.00

Creditable Taiwan Taxes: 51.00
for determining foreign tax credit:
1. gross foreign income: 264.00
2. traceable expenses / foreign-source income:
(costs associated with trading
foreign equities): 5.00
3. non-traceable expenses allocated to foreign-source income:[24]
(180.00) (non-traceable expenses)
x [(264.00) (gross taxable foreign-source income)
- (5.00) (traceable foreign source expense)
/ {(601.00) (gross taxable income)
- (13.00) (traceable expenses)}] = 79.89
net foreign income:
(264.00) – (5.00 + 79.20) = 179.80

Report to Resident Business Enterprise:
[Note: Investor has held one unit, or 25 percent of the fund, during the entire year. Each of the relevant figures must therefore be divided by four.]

Total Taxable Income: 100.25
Creditable Taiwan Taxes: 12.75
Net Foreign Taxable Income: 44.95
Creditable Foreign Taxes: 5.00

B. *Computation of report to a resident individual: Gross Taxable Income:*

1. Domestic-Source Periodic Income:
(300.00) (interest) + (125.00) (dividends)
+ (20.00) (royalties) = 445.00
2. Domestic-Source Capital Gains Income: – 8.00
Deductible Expenses:
1. traceable costs (from trading copyrights):[25] – 8.00
2. non-traceable costs (allocable to trading copyrights):
(180.00) (non-traceable expenses))
x [(12.00) (royalty income minus
traceable expenses)[26]
/ (437.00) (gross taxable income)
– (13.00) (traceable expenses)][27] = 5.04
Total Deductible Expenses: 13.04
Net Taxable Income [less taxable capital gains]:
(445.00) (gross periodic income) – [13.04] = 431.96

Report to Resident Individual:
Note: Investor has held one unit, or 25 percent of the fund, during the entire year. Each of the relevant figures must therefore be divided by four.]

Taxable income: 107.99
Taxable Capital Gains [loss]:[28] $ – 2.00
Creditable Taiwan Taxes: $12.75

C. *Computation of report to each non-resident investor:*[29]

20% periodic income:
(300.00) (taxable interest)
+ (20.00) (royalties)
+ (25.00) (dividends in approved companies) = 345.00
35% periodic income:
(100.00) (dividends) = 100.00
capital gains income: – 8.00
allocable shares of income:

[Note: Investor has held one unit, or 25 percent of the fund, during the entire year. Each of the relevant figures must therefore be divided by four.]

(345.00)(20% income) x .25 = 86.25
(100.00)(35% income) x .25 = 25.00
tax due:
21.56 + 8.75 = 30.31
creditable share of Taiwan tax: 12.75
Report to Non-Resident:
Tax Due: 17.56
Capital Gains income: $ – 8.00

23. In this example, no interest or management expense is being disallowed which relates to earning of tax-exempt income. However, as discussed earlier, a percentage if these costs could be disallowed based upon the ratio of tax exempt income to total income.
24. For purposes of brevity, this example does not allocate non-traceable costs on the basis of economic income, but on the basis of taxable income only. Including tax-exempt income would be preferable from a tax policy viewpoint. If tax-exempt income were to be included, additional information relating to tax exempt income, etc. would have to be recorded by the fund.
25. Only expenses relating to income from rent and royalty investments are allowable as deductions to individuals.
26. This calculation could be made using total income, and not simply total taxable income. Because interest expense and management costs are generally not allowable to individuals, in this case the difference would be quite minor.
27. For purposes of this calculation, the full amount of capital loss on copyrights was allowed.
28. This amount must be reported separately, because individuals must aggregate all of their taxable capital gains and deduct all of their taxable capital losses, but only to zero.
29. Though both types of non-resident investor would get the same report, a non-resident business enterprise would be taxed at a rate of 25% on net capital gain, while a non-resident individual would be taxed at 20%.

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allowing the investor to step up its basis on the unit by the net increase in amount of undistributed economic income by the fund since the date the investor purchased the unit. Perhaps the fund could be required to provide to its investors information regarding the amount of undistributed economic income held by the fund on a day-by-day basis.

However, once again, substantial distortions would remain with this system. Whether it should be adopted would depend on factors unique to Taiwan.

(3) *Bearer units*

Bearer units could pose additional substantial problems from a recordkeeping perspective. One way of solving these problems would be to keep records for each individual unit. In the case of transfer of any unit which did not involve a redemption, the transferor would be required to inform the fund of a transfer, so that tax could be assessed on the unit holder at the moment of transfer. If no notice were made, the old unit holder of record would continue to be liable to tax.

(c) *Non-tax considerations and the effect on administration*

Non-tax considerations in regulating investment funds may make tax administration much simpler. Restrictions on types of investments or on the incurring of costs can reduce the difficulty of making reports of income to investors. For example, the allocation of interest expense among different types of income would become unnecessary if funds were not permitted to borrow.

The assessment and reporting of unrealized, taxable gains for closed-end funds would be much simpler if such funds were prohibited from investing more than a small percentage of their capital in assets for which there was no easily discernable fair market value. Restricting the use of bearer units would also ease administrative problems.

H. *Other methods of taxing investment funds*

There are a number of other methods of taxing investment income earned through an investment fund. These methods, broadly speaking, treat the fund as a taxpayer. Distributed income is not taxed at the fund level but is taxed as income to the investor. Double taxation is avoided by using different techniques. Among those most frequently used are: (1) taxing the fund at the top marginal personal rate,[19] and allowing a deduction at the fund level for distributed income, (2) taxing the fund at a zero percent rate if all income is distributed, and levying a tax at the top marginal personal rate if income is retained, (3) taxing the fund at the top marginal personal rate, and allowing a credit at the investor level for taxes paid at the fund level on distributed income.

By treating the fund as a taxpayer, the character of income as well as its timing, cannot easily be preserved. Some systems preserve some characters of income, such as allowing special "tax-exempt interest" distributions or "foreign-source income" distributions which differ from each other in tax treatment at the investor level. However, such systems, by preserving some income characters, are essentially looking through the fund for purposes of these characters. In effect, they are a hybrid between the reporting system discussed above, and the treating of the fund as a taxpayer.

Most tax jurisdictions have adopted variations on the "fund as taxpayer" system for at least certain types of investment funds. However, with the advent of modern computers, the simplifications inherent in these systems seem no longer desirable or necessary, at least with regard to open-end funds. If the simplification systems proposed above for closed-end funds appear not likely to work in the Taiwan situation, a variation of the "fund as taxpayer" system could be applied for closed-end funds.

APPENDIX

Example of reporting system for transparent investment fund
Investment Fund Activity over Year 1:

[Note: a fund would have to make these computations on a daily basis in order to take account of investors whose proportionate interests shifted during the year. This example assumes no change in proportionate interests.]

Taxable interest income on Taiwan bonds:	300.00
Dividends on stock in taxable Taiwan companies:	100.00
Dividends on stock in approved Taiwan companies:	25.00
Royalties on Taiwan copyrights:	20.00
Taxable capital gains on Taiwan copyrights:[20]	10.00
Interest income on foreign bonds:	110.00
Dividends on foreign companies:	150.00
Capital gains on foreign equities:	15.00
Interest expense:	125.00
Special costs associated with trading Taiwan copyrights:	8.00
Special costs associated with trading foreign equities:	5.00
General management costs:[21]	55.00
Capital losses on Taiwan copyrights:	18.00
Capital losses on foreign equities:	11.00
Taiwan withholding taxes:[22]	51.00
Foreign income/withholding taxes paid:	20.00

Assume that there are four investors, each of which holds 25 percent of the units in the Investment Trust. The four investors are (1) a resident business enterprise, (2) a resident individual, (3) a non-resident business enterprise and (4) a non-resident individual.

19. Or at some other high rate designed to eliminate any tax incentive for the fund to retain income.
20. As noted above, apparently, capital gains tax on virtually all domestic assets can easily be avoided merely by placing the asset in a company and trading the company stock instead. In the future, however, Taiwan may wish to make some or all of its domestic assets amenable to income tax on capital gains.
21. Presumably other trading costs could be specifically allocated. The two special costs listed here are only to provide examples.
22. This assumes that entities paying periodic income to a Taiwan investment trust would withhold at rates prescribed for domestic enterprises.

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unit may be equal to an amount greater or lesser than the value of its proportionate interest in the underlying fund assets. Therefore, when an individual investor sells a unit, it can be difficult for the fund to determine and report to an investor her or his share of any unrealized, taxable capital gains in the underlying fund assets.

Both of these problems can be reduced. First, provisions could be made requiring the prompt reporting of unit ownership changes to a closed-end fund. Second, the fund could be required to make approximations of unrealized taxable capital gains. However, a more general simplification could be adopted for closed-end funds.

(a) *Simplification of reporting system for closed-end funds*

(1) *Periodic imputation*

The problems of taxing closed-end funds could be further addressed by introducing two simplifications. First, the actual assessment of the investors' proportional amount of fund income could be made not on a daily basis, as with open-end funds, but on a less frequent basis. One way of accomplishing this would be to impute income to investors only when the fund made actual distributions to investors, or, if no distributions are made, on a particular set day or days during the year. In this way, income for the previous period would be imputed only to investors of record on that date.

By imputing income to investors of record only a few times per year, some actual investors would not be taxed at all, while others would be taxed on income which was properly attributed not to them, but to others. The market would, however, make some adjustment to the value of a unit for the tax liabilities (or benefits) attached to a unit. But because the level of tax paid on investment income varies based on the characteristics of the taxpayer, this "market adjustment" would never be exactly equivalent to daily reporting. Therefore, the adjustment could result in a tax paid that is higher or lower than would have been paid if accurate reporting had been made.

Whether this simplification makes sense would depend on factors unique to Taiwan, particularly the ability of a closed-end fund to keep accurate track of its investors. However, it would seem likely that this would not be too great a problem. Either way, this simplification would still leave a number of major distortions.

(2) *Capital gains assessment*

Periodic imputation will not solve the problem of assessing the fund's unrealized, taxable capital gains when an investor sells a unit. And, because capital gains taxes should only be paid when there is a realization event, they should not be assessed on a periodic basis when income is assessed. There are two basic ways of resolving this problem through approximation, without imputing unrealized gains held by the fund to the investor. The first is simply to tax capital gains on the sale of the unit itself. The second is to exempt from tax any capital gains on the sale of the unit.

The first method threatens to double tax (1) all income realized and retained by the fund, and (2) all tax-exempt unrealized capital gains income. Under the second method, all unrealized taxable capital gains income will escape tax. Under the first method, double taxation of income retained by the fund could be reduced if the fund could report to the investor the amount of net economic income earned by the fund, minus any distributions to investors, during the period in which the investor held the unit. The investor could then step up the basis in the unit by that amount. This could conceivably be done by having the fund report the amount of retained net economic income per unit on a daily basis; the investor could then calculate the difference, if any, by which it could step up its basis.[18] Again, because the fund would be reporting a distribution of net economic income, the character of income would not be preserved. And unrealized tax-exempt capital gains income would be subject to tax, an amount which would also differ depending on the characteristics of the taxpayer. These two problems could be quite substantial.

(b) *Selecting a method for approximation*

(1) *Considerations*

In choosing which simplification to make, a tax administration would have to determine which would combine simplicity of administration with the closest approximation of the correct result. If a fund were to have few investments in taxable capital gains assets, a situation likely to arise in Taiwan, the second approximation above, i.e. not taxing capital gains at all, would be both the simplest to administer and relatively accurate. If a fund invested relatively more capital in assets which give rise to taxable capital gains, another simplification route should probably be taken.

(2) *Defining two types of closed-end funds*

One possibility would be to have two different tax systems for two different types of closed-end funds. The first type would consist of funds which invested less than a certain percentage of their capital in assets on which capital gain was taxable to resident investors. There would be no attempt to capture any unrealized taxable gains on the sale of a unit.

In the case of all other closed-end funds, there could be two choices. The decision as to which to use would depend on the various factors involved. One possibility could be simply to require the fund to make daily approximations of the value of its unrealized, taxable gains. The fund might also be required to make the necessary calculations of the investor's liability, based upon the recorded date of purchase and sale of a unit. Which, if any, of these requirements would be practicable would depend on factors present in Taiwan, including the types of investment such funds normally made, and the consequent ability to estimate unrealized gains.

Another possibility would be to require the investor to pay a capital gains tax on the sale of its unit, as was discussed above. Also as discussed above, a possible reduction in any extra tax the investor might pay could be implemented by

18. The difference between retained net income on the day of purchase and the retained net income on the day of sale.

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ed a portion of her or his investment (a "unit"), the fund would also calculate and add the amount of unrealized capital gains income to the investor's income. A yearly report would be sent to the investor, and to the tax authorities, on the investor's earnings for that year.

The categories of income used above are illustrative only, although they are based on the current tax system in Taiwan. It should be remembered that a reporting system of taxation is designed to retain all the relevant categories of income, etc. If those categories change, it is simple to require the fund to adapt to those changes.

F. *Excise taxes*

Various excise taxes, such as the securities transfer tax and the land value increment tax, are not income tax deductible. Because currently in Taiwan gains or losses on the sales of securities and land are tax exempt, they can be disregarded for purposes of assessing income tax. If, however, capital gains tax is reintroduced on securities, or introduced on land, and any excise tax is retained and made income tax deductible, then the full amount of the gain (or loss) would be reported as income or loss, and excise taxes would be reported to be used by unit holders as deductible expenses.

G. *Practical issues of administration in a reporting system*

Treating individual investors as if they had invested directly, rather than through a fund, would require that the fund keep records of the relevant categories of income and other characteristics discussed above. The reason for the multiplicity of such reporting can easily be seen: Taiwan treats different types of income differently, both for the same taxpayer and among different taxpayers. Depending upon the type of organization and the fund, these reporting problems can present lesser or greater difficulties.

1. Open-end funds

Open-end funds, which are currently the most common throughout the world, continuously issue and redeem units in the fund. Fund units are not normally traded among investors; they are issued and redeemed only by the fund itself. Because of this, the fund is normally able to keep an account for each of its investors. Actual distributions of earnings to investors may take place at any time.

In order to operate an open-end fund, it is necessary for the fund to be able to calculate the market value of its holdings at any time; only in this way can it determine issue and redemption prices. As a result, open-end funds normally invest only in assets for which fair market values can be easily, reliably and regularly ascertained. In most instances, open-end funds must invest only in different types of securities which are regularly publicly traded.

In general, open-end funds: (1) are aware of each transaction involving units, (2) invest predominantly in listed securities and (3) calculate daily fund income expenses, deductions and the value of fund investments. Because the fund must keep records of these transactions for financial purposes, reporting such transactions by relevant categories to taxpayers on a timely basis should be relatively easy. The fund would be required to keep an account for each investor. That account would be adjusted daily to indicate the investor's proportionate income as realized by the fund.

In the example above, the type of calculation which was made over one year would be made each and every day. The investor's account would be changed to reflect the daily activity of the fund and of the investor's fund investment. Whenever a unit was liquidated, the fund would add to the investor's account the proportionate amount of the fund's unrealized taxable capital gains income which had accrued since the purchase of the unit. For this reason, the fund would have to keep a daily record of its unrealized taxable gains.

The purchase or liquidation of a unit would also change the proportionate interest of each investor to the fund's earnings. This would also be reflected in how the allocation of fund income was made in the investors' accounts. A relatively simple computer programme could easily keep track of such information, and could report it not only to the investor, but to the tax authorities as well.

One potential difficulty with this system is that units could be transferred from one investor to another without the investor actually redeeming the units. In such instances, the transferor would be required to inform the fund, or would continue to be treated for tax purposes as the holder of the unit. In order to create an additional incentive for reporting transfers (so as to reduce the deferral of tax on gains) Taiwan property law could be changed to require tax reporting as a prerequisite to complete legal transfer of unit interests.

The system as proposed above is similar to the French system of apportioning and taxing income from open-end trust investment funds.[17]

2. Closed-end funds

The reporting of fund income to investors is more problematical with closed-end funds. Closed-end funds issue a fixed set of units, and investors trade units with other investors. The value of a unit is fixed not by evaluating the underlying assets of the fund, but by the price offered by another investor.

The allocation of income to a unit in a closed-end fund can raise substantial administrative difficulties. It frequently takes time for a fund to register a new owner of a unit. Because of this, it could be more difficult to determine exactly who owns any one unit at a particular time. Second, because it may not be necessary for a closed-end fund to calculate with great accuracy its net asset value on a frequent basis, a closed-end fund may invest in types of capital assets upon which a taxable gain has accrued, but which would be difficult for the fund itself to evaluate. In addition, because the fund does not issue or redeem units, the market value of a

17. It is different, however, from the system of taxation of income from open-end investment companies, or the SICAV (societe d'investissment a capital variable).

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classes of taxpayers, and report the information to them each year. An example of such a reporting system is provided as an appendix.

Some of the different income characters, deductions and credits listed below may appear relatively trivial in the Taiwan tax context. However, they may not be trivial in the context of tax systems of other emerging capital markets, or even in Taiwan, if substantive income tax changes are enacted in the future. The relevant characters of income and deductions under current Taiwan law would include:

Income:

a. Taxable Taiwan-source income
   1. taxable interest income[8]
   2. non-tax-preferred dividend income[9]
   3. tax-preferred dividend income
   4. non-tax-preferred dividend income from exempt companies[10]
   5. tax-preferred dividend income from exempt companies
   6. gross royalties and rents[11]
   7. taxable capital gains income minus taxable capital losses[12]

[The following tax-exempt Taiwan-source income categories would be needed if non-traceable costs, such as interest expense and general management fees, were to be allocated to different characters of income on the basis of economic income, and not simply taxable income. This issue is addressed below in the allocation of non-traceable costs.]

b. Tax-exempt Taiwan-source income:
   1. tax-exempt interest income
   2. tax-exempt capital gains income minus tax-exempt capital losses on the sale of land
   3. tax-exempt capital gains income minus tax-exempt capital losses on the sale of securities

c. Non-Taiwan-source income:
   1. interest, royalties, rents, capital gains minus capital losses
   2. dividend income[13]

Deductions:

a. interest
(interest expense relating to investment in each of the above categories)
b. management fees
(management fees relating to each of the above categories)

Credits:

a. creditable Taiwan withholding taxes on periodic income
b. potentially creditable foreign withholding taxes.

Under the reporting scheme, the tax system would be indifferent to actual distributions of earnings to investors. From a tax perspective, it would not matter if the fund retained earnings or paid them to investors; all earnings would be attributed to investors as earned. Any distribution of earnings or retention by the fund would be after tax.

E. *Disposition of interests*

Under current Taiwan rules, capital gains resulting from the sale or exchange of most non-operating income-producing investments (mostly securities and land) is exempt from income tax, although the gains or transfer may be subject to other taxes. However, capital gains on the sale of some assets, such as buildings,[14] copyrights and leases, apparently are still subject to income tax. It is important to note that individuals and profit-making enterprises treat capital gains differently under the income tax.

In addition, it is our understanding that the capital gains income tax exemption for securities may be changed or eliminated sometime in the future. It is also our understanding that the land value increment tax may be repealed, and that an income tax on capital gains on the sale or exchange land may be introduced in its place.

The vast majority of investment funds worldwide are organized as open-end funds.[15] When an investor liquidates her or his interest in such a fund, he or she does so by redemption, that is, the fund purchases her or his investment. As a result of the redemption, the investor receives value equivalent to her or his proportional interest in the underlying assets of the fund. If any of these underlying assets include unrealized but taxable gains, the investor should be assessed for its interest in those unrealized but taxable capital gains.[16]

This problem could be solved by the fund determining the value of the investor's share of those assets on which gains are taxable. This would be based on the difference between the value of those assets at the time of investment and at the time of liquidation of the investment. As with the case of reporting of those gains which have been realized at the fund level, such reports would have to be made by character of income. These amounts could be added into the taxpayer's other categories of income.

As discussed above, the fund would make daily calculations of income, etc. for each investor. When an investor liquidat-

8. All classes of taxpayers pay tax on taxable interest income.
9. Dividends from companies in which investment has not been approved by the Taiwan government are not tax preferred for non-resident investors. This category does not include dividends paid by companies which are tax exempt.
10. While a business enterprise normally excludes 80 percent of the value of a dividend, dividends from tax-exempt companies are fully taxed.
11. Apparently a business enterprise may deduct all relevant expenses, while individuals apparently may deduct expenses only up to the total amount of income from these sources.
12. Apparently a business enterprise treats gains and losses as ordinary income and losses, while an individual may deduct losses up to the total amount of taxable capital gains income.
13. If an indirect foreign tax credit were allowed, a separate dividend category would be required. Taiwan does not currently allow indirect tax credits. Other categories may be necessary depending on how the foreign tax credit limitation is determined in Taiwan.
14. For a building to produce solely investment income, presumably it would have to be let out on a net operating lease basis.
15. In closed-end funds, investors sell or exchange their investment with other investors, not with the fund itself. See the discussion below regarding reporting for closed-end funds.
16. It should also be true that the interest of an investor in a closed-end fund should reflect accrued but unrealized gains at the fund level.

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ability to deduct taxable capital losses, and apparently may deduct expenses relating to the trading of such assets.

While domestic business enterprises are normally allowed to deduct expenses relating to interest and dividend income, resident individuals normally are not. However, apparently, both resident individuals and resident profit-seeking enterprises are allowed to deduct expenses relating to the receipt of rents and royalties, although deductions for resident individuals are limited to total income from these sources.[6] For resident individuals, all non-Taiwan-source income is exempt. It is presumed, therefore, that no deductions are allowed with respect to any foreign-source income, including foreign-source rents and royalties.

For resident business enterprises, foreign-source income is taxable; presumably expenses incurred to earn such income are deductible. However, because a foreign tax credit is allowed against foreign-source income, it is further presumed that the credit is subject to a limit, determined in part by expenses properly allocated against the foreign-source gross income. Because of the need to calculate the amount of allowable foreign tax credit, the determination of whether expenses are properly allocated to foreign-source income is important to resident businesses as well as to resident individuals.

Taiwan withholding taxes are creditable and refundable against all taxable resident income. The foreign tax credit, however, is presumably subject to a limitation as discussed above, and is not refundable.

(b) *Non-resident individuals and businesses*

In general, non-resident individuals and business enterprises are taxed on a gross basis, and are not permitted any deductions.[7] Non-residents are, however, allowed to deduct taxable capital losses against any taxable capital gains, up to the amount of total taxable capital gains.

3. Characters of income and tax neutrality

In most cases the different treatments afforded to different characters of income unnecessarily violate the SHS principle of tax neutrality, and are themselves sub-optimal. As discussed above, we do not approve of such avoidable tax incentives. In the case of some others, such as special treatment afforded to foreign income, it is not so clear which treatment most closely comports with tax neutrality. However, until tax neutrality is introduced fully into the treatment of investment income in Taiwan, if the taxation of investment income is to be the same regardless of whether the income is earned directly or through an investment fund, the character of income must be maintained.

B. *Timing of inclusion of income*

The timing of the inclusion of income and the allowance of deductions can also be crucial to the accurate assessment of tax. The deferral of the receipt of gross income, or the acceleration of deductions or credits, provides interest-free loans to the taxpayer. Because of loss carryforward and carryback limitations, adjusting the timing of income and deductions by character may also defer or reduce taxes owed. Therefore, if the taxation of investment income is to be the same regardless of whether the income is earned directly or through a fund, the timing of income recognition must be the same.

C. *Characteristics of the taxpayer*

The character and timing of income affects different taxpayers with identical amounts of investment income differently. As has been noted above, tax will vary depending upon to which of the three classes of taxpayer the investor belongs. However, even if there were only one class of taxpayer, for example, resident individuals, the amount of tax on a given amount of investment income would vary from resident individual to resident individual. This is because resident individuals pay tax based upon the application of graduated tax rates on total net taxable income. Among different residents, the marginal rate of tax on any one part of a taxpayer's investment income will vary depending upon the other income of the taxpayer.

Because net taxes due on investment income vary based upon characteristics of the taxpayer, it is impossible simply to tax the fund in lieu of the investor and still maintain tax neutrality. Because different types of income are taxed differently, neutrality can only be maintained if the character and timing of the income is not changed. Therefore, if investment funds are to be taxed neutrally, the character and timing of the investment income, and the characteristics of the taxpayer, must remain the same, regardless of whether the income is earned through direct investment or through one or another type of fund.

D. *The fund as a "reporting system"*

The most accurate and direct way of preserving the character and timing of investment income and the characteristics of the taxpayer is essentially to "look through" the particular fund vehicle and to tax investors as if they had invested directly. In this way, all relevant characteristics of income and of the taxpayer would be preserved.

Under such a system, the fund vehicle would act only as a reporting mechanism; it would inform each investor of its proportional share of the character and timing of its investment income. The taxpayer would then treat the different characters of income as if realized directly. If the taxpayer were a resident, it would include such income in its tax return along with other types of income and pay tax accordingly. If the taxpayer were non-resident, it would pay the appropriate flat rates on taxable Taiwan-source income.

In order to have a complete tax correspondence between investing individually and investing through a fund, the fund would first have to record each of the relevant characters of income on a daily basis. The fund could then aggregate taxable income, deductions and credits for each of the three

6. It is not clear as a statutory matter whether deductions such as interest expense or investment manager fees are allowed against non-operating income (e.g. a net operating lease). However, this paper assumes that they are so deductible.

7. In some instances, credits are properly allowable. See the example of credits for withholding taxes on periodic income paid to the fund by Taiwan domestic sources.

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III. TAXATION OF INVESTMENT FUNDS

A. *Character of income, deductions and credits*

Many factors affect investment income's overall tax burden. Those factors include the character of the income, of deductions and of credits, certain characteristics of the taxpayer and the timing of the receipt of the income by the taxpayer. As discussed above, not every type or "character" of income is treated identically in Taiwan. This is also true of the subset of investment income, where different tax treatment is afforded income depending, e.g. on geographical source, or on whether the income is periodic or capital in nature. In addition, depending on the characteristics of the taxpayer, some characters of income are taxed at lower rates, or are not taxed at all.

Also often depending on the characteristics of the taxpayer, some types of income are taxed based upon their gross amounts, while certain deductions are allowed only against other types of income. Credits are also permitted to be taken against some types of income, and not others. Another way of describing the tax treatment of deductions and credits would be to state that they have different characters as well. Of course, if all net economic income were fully taxable at the same rates, it would be unnecessary to worry about income characters; the tax system is concerned with the particular character of income, deductions and credits only if they are taxed on a different basis. In Taiwan, the tax treatment of investment income of different characters differs for four different types of investor taxpayers. These different types are: resident individuals, resident profit-seeking enterprises, non-resident individuals and non-resident profit-seeking enterprises.

1. Gross income

(a) *Taiwan-source income*

Among the most important types of Taiwan investment income are those which are fully tax exempt. Perhaps the most common form of tax-preferred income is capital gains on the transfer of securities[3] and of land. It should be noted that while a transfer tax is assessed on land and on securities, in neither case is the tax an income tax. Properly, these levies are excise taxes only, assessed on sales price or value (although the land transfer tax is adjusted for purchase price and inflation). However, for all four classes of investors, capital gains from these transfers are income tax exempt. The effect of excise and transfer taxes will be discussed further below.

Other types of capital gains are not tax exempt.[4] For resident individuals and business enterprises, gains are taxed in the same manner as other income. However, non-resident business enterprises pay tax on such capital gains at a rate (25 percent) different from that which they pay on other forms of income. Non-resident individuals pay at their normative rate of 20 percent. There are also certain types of Taiwan-source interest income which are tax exempt to all classes of investors. Apparently the only obligation which pays tax-exempt interest in which a Taiwanese investment fund could invest is an original issue discount (OID) bond. The OID portion of the interest on such bonds is income tax exempt, although an excise tax is levied on the income amount.

Treatment of Taiwan-source dividends varies by characteristics of the investor. For resident individuals Taiwan-source dividends are taxed at regular marginal income tax rates. For resident business enterprises, however, 80 percent of Taiwan-source dividends are exempt from tax, provided that the company paying the dividend is not itself tax exempt. In general, both non-resident individuals and business enterprises are taxed at the rate of 35 percent on dividends. However, if the dividend is from an investment approved by the government, the tax for both classes of non-resident investor is reduced to 20 percent.

(b) *Foreign-source income*

For resident individuals, and for all non-residents, foreign-source income is fully exempt from Taiwan income tax. Only for the class of resident business enterprises is foreign-source income taxed, at regular rates, although a foreign tax credit is allowed.[5]

2. Deductions and credits

(a) *Resident individuals and business enterprises*

Resident individuals and business enterprises are not permitted to deduct any capital losses on any property which is exempt from the capital gains tax. Resident individuals are not permitted to deduct any expenses relating to the earning of capital gains income, whether gains on the property are taxable or exempt. The position for business enterprises in Taiwan, however, is not clear. Most tax jurisdictions restrict deductions for expenses, including interest expense, incurred to finance assets which produce tax-preferred income. There are a number of ways in which jurisdictions disallow such expenses. One of the most common is "tracing", where a particular expense is directly traced to the production of the exempt income, and is then disallowed. However, due to fungibility of money, it is particularly difficult to trace interest expense. This problem is compounded when a particular asset (such as stock) earns both taxable income (such as dividends) and exempt income (such as capital gains). A common way of resolving this problem is to disallow interest expense by a percentage equal to the total amount of tax-exempt income divided by the total amount of income, both exempt and taxable. A further discussion of this issue can be found below.

Although resident individuals are not permitted to deduct any expenses relating to taxable capital gains, Taiwan law appears to allow resident individuals to deduct taxable capital losses, but only up to the amount of total taxable gains. Resident profit-making enterprises are not limited in their

3. Although an exemption from capital gains tax for securities has been adopted, it is not certain that this exclusion will be permanent.
4. Apparently, capital gains on virtually all domestic assets can easily be avoided merely by placing the asset in a company and trading the company stock instead.
5. See discussion below on the importance of foreign tax credits.

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Although this paper examines the case of Taiwan, we believe that the general theory discussed, as well as many of the specific problems and solutions, would apply to other emerging capital markets as well.

II. BASIC TAX POLICY CONSIDERATIONS

For most tax policy theorists the principal goal in designing any aspect of an income tax system is neutrality. There are, however, a number of different types of "tax neutrality". The first, and perhaps the most important, is complete "market neutrality". Most economists would agree that the most market-neutral income tax base would approximate the Schanz-Haig-Simon ("SHS") definition of income, i.e. the change in a taxpayer's net worth plus consumption, measured over a particular period of time.[2] While a tax on such a base might not be neutral with regard to the choice between savings and consumption, it would be neutral across different types of savings and consumption. In theory, a neutral tax would allow the market to allocate resources throughout the economy in the most efficient manner.

However, every income tax system, Taiwan's included, varies substantially from the taxation of an SHS base. Some variations are made largely to simplify administration. For example, tax systems normally require a "realization event" before increases (or decreases) in the capital value of an asset are subject to taxation. Often other variations are implemented in order to effect a particular government policy or purpose. Such tax expenditures, though largely frowned on by economists, are present in virtually every tax system. Still more variations are the unintended consequences of failures to implement tax laws as drafted.

As will be noted below, Taiwan's income tax system already includes a number of variations from the SHS definition of income. At least some variations appear to stem from each of the three considerations discussed above. Although we generally approve of reform efforts designed more closely to approximate the SHS definition of income, we accept that it is beyond the scope of this paper to recommend changes in the current substantive Taiwan income tax law other than those necessary to implement a rational system of investment fund taxation. Because of this limitation, we confine ourselves to recommendations for implementing a market-neutral system of taxing the income of investment funds only in the general context of the existing Taiwan system of taxing income from investment.

For the purposes of this paper, we therefore define a "market-neutral" system of investment fund taxation to mean simply that all investment income should be treated similarly, regardless of whether an investment is made directly (meaning not through an investment fund) or through a fund. This also means that tax treatment should be identical regardless of the legal structure of the fund itself. Funds can be organized as partnerships, companies and trusts; tax treatment should not vary with the nature of the vehicle.

This definition of neutrality, though more limited than the SHS- related definition, still has potential for important economic gains to the economy. First, such neutrality would make it more likely that investment capital would be mobilized and allocated either directly or through funds on the basis of market efficiency, not because of tax differences. Second, such neutrality would tend to reduce tax planning transaction costs, by reducing the need to examine and implement investment schemes based on tax-created rent seeking. Although these costs might be difficult to measure, it is our opinion that they may be substantial.

Third, and perhaps of equal importance, is that equality of treatment among different forms of investing capital makes future tax reform that much easier. A change in the method of taxing investment income can then be more easily applied to all forms of such income, regardless of whether the investment is held directly or through a fund. In addition, the actual investment fund vehicle may take a number of different legal forms, including trusts, partnerships and corporations. Therefore, in order to complete the definition of neutrality, all investment funds, regardless of their legal form, should be subject to the same substantive tax regime.

There are various non-tax policy issues of interest to governments regarding the operation of investment funds. In general, these issues relate to two basic goals. The first has already been alluded to, and involves "regulated" investment funds. These include government policies designed for the protection of fund investors specifically and of investors in financial markets in general. Many countries, including the United States and many European countries, extend special tax treatment to "regulated" investment funds only. In general, based on our definition of neutrality, we would counsel against this choice. Any policy decision to favour "regulated" over unregulated investment funds would best be implemented through non-tax means.

The second issue involves the carrying out of various government economic policies through tax-favoured investment policies. We have made reference above in general to the use of tax incentives to influence economic behaviour, something which Taiwan's tax system already apparently does. As we will illustrate below, some of these incentives affect investment income. However, some countries also provide specific tax incentives for those funds which limit their investment activities to specific sectors of the economy. Examples include "venture capital" funds, which frequently are restricted to investments in start-up or small-scale industry; and "technology" funds, which frequently are restricted to investments in companies engaging in high technology research or manufacturing.

In keeping with our earlier comments on the SHS income tax base and market-neutral systems, we do not advocate the creation of tax preferences for funds with special investment portfolios. Given that Taiwan is rethinking a tax system for investment funds, the Ministry of Finance has the opportunity to avoid the complexity and distortions arising from using the tax system to achieve non-tax goals. This paper will attempt to present a single, uniform system of taxation for all investment funds, regardless of how they are organized or the nature of their portfolio, which reduces tax differences between investing through funds and investing directly.

2. An in-depth discussion of income concepts and related references can be found in D. Bradford, *Untangling the Income Tax* (1986).

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TAIWAN:

TAXATION OF INVESTMENT FUNDS IN EMERGING CAPITAL MARKETS: THEORY, PROBLEMS AND SOLUTIONS IN THE CASE OF TAIWAN

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I. INTRODUCTION

An investment fund ("fund") is a financial intermediary consisting of capital pooled from different investors. Funds provide four potential benefits over the investment of capital directly. First, funds give relatively smaller investors the opportunity to diversify their investment risk. This is because a fund can normally make far more diversified investments with its larger pool of capital than could an individual with her or his relatively smaller amount of capital. Second, funds allow relatively smaller investors great economies of scale in securing expert financial management of their investments. This is because the fund need hire only a single manager for the entire amount of pooled capital. Third, funds benefit the economy as a whole by providing a vehicle for mobilizing capital from a sector of the public which might not otherwise invest.

The fourth potential benefit, which is closely related to the first three, is that funds can be made subject to rules and regulations designed to protect fund investors by reducing their risk of loss. Such rules and regulations can include mandatory diversification of fund investments, the employment of a clearly qualified expert manager, fiduciary requirements and guarantees and detailed disclosure rules. Other rules regarding the type and manner of fund investment in listed securities are often included for the protection of all capital market investors. Funds subject to such rules are often termed "regulated" investment funds, and may form a subset of all investment funds. By having such designated regulated funds, the benefits of risk diversification, economies of scale and mobilization of capital can be maximized.

The topic of this paper is "investment" funds, i.e. funds which mobilize capital solely for investment, and not for management, purposes. Therefore, the discussion will be limited to funds whose activities are limited to the buying, selling or holding of properties which produce "non-operating income". That term is defined under Taiwan tax law to include most equity and debt securities, certain income-producing intangibles such as copyrights or patents, and real property.[1] Income from such property includes dividends, interest, royalties, rents and capital gains; such income will be referred to as "investment income". This definition of investment income is not too dissimilar from that found in most emerging economies.

This paper also assumes that an investment fund will either have no operating income, or that such operating income will be segregated as income of the fund management. This is also the assumption of most financial intermediary regulations in emerging economies. However, even if the financial intermediary regulatory framework does not require segregation of fund operating income, such separate accounting can be required for the purposes of income taxation. The issue of fund management income and expenses will be addressed further below.

1. Information regarding the Taiwan income tax law comes from the International Bureau of Fiscal Documentation, *Taxation in Taiwan* (Amsterdam: IBFD, July 1991), and Ministry of Finance, *Taxation in the Republic of China* (1991).

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TABLE 16

The effects of tax harmonization in the EC on the incentives to invest in the EC, Japan and the USA

	Dom.	Retained Earnings		New Equity		Debt		Average	
		Res	Source	Res	Source	Res	Source	Res	Source
Abolish Withholding Taxes within the EC									
EC	5.7	7.3	7.3	5.9	5.9	5.9	5.9	6.4	6.4
Japan	6.5	7.3	8.7	7.7	9.5	7.6	6.5	7.6	8.2
USA	5.9	7.3	7.4	6.7	8.3	6.1	6.9	6.7	7.5
USA and Japan Abolish Withholding Taxes to the EC									
EC	5.7	7.3	7.3	5.9	5.9	5.9	5.9	6.4	6.4
Japan	6.5	7.3	8.7	7.7	7.3	7.6	5.5	7.6	7.1
USA	5.9	7.3	7.4	6.7	6.5	6.1	6.2	6.7	6.2

ness of the two countries as locations for EC investment. It would therefore seem the most likely response to any perceived need to promote inward investment. Whether there would be a need to take such a measure is dependent both on developments within the EC and the competitive pressures to reduce rates. Part II indicated that harmonization of rates and bases in the EC would have little effect on the required rates of return if the harmonization were to current average levels. Abolition of withholding taxes – a more likely scenario, would have a significant effect. Part III indicated that evidence for competition even within the EC is at best inconclusive. Abolition of withholding taxes between the three regions is probably desirable on the grounds of improving the allocation of capital in the global economy, but it does not seem that competitive pressures will force such a change to take place.

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TABLE 14

Required pre-tax rates of return. Actual inflation

	1980	1985	1991
Belgium	6.1	5.9	5.4
Denmark	5.2	5.3	5.8
France	6.8	6.6	5.4
Germany	7.3	7.4	5.8
Ireland	4.7	4.8	5.1
Italy	4.0	5.0	5.6
Luxembourg	7.1	7.0	6.3
Netherlands	5.8	5.4	5.7
Portugal	4.1	4.3	5.2
Spain	6.0	5.8	6.3
UK	1.7	5.7	6.0
EC Average	5.3	5.7	5.7
Japan	6.9	8.1	6.5
USA	6.3	7.3	5.8

Based on no personal taxes, actual inflation rates, weighted average of three forms of finance and three types of asset and a 5% real interest rate.

TABLE 15

Required pre-tax rates of return over time. Inflation of 3.1% in all countries at all times

	1980	1985	1991
Belgium	5.9	5.8	5.4
Denmark	5.3	5.3	5.8
France	6.4	6.4	5.4
Germany	7.7	7.3	5.8
Ireland	4.9	4.9	5.1
Italy	5.4	5.6	5.8
Luxembourg	6.7	6.7	6.4
Netherlands	5.8	5.4	6.0
Portugal	6.3	6.3	5.7
Spain	5.4	5.4	5.9
UK	4.5	5.6	5.9
EC Average	5.8	5.9	5.7
Japan	7.3	8.0	6.5
USA	6.8	7.3	5.9

Based on no personal taxes, 3.1% inflation, weighted average of three forms of finance and three types of asset and a 5% real interest rate.

from this rate, so the results are fairly similar. Hence tax wedges increased to 1985, then fell to 1991.

The conclusions of this section are therefore not clear-cut. Taking into account the major changes within domestic structures during the 1980s, the region where the largest reductions in tax rates might have been expected – the EC – has seen the smallest reductions. In Japan and the United States the overall fall during this period is made up of first a rise and then a fall.

C. *Conclusion: might the United States and Japan respond to reforms in the EC?*

The discussion and evidence presented in Part III of this report suggest that it is unlikely that the United States and Japan would respond to corporation tax reforms in Europe by making major changes to the domestic structure of their own corporation taxes, even if the European reforms had a substantial impact on cross-border investment incentives. But the evidence in Part II also suggested that the apparently more far-reaching reforms in Europe – harmonizing tax rates and tax base – actually had little impact on investment incentives: what impact they did have seemed to favour the United States. So the prospect of a tax war between the three main trading blocks of the EC, the United States and Japan seems remote.

However, the most important of the European reforms analysed in terms of its effects on cross-border investment incentives – and also the one which has already been agreed by member states – is the abolition of withholding taxes between parent and subsidiary. The extension of this has been proposed by the Ruding Committee. This reform had the effect of making the EC a more attractive place for cross-border investment made by parent companies resident within the EC, which, in turn, may have an effect on the extent of outward investment flows from the EC to Japan and the United States.

This raises the possibility that *if* the other two countries were to respond in a competitive manner, in an attempt to maintain the flow of inward investment, the most effective response would be also to abolish withholding taxes on dividends (and possibility interest and royalties) paid by subsidiaries located in Japan or the United States to parent companies resident in the EC.

Table 16 illustrates the effect of such a change. As a source for investment from the EC, both countries would become substantially more "competitive". For investments financed by new equity, whereas before EC firms would have required a rate of return of 9.5 and 8.3 percentage points when investing in Japan and the United States, respectively, abolition of withholding taxes would give required returns of just 7.3 and 6.5 percentage points. For debt-financed investments, the reductions in effective tax rates are smaller, but still significant – EC firms in Japan would require a return of 5.5 percent as opposed to 6.5 percent, and in the United States a return of 6.2 percent as compared to 6.9 percent before. Overall, falls of 1.1 and 1.3 percentage points would be experienced by EC firms investing in Japan and the United States.

Such a move would have relatively little impact on revenue for either Japan or the United States, would leave their domestic tax structures and rates unchanged, and yet as Table 16 shows, would have a significant impact on the attractive-

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TABLE 12

Value of depreciation allowances for industrial buildings discounted at the nominal interest rate with a 5% real interest rate

	Actual inflation			Constant inflation of 3.1%		
Country	1980	1985	1991	1980	1985	1991
Belgium	0.55	0.55	0.67	0.63	0.63	0.67
Denmark	0.36	0.49	0.53	0.53	0.53	0.53
France	0.30	0.44	0.52	0.52	0.52	0.52
Germany	0.20	0.58	0.71	0.26	0.53	0.72
Greece	0.39	0.66				
Ireland	1.00	1.00	0.81	1.00	1.00	0.80
Italy	0.32	0.47	0.33	0.62	0.62	0.41
Luxembourg	0.33	0.37	0.35	0.45	0.45	0.35
Netherlands	0.57	0.63	0.49	0.66	0.61	0.48
Portugal	0.19	0.20	0.33	0.45	0.45	0.52
Spain	0.46	0.55	0.49	0.67	0.67	0.57
UK	0.67	0.57	0.37	0.80	0.62	0.45
EC Average	0.45	0.53	0.51	0.60	0.60	0.55
Japan	0.26	0.35	0.50	0.32	0.32	0.48
USA	0.25	0.51	0.35	0.41	0.52	0.38

EC average based on the 11 EC countries, excluding Greece.
Figures based on depreciation allowances, discounted by the nominal interest rate.

TABLE 13

Value of depreciation allowances for machinery discounted at the nominal interest rate with a 5% real interest rate

	Actual inflation			Constant inflation of 3.1%		
Country	1980	1985	1991	1980	1985	1991
Belgium	0.89	0.89	0.96	0.92	0.92	0.96
Denmark	0.73	0.89	0.85	0.83	0.89	0.85
France	0.72	0.80	0.89	0.84	0.84	0.89
Germany	0.75	0.82	0.86	0.80	0.80	0.87
Greece	0.68	0.86				
Ireland	1.00	1.00	0.80	1.00	1.00	0.80
Italy	0.58	0.71	0.75	0.81	0.81	0.81
Luxembourg	0.80	0.82	0.88	0.86	0.86	0.89
Netherlands	0.76	0.91	0.85	0.84	0.90	0.86
Portugal	0.65	0.67	0.76	0.86	0.86	0.86
Spain	0.73	0.83	0.76	0.92	0.92	0.82
UK	1.00	0.85	0.77	1.00	0.88	0.81
EC Average	0.78	0.84	0.83	0.88	0.88	0.86
Japan	0.73	0.78	0.85	0.77	0.77	0.84
USA	0.68	0.69	0.84	0.81	0.70	0.85

EC average based on the 11 EC countries, excluding Greece.
Figures based on depreciation allowances, discounted by the nominal interest rate.

by one percentage point or more between 1980 and 1985, but then fell substantially by 1991 to be around half a percentage point below the 1980 level. Taken together with the slight rise in the average EC rate, this means that the effective tax rates moved substantially closer during the 11 years in question.

However, these results have been obtained by imposing *actual* inflation rates. Given the pervasive and complex effects of inflation on the effective rates of corporate taxation, this may simply reflect convergence of the inflation rate experience across these countries. In 1980, Japanese inflation was 6.2 percent, which fell to 2.2 percent in 1985 and rose to 2.5 percent in 1991. The comparable figures for the United States were 10.8, 3.3 and 4.3 percent, whereas the averages within the EC were 13.1, 6.7 and 4.7 percent. To identify the convergence of tax structures, it may therefore be more revealing to abstract from differences in economic conditions by assuming a constant inflation rate over the period. This is done in Table 15, which holds inflation constant at 3.1 percent throughout the time period and across all countries.

Within the EC, the broad outlines of the conclusions drawn using actual inflation rates remain valid. The average EC tax rate has essentially remained constant, with marginal increases to 1985 and falls to 1991. Although the size of the effects of the UK tax reform were exaggerated by using actual inflation, movements in the same general direction can still be discerned, with a rise in the tax wedge amounting to around 1.5 percentage points over the decade. However, the German reforms prove to have resulted in an even more substantial fall with constant inflation than with actual inflation. Substantial convergence has taken place within the EC, although removal of the effects of differential inflation shows that the tax rates were not that far apart even in 1980.

For Japan and the United States, as with the EC, the higher inflation prevalent in 1980 results in a lower tax wedge than when inflation is at 3.1 percent: thus higher inflation tended to reduce the required rate of return in 1980. For the other two years examined, the actual inflation was not that much different

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TABLE 11

Typical depreciation rates on industrial buildings and machinery

Country	1980		1985		1991	
	Builds	Mach	Builds	Mach	Builds	Mach
Belgium	10DB%x7 then 5%SL	40%DBx2 then 20%SL	10DB%x7 then 5%SL	40%DBx2 then 20%SL	10DB%x7 then 5%SL	40%DBx2 then 20%SL
Denmark	6%SLx10 then 2%SL	22.5%x1 then 30%DB	6%SLx10 then 2%SL	25%x1 then 30%DB (indexed)	6%SLx10 then 2%SL	30%DB
France	5%SL	27.8%DBx7 then 11.1%SL	5%SL	27.8%DBx7 then 11.1%SL	5%SL	35.7%DBx5 then 5.5%SL
Germany	2%SL	20%DBx5 then 10%SL	5%SLx8 then 2.5%SLx5 then 1.25%SL	20%DBx5 then 10%	10%SLx4 then 5%SLx3 then 2.5%SL	30%DBx4 then
Greece					8%SL	20%SL
Ireland	100%	100%	100%	100%	50%x1 then 4%SL	50%x1 then 2.5%DB
Italy	7%SL	15.5%SL	7%SL	15.5%SL	6%SL	17.5%DBx3 then 10%SL
Luxembourg	4%SL	20%SL	4%SL	20%SL	4%SL	30%DBx2 then 20%SL
Netherlands	6.6%DB	25%DBx3 then 12.5%SL	6.6%DB	25%DBx3 then 12.5%SL	6.6%DB	25%DBx3 then 12.5%SL
Portugal	4%SL	20%SL	4%SL	20%SL	5%SL	31.25%DB
Spain	7.5%DB	20%DB	7.5%DB	20%DB	7.5%DB	20%DB
UK	50%x1 then 4%SL	100%	25%x1 then 4%SL	50%x1 then 25%DB	4%SL	25%DB
Japan	3.5%DB	23%DBx9	3.5%DB	23%DBx9	6.6%DB	30%DBx9
USA	3.5%SL	18.8%DBx2 then 12.5%SL	ACRS[1]	ACRS[1]	3.2%SL	28.6%DBx3 then 9.1%SL

Key: SL - Straight line. DB - Declining balance. 10%DBx7 then 5%SL means 10% declining balance depreciation for seven years followed by depreciation at 5% straight line until the asset is fully depreciated.

Note: 1. The Accelerated Cost Recovery System in the USA during the mid-1980s involved complex depreciation provisions; typical straight-line depreciation rates for machinery were 8% in the first year, 14% in the second, 12% in the third, 10% for the next three years and 9% for the next four years. Industrial buildings might typically be depreciated at 6% for 10 years and 5% thereafter.

Source: Information provided to the Ruding Committee by national tax authorities.

average figure within the EC. For example, the largest change in the tax wedge takes place between 1980 and 1985 in the United Kingdom when the tax wedge went from being strongly negative to being positive. This reflects the ending of 100 percent initial depreciation allowances in the United Kingdom, which resulted in a tax regime which effectively subsidized marginal investments. The other large change took place in Germany, where more generous depreciation allowances were combined with a reduction in tax rates, sharply cutting the marginal effective tax rates. The net effect of these two tax reforms has been to converge the marginal effective tax rates within the EC. Hence there does seem to have been some convergence of effective tax rates, but there has been little sign that they have also fallen.

If there has been no downward pressure within the EC, it would be surprising had there been such pressure outside of the EC, as for the reasons described above, pressures might be expected to have been highest within the EC. However, in both Japan and the United States the tax wedge first increased

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TABLE 9

Taxes on corporate income as a percentage of total taxation (including social security contributions)

Country	1965	1970	1975	1980	1985	1989
Belgium	6.2	6.8	7.2	5.7	6.4	6.7
Denmark	4.5	2.6	3.1	3.2	4.9	4.2
France	5.3	6.3	5.2	5.1	4.5	5.5
Germany	7.8	5.7	4.5	5.5	6.1	5.5
Greece	1.9	1.7	3.5	3.8	2.7	4.6
Ireland	9.1	8.8	4.8	4.5	3.2	3.4
Italy	6.9	6.5	6.3	7.8	9.2	10.1
Luxembourg	11.0	19.3	15.7	16.5	18.2	17.3
Netherlands	8.1	6.7	7.7	6.6	7.0	7.7
Portugal						3.9
Spain	9.2	8.2	6.9	5.1	5.2	8.6
UK	7.1	9.1	6.7	8.3	12.6	12.3
EC Average	7.0	7.4	6.5	6.6	7.3	7.5
Japan	22.2	26.3	20.6	21.8	21.0	24.4
USA	15.8	12.7	10.8	10.2	7.1	8.5

Source: OECD (1990)
Notes: Corporation taxes are defined in detail by OECD (1990) item 1200. Note that this includes (i) local corporate taxes and (ii) part of corporation tax which is imputed to individuals to credit against personal taxes. Differences between countries arise for a number of reasons other than differences in the form of taxation; the Table is therefore designed to permit a comparison over time rather than between countries.

TABLE 10

Overall (national and local) Corporate Tax rates

Country	1980	1985	1991
Belgium	48	45	39
Denmark	37	50	38
France	50	50	34/42
Germany	61.7/44.3	61.7/44.3	56.5/44.3
Greece		49	46(41)[1]
Ireland	45	50(10)[2]	43(10)[2]
Italy	36.3	47.8/36	47.8/36
Luxembourg	45.5	45.5	39.4
Netherlands	46	42	35
Portugal	51.2/44	51.2/44	39.6
Spain	33	33	34
UK	52	40	34
EC Average	46.0	46.9	40.1
Japan	52.0/42.0	55.4/45.4	50
USA	49.2	49.5	38.3

Notes: 1. A lower tax rate (40% in 1991) applies where companies are quoted on the Athens stock market.
2. Figure in brackets is the tax rate on manufacturing industry. Where two rates are given the former reflects the tax rate on retentions, the latter the tax rate on distributions. The average and standard deviations for the EC are calculated on the basis of retained profits.
Source: OECD (1991) and information provided to the Ruding Committee by national tax authorities.

Denmark, the restriction of allowances in the Netherlands and the reduction in additional first year allowances in Spain.

The other aspect of broadening the tax base is to change depreciation rates to more closely reflect true economic depreciation rates. Table 11 gives the depreciation rates applied to machinery and buildings in 1980, 1985 and 1991. This suggests that this form of base-broadening has not been universal. Indeed, in France, Germany, Luxembourg, Portugal and Japan the changes between 1985 and 1991 have been in the opposite direction, with accelerated depreciation rates. The restriction in the size of depreciation rates has been a feature of the Irish and British tax systems. In the United States, allowances were first explicitly increased (the Accelerated Cost Recovery Scheme) then restricted once again.

However, in one important respect the figures in Table 11 are misleading. With the exception of Denmark in 1985, countries did not index depreciation allowances for inflation. Hence the higher the rate of inflation, the lower the real value of any allowances. If the reforms of depreciation allowances were simply to compensate for the change in inflation rates, then the reforms to the tax base in the 1980s might indicate very little. Tables 12 and 13 therefore present the present discounted value of the allowances, based on a five percent real interest rate with both actual and a typical inflation rate.

These figures indicate that the real value of US depreciation allowances for buildings did indeed at first rise and then fall, although for machinery the position is less clear-cut; the decline in inflation rates led to the real value of depreciation allowances increasing over the period in question. Within the EC, there was a slight increase in the generosity of allowances up to 1985, whereas after that time there was little change for both sorts of assets. In Japan, there was a fairly substantial increase in the value of allowances for both assets in both sub-periods in question. If the reforms of the 1980s can be characterized in terms of tax reductions and base-broadening, it would seem that the base-broadening was not generally in the main tax code, but rather in the restriction of special reliefs.

Both the reduction in tax rates and the slight narrowing of the tax base suggests that there has been a reduction in average tax rates paid by companies. However, this raises the question once more of what has happened to tax incentives over the period – measured by the required return or the marginal effective tax rate.

Table 14 gives the required pre-tax rates of return necessary to earn five percent after corporation tax. The numbers are calculated for zero-rated personal taxpayers. Hence the tax wedge is the required pre-tax rate of return minus five percent. In Table 14, the actual inflation rates in each country in 1980, 1985 and 1991 are applied.

For the 11 EC countries for which data is available there has been a slight increase in required returns during the first half of the decade, followed by stability. However, closer examination shows that the situation is rather more complicated. In fact, the largest changes in tax wedges have taken place in only a few countries, and these countries drive the overall

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TABLE 8

Changes in corporation tax regimes since 1984

Country	Base Broadening	Reduction of Rates	Changes in treatment of dividends	Other
Belgium	1989/90	1989/90	From partial shareholder relief to classical, 1990	
Denmark	1990/91	1990/91	Move to partial shareholder relief, 1991	
France		1989 1990	Lower rate for retained profits, 1989.	Incentive for new firms, 1989
Germany	1990		Limits to	regional incentives, 1988
Greece		1988		
Ireland	1990	1988 1989		
Italy		1989		
Luxembourg		1987 1988 1989 1990		Withholding taxes on flows to other EC countries, 1991.
Netherlands	1988	1988		
Portugal	1989	1989	From split rate to partial shareholder relief, 1989	Removal of various incentives, 1989
Spain				Limits to investment credits, 1989
UK	1986	1986 1991 1992		
Japan		1988 1989 1990	From split rate to classical, 1990	
USA	1987	1987		Removal of various investment tax credits

Source: OECD (1991).

The main question for the purposes of this report is whether these reforms are consistent with the hypothesis that they occurred through a process of tax competition – or at least did not exacerbate existing differences.

A first step in answering this question is to examine corporation tax revenues. Recalling that one of the arguments for expecting tax competition was that it is likely that tax would be shifted from capital onto less mobile factors such as labour, it might therefore be expected that revenue from corporation taxes may have declined as a proportion of total tax revenue, as competitive forces have increased. Table 9 presents the proportion of total taxation accounted for by taxes on corporate income for the EC countries and Japan and the United States every five years from 1965.

In the EC and United States corporation tax provides less than ten percent of total revenue, whereas in Japan the figure is between one-fifth and one-quarter of total revenue. Comparisons between countries are subject to problems such as the size of the corporate relative to the unincorporated sector. What is important here, however, is that in both Japan and, on average in the EC, corporate taxes have retained their importance as sources of revenue. This is surprising if one considers that competition is more likely to occur in the EC, since the additional costs of investing across borders are likely to be less than between Japan, the United States and the EC.

However, such comparisons obviously depend on the level of profits as well as the structure of taxation; the end of the 1980s was a period when many economies were growing strongly, and so corporate tax revenues were high. There are also problems with interpreting the data when there is a change in the tax system – revenue may start being classed as income tax rather than corporation tax. In addition, if there was competition, then those countries which succeeded to restructure their tax system in order to attract inward investment, then it is possible that a successful policy may yield higher corporation tax revenues.

It is therefore also necessary to examine the tax structures in detail. Table 10 looks first at corporate tax rates in 1980, 1985 and 1991. Between 1985 and 1991 every country bar Italy and Spain reduced the corporation tax rate. This reversed a trend in the first half of the 1980s to increase corporate tax rates slightly. This data is therefore consistent with the belief that in the latter half of the 1980s competition between countries became more intense and so they reduced their tax rates. However, it is more likely that this would have occurred in the process of competition over "paper profits" than over inward physical investment. It is also consistent with numerous other explanations.

Another aspect of the tax reforms since 1984 has been a broadening of the tax base. This has often meant the ending of special investment allowances and accelerated depreciation if companies invest in certain regions or types of assets. Examples are the ending of the investment reserve system in

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reasons why competition between countries to attract inward physical investment may not be very strong.

The first group of reasons concerns the responsiveness of investment flows to differences in effective tax rates. Physical capital is not very mobile. Once a factory has been set up, together with a local labour force and transport arrangements for raw materials and finished goods, it would be very costly to shift location. This cost could easily outweigh the tax benefits of shifting location. Shifting location would be even less likely if it were suspected that the tax advantage would only be temporary because of a response by the government of the less tax-favoured country.

Of course, these arguments are weaker for some types of activity – for example financial services, which may be relatively mobile. This leads to the possibility that countries may maintain higher tax rates on relatively immobile capital than on more mobile capital, and this is reflected in existing incentives for financial services: the Dublin Docks scheme,[18] the Luxembourg unit trust legislation and the Belgian coordination centres. However, it is also worth noting that these schemes exist in relatively small countries. The gain to larger countries introducing such schemes may be much smaller because they will lose more revenue from existing activity by implementing a more generous tax structure.

Even if differences in taxation do affect location decisions, it is not clear that countries would compete to attract inward direct investment. There are at least four reasons why this may be so.

First, many countries operate a credit system for taxing foreign- source income. If the parent company resides in such a country, then reducing the statutory tax rate in the country in which the activity takes place will serve mainly to shift tax revenue to the residence country of the parent company.[19] This may well be an important consideration given that the United States, Japan and the United Kingdom – the three largest capital exporters at the end of the 1980s – all have credit systems for their foreign- source income. This would certainly reduce the incentive for US and Japanese companies to invest in low-rate European countries, although the US and Japanese credit systems clearly have no impact on EC resident companies. However, given the relatively low rates of tax in the United Kingdom and United States, there is clearly room for *some* downward movement in many countries before this constraint binds.

Second, some activities will earn a higher rate of profit in one location than any other. An obvious example of this is oil extraction, which can only take place where there is an oil field. However, the profitability of other activities may depend on, for example, proximity to raw materials or markets. This suggests that countries may maintain a corporation tax in order to capture part of this "location specific profit" earned within their jurisdiction.

Third, each country needs to maintain a source of revenue. Cutting revenue from corporation tax implies a need to increase other tax rates on less mobile factors, notably labour. Fourth, governments are likely to consider the possible response of their rivals in bidding for inward direct investment. If the policy of reducing tax rates were successful in the short run in attracting inward investment, it is not likely to continue to be in the long run. This is because other governments will need to respond by cutting their own tax rates. If they do so, the competitive advantage accruing to the first government will be lost. It is possible that the only outcome of such tax cutting would be less revenue, with an unchanged allocation of investment. This point raises general issues of the nature of competition in an imperfect market, about which there is a vast economic literature. It would certainly be over-simplistic and wrong to imagine that any competitive market must produce an optimal outcome.

In considering the possible response of the United States and Japan to the abolition of withholding taxes in the EC, however, these arguments would not rule out the possibility that the United States and Japan might respond by cutting their own withholding taxes for inward investment by European companies. The logic of the argument would not require the EC to abolish withholding taxes on US and Japanese companies investing in Europe – the United States and Japan could in theory wish these to remain,[20] although of course in practice countries expect reductions in withholding tax to be reciprocal. Such a policy would encourage inward investment by European companies, but would not affect domestic activity in these countries and so would have a minimal impact on government revenue, which, in any case might be offset if the policy were successful. Further, there is little prospect that the EC could view such a move as an aggressive tax competing strategy, responding by cutting taxes still further in the EC.

B. *Is there any evidence of competition from the 1980s?*

This section examines the changes in corporation taxes which have taken place over the past decade to see if any trend can be identified. One notable feature of the EC, Japanese and American corporate tax regimes already remarked on is that they have all changed their rates, base or system since 1984. Table 8 indicates that in half the EC countries and in the United States, the reforms have had the effect of broadening the base (sometimes by restricting special allowances) whilst reducing corporation tax rates. Changes to the tax system (whether or not the corporate tax is integrated with the personal tax) have not demonstrated such a strong trend, with some countries moving towards a classical system and some moving away from it. However, in the EC there has been a move towards a "partial shareholder relief" system – essentially a classical system at the corporate level, but with a marginal personal tax rate below that of the marginal personal tax rate on labour income of the shareholders.

18. Although of course Ireland has equally generous incentives for less mobile capital, such as manufacturing.
19. This is of course only true when dividends are paid to the parent. If they are not, paying the higher tax rate in the residence state is postponed.
20. If the withholding taxes are retained, the incentive to invest in the EC is lowered, encouraging domestic investment. On the other hand, lower withholding taxes reduce the credit given by these countries on EC taxes, increasing revenues.

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points) and the United States (0.3 percentage points). Japanese and US companies face a slightly higher average required return when investing in the EC.

5. Abolition of withholding taxes

Abolition of withholding taxes on dividends between parent and subsidiary within the EC has been agreed by all member states; the Commission has in addition also proposed abolition of withholding taxes on interest payments.[16] Clearly, abolition of withholding taxes within the EC has no direct effect on the taxation of flows between the EC and Japan and the United States, so such tax wedges remain constant. Similarly, as there are no flows taxed through withholding taxes when finance is provided by retaining earnings, the tax wedges are unchanged.

Tax wedges on intra-Community flows are substantially reduced when investment is financed by new equity and *debt* – the average wedge falls 1.3 percentage points from 7.2 to 5.9 percent for new equity, by 0.5 percentage points from 6.7 to 6.2 percent for debt finance if only withholding taxes on dividends are abolished and by 0.8 percentage points for debt finance if withholding taxes on interest are also abolished.

On average, using equal weights for the three sources of finance, this gives a considerable incentive to EC companies to invest in the EC rather than in Japan and the United States, relative to the current position.

C. *Conclusions*

This part of the report has presented the results derived from a model which estimates marginal effective tax rates and hence the impact of taxation on required rates of return on domestic and cross-border activity. There are considerable differences in the existing structure of tax incentives which depend on the country of residence of the parent company, the country in which the activity takes place and the way in which the activity is financed.

On average, domestic investment is tax favoured over cross-border investment. However, within cross-border investment, there already exists a tax incentive for both EC and US companies to invest in the EC in preference to Japan. On average, however, Japanese companies face an incentive to invest in the United States rather than in the EC.

Harmonization of tax rates and tax base within the EC would have surprisingly little impact on these conclusions. The average required return faced by US and Japanese companies investing in the EC would be virtually unchanged. The only noticeable effect would be a small reduction in the average required return faced by EC companies investing in the United States.

Abolition of withholding taxes within the EC has a much greater impact on average required returns within the EC, although it obviously does not affect the returns required on investments out of or into the EC. However, these reforms – and the abolition of withholding taxes on dividends is the only reform to have already been agreed – significantly increase the incentive for EC companies to invest in the EC rather than in the United States or Japan.

It should be recalled, of course, that these results are averaged over a number of different types of investment, and across all the countries of the EC. Therefore a lot of relevant information is missing from the results presented. Nevertheless, the results suggest that the abolition of withholding taxes may affect outward investment from the EC to Japan and the United States. In the next part of this report, we discuss whether it is likely that the other two countries will respond.

III. THE POSSIBLE RESPONSES OF JAPAN AND THE UNITED STATES

A. *Is competition likely?*

The possibility of tax competition between countries arises because economic activity in a country generally increases economic welfare in that country. Therefore the more inward investment that can be attracted (up to a point) the higher will be welfare. This observation has led some commentators to suggest that competition between countries will drive down corporate taxes. Indeed, some theoretical models (Razin and Sadka, 1989 and 1991) point to the possibility that international competition between countries will drive corporate taxes to zero, in a kind of "tax war".

Such models and such comments often do not specify exactly what elements of the structure of corporate taxes might be the initial subject of competition. Clearly, to induce inward investment of physical capital, generous depreciation allowances may be just as effective, or even more so, than reducing the tax rate. Also, as the previous part of the report argued, withholding taxes on dividend payments may have a significant impact on the incentive to invest in a foreign country. To the extent that the argument suggests that marginal effective tax rates are the important measure, then it is not even clear that a process of tax competition would stop at zero – marginal effective tax rates can easily become negative.[17]

An alternative view of tax competition might be that countries compete over the location of "paper profits". If statutory tax rates differ across countries, then companies may have an incentive to so arrange their affairs such that taxable profit is reduced in high tax countries and correspondingly increased in low tax countries. In order to boost their corporate tax revenue, countries therefore have an incentive to undercut other countries. Methods such as thin capitalization and transfer pricing can be used (subject to existing rules) to achieve precisely this. In this case, countries are much more likely to compete purely on the statutory tax rate: the relative generosity of depreciation allowances would be unimportant.

However, this report is concerned with investment in physical capital, not with the transfer of "paper profits" (nor with the location of portfolio investment). There are two groups of

16. The Ruding Committee has further proposed to extend the scope of these proposals, but it is not possible to examine the effects of these extensions within the framework being used here.
17. As was the case in the United Kingdom before 1984, for example.

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For Japanese parents, the ordering of locations according to the tax incentive requires examination of the domestic cost of capital (6.5 percent), the cost of capital if investing in the United States (at the foot of the table) and the cost of capital if investing in the EC – the second row, under the "Res" column. This comparison suggests that domestic investment is most tax-favoured regardless of the source of finance, with the EC and the United States almost identical in the tax incentive to invest in each. American parents will also generally prefer domestic investment, although Japan is equally attractive with debt finance. However, the EC is tax-favoured over Japan for investments financed by retained earnings or new equity.

2. Harmonization of rates

Suppose tax rates in the EC were harmonized at 37.5 percent. At this rate, the average required domestic rate of return in the EC would stay constant. This rate is also between the two extremes set by the Ruding Committee of 30 percent minimum and 40 percent maximum.

Such a reform would, on average, reduce from 7.3 to 7.2 percent the average required return faced by parents from any country when they invest in the EC, financing that investment by retained earnings.

With new equity finance, required returns within the EC would also fall slightly for EC parents (from 7.2 to 7.1 percent), but equally the required return for EC parents investing in the United States would fall (8.3 to 7.9 percent), so the differential is actually reduced, suggesting that, relative to the current position, the result would be to encourage outward investment from the EC to the United States. While this reform does not change the position of Japanese parents, the EC becomes a slightly more attractive location to US parents. This because the effects of a tax rate harmonization in the EC is asymmetric – it lowers the tax paid when investing in high tax EC countries, without necessarily increasing the tax paid in lower tax countries – the revenue is merely collected by EC governments, not the United States.

With debt finance, the average required returns faced by EC companies would fall regardless of where they invested (from 6.7 to 6.2 percent for EC investments, 6.5 to 6.1 percent for Japanese investments, and 6.9 to 6.6 percent for American investments). The ordering remains unchanged, but as the largest fall is in the EC, the move would favour EC investments slightly. However, from the point of view of Japanese and US parents, the effects would be to make the EC less attractive – the average required return would rise by 0.1 percentage points for Japanese companies, and by 0.2 percentage points for American companies.

On average, the effects of rate harmonization for EC parents is to reduce the required return on investments in the EC by the same amount as it reduces required returns on investments in the United States – 0.3 percentage points. The reduction for investments in Japan is only 0.1 percentage points and so *relatively* Japan becomes a slightly less attractive location relative to the current position. For US and Japanese parents, the EC becomes (very slightly) more attractive.

3. Harmonization of the base

Harmonizing the tax base in the EC in such a way as to leave the average domestic cost of capital unchanged, fractionally increases the average required returns for cross border investment into the EC financed by *retained earnings*, regardless of the home of the multinational.

There is no change in the average cost of capital when investing out of the EC, since the tax base within the EC is irrelevant.[14] More surprisingly, however, there is also no change in the cost of capital faced by Japanese and US companies when investing in the EC when the subsidiary is financed by either *new equity* or *debt*.

On average, then, harmonizing the tax base has no impact on the relative tax incentives to invest either into or out of the EC. Note that this of itself does not imply that such a measure would be useless, however, since it may be the case that distortions to investment within the EC might be removed.[15]

4. Harmonization of rates and base

The effects of harmonizing both rates and base on the marginal effective tax rates are more complex than simply harmonizing each separately; the fact that rates change also affects the value of any change in the tax base. Once again, the precise reforms considered do not change the required return when investing domestically.

When financing an investment through retained earnings, there is again a very small reduction in the cost of capital faced by all companies, irrespective of their country of residence.

With new equity, however, EC parents would find that the average required return when investing in the EC went *up* markedly from 7.2 to 7.7 percent. However, by contrast, the average required return for EC parents investing in the United States *fell* sharply, from 8.3 to 7.9 percent. The net effect of these two movements would be to significantly favour the United States as a location for investment by EC parents, relative to the current situation. The average required return for EC parents investing in Japan is unchanged – which, of course, represents a relative improvement. Similar effects are observed for Japanese and American parents when investing in the EC – the average required return increases by 0.4 percentage points. Thus, the EC would become a less attractive location for investment financed by new equity irrespective of the country of residence of the parent.

When using debt, the average required return for EC parents investing in the EC falls, but by slightly less than it falls for EC parents investing in Japan or the United States. Japanese and US companies face a small rise in the average required return when investing in the EC.

On average, the required return for EC companies investing in the EC is unchanged, but there is a slight drop in the required return from investing in Japan (0.1 percentage

14. At least it is irrelevant given the assumptions of the model, notably that in taxing foreign-source income, the residence country accepts the definition of taxable profit computed in the source country.
15. Although calculations for the Ruding Committee by the authors suggest that this gain would also be small.

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TABLE 7

The effects of tax harmonization in the EC on the incentives to invest in the EC, Japan and the USA

	Dom.	Retained Earnings		New Equity		Debt		Average	
		Res	Source	Res	Source	Res	Source	Res	Source
Base Case									
EC	5.7	7.3	7.3	7.2	7.2	6.7	6.7	7.1	7.1
Japan	6.5	7.3	8.7	7.7	9.5	7.6	6.5	7.6	8.2
USA	5.9	7.3	7.4	6.7	8.3	6.1	6.9	6.7	7.5
Harmonize Tax rates in the EC at 37.5%[1]									
EC	5.7	7.2	7.2	7.1	7.1	6.2	6.2	6.8	6.8
Japan	6.5	7.2	8.7	7.7	9.5	7.7	6.1	7.5	8.1
USA	5.9	7.2	7.4	6.5	7.9	6.3	6.6	6.6	7.2
Harmonize Tax base in the EC[2]									
EC	5.7	7.4	7.4	7.2	7.2	6.7	6.7	7.1	7.1
Japan	6.5	7.4	8.7	7.7	9.5	7.6	6.5	7.6	8.2
USA	5.9	7.4	7.4	6.7	8.3	6.1	6.9	6.7	7.5
Harmonize Tax base and Rates in the EC[3]									
EC	5.7	7.2	7.2	7.7	7.7	6.4	6.4	7.1	7.1
Japan	6.5	7.2	8.7	8.1	9.5	7.8	6.1	7.7	8.1
USA	5.9	7.2	7.4	7.1	7.9	6.2	6.3	6.8	7.2
Abolish Withholding Taxes on Dividends in the EC[4] *(Figures in brackets reflect additional effect of abolition of withholding tax on interest payments).*									
EC	5.7	7.3	7.3	5.9	5.9	6.2	6.2	6.5	6.5
						(5.9)	(5.9)	(6.4)	(6.4)
Japan	6.5	7.3	8.7	7.7	9.5	7.6	6.5	7.6	8.2
USA	5.9	7.3	7.4	6.7	8.3	6.1	6.9	6.7	7.5

	Retained Earnings	New Equity	Debt	Average
Japan to the US	7.4	7.6	7.6	7.5
The US to Japan	8.7	8.2	5.9	7.6

1. National tax rates harmonized at 37.5%. Local corporation taxes abolished. Imputation credits kept at current levels unless that leads to a gross imputation rate in excess of the tax rate, in which case the imputation rate is reduced to be the same as the corporate tax rate.
2. Depreciation rate for buildings harmonized at 6% straight line; for machinery, 25% declining balance; inflationary gains in the value of inventories not taxed; all grants/accelerated depreciation allowances ended.
3. Rates and base as for notes 1 and 2.
4. No change in the method of calculation of part repayment of imputation credit sometimes given by the UK on dividends flowing abroad.

seems that the type of averaging used is not likely to have a significant effect on the overall average tax wedges. In the next section, therefore, attention is focused on just one average measure. However, it is important to continue to note that if a company is able to use just one sort of finance, or is limited by some reason from using whichever finance it wishes, then the patterns given by any overall average figure may hide as much as they reveal.

C. *Effects of harmonization on effective tax rates*

This section examines the effects on the patterns of investment incentives of various potential changes to the EC tax regime as a result of harmonization. The reforms examined are harmonization of tax rates, harmonization of the tax base, harmonization of both and abolition of withholding taxes. Obviously, these reforms may alter the incentives faced by firms resident in the EC, Japan or the United States.

Table 7 presents a shortened version of the previous tables, focusing on the average EC results, rather than giving the results for each EC country. Results are shown for each of the three financing possibilities, together with an overall average based on giving an equal weight to each. Since none of the reforms affect the required returns when investing between the United States and Japan, these figures have not been reported; nevertheless, they are of some importance in interpreting the Table. Note, therefore, that the required returns when investing from Japan to the United States are given at the base of the Table.

As in the previous tables, the column heading of "Res" (residence country) and "Source" (source country) refers to the country named in the first column. Consider the average columns under the base case, for example. First consider the "Res" column: when the EC is the residence "country" (i.e. an average of the EC countries), the cost of capital when investing in the EC is 7.1 percent; when Japan is the residence country, the average cost of capital when investing in the EC is 7.6 percent; and when the United States is the residence country, the average cost of capital when investing in the EC is 6.7 percent. The results in the "Source" column indicate that when Japan is the source country, the average cost of capital into Japan from the EC is 8.2 percent. The average cost of capital for investing from the EC into the United States is 7.5 percent.

1. Base case

Consider now the base case which simply summarizes Tables 2-5; the incentives faced on average by an EC resident company deciding on the location of its investment can be identified by looking down the various source columns. When the EC is the source, a return of 7.3 percent is required when earnings are retained. The United States is almost exactly as attractive with 7.4 percent, but Japan is less attractive with 8.7 percent. A similar pattern is observed with new equity, although the differences are greater. With debt, investments in Japan require the lowest rate of return (6.5 percent), followed by EC investment and then the United States. The overall average figure gives a ranking of EC, United States, Japan. In all cases, the individual EC countries would prefer domestic investment to any other location.

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States (both 7.6 percent). Finally, American companies find Japan as attractive as domestic investment (at 5.9 percent) with EC investment not that much different (6.1 percent).

A Japanese parent faces a tax incentive to invest in just one EC country (Germany) relative to investing in Japan. American parents have an incentive to invest in four EC countries relative to the United States. On average, the EC countries would prefer 3.6 other EC countries to investing in Japan, whereas they would prefer 6.1 EC countries to the United States.

It is apparent from Tables 2 to 4 that the incentive structure faced by parent companies in the three regions is complex. If finance is provided by retentions in the subsidiary, the EC is attractive but Japan is distinctly unfavourable. If investment is provided by issuing new equity, domestic investment is always preferentially treated. Otherwise, EC and American companies will prefer EC investment; but Japanese companies will be indifferent between American and European locations. With debt financed investment, Japan becomes attractive; sometimes as attractive as domestic investment, regardless of the parent's country of residence.

The reasons for this pattern are sometimes unsurprising. For example, Japan is an attractive location when debt is used because nominal interest payments reduce the tax base and Japanese tax rates are high, so the *value* of this deduction is large. Equity is generally unattractive as a transnational source of finance, because imputation credits are not passed generally across frontiers,[13] and withholding taxes tend to be high.

Any averaging across the alternative forms of finance must therefore hide much variation. In the absence of any reliable data, the most appropriate averaging technique is unclear. Nevertheless, some averaging is desirable, because although debt might be the most attractive method of financing an investment, it might, for example, be prevented by thin capitalization rules, by the desire of parent companies to have the flexibility in timing of repatriations offered to them by equity finance or because of transactions costs which are avoided by retaining earnings.

Table 5 offers one possible average table, based on foreign investment being financed one-third by retentions by the subsidiary, one-third by a new equity issue and one-third by borrowing from the parent. Where the parent needs to raise money, including for domestic investment, the same assumptions as before are made; 55 percent retentions, 35 percent debt and 10 percent new equity.

Given the pattern of effective tax rates already referred to, it is unsurprising to find that companies will, on average prefer domestic investment over foreign investment, and that the differences in effective tax rates are smaller than in the constituent tables. Nevertheless, on average EC companies will prefer investing in other EC countries, followed by the United States, followed by Japan. Japanese companies will prefer the United States by an insignificant amount over the EC. American companies prefer the EC over Japan.

An alternative method of averaging is given in Table 6, which assumes that the use of the three sources of finance by the subsidiary mirrors the use made by the parent; that is, 55 percent retained earnings, 35 percent debt and 10 percent new equity.

TABLE 5

Required pre-tax rates of return to yield 5% after tax when investing in and from the EC, Japan and the USA. Investment financed one third by borrowing from the parent, one third by new equity from the parent, and third retentions by the subsidiary

		EC		Japan		USA	
	Domestic	Residence	Source	Residence	Source	Residence	Source
Bel	5.4	6.5	6.6	8.0	6.9	6.8	6.1
Dk	5.8	6.1	6.9	7.2	7.4	6.5	6.5
Fra	5.4	6.2	7.6	7.3	7.7	6.4	7.0
Ger	5.5	7.3	6.1	8.1	6.9	7.6	6.4
Gre	5.1	7.9	7.0	8.5	7.0	9.5	6.2
Ire	5.1	8.6	6.7	7.6	8.2	6.8	7.1
Ita	6.0	8.0	7.1	7.7	7.6	7.9	6.6
Lux	6.2	6.6	7.0	8.3	7.8	6.6	7.0
Nl	5.7	6.5	7.0	7.6	7.5	6.6	6.4
Por	5.7	8.0	7.9	13.4	7.8	12.3	7.6
Spa	6.1	6.6	8.0	7.6	7.9	6.8	7.0
UK	5.9	6.4	6.8	7.3	8.1	6.4	6.9
EC	5.7	7.1	7.1	8.2	7.6	7.5	6.7
Japan	6.5	7.6	8.2	-	-	7.5	7.6
USA	5.9	6.7	7.5	7.6	7.5	-	-

The average rates for transnational investment are different from Table 4, but not substantially so. For Japanese companies, both the EC and United States become equally attractive; otherwise, only the size of tax differences changes, not the ordering of countries from lowest to highest. Hence it

TABLE 6

Required pre-tax rates of return to yield 5% after tax when investing in and from the EC, Japan and the USA. Investment financed 35% by borrowing from the parent, 10% by new equity from the parent, and 55% retentions by the subsidiary

		EC		Japan		USA	
	Domestic	Residence	Source	Residence	Source	Residence	Source
Bel	5.4	6.7	6.6	7.7	6.9	6.9	6.3
Dk	5.8	6.3	6.9	7.2	7.3	6.7	6.7
Fra	5.4	6.5	7.3	7.3	7.4	6.6	6.9
Ger	5.5	7.7	6.7	8.4	7.6	7.9	7.2
Gre	5.1	7.4	7.1	7.9	7.1	8.2	6.4
Ire	5.1	8.1	6.6	7.8	7.3	7.0	6.5
Ita	6.0	7.8	7.5	7.8	8.0	7.7	7.3
Lux	6.2	6.8	7.2	8.0	6.2	6.8	7.2
Nl	5.7	6.7	6.9	7.6	7.3	6.7	6.6
Por	5.7	7.6	7.4	11.1	7.6	9.5	7.2
Spa	6.1	6.7	7.6	7.6	7.8	6.9	7.1
UK	5.9	6.5	7.1	7.3	7.9	6.6	7.1
EC	5.7	7.1	7.1	8.0	7.5	7.3	6.9
Japan	6.5	7.5	8.0	-	-	7.5	7.7
USA	5.9	6.9	7.3	7.7	7.5	-	-

13. They are often granted by provisions in tax treaties involving investment in the United Kingdom, and this is taken account of in the calculations.

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percent if they invest in the United States. Japanese companies must earn 8.7 percent on domestic investments, compared to 7.4 percent in the United States and 7.3 percent in the EC. US companies must earn 7.4 percent on domestic investments, compared to 8.7 percent in Japan and 7.3 percent in the EC. Thus, EC investment is on average most attractive, regardless of the country of residence. However, the results for the EC are very close to those for the United States: the difference is unlikely to be important for actual investment flows.

Breaking down the EC numbers further indicates that Japanese parents face a lower tax wedge investing in ten of the EC countries than if they invested in Japan. The only EC countries with a higher tax wedge are Germany and Italy. US parents face a lower cost of capital in seven EC countries than for domestic investment. Similarly, only German and Italian parents would prefer investing in Japan to investing in their domestic economy; parents from seven EC countries would prefer investing in the United States over domestic investment.

TABLE 3

Required pre-tax rates of return to yield 5% after tax when investing in and from the EC, Japan and the USA. Investment financed by new equity from the parent[1]

		EC		Japan		USA	
	Domestic	Residence	Source	Residence	Source	Residence	Source
Bel	5.4	6.6	6.8	9.5	7.0	6.8	5.9
Dk	5.8	5.9	7.1	7.6	7.5	6.2	6.3
Fra	5.4	6.1	8.6	8.5	8.0	6.5	7.4
Ger	5.5	5.9	5.8	7.7	5.9	6.4	5.8
Gre	5.1	9.2	6.8	10.9	7.0	13.0	6.0
Ire	5.1	9.7	6.4	8.0	9.6	6.5	8.0
Ita	6.0	8.3	6.7	8.0	7.0	8.1	5.5
Lux	6.2	6.3	6.9	9.7	7.8	6.3	6.8
Nl	5.7	6.2	7.3	8.4	7.8	6.5	6.0
Por	5.7	9.1	9.2	19.2	8.5	19.4	9.1
Spa	6.1	6.8	8.9	8.4	8.1	7.1	7.1
UK	5.9	6.4	6.2	8.4	8.4	6.4	6.7
EC	5.7	7.2	7.2	9.5	7.7	8.3	6.7
Japan	6.5	7.7	9.5	-	-	7.6	8.2
USA	5.9	6.7	8.3	8.2	7.6	-	-

1. Parent raises finance by 55% retained earnings, 35% debt and 10% new equity. These proportions used to finance domestic investment.

However, this picture is very different when the subsidiary is financed by issuing new equity to the parent, as shown in Table 3. In this case, EC companies face a lower cost of capital investing domestically, requiring on average 5.7 percent. Investment in the rest of the EC is the next most attractive (7.2 percent) followed by the United States (8.3 percent), with Japan being on average the least attractive (9.5 percent). Japanese companies also find domestic investment in Japan most attractive (6.5 percent), followed by investment in the United States (7.6 percent) with the EC being on average the least attractive (7.7 percent). Finally, American companies face a tax incentive to invest domestically (5.9 percent), with the EC being more attractive than Japan (6.7 percent as opposed to 8.2 percent). Hence when finance has to be given to subsidiaries through new equity (perhaps because of thin capitalization rules, for example), the result is that each country will tend to prefer investing domestically. Failing that, European and American companies prefer EC investment to Japanese, but Japanese prefer American to European (though by a negligible amount).

American parents face a lower cost of capital in just two EC countries (Germany and Italy) than if they invested in the United States. For Japanese companies only investment in Germany is more attractive. EC countries on average prefer between nine and ten other EC countries to investing in Japan, and between six and seven other EC countries to the United States.[12]

TABLE 4

Required pre-tax rates of return to yield 5% after tax when investing in and from the EC, Japan and the USA. Investment financed by borrowing from the parent[1]

		EC		Japan		USA	
	Domestic	Residence	Source	Residence	Source	Residence	Source
Bel	5.4	5.6	6.1	5.7	7.0	6.2	5.5
Dk	5.8	5.4	6.4	5.8	7.5	6.0	6.0
Fra	5.4	5.2	7.4	4.7	8.0	5.3	6.6
Ger	5.5	8.8	3.8	8.0	5.5	9.0	4.4
Gre	5.1	7.0	7.2	5.9	7.0	8.2	5.5
Ire	5.1	8.7	8.4	6.2	9.6	6.5	7.8
Ita	6.0	8.5	5.8	6.3	7.0	8.1	5.4
Lux	6.2	6.1	6.4	6.4	7.8	6.1	6.3
Nl	5.7	5.9	6.7	5.6	7.8	5.8	6.0
Por	5.7	7.7	7.1	12.5	7.8	10.0	6.6
Spa	6.1	5.7	7.6	5.6	8.1	6.0	6.6
UK	5.9	5.3	6.9	4.8	8.4	5.3	6.6
EC	5.7	6.7	6.7	6.5	7.6	6.9	6.1
Japan	6.5	7.6	6.5	-	-	7.6	5.9
USA	5.9	6.1	6.9	5.9	7.6	-	-

1. Parent raises finance by 55% retained earnings, 35% debt and 10% new equity. These proportions used to finance domestic investment.

If the parent finances the subsidiary through debt, Table 4 indicates that EC companies will on average face the lowest cost of capital by investing in their home market (5.7 percent). Following that, Japan is the next most attractive (6.5 percent), then the rest of the EC (6.7 percent) and the United States (6.9 percent). Japanese companies also prefer domestic investment (6.5 percent) over the EC and the United

12. The actual mean numbers are that 9.66 countries have lower effective tax rates than Japan on average, and 6.7 lower than the United States.

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corresponding to the ways in which the subsidiary is financed. Where finance is provided in the form of new equity, it is assumed that all post-tax profits are paid by the subsidiary to the parent, and that the parent in turn pays out all the profits (after any residence country tax) to its shareholders. It is assumed that there are sufficient domestic profits to avoid such problems as the surplus ACT issue in the United Kingdom. The required rates of return below are based on the tax position as of 1 January 1991. The data applied are those given in detail in both the OECD report (OECD, 1991) and the Ruding Committee report.

It is convenient to summarize the incentives faced by companies in the manner found in Tables 2-4. In each case, it is assumed that the real pre-personal tax rate of return paid to individuals is five percent. To abstract from differences between countries due to inflation, the OECD average inflation rate of 3.1 percent for 1991 has been used. Finally, it is also assumed that personal tax rates are zero.[10]

The first column of these tables lists the countries investigated. The second column gives the required pre-tax rate of return for a domestic investment in each country. Compared to this are the average required pre-tax rates of return when a company from the country named in the first column invests into the EC (on average), Japan or the United States (columns 2, 4 and 6). Also compared is the case in which a company from either the EC (again on average), Japan or the United States invests in the named country.

For example, from Table 2, if a Belgium firm invests domestically, financing the project by retaining earnings, it needs to earn a 6.9 percent real rate of return before tax to pay 5 percent after tax. If a Belgian multinational invests abroad in one of the other 11 EC countries, it needs on average to earn 7.4 percent. When multinationals from the rest of the EC invest into Belgium, they need to earn, on average, 6.9 percent. A Belgian company investing in Japan requires a pre-tax rate of return of 8.7 percent, whereas a Japanese company investing into Belgium requires 6.9 percent. Finally, a Belgian company investing into the United States requires 7.4 percent; an American company investing into Belgium 6.9 percent.

From the last three rows of the table, the first column shows that *on average* EC companies investing domestically require a real rate of return of 7.3 percent; by comparison, domestic investments by Japanese and American companies require 8.7 and 7.4 percent, respectively. A equivalent interpretation can be given to the results in the other columns.

The focus of interest in the following discussion will be which economy provides the most attractive tax regime for investors from that or other countries. Tables 2 to 4 have quite different consequences for the incentives faced by countries, so they are considered in turn.

When finance is provided by retaining earnings, the only tax paid is in the source country (the exception is with Denmark, whose multinationals receive an allowance for foreign-source income). The reason for this is that residence countries which have credit systems only tax foreign-source income earned by subsidiaries when it is repatriated. It might be thought that the residence tax does not apply because the profits are not repatriated. This, however, would not be entirely correct. Shareholders would not (or, rather, should not) acquiesce in an investment if they were never to see a return. The reason why residence country taxes – and withholding taxes – have no effect on the taxation of a *marginal investment* is as follows. Shareholders give up a return when a subsidiary retains earnings – the dividend which they would otherwise have received, after taking account of any tax which would have been paid. When the profits are eventually repatriated by the subsidiary at some point in the future, the present discounted value of the tax which will be paid by the subsidiary is exactly equal to the tax originally saved by not repatriating (as shown by Hartmann, 1985). The figures in Table 2 reflect tax being saved when the subsidiary retains profits and the tax which will be paid when the profits are paid to the parent. The effect of taking both into account is equivalent to saying that withholding taxes and the operation of a credit system have no effect on the overall rate of return on a marginal investment when finance is through retained earnings.

EC multinationals on average[11] need to earn 7.3 percent when they invest domestically, 7.3 percent when they invest elsewhere in the EC, 8.7 percent if they invest in Japan and 7.4

TABLE 2

Required pre-tax rates of return to yield 5% after tax when investing in and from the EC, Japan and the USA. Investment financed by retained earnings in the subsidiary[1]

		Japan		USA		EC	
		the row country is the:		the row country is the:		the row country is the:	
	Domestic	Residence	Source	Residence	Source	Residence	Source
Bel	6.9	7.4	6.9	8.7	6.9	7.4	6.9
Dk	7.2	7.0	7.2	8.2	7.2	7.4	7.2
Fra	7.0	7.4	7.0	8.7	7.0	7.4	7.0
Ger	8.8	7.2	8.8	8.7	8.8	7.4	8.8
Gre	7.1	7.4	7.1	8.7	7.1	7.4	7.1
Ire	5.4	7.5	5.4	8.7	5.4	7.4	5.4
Ita	8.8	7.2	8.8	8.7	8.8	7.4	8.8
Lux	7.8	7.3	7.8	8.7	7.8	7.4	7.8
Nl	7.0	7.4	7.0	8.7	7.0	7.4	7.0
Por	7.3	7.4	7.3	8.7	7.3	7.4	7.3
Spa	7.5	7.3	7.5	8.7	7.5	7.4	7.5
UK	7.4	7.3	7.4	8.7	7.4	7.4	7.4
EC	7.3	7.3	7.3	8.7	7.3	7.4	7.3
Japan	8.7	7.3	8.7	-	-	7.4	8.7
USA	7.4	7.3	7.4	8.7	7.4	-	-

1. Domestic investment is also assumed to be financed by retained earnings.

10. This implies that tax wedges can be computed by deducting 5% from the figures in the tables.

11. The averages here, as in the rest of the report, are arithmetic ones, ignoring the size of foreign investment into and out of each EC state. The difficulties in finding and using reliable investment flows are extensively discussed in OECD, 1991.

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account of such factors as withholding taxes on interest and dividends and the tax treatment of foreign-source income.[8]

It is apparent from the above that calculating the marginal tax wedge is complicated by the fact that different aspects of the corporate tax system interact with one another. Nevertheless, since the formalization of the techniques involved in the mid-1980s (especially in King and Fullerton, 1984), the advantages and disadvantages of the technique have been extensively analysed (see OECD, 1991, and Ruding Committee, 1992).

The advantages lie in the fact that it is the only technique which can systematically take into account the key aspects of corporate and personal tax systems. It looks at *marginal* investments – which have an important economic significance. In addition, because it enables separate examination of investments in different types of assets and different sources of finance, it becomes possible to consider the distortions the tax system causes between different types of assets or types of finance.

The disadvantages for domestic calculations are principally to do with the calculation of averages. Whilst each individual tax wedge may be correct, in order to compare levels of taxation and changes over time, it is useful to impose "typical" investment weights. Following the OECD (1991) reports, we assume that 50 percent of all investments are in machinery, 28 percent in buildings and 22 percent in inventories, with 55 percent of finance provided by retaining earnings, 35 percent by borrowing and 10 percent by issuing new equity. However, if tax changes over time or differences across countries result in different advantages given to different types of investment, it may be that the proportion of total investment which is in particular assets or financed in particular ways may be different, and imposing an average may obscure this. Hence, country A may have a higher average tax wedge than country B, but if investment can be financed by debt, the relative positions may be reversed. What evidence there is on this question is considered in the OECD report, which shows that there is in fact relatively little difference (on average) in the types of assets and sources of finance between countries.

With transnational investment one problem is again to decide the appropriate weights to be given to different forms of finance. Lending to the subsidiary is nearly always the most attractive financing option. However, thin capitalization rules may prevent this.[9] There is very little evidence available on what proportion of finance is provided in different forms by parents to their subsidiaries. In the next section, average results are therefore presented using two sets of weights: the first follows OECD (1991) in giving equal weight to each source of finance available to the subsidiary and the second weights the source of finance used by the subsidiary in the same proportions as that assumed for the parent company. The tables indicate that the qualitative results are unaffected by the weighting pattern and so only the former averages are presented in the remainder of the report.

A more general problem in computing cross-border marginal effective tax rates is tax planning. The organizational structure and flow of finance and profits described assumed in the framework used here rules out a range of tax planning techniques and organizational structures which could affect the tax paid. In answer to the question "to what extent does tax planning enable you to transfer profits between countries so as to enable you to pay tax in the country of your choosing", more than half of the respondents to the questionnaire distributed on behalf of the Ruding Committee answered three, four or five on a scale of one (not at all) to five (substantially). In other words, tax planning is widespread.

This implies that transnational effective tax rates presented here should not be taken as indicating the tax wedges which companies *actually* pay. However, they are indicative of the tax wedges which authorities would like companies to pay, and which they attempt to enforce by imposing rules (for example, on thin capitalization and transfer pricing). The pattern of effective tax rates and the changes in effective tax rates are relevant in indicating how incentives facing companies might change in response to changes in tax regimes, even though companies may be able to avoid the consequences through legitimate tax planning.

B. *The current pattern of incentives to invest*

Before looking at the effects of harmonization in the EC on the incentives faced by European, Japanese and American companies, it is necessary to consider in detail the current situation. Unfortunately, this is difficult to summarize, even in the simplified model used in this report, because there are so many possibilities. For each bilateral relationship (for example, investment from Japan into the United States) 21 separate tax wedges can be calculated, reflecting investment in each of the three assets (machinery, buildings and inventories) financed in one of seven ways (retained earnings in the subsidiary, new equity from the parent and borrowing from the parent, with the parent in these latter two cases raising finance by retaining earnings, borrowing or issuing new equity). This can be simplified by assuming that the subsidiary invests in a weighted average of assets, as described already, and when the parent needs to raise funds it does so according to a weighted average of different types of finance. This limits the possibilities to just three for each bilateral relationship,

8. Foreign-source income from subsidiaries is either exempt or given credit for foreign taxes already paid. Broadly, there are two types of credit system. One compares profit earned abroad on a country-by-country basis (the "credit by source" system). The other aggregates all foreign-source income, and compares total tax paid with the tax which would have been paid domestically (the "worldwide credit system"). In the latter case, an investment in a country with a higher tax rate than the residence country rate may or may not result in additional residence country tax depending on whether other foreign profits are generated in countries with higher or lower tax rates. In this report it is assumed that the average tax rate abroad on existing investments is below the residence country rate, and so any additional investment results in an additional residence country tax charge if the residence country rate exceeds the source rate.
The taxation of foreign-source income in the United States is even more complicated, as an attempt is made to adjust the foreign tax base to take account of differences from the US base before applying the credit. This is not simple to model within the effective tax rate methodology. The precise methodology used (described in greater detail in OECD, 1991) is to calculate the effective tax rate on an investment by a foreign company in its domestic country, and compare that with the US tax rate. This takes account of differences in the tax base.

9. Two-thirds of a sample of international businesses surveyed by the Institute for Fiscal Studies for the Ruding Committee indicated that they were limited to a greater or lesser extent by thin capitalization rules (Ruding Committee, 1992).

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States.[2] The United States is the recipient of at least half of all UK overseas investment, with a further quarter going to the EC.[3] Sixty-one percent of German foreign direct investment remains within the EC, with a further 20 percent going to the United States.[4] Foreign direct investment in the EC is 1.5 percent of GDP (2.5 percent in the United Kingdom).[5] Finally, in 1969 there were in total 25 European affiliates of Japanese manufacturing firms whereas a further 118 were established in 1989 alone.[6] Hence it is apparent that these three economies are linked through foreign direct investment, and that the flows involved are significant.

The structure of the report follows the two questions outlined in this Introduction. The first question, addressed in Part II, is what investment incentives currently exist with regard to investment between the EC, Japan and the United States and how these incentives would change following reform in Europe. The measure which economic theory suggests is most appropriate for considering investment incentives is the "effective marginal tax rate". Calculating this rate for cross-border investment is by no means straightforward, but Section A outlines the main elements of the calculation. Section B then uses this measure to assess in detail the current state of investment incentives within the EC and between the EC, Japan and the United States. Section C then assesses how these incentives would be changed in the event of further reforms within Europe.

The second question addressed in this report is whether it is likely that the Japanese or US government would respond to reforms in Europe by introducing their own reforms, in an attempt to prevent too high a capital outflow. This question is addressed in three sections in Part III. First, Section A briefly discusses factors influencing the possibility of tax competition. Section B examines the degree to which corporation taxes and investment incentives in the EC, Japan and the United States have moved together or apart since 1980. This may provide some indication of whether it is likely that Japan and the United States would respond to further reforms in Europe. Finally, Section C concludes by considering possible responses by the United States and Japan to new reforms in Europe.

II. INVESTMENT INCENTIVES IN THE EC, JAPAN AND THE UNITED STATES

A. *Marginal effective tax rates: the concept and its limitations*

The concept underlying marginal effective tax rates is simple. Individuals will invest in companies only if they expect companies to pay them a rate of return at least equal to the return they could get by investing elsewhere (for example in government debt). The pre-tax rate of return which companies need to earn in order to fund corporation, personal tax and the individuals' required post-tax return is likely to be higher than this post-tax return.[7] The difference between the pre-corporate tax rate of return on an investment project and the return received by the ultimate investor is known as the *tax wedge*. The tax wedge expressed as a proportion of the pre-tax required return is the *effective tax rate*.

The tax wedge and effective tax rate are generally calculated for *marginal* investments: that is, the investment which is just worth undertaking. The pre-tax rate of return on a marginal investment is often referred to as the *cost of capital* – it is the minimum acceptable pre-tax rate of return on an investment project. If a slightly lower post-tax rate of return is earned, the project will not be funded. The economic importance of the marginal investment is that companies and investors will undertake all investments which earn at least the cost of capital before tax. In the absence of tax, they would have undertaken all investments which earned the investors' required rate of return. Any project which would have earned a pre-tax return between these two levels would have gone ahead in the absence of taxation, but will not go ahead in the presence of taxation. The higher the cost of capital – and therefore the higher the *marginal tax wedge* and the *marginal effective tax rate* – the lower will be aggregate investment.

Computing the pre-tax rate of return needed to pay a given post tax rate of return requires many different aspects of the tax system to be taken into account. Depreciation allowances on physical assets for tax purposes and the corporation tax rate itself will determine the net cost of an asset. The corporation tax rate is also, of course, applied to the return generated by the investment and so affects the size of the return available to be paid to the investor. In addition, however, it also determines the value of interest deductibility. Also the degree of integration between taxes at the corporate and personal level affect the required rate of return: for example, if there is an imputation system, some or all of the tax paid at the corporate level can be used to reduce the tax paid at the personal level, so reducing the required rate of return. Finally the degree of indexation available within the tax base and on capital gains earned by investors will affect the degree to which the tax wedge rises with inflation (see Bond, Devereux and Freeman (1990) for a recent examination of the impact of inflation on investment incentives in the United Kingdom).

In this report, marginal effective tax rates are computed for nine possible types of investment: investments in machinery, industrial buildings and inventories may be financed by borrowing, issuing new equity or by reinvesting earnings from other projects.

The framework can also be used to look at transnational investments. It is assumed that multinationals invest in one of the three types of assets through a subsidiary. The subsidiary is financed either by retaining its own earnings, by borrowing from the parent or by issuing new equity to the parent. If the parent finances the investment, it is assumed to raise money in turn by borrowing, retaining its own earnings or issuing new equity. The transnational effective tax rates must take

2. Balance des paiements de la France, "Rapport Annuel – Annexes" (1989). Ministère de l'économie, des finances et de la privatisation: Direction du Trésor.
3. UK Central Statistical Office, Business Monitor, MA4 "Overseas Transactions" (1988).
4. Statistische Beihefte zu den Monatsberichten der Deutschen Bundesbank: Reihe 3 – Zahlungsbilanzstatistik.
5. Thomson and Nicolaides, 1991.
6. JETRO, 1990.
7. Although this is not always the case.

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a non-discriminatory treatment of relief from double taxation for dividends. Box 2 lists more radical measures proposed, including a minimum tax rate of 30 percent and various reforms of the tax base.

BOX 1 Phase I
Anti-Discrimination Measures

(i) Extend parent/subsidiary Directive to cover all incorporated enterprises
(ii) Substantial reduction in participation threshold
(iii) Extend interest and royalties Directive to encompass all such payments between enterprises
(iv) Member states should ratify the Arbitration Convention on transfer pricing disputes
(v) Commission to establish rules concerning transfer pricing adjustments by member states
(vi) Member states should adopt draft directive on losses of permanent establishments and subsidiaries
(vii) Bilateral tax treaties between member states should be completed
(viii) Common attitude towards third countries should be fostered
(ix) imputation taxes should be offset against foreign taxes, on a reciprocal basis
(x) Equivalent relief for resident shareholders on domestic and foreign profits, on a reciprocal basis

BOX 2 Phase I
Other Measures

(i) Minimum statutory tax rate
(ii) Various proposals for harmonizing the tax base, including
  (a) historic cost depreciation allowances
  (b) special depreciation rules
  (c) uniform treatment of goodwill and other intangibles
  (d) free choice of stock valuation
  (e) contributions to pension schemes to be tax deductible
  (f) establishment of rules for deductibility of headquarter costs
  (g) adoption of draft directive on carryforward and carryback of losses

It is not the intention here to discuss the merits of these proposals (see, for example, Devereux, 1992, and Gammie, 1992, for analyses of the proposals themselves). Rather the aim here is to consider the impact of potential and actual reform in the EC on the balance of tax incentives between the EC, Japan and the United States.

A subsidiary aim for this report is to consider whether it is likely that either the United States or Japan might respond to developments in Europe. The issue here is one of "competitiveness" between the three trading blocks (as well as between the individual member states within Europe). If reforms within the EC make investment in Europe more attractive relative to the United States and Japan, then capital may flow from these countries into Europe. If this happened, then Japan and the United States would have some incentive to make corresponding reforms to their own tax structures in an attempt to stem the flow. Of course, there are other factors governing decisions by the Japanese and US governments. In Part I we discuss briefly some of the issues surrounding the possibility of tax competition countries.

The importance of the interrelationships of these three regions is illustrated in Table 1, which gives the percentage of total inward investment into the EC by country of origin. For example, of total inward investment into Belgium and Luxembourg, 44 percent comes from the United States, 3 percent from Japan and 31 percent from the rest of the EC; investment from other countries accounts for just 22 percent. As can be seen, foreign direct investment into the EC is dominated by other EC countries, followed by the United States, although an important and growing proportion is from Japan.

TABLE 1

Percentage of total inward investment into the EC and the USA by country of origin

	USA	Japan	EC
Belgium and Luxembourg	44	3	31
Denmark	28	1	36
France	16	2	54
Germany	33	7	24
Ireland	38	-	45
Italy	15	1	54
Netherlands	25	3	40
Portugal	16	2	48
Spain	13	3	61
UK	47	4	26
USA	-	17	59

Source: EC countries: Thomsen and Nicolaides, 1991.
USA: Bureau of Economic Analysis, 1990. Figures are for stock of investment.

Another measure of the importance of flows between the three trading blocks is that, in 1989, 58 percent of all foreign investment by the United States went to the EC or Japan (BEA, 1990); 23 percent of all Japanese foreign direct investment to the EC and 51 percent to the United States.[1] Two-thirds of French foreign direct investment went to other EC countries, and 70 percent of the remainder to the United

1. Annual Report, International Finance Bureau, Ministry of Finance, 1990.

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INTERNATIONAL:

THE INTERACTIONS OF CORPORATE TAX BETWEEN THE EC, JAPAN AND THE UNITED STATES

Michael Devereux and Mark Pearson

I. INTRODUCTION

The years since 1984 have seen one of the most remarkable sequences of tax reform ever. Since that date, all 24 OECD countries have significantly altered their corporation taxes at least once. In some cases, the reform has involved changes to virtually every aspect of the corporate tax regime – rates, base and degree of integration with the personal tax system. In others, the changes have been less dramatic, though still significant – large reductions in tax rates, or the ending or severe curtailing of special allowances for investment in certain regions or types of business.

Of course, these reforms have had a substantial impact on the taxation of capital invested internationally by multinational companies as well as on capital invested domestically. Changes in the domestic structure of corporation tax in one country can affect the investment incentives not only of companies resident in that country, but also of non-resident multinational companies either operating or considering an operation in that country. This may have knock-on effects on the activity in third countries as well, if the location of economic activity depends on tax incentives in several countries. If corporation tax ever was a purely domestic issue, it certainly is not now.

The primary aim of this report is to analyze how reforms to corporation tax in the European Community (EC) might affect incentives to invest in and from the three main trading blocks: the EC itself, the United States and Japan. In March 1992, the Committee of Experts set up by the European Commission, chaired by Onno Ruding, presented a set of proposals for reform of corporation taxes within the EC. These reforms build on Directives already issued by the EC and agreed by member states. The existing Directives, together with existing draft Directives and any proposals of the Ruding Committee which are taken up by the Commission, will not only change the pattern of tax incentives for European companies seeking to invest within Europe and elsewhere, they will also affect the tax incentives facing US and Japanese companies.

The European Commission has long seen differences in corporate tax regimes in the EC as being a barrier to the integration of the EC economy. It has at various times proposed a degree of harmonization of corporate tax regimes which taken together would have amounted to a common corporation tax, with only minor differences in tax rates between different countries. More recently, member states agreed to implement three Directives to abolish withholding taxes on dividends paid between parents and subsidiaries in the EC, to reform the tax treatment of cross-border mergers and to coordinate procedures dealing with transfer pricing disputes. Two draft Directives which have been tabled propose the abolition of withholding taxes on other interest and royalties and allow the offset of profits made in one country against profits made in another.

The Ruding Committee proposed a further phased series of reforms. The most important of these – those intended to be introduced by 1994 – are summarized in Box 1 and Box 2. Box 1 contains a number of proposals to reduce discrimination between companies or shareholders. Some of these are extensions to the Directives and draft Directives which already exist, while others begin to tackle issues such as

Michael Devereux is Professor of Finance at Keele University and Research Fellow at the Institute for Fiscal Studies, London. For the academic year 1992/3, he will be the Houblon Norman Research Fellow at the Bank of England. He is joint Managing Editor of Fiscal Studies, *with Mark Pearson.*

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Recently, Professor Devereux's research has been primarily in the field of taxation of international business. Together with Mark Pearson, he published a report in 1989 entitled, "Economic Efficiency and Corporate Tax Harmonisation", and subsequently has acted as consultant for the OECD's Committee for Fiscal Affairs and for the European Commission's Committee of Independent Experts on corporate taxation chaired by Onno Ruding.

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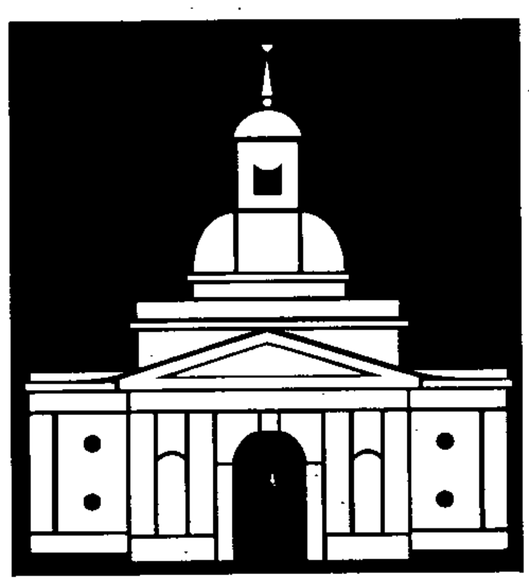

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(B. 111.762)

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(B. 111.729)

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The publications are up to date as of August 1991.
(B. 111.642/695/696)

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Edited by Malcom Gammie and Jeremy de Souza.
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Loose-leaf publication in 2 volumes covering all major taxes: income tax, corporation tax, capital gains tax, inheritance tax, stamp duty, value added tax. Further the book gives practical information on transactions affecting or concerned with the land, the interests that can be created in land and buildings, the uses to which the land can be put, tax planning, minimizing of liabilities. Local authority rates and the uniform business rate, the community charge and petroleum revenue tax are not covered.
(B. 111.697)

BRITISH MASTER TAX GUIDE 1991-92.
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(B. 111.725)

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(B. 111.776)

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(B. 111.764)

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EEC

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 104-108 of the January/February 1992 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

South Africa

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(d) *Deductible expenses*

It appears that no specific deductions from income are allowed.

(e) *Rates*

The rates of tax applicable to individuals are:

Annual taxable income (YR)	*Rate*
0 – 3,600	3%
on the next 3,600	6%
on the next 3,600	9%
on the next 3,600	12%
on the next 3,600	16%
on the next 3,600	22%
on the next 3,600	28%
on the next 3,600	32%
any amount in excess of this	36%

The highest rates appear not to be in use at the present time.

This tax progression stops at 16 percent for residents liable to tax on wages and salaries and at 22 percent for non-residents. For individuals liable to payment of Commercial and Industrial Profits Tax, the progression stops at 28 percent.

Each individual taxpayer is allowed an annual personal exemption of 24,000 YR.

(f) *Administration*

The tax on salaries and wages is deducted at source by the employer under the system described above.

An individual aggrieved of his assessment to tax may object by application in writing to the party deducting the tax, in most cases the employer. This objection should then be sent to the tax authority within 30 days of its receipt. The tax authority will then examine the objection and notify the taxpayer of its decision (for further appeal possibilities see above).

No specific penalties are provided for under this schedule and, therefore, it is likely that the general penalties described above for companies also apply.

(g) *Deduction at source*

Tax is withheld at source by the employer, who is responsible for monthly payment of tax on the assessable income to the tax authority. Payment must be effected within the first ten days of the month following that for which the tax is due. Tax on the total net monthly income subject to salary and wage tax is fixed at $^1/_{12}$ of the annual rates.

Employers with eight or more employees must keep a register of their names as described in the Executive Regulations.

2. Tax on non-commercial and non-industrial professions

(a) *Taxable persons and taxable base*

Chapter IV of the Income Tax Act imposes income tax on non-industrial, non-commercial professions which are practiced independently or which generate fees for consulting, arbitration or expertise. The Minister of Finance may specify the occupations that fall within non-commercial and non-industrial professions.

(b) *Exemptions*

With the exception of those which are available exclusively to companies, the exemptions for individuals are the same as those for companies. In addition, persons holding high post-graduate degrees in unique specializations who engage in non-industrial and non-commercial professions are exempt from tax for three successive years.

(c) *Deductions*

Deductible expenses, depreciation allowances and losses are the same as those available for companies.

(d) *Rates*

The progessive tax rates which apply to individuals also apply to income from non-industrial and non-commercial professions, but stop at a maximum of 22 percent.

The annual personal allowance of 24,000 YR also applies to non-industrial and non-commercial professionals.

(e) *Administration*

Tax is levied annually on the total income from the exercise of the profession less expenses. A declaration must be submitted to the tax authority by 30 April of the following year showing total income, expenses and net profit or loss, and accompanied by payment of the tax due.

B. *Other taxes on individuals*

At the present time, no further information concerning other taxes on individuals is available.

III. AVOIDANCE OF DOUBLE TAXATION

It is unclear whether Yemen will provide unilateral relief from double taxation. The former YAR was a signatory to the "Agreement for the Avoidance of Double Taxation and Prevention of Tax Evasion Between the States of the Arab Economic Council" (1973) and had an agreement for the avoidance of double taxation arising from international air and sea transport with Germany (Fed. Rep.). Both the former YAR and PDR had agreements for the avoidance of double taxation of income derived from international air transport with India. The current status of these agreements is unknown.

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(d) *Depreciation*

Depreciation of assets is deducted in computing taxable income. The Cabinet Minister will determine the rates and methods of depreciation, and will issue schedules.

(e) *Losses*

Subject to verification by the tax authority, losses incurred in a year may be set off against total income from all sources for that year. Any loss not set off in the year in which it is incurred may be carried forward for deduction from taxable income derived during the subsequent four years. Accurate records must be maintained to support the setting off of losses. Losses may not be carried back.

(f) *Treatment of dividends*

There is no special tax treatment for dividends. Dividends are not subject to withholding tax; they may be paid out of company profits which are taxed or out of profits which are specifically exempted.

B. *Other taxes on companies*

1. *Zakat*

Yemen appears to levy *zakat* on business profits of Yemeni owned companies at the rate of 2.5 percent.

2. Practice tax

All foreign companies which are not legally liable to pay *zakat* must pay a practice tax at the rate of 2.5 percent of their working capital. Such companies must submit a tax declaration with payment by 30 April each year.

3. Real estate taxes

(a) *Real Estate Revenue Tax*

An annual tax is levied on the total income from rental properties of all kinds less repair and maintenance costs, provided these costs do not exceed ten percent of the total income for properties located in Sana'a and Aden, 20 percent for properties located elsewhere and 30 percent for properties located in areas with less than 5,000 inhabitants. Various exemptions are provided for personal residences, charitable, government and public properties. Tax is levied at progressive rates up to a maximum of nine percent for non-residential property used by the owner for commercial, professional or industrial purposes; or up to a maximum of 16 percent for all other leased properties.

(b) *Real Estate Sales Tax*

Tax at the rate of three percent is levied on the proceeds from the sale of real property. The seller is responsible for filing a declaration and paying the tax within 15 days of the sale. Sales of agricultural land, land grants to schools and charities, and inherited real estate are exempted from this tax.

(c) *Stamp duty*

Stamp duty is imposed; however, no information on rates or types of documents subject to stamp duty is currently available.

II. TAXATION OF INDIVIDUALS

A. *Income tax*

Individuals are taxed on their salaries and wages and on income derived from the practice of non-commercial and non-industrial professions. Sole proprietors are liable to payment of Commercial and Industrial Profits Tax (see above). In addition, it appears that the Real Estate Revenue Tax and the Real Estate Sales Tax also apply to individuals.

1. Tax on salaries

A tax is levied on the employment income of all resident and non-resident individuals derived in Yemen from salaries, wages, allowances and bonuses. The amount of tax is deducted at source by the employer and paid over to the tax authority.

(a) *Taxable persons*

Individuals who receive income from employment in Yemen are subject to tax on salaries. Liability to tax extends to wages and salaries from employment outside Yemen where the employer is either the Government of Yemen or Yemeni Private and Mixed Economic Sector Units, but only if the employee is not subject to tax in the other country.

(b) *Taxable base*

Tax is levied on salaries, wages, emoluments, bonuses, premiums and all remuneration related to employment whether recurring or non-recurring and whether paid in cash or in kind. Taxable benefits include incentives, commissions, allowances for attending meetings and housing.

The following amounts are excluded from taxable income:
(a) amounts contributed to pension funds;
(b) amounts paid to the taxpayer to cover work-related expenses, e.g. hospitalization, travel, per diems, etc.; and
(c) stamp duty.

(c) *Exemptions*

The following income is specifically exempted from income tax on salaries:
(a) salaries of foreign diplomats and embassy staff, etc. (subject to reciprocal treatment) and members of UN delegations and specialized agencies;
(b) salaries of foreign experts sent to Yemen on aid programmes;
(c) pensions and termination of employment payments;
(d) lifetime compensation paid to victims of work accidents;
(e) wages of Yemeni workers engaged in agriculture, fishing or domestic service;
(f) income of daily wage labourers as specified in the Executive Regulations;
(g) income that is exempted from tax under international treaties for the prevention of double taxation or other international agreements.

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Court must issue its judgment within two months. Further appeal may be made before a Divisional Appeal Court. The decision of the Divisional Appeal Court is final.

A taxpayer must, on filing a return, pay the amount of tax admittedly due, unless the tax authority permits the taxpayer to pay by instalments. Taxpayers are given a discount for early payment of taxes. The discount is four percent for tax paid in January, three percent for tax paid in February and two percent for tax paid in March. Instalment payers are also entitled to these discounts for any instalment paid during these months. A fine of two percent of the tax due will be levied for each month tax is delinquent, not to exceed 18 percent of the total tax due for the year.

Any person who tries fraudulently to avoid payment of any tax imposed by the Income Tax Law or who assists or urges others to avoid tax is punishable by imprisonment for a period of not less than one month and not more than one year, or by payment of a fine not less than 50 percent and not more than 150 percent of the benefit derived as a result of committing such a fraud. Punishment will be doubled in the case of repeat offenders.

Every entity in Yemen must possess a tax card issued by the tax authority as evidence that all taxes due have been paid. Presentation of a tax card is required when transacting any business or when renewing any professional licences.

2. Computation

(a) *Sources and basis of assessment (Article 6)*

Tax is payable on gains and profits from any commercial, industrial, financial or real estate activity; from any single transaction which may be considered a trade or business; and from any other source which is not expressly excluded. Taxable profits include, but are not limited to, the following:

(1) income derived from brokerage or commission business;
(2) income or rent and other profits derived from both movable and immovable property;
(3) income from the sale or hire of any trade mark, design, patent or copyright;
(4) income derived from all insurance business and from haulage, sea and air freight;
(5) interest, discounts, exchange gains and commissions;
(6) gains from any contract concluded in Yemen whether or not the gain arises in Yemen. Such gains include profit on contracting, tenders, warranties, agency commissions, registration agreements and commercial brokerage;
(7) capital gains arising from the disposal of movable or immovable property during the course of a business.

Any interest or commission earned outside Yemen by a resident entity is taxable in Yemen if it arises from funds or deposits within Yemen.

(b) *Exemptions (Article 15)*

The following categories of income are exempt from tax:

(1) income of cooperative, agricultural and fisheries associations from non-commercial activities;
(2) income derived from agriculture, horticulture, forestry, breeding livestock, poultry and fish. Such income includes income derived from the processing of products by simple manual labour;
(3) income received by national educational institutions and licensed language schools;
(4) interest on treasury bills paid to individuals;
(5) income from agricultural products of Yemeni origin;
(6) profits exempted in accordance wtih the Investment Promotion Law;
(7) income of airlines and other carriers covered by reciprocal tax exemption agreements, approved by the Council of Ministers;
(8) income of individuals from interest on bank deposits or post office savings, and from dividends.

(c) *Deductions (Article 9)*

The expenses listed below may be deducted from taxable income provided they are incurred wholly and exclusively in the production of that income:

(1) rent;
(2) depreciation;
(3) taxes and fees;
(4) *zakat* paid on business income;
(5) amounts donated to the government, the armed forces, public institutions and projects, and mosque and orphanage building funds, and up to five percent of taxable income donated for approved domestic charitable purposes;
(6) salaries and wages, termination of service benefits, and employers' contributions to social security and approved pensions, provident and other funds;
(7) foreign travel expenses directly connected with the business;
(8) judicially proven bad debts;
(9) amounts lost to theft or embezzlement;
(10) interest and commissions;
(11) a branch's share of head office expenses, subject to a maximum of two percent of the branch's taxable income;
(12) other ordinary expenditures permitted by the Executive Regulations.

Article 9 also contains a list of items for which no deduction is allowed, including the following:

(1) any amounts intended for a compulsory reserve or any other reserve except an amount held as a reserve for annual employee bonuses which does not exceed the total of two months' salaries per year;
(2) interest on capital or any salary or wages or other amounts paid to a partner of a partnership or a director or a shareholder of a private company for services rendered;
(3) capital disbursements;
(4) stamp duty; and
(5) personal fines.

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YEMEN: THE TAXATION OF COMPANIES AND INDIVIDUALS[1]

Geralyn M. Fallon

The Income Tax Law 31 of 1991 replaces the previous tax laws of Yemen (A.R.) and Yemen (P.D.R.) and applies with effect from 12 April 1991. A number of ambiguities in the Law have yet to be clarified by Executive Regulations and it remains to be seen how certain of its provisions will be applied in practice.

Geralyn Fallon is a research associate of the IBFD and editor of the publication Taxes and Investment in the Middle East.

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I. TAXATION OF COMPANIES

A. *Income tax*

The Income Tax Law imposes a Commercial and Industrial Profits Tax on the income of "legal entities", a term which encompasses companies, partnerships, cooperatives and other bodies. For convenience, the term "company" will be used to refer to all types of entities unless the context requires a distinction.

1. *System and rate structure*

(a) *Taxable persons*

Companies resident in Yemen are subject to tax on all their income wherever earned. Any company, whether formed under Yemeni law or a foreign law, having its place of business, management or supervision in Yemen is resident in Yemen. Non-resident companies are subject to tax on their income earned in Yemen.

(b) *Rates*

Different rates of Commercial and Industrial Profits Tax apply depending on the nature of the business entity and the activities in which it is engaged:

Type of concern		*Rate*
(a)	capital companies and economic sector units (public or mixed)	32%
(b)	partnership companies (including joint ventures); sole proprietors	28%
(c)	concession companies and other non-resident companies of all kinds	36%
(d)	commission and brokerage businesses of all kinds	28%

(c) *Administration and assessment*

The tax year is from 1 January to 31 December, unless otherwise stated in the company's articles.

Annual tax returns (or "declarations") accompanied by final audited accounts must be filed with the tax authority by 30 April following the end of the preceding tax year. Associations of capital must file audited financial statements along with the amount of tax due within one month of the shareholders' annual meeting approving the accounts. Companies enjoying tax exemptions are not excused from the obligation to file a return with final accounts by 30 April. Tax is assessed on the basis of the details provided by the company in the submitted declaration.

The taxpayer has the right to object to the tax authority's final tax assessment within 30 days of notification of assessment. The objection must be submitted in writing to an appeal committee stating the reasons for the appeal and must be accompanied by payment of the amount of tax the taxpayer believes is correct. The tax authority may refuse the objection if such a settlement amount is not paid by the taxpayer. The taxpayer will receive notice of the appeal committee's decision and either the taxpayer or tax authority may appeal the committee's decision to the Income Tax Court within 21 days of the date of the committee's decision. The Tax

1. For detailed information see *Taxes and Investment in the Middle East*, Chapter Yemen, International Bureau of Fiscal Documentation (1992).

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IFA NEWS

AUSTRALIA BRANCH

Three technical meetings have been held thus far this year, the topics being "Foreign Investment Funds", "Australian Investment into North America" and "Tax Aspects of Inbound Investment into the USA". Additional meetings are scheduled for 21 September ("Australian Investment into Europe") and 30 November ("Australian Investment into Asia").

UK BRANCH

The Annual General Meeting was held on 16 June; a technical meeting followed on the subject of "The Potential Impact of the Ruding Committee Report". Speakers were Dr Donald De Buitleir, one of the members of the Committee, and Dr David Williams, a professor of international taxation at Queen Mary & Westfield College, University of London.

US BRANCH

The US branch, along with the Tax Foundation, recently hosted a conference entitled, "The Discord in US Tax and Trade Policies: Prescriptions for Change". Key policymakers and senior corporate executives discussed how tax and trade policy relate to each other.

The US/German joint meeting will be held 9-10 October 1992 at the Sheraton-Carlton Hotel in Washington, DC.

CONFERENCE DIARY

For further details of the events listed below please write to the organizers at the addresses indicated.

JULY 1992

Offshore Tax Planning for Business, London (United Kingdom), 3 July (Engllish):
IBC Legal Studies and Services Ltd., 57-71 Mortimer Street, London W1N 7TD, United Kingdom, Tel.: (0)71-6374383, Fax: (0)71-6313214.

Tax Planning for International Treasury Operations in Europe, Old Windsor, Berkshire (United Kingdom), 7-10 July (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard London EC4V 5EX, Tel.: (0)71-7798601, Fax: (0)71-7798599.

International Taxation and Asset Financing, London (United Kingdom), 8-10 July (English):
Euromoney Publications PLC, Nestor House, Playhouse Yard London EC4V 5EX, Tel.: (0)71-7798793, Fax: (0)71-7798795.

SEPTEMBER 1992

Restructuring Tax Policy for Economic Growth, Johannesburg (South Africa), 17 September (English):
South African Fiscal Association/International Executive Communications, P.O. Box 91052, Auckland Park 2006, South Africa, Tel.: (11)726 6003, Fax: (11)736 1304.

Doing business and acquisitions in Central Europe, Nijmegen (the Netherlands), 24-26 September (English):
Centrum voor Postdoctoraal Onderwijs/Bureau Symposia, P.O. Box 9049, 6500 KK Nijmegen, Tel.: (0)80 612022, Fax: (0)80 615949.

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that the Luxembourg tax legislation which allowed a refund of excess withholding taxes on wages only to individuals who were tax resident in Luxembourg for the entire fiscal year, was discriminatory against non-Luxembourg nationals to the extent that aliens were more likely than Luxembourg nationals to be resident in Luxembourg for only part of the year. The Court rejected the argument that the law did not set forth a nationality criterion but rather a full residency criterion in allowing a refund of excess withholding tax. The Court reiterated the EC principle that equal treatment forbids not only direct discrimination based on nationality, but other forms of indirect discrimination that may lead to the same discriminatory result.

There is adequate reason to believe that the EC of Justice would follow the same line of reasoning and consider the one-year residency test as indirect discrimination prohibited under Article 48.2 of the EC treaty.

NEW

The new (1992) edition of this book provides extensive summaries of the corporate and individual tax systems on 1 January 1992. To the 21 countries covered in the 1991 edition Hungary, Iceland, Isle of Man, Monaco and Poland have been added. The chapter on the former U.S.S.R. has been replaced by a brand new chapter on the Russian Republic.

The corporate tax summaries include a description of all corporate income taxes, group treatment, social security contributions, turnover taxes and net worth taxes. A special feature in every chapter is a comprehensive treaty chart listing all the withholding tax rates.

The individual income tax summaries include all relevant income taxes (including local taxes), inheritance and gift taxes, social security contributions and net wealth taxes.

Both the corporate and individual sections pay special attention to non-residents and relief from double taxation.

The **IBFD EUROPEAN TAX HANDBOOK** is published annually every Spring. (Copies of the 1991 edition are still available at the special price of Dfl. 245 to subscribers to the 1992 edition).

Price: Dutch Florins 285
including update and postage

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It should also follow from this definition that a French national who was born in France, left France just after his first birthday and thereafter lived abroad should be considered to meet the residency test. There is no reason to deny residency to a child simply because he was not a "taxpayer". The French tax authorities, in their recent Statement of Practice, have recognized that tax residency requirements are fulfilled where the seller is a member of a family whose tax domicile is in France under CGI Article 4 B. Obviously, such a situation may create evidenciary problems (see below).

The second issue concerns the evidence required to fulfil the test. As drafted, the exemption is conditioned on the fact that the taxpayer was tax resident in France in the past. It is therefore up to the taxpayer to come forward with sufficient evidence to establish that he meets the residency test. However, individual taxpayers are not required to keep tax returns or other documents relevant to their tax status under French tax law. Under Article R 111-4 of the French Tax Procedures Code, the tax authorities are authorized to keep tax data on individual taxpayers throughout the statute of limitations period, i.e. three years from the year the tax bills were issued, so it would seem that taxpayers would in any event encounter formidable obstacles in producing such evidence after the three-year period.

Given this situation, it may be onerous for taxpayers to produce formal evidence of past residence in France, and the recent Statement of Practice does not lend much assistance in this respect. No formal procedures are mandated by the tax authorities, and in most cases, proof may be made by a mere income tax return. As a matter of principle, a taxpayer should be entitled to produce any kind of evidence, such as affidavits, to support his claim that he was resident in France. It is not certain whether the tax authorities will accept such evidence, in which case the taxpayer's only option will be to bring the case before the court and convince the judges that he was tax resident. Such an alternative is clearly unsatisfactory and the number of disputes arising from this test may rapidly become unmanageable.

C. *Is the residency test consistent with the non-discrimination principle?*

On its face, the amendment to Article 150 CIb does not appear to discriminatate against aliens since the seller's nationality is irrelevant. Basically, the test requires a determination of whether French nationals have been tax resident in France for at least one year in the past. Therefore, in principle France should not be obliged under non-discrimination clauses to treat aliens who have not been tax resident in France for at least one year in the past the same as it treats French nationals who have been tax resident in France in the past. France's only undertaking under the non-discrimination principle is to treat aliens in the same way as it would treat its own nationals who fail to meet the one-year residency test.

However, it is likely that the residency test will prevent many more aliens from claiming the exemption under Article 150 C than it will French nationals.[16] Interestingly enough, when the amendment was first introduced in Parliament, it was presented as a means to prevent aliens with no connection to France from claiming the exemption under non-discrimination clauses and the Réponse Mesmin.[17]

Introduction of the new residency test restricts the use of the non-discrimination principle as construed by the tax authorities in the Réponse Mesmin. The authorities stated at that time that, for purposes of the non-discrimination clause, the tax treatment of an alien should be identical to that of a French national in the same situation, most notably in respect of his tax residency. Thus French nationals and aliens resident in France should receive the same tax treatment, as should French nationals and aliens resident abroad.

The amendment introduces a further subdivision in the second branch of the comparison, i.e. between those who have been tax resident in France and those who have not. The rationale for such a distinction is certain to be found in the Réponse Péricard,[18] according to which the situation of French nationals who are resident abroad substantially differs from that of aliens resident in other countries.

The residency test for all practical purposes can be summarized as follows: French nationals domiciled abroad may (almost) always claim the exemption under Article 150 CIb.[19] Non-resident aliens may not claim the exemption under Article 150 CIb and a non-discrimination clause unless they have been French tax resident for at least one year in the past. To this extent, the residency test, in introducing a prerequisite which is more likely to be met by French nationals than by aliens, could be regarded as indirect and insidious discrimination between French nationals and aliens and therefore could be challenged in the courts.

Interestingly enough, France has made the following reservation to the non-discrimination article of the OECD model treaty: "France accepts the provisions of paragraph 1 but wishes to reserve the possibility of granting to only French nationals the exemption provided for in its domestic laws, of gains from the alienation of immovable property which constitutes, whether in whole or in part, the dwelling in France of French nationals non-resident in France for tax purposes."

The residency test provides a way to restrict the use of the non-discrimination clause and thus fully accords with France's reservation to Article 24, paragraph 1 of the OECD model. However, the OECD model is not binding, and the policy of the tax authorities under the Réponse Péricard, which was designed to elucidate on the alleged consistency between the reservation and the non-discrimination principle, has been successfully challenged and later repealed. Therefore, where the applicable non-discrimination clause is drafted according to the OECD model, a denial of the exemption to aliens who do not meet the test should be considered discriminatory.

In the EC, indirect and insidious discrimination has been successfully challenged before the European Court of Justice.[20] On the basis of Article 42.8 of the EC treaty, the Court has held

16. Indeed, the most likely hypothesis for an individual is that he is or has been resident in his country of citizenship rather than in any other country.
17. See *supra* note 4.
18. See *supra* note 6.
19. With the exception of nationals domiciled in overseas territories and territorial communities; see *supra* note 8.
20. ECJ May 1990 No. 175/88 Biehl.

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acquired or completed, or for at least three years; effective occupation is not required where the sale is motivated by family circumstances or a change of work place following the return to France. (emphasis added).

Thus two additional tests have been introduced by the Finance Law, i.e. a residency test and an effective occupation test.

A. *Residency test*

To benefit from the exemption under the new Article 150 CIb, a taxpayer must have been a French resident for tax purposes for at least one year at any time prior to the sale. The residency test is particularly flexible to the extent that the required period of residency is only one year and that it can be met *at any time* prior to the sale.

Although the seller's nationality is irrelevant for purposes of this test, the consequences appear to be different depending on whether French nationals or aliens are involved. French nationals residing abroad are unlikely to be affected by this new text; indeed, in most cases, they were originally French residents who have been seconded abroad.[9] Aliens who are non-resident in France, however, are more likely to be affected by the residency test because they are more likely not to have been resident for tax purposes in France.

In part III of this article we examine the compatibility of the residency test with the non-discrimination principle.

B. *"Effective occupation" test*

Under the "effective occupation" test, the tax authorities have found a means to reverse the decision of the Supreme Administrative Court and reinstate their own interpretation of the law.[10]

Whether the seller is a French national or an alien is irrelevant for the purposes of the effective occupation test. Of overriding concern is how the concept "effective occupation" will be interpreted by the tax authorities. In a similar context (i.e. in deciding the primary residence of a resident), the tax authorities have held that "effective occupation" means that the taxpayer's occupation of the property must be possible at any time, so the test is not met when the property is rented out or used free of charge by third parties.[11] The Supreme Court, on the other hand, has held that a taxpayer continues to have effective occupation of property even when a family member uses the property on an intermittent and a free of charge basis.[12]

III. ISSUES CREATED BY THE AMENDMENT

The 1992 Finance Law amendment creates a number of issues and potential difficulties, including the following:

- does the amendment apply to a transaction entered into in 1991;
- when and how can a taxpayer prove the one-year period of residence;
- is the residency test consistent with the non-discrimination principle?

Although some issues were addressed by the tax authorities in a Statement of Practice dated 26 February 1992,[13] all obstacles have not been removed.

A. *1991 sale*

As no effective date is stipulated in the amendment, the question arises as to whether a gain arising from a transaction entered into in 1991 and exempted under a combination of the then-applicable provisions of Article 150 CI and a non-discrimination clause can be "clawed back" by the amendment. The tax authorities have confirmed in their February 1992 Statement of Practice that the residency test will only apply to transactions entered into after 1 January 1992.[14]

B. *Proving the one-year residency requirement*

Under the residency test, the seller must qualify as tax resident in France for at least one year at any time prior to the sale. This requirement raises the following issues:

- when must the test be met;
- what evidence of residency must be produced and who bears the burden of proof?

The actual wording of the residency test does not impose any restriction on the period of residence. The amendment merely provides that the test may be fulfilled "at any time prior to the sale". Clearly, the period of residence need not coincide with the period of ownership of the French dwelling. But how far in the past may one go to fulfill the residency test?

Under French domestic law, an individual is considered a French tax resident if he meets one of the following requirements:

- he has his home in France; or
- he has his principal abode in France; or
- he carries out his main professional activity in France; or
- the centre of his economic interests is in France.[15]

Thus a French national who has been a resident taxpayer in France for years and is seconded abroad meets the test, as does a French national born abroad who resided in France for a sufficient period of time to become a French tax resident, and later lived abroad.

9. One category of French nationals, however, will be directly affected, i.e. those from overseas territories and territorial communities such as Polynesia, New Caledonia, French Austral and Antartic land, Wallis et Futuna, Saint-Pierre et Miquelon and Mayotte. Politically, these territories are part of France, but are not considered as such for tax purposes. French nationals of these territories are not regarded as French residents and are consequently excluded from the benefit of the new Article 150 CIb exemption unless they have lived in mainland France or any Overseas Department and have been deemed French residents for tax purposes for at least one year in the past.
10. See *supra* note 4.
11. D Adm 887 242 No. 5 and Réponse Cousté of 26 August 1978, No. 692, at 4655.
12. CE of 10 May 1991, No. 81593 7e et 9e s.s.; RJF 7/91 No. 890; CE of 30 October 1991; Bulletin Fiscal Lefebvre (BF) 12/91 inf 1678.
13. 8M392 of 26 February 1992.
14. However, it is interesting to note that this is merely administrative forebearance for practical purposes, but it could as a matter of principle, have been given retroactive effect to 1 January 1991.
15. CGI, Art. 4B.

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ly, a 6,000 Ffrs. standard general allowance is deducted from the taxable base resulting from the above computation.

Example

Sale price 12-1-90		400
Purchase price 11-1-83	100	
Cost (notional figure)	10	
	110	
Legal inflation ratio: 1.32		
110 x 1.32		(145.20)
Capital gain		254.80
Over 2 year-relief		
3.33% x (7 - 2) = 16.65%		
254.80 x 16.65%		(42.42)
Net capital gain		212.37
General annual relief (6,000 FF)		(6.)
Taxable gain		206.37
One-third levy		
206.37 x $\frac{1}{3}$	68.79	

B. *General exemption for non-resident French nationals under Article 150 CIb*

CGI Article 150 C provides that capital gains derived from the sale of a taxpayer's primary residence are exempt from capital gains tax. The general exemption expressly extends to real property or part of such property which constitutes the residence in France of a French national domiciled abroad.[3] Only one residence per taxpayer may be deemed a primary residence for these purposes.

According to the French tax authorities, a French national who is non-resident in France for tax purposes is only exempt from capital gains tax if the taxpayer has effectively occupied the real property from the date of acquisition or completion, or for at least three years (whether or not continuously). The three-year threshold may be reduced to one year when the sale is due to a change of place of work after the employee returns to France. No holding period is required for a sale motivated by family circumstances. Although these conditions have been successfully challenged before the French Supreme Court,[4] the tax administration still refuses to grant the exemption if the above requirements are not met.

C. *Article 150 CIb exemption and non-discrimination clauses*

The extension of the exemption under Article 150 C to aliens was first recognized by the judiciary. On 3 August 1988, the Administrative Court of Nice held that, under the non-discrimination clause in Article 25 of the France/Belgium tax treaty, the gain realized by a Belgian national, resident in Belgium, upon disposition of his private residence in France was exempt from capital gains tax under Article 150 CIb.[5]

This decision contradicted the then-existing administrative position, under which aliens residing abroad were not considered to be in the same situation as French nationals resident abroad, and therefore could not claim the benefit of the non-discrimination clause and the resulting exemption under Article 150 C. The rationale underlying this position was that French nationals seconded abroad maintain close personal and economic connections with France and most will return to France after their stay abroad. This special relationship places French nationals in a situation different from that of aliens owning a private residence in France.[6]

Following this decision, the tax authorities radically altered their analysis of the non-discrimination clause and their new policy was published in a 1989 ministerial reply, known as Réponse Mesmin.[7] According to the Réponse Mesmin, any national of an EC member state or state which is linked to France by a tax treaty providing for non-discrimination may, in principle, qualify for the same exemption as that granted to a French national domiciled abroad, provided the alien is in a situation similar to that of the French national. Under the "similar situation test", the alien must be in the same legal and de facto situation as a French citizen qualifying for the exemption. Among other things, the exemption may only be claimed once, the taxpayer must be a non-resident of France within the meaning of a tax treaty, and he must have effectively occupied the real property from the date it was acquired or from the date it was completed (however, see above for this condition).

The benefit of the exemption on the basis of a non-discrimination clause, however, depends on the language of the relevant treaty. Certain tax treaties have specifically excluded Article 150 C from their scope; for instance, the treaties with Argentina, Bangladesh, Bulgaria, Cyprus, South Korea, Egypt, Hungary, Mauritius, Jordan, Malta and Norway all exclude Article 150 CIb.[8] As a result, nationals of these countries may not claim the exemption on the basis of the treaty, and are therefore, in principle, subject to capital gains tax upon the disposition of their French residence.

II. 1992 FINANCE LAW

CGI Article 150 CI, as amended by the 1992 Finance Law, now reads as follows:

> Any capital gain realized upon the sale of a primary residence is exempt from tax.
>
> The following, inter alia, are considered to be a primary residence:
> a) ...
> b) real property or part of such property which constitutes the residence in France of a French national domiciled abroad, limited to one residence per taxpayer, *provided the seller has been tax resident in France for a continuous period of at least one year at any time prior to the sale of the property, and provided further that he has effectively occupied the property since the date it was*

4. Conseil d'Etat (CE) 28 October 1983, *Revue de Jurisprudence Fiscale* (RJF) 12/83.
5. T. Adm. Nice, 3 August 1988, No. 9897.88III. *Revue de Jurisprudence Fiscale*, 1/89.
6. Réponse Péricard, Assembleé Nationale (AN) 26/7/82, No. 2466, at 456.
7. Réponse Mesmin of 19 June 1989, No. 10842, at 2807.
8. *Id.*

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FRANCE:

SALE OF FRENCH RESIDENCE BY NON-RESIDENT INDIVIDUALS: NEW LIMITS

Philippe Juilhard and Stéphane Salou

The 1992 Finance Law introduces a major limitation on the ability of non-residents to claim an exemption from capital gains tax upon the disposition of their private residence in France. Until 1992, non-resident citizens of countries which had concluded a tax treaty with France containing a non-discrimination clause, were generally entitled to claim the benefit of the same exemption under Article 150 CIb of the French Tax Code (CGI) as that offered to French nationals. However, henceforth, taxpayers may benefit from this provision only if they have been French tax residents for at least one year, and if they effectively occupied the real property for the entire period of ownership or for at least three years. Under the amended Article 150 CIb, some non-resident individuals may no longer be able to claim the exemption from capital gains tax because they fail to meet the one-year residency test.

This article reviews the pre-1992 Finance Law tax regime, the general principles governing the taxation of non-residents and the use of non-discrimination clauses, and then examines the amendment, its consequences and the issues it raises, particularly with respect to the non-discrimination principle.[1]

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I. PRE-1992 FINANCE LAW TAX REGIME

The pre-1992 Finance Law tax regime is defined by reference to three statutory texts: CGI Article 244 Bis A, CGI Article 150 C, and the non-discrimination clause in the pertinent tax treaty, if any.

A. *General principle of taxation of non-residents*

Under CGI Article 244 bis A I, non-residents are subject to income tax of 33 1/3 percent on the capital gains arising from the sale of real property in France.[2] This tax is a final tax for individuals.

The assessment is made based on whether the real property has been held for more than two years. If held for less than two years, the 33 1/3 percent levy applies without any capital gain adjustment. In other words, the taxable gain will be equal to the sale price less the purchase price, increased by relevant expenses. If the property has been held for more than two years, a price index ratio is first applied to the acquisition price, as increased by actual expenses (notably registration duties and notary fees) or by a ten percent notional amount. The result is reduced by 3.33 percent for every year of ownership beyond the second year (resulting in a full exemption if the property is owned for 32 years). Final-

1. The article will not address other capital gains tax exemptions on real property, such as for example, the exemption provided under CGI Art. 150 II.
2. The rate is increased to 50 percent if the taxpayer is deemed to engage in "habitual" operations.
3. CGI Art. 150 CIb.

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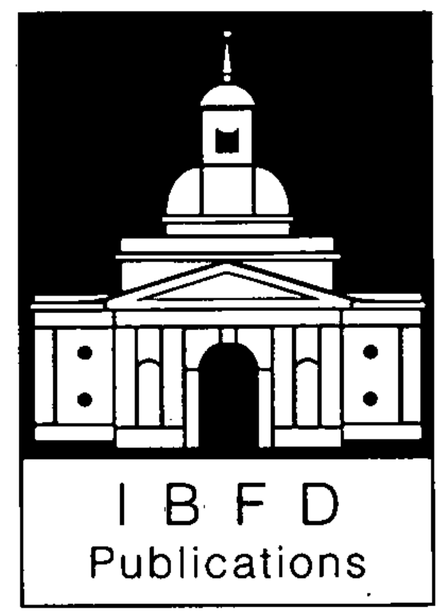

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Table

	Belgium	Denmark	France	Germany	Ireland	Italy	Luxembourg	Netherlands	Spain	U.K.
DIVIDENDS RECEIVED										
Exemption or Credit method	Exemption[1]	Exemption	Exemption	Exemption[2]	Credit	Exemption	Exemption	Exemption	Credit	Credit
Minimum Participation (%)	None	25	10[3]	10	25	25	10[4]	5/25[5]	25	10
Minimum Holding Period	None	2 years	2 years[6]	1 Year[7]	None[8]	1 year	1 year[7]	None	2 years	None
DIVIDENDS PAID										
Minimum Participation (%)	25	25	25	25/10[9]	N/A	25	25	25	25	N/A
Minimum Holding Period	1 year	2 years	2 years	1 year	N/A	1 year	2 years	1 year	2 years	N/A
SPECIFIC ANTI-ABUSE PROVISIONS	Yes	No	Yes	No	No	Yes	No	Yes	Yes	No
APPLICABLE TO COMPANIES NOT MENTIONED IN ANNEX	Yes[10]	No	No	Yes[9]	No	No	No	Yes	Yes[9]	Yes
PROVISIONS FOR VOTING RIGHTS	No	No	No	No	No[11]	No	No	Yes	No	Yes
CAPITAL LOSS DEDUCTION	No	No[12]	Yes	Yes	Yes[13]	Yes	Yes	No	No	Yes[13]

NOTES

1 A deduction of 95% is granted
2 If a dividend is not exempt under an EC bilateral treaty then credit method applies
3 Or a value of 150 million francs
4 Or a value of 50 million francs
5 For a portfolio investment
6 No minimum holding period if shares acquired by subscription
7 The shareholding must have been held continuously for a period of at least 12 months prior to the year end in which the dividend is received
8 Two years if stipulated in a bilateral agreement
9 Subject to reciprocity
10 For dividends received only
11 Yes if a bilateral agreement provides otherwise
12 Yes if shares are sold less than 3 years after acquisition
13 Restricted to set off against capital gains

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VI. EXTENSION OF THE DIRECTIVE TO ENTITIES NOT MENTIONED IN THE ANNEX

The Directive only covers entities which take one of the forms specifically mentioned in the Annex. For example, in the case of the United Kingdom it covers companies incorporated under UK law, and in the case of France it covers companies known as "société anonyme', "société en commandite par actions", société à responsabilité limitée" and industrial and commercial establishments and undertakings. The scope of this particular provision of the Directive has been extended by several member states either because of an existing provision in the domestic law of a particular member state or by express inclusion in its implementing legislation.

Under the Belgium participation exemption regime, dividends received by a Belgium company from a participation in a non-resident company which is subject in its local jurisdiction to a tax similar to the Belgium corporate income tax will qualify for exemption. Therefore if a Belgium company is a shareholder in a French SNC (Société en nom collectif) which has elected to be subject to corporate tax in France then a distribution from the SNC to the Belgium shareholder will qualify for exemption in Belgium notwithstanding that an SNC is not listed as a qualifying company in the Annex.

Under the Dutch participation exemption regime, it is sufficient that a foreign subsidiary be subject to a tax on profits in the country in which it is resident. The comments above regarding a French SNC would equally apply here.

Germany will also apply the reduced rate of withholding tax on distributions by any entity which falls within the provisions of Article 1 (1) of the German Corporate Income Tax Act and which is not included in the Annex provided the country in which the parent company is resident grants a tax exemption or credit for German corporate tax suffered on the distribution, and such country exempts from withholding tax any distributions made to a German parent company.

In Spain's implementing legislation, the Ministry of Finance is authorized to extend the provisions of the Directive to parent and subsidiary companies which take a form other than that mentioned in the Annex provided reciprocal treatment is accorded by the other member state.

The United Kingdom grants unilateral relief in respect of tax payable under the law of any territory outside the United Kingdom. It is not necessary that the entity be listed in the Annex in order to qualify for this treatment.

VII. VOTING RIGHTS

Under Article 3(1) of the Directive, a subsidiary is defined as a company in which a company of another member state has a holding of at least 25 percent of its capital. Article 3 (2) grants member states the option, by means of a bilateral agreement, of replacing the 25 percent holding requirement in the capital by a holding of 25 percent of voting rights. The majority of member states did not take up this option and left the qualifying requirement at 25 percent of share capital.

Ireland, however, provides in its implementating legislation that the voting requirement may be substituted for the holding requirement where a bilateral agreement so provides.

UK domestic legislation already provides for a voting test and the Consultative Document issued by the Inland Revenue does not contain any proposal to change this to a simple shareholding requirement.

The Netherlands also opted for the voting rights test in instances where a tax treaty provides such a test for reducing the source taxation of dividends.

VIII. CHARGES/CAPITAL LOSS DEDUCTION

Article 4(2) of the Directive provides that each member state should retain the option of providing that any charges relating to a shareholding and any losses resulting from the distribution of the profits of the subsidiary may not be deducted from the taxable profits of the parent company. Where the management costs relating to a shareholding are fixed at a flat rate, the rate may not exceed five percent of the dividends received. No member state in its implementing legislation has introduced any specific provisions on the non-deductibility of charges relating to a shareholding. Generally such costs are allowed as a deduction in each member state with the exception of the following:

- Under existing legislation, France restricts the deductibility of costs relating to a qualifying shareholding. A company may either exclude all associated costs or alternatively add back in its tax computation a lump sum amount equal to five percent of the exempt dividends.
- The Netherlands, under its participation exemption, does not allow the deduction of any costs attributable to a qualifying shareholding.
- Luxembourg has a partial restriction on the deduction of costs attributable to a qualifying shareholding. These costs are set off against any tax-exempt dividends or capital gains received during the taxable year; any excess may then be set off against other taxable income.

  The deduction of losses resulting from the distribution of the profits of a subsidiary are generally deductible in France, Germany, Italy and Luxembourg.
- In the United Kingdom and Ireland capital losses are only deductible against capital gains.
- Belgium and Spain have amended their legislation as a result of the Directive so that such losses are no longer deductible.
- Under the Danish participation exemption system capital losses are only allowed as a deduction if the shareholding has been held for less than three years at the time of disposal.

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III. TAX CREDITS/PREPAYMENTS

The Directive makes clear in Article 7 that the term "withholding tax" does not cover an advance payment or prepayment of corporation tax which is made in connection with a distribution of profits to a parent company. The United Kingdom and Ireland operate an advance corporation tax system and both Italy and France have a prepayment system which applies to the distribution of profits which have not borne the normal rate of tax.

The Directive also does not affect the application of provisions relating to the payment of tax credits attaching to dividends. There are four member states that grant refunds of tax credits in certain circumstances to non-residents, i.e. France, Ireland, Italy and the United Kingdom. These tax credit refunds are reduced by an amount called a withholding tax which is based on the combined value of the dividend and the tax credit. It has been suggested in some press reports that such reduction of the tax credit is contrary to the Directive. However, this writer is of the opinion that the reduction of the tax credit refund is permitted by the Directive by virtue of Article 7 (2).

IV. OTHER COMMENTS

It is interesting to note that France in its implementing legislation has made it a condition for obtaining exemption from withholding tax that the foreign parent company must not, by virtue of a tax treaty, be entitled to a payment from the French Treasury which is equal to the tax credit (avoir fiscal) or equal to a fraction of the tax credit which is greater than the rate of withholding tax on dividends provided for by the same treaty. In the opinion of the writer France's position cannot be supported by the wording of the Directive. This provision may cause problems for Italian parent companies under the new France/Italy treaty because of the provisions for the refund of tax credits, and to Dutch parent companies, for example, because of the provisions for the refund of the précompte in the France/Netherlands treaty.

V. ANTI-ABUSE PROVISIONS

Article 1(2) of the Directive states that "this Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse". Thus the Directive may be overridden by provisions in the domestic law of any member state and, for example, by any provisions in a double taxation agreement.

In implementing the Directive, France has introduced an anti-Directive shopping provision into its Tax Code which states that if a parent company in another member state is controlled directly or indirectly by non-residents of the EC then France will deny the benefits of the Directive to that parent company on the payment of dividends by a French subsidiary. A defence is available to the parent company if it can demonstrate that the relationship with its subsidiary does not have as its main object or one of its main objects the obtaining of the reduced withholding under the Directive.

Spain has introduced a similar provision which denies the benefits of the Directive to parent companies located in other member states where the majority of the voting rights of such parent companies are held directly or indirectly by persons who are not residents of the EC. As in the case of France, a defence is available if the parent company can demonstrate that it conducts a business activity related to the activities of its subsidiary or its purpose is to manage and control its subsidiary and it has adequate human and material resources to do so or can evidence that it was established for valid economic reasons and not for taking undue advantage of the new legislation.

Two of the six criteria set by the Italian Parliament for the implementation of the Directive specificly mention the withdrawal of Directive benefits in the event of fraud or abuse, i.e. in respect of the exemption of dividends received from EC subsidiaries and a general withdrawal of all benefits that may arise from the implementation of the Directive in the event of fraud or abuse.

Belgium introduced anti-abuse provisions in 1989 in respect of the receipt of dividends from foreign subsidiaries. These provisions were extended when the Directive was implemented to include an anti-conduit provision which is designed to prevent the use of an intermediate holding company. Broadly, the new provisions state that if dividends were received directly by the Belgium parent and the exemption would not apply then the redistribution of the dividends by the intermediate holding company would similarly not qualify for exemption.

The Netherlands has made proposals to amend its Dividend Tax Act so that generally there will be no withholding tax on the payment of dividends by a Dutch company to an EC parent company. However, one of the conditions to qualify for the reduced withholding is that the EC parent is not precluded from claiming reduced dividend withholding tax by virtue of anti-abuse provisions contained in an existing double taxation agreement between the Netherlands and the country of residence of the parent company. It would appear that currently this anti-abuse provision has limited scope as no treaty signed by the Netherlands with any other EC country has such an anti-abuse provision, with the exception of the treaty with Luxembourg and then only with respect to Luxembourg holding companies which, in any case, are already excluded from the Directive.

The Netherlands has also made proposals to make amendments to its participation exemption regime which covers, inter alia, the receipt of dividends from foreign qualifying companies. One of the conditions to qualify is that the participation in the foreign company must not be considered a portfolio investment. This requirement will be withdrawn in future. However, the requirement that the shareholding must not be held as inventory will remain. The retention of this condition by the Dutch government has been justified by its domestic provisions for the prevention of abuse.

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Germany presently exempts all dividends received from qualifying subsidiaries in other EC member states. In effect, Germany has an exemption method for purposes of the Directive.

Ireland and Spain have opted for the credit method. Under existing legislation, the United Kingdom operates the credit method for foreign withholding and underlying taxes.

B. *Minimum participation*

The Directive attributes the status of parent company at least to a company which, inter alia, has a minimum holding of 25 percent in the capital of a company of another member state. There is no requirement that the holding be maintained for any minimum period of time. However, a member state may require a minimum holding period of at least two years.

Under the participation exemption regime in Belgium there is no minimum participation requirement, so Belgium did not need to amend its legislation in this respect.

In Denmark, a minimum participation of 25 percent is already provided for under existing law.

In France, the present participation exemption regime requires that the value of the shareholding be equal to at least 150 million francs or represent at least ten percent of the subsidiary's share capital. Consequently, France has made no alterations to its existing law in this respect.

The existing German system for the taxation of dividends from foreign subsidiaries provides for a minimum participation of ten percent.

Under the participation exemption system in Luxembourg, there is a requirement for a minimum shareholding of ten percent or a minimum value of 50 million francs.

The Dutch participation exemption system normally requires a shareholding of at least five percent. However, the participation exemption does not apply to shareholdings which constitute a portfolio investment or to shareholdings which are held as inventory. The Dutch government has amended its law to comply with the Directive as far as portfolio investments are concerned, and a 25 percent shareholding in such a company will now qualify for exemption. However, no such change has been made for shareholdings held as inventory. Presumably this position is defended by the Dutch Government on the grounds that domestic anti-abuse provisions are not precluded by the Directive.

UK domestic law requires a ten percent shareholding.

C. *Minimum holding period*

The Directive requires no minimum holding period, or alternatively an uninterrupted period of at least two years. In this respect Germany, by maintaining a minimum period of at least 12 months prior to the end of the year in which the dividend is received, has not, strictly speaking, complied with the terms of the Directive. Luxembourg has the same 12 month rule and has not amended its legislation. The Italian Parliament has recommended a minimum holding period of one year. All other member states have either opted for no holding period, a minimum two year holding period or a mixture of the two.

II. DIVIDENDS PAID TO AN EC PARENT COMPANY

The Directive provides that profits distributed by a subsidiary to its parent company be exempt from withholding tax at least where the parent holds a minimum of 25 percent of the capital of the subsidiary. Special derogations to this rule are accorded to Germany, Greece and Portugal.

Germany is allowed to maintain a five percent withholding tax until 1 July 1996 so long as it charges corporation tax on distributed profits at a rate at least 11 percent lower than the rate applicable to retained profits. Greece may continue its present system of withholding taxes as dividends paid are allowed as a deduction in calculating taxable income. However, the rate of withholding tax must not exceed the rate provided for in double taxation agreements. Portugal may continue to levy withholding taxes until 31 December 1999 but subject to existing double taxation agreements concluded with other member states the rate of withholding tax may not exceed 15 percent during the first five years and ten percent during the last three years.

It should also be noted that under existing legislation in the United Kingdom and Ireland there is no withholding tax on the payment of dividends to foreign residents.

The only country that has lowered the qualifying minimum participation in its implementing legislation is Germany. According to new Article 44 d(3) of the Income Tax Act, the minimum participation of 25 percent may be lowered to ten percent provided that a tax exemption or a tax credit is granted in the parent company's jurisdiction for the German corporate income tax suffered on the distributed profits, and such country exempts from withholding tax distributions of profits made to a German parent company with a shareholding of at least ten percent.

In its implementing legislation, Germany has amended its refund procedure for withholding taxes on dividends paid to qualifying parent companies. If a parent company has obtained an exemption certificate from the German Finance Ministry the German payor may apply the lower Directive or treaty rate immediately upon payment. Otherwise the standard 25 percent withholding tax rate will be initially applied and the recipient must apply for a refund.

As mentioned above, the Directive does not lay down any minimum holding period in order to qualify for the reduced withholding. However, the Directive by way of derogation allows a member state to require a minimum holding period of at least two years. This two year option has been taken up by Denmark, France, Luxembourg and Spain. Belgium, Germany, Italy and the Netherlands have opted for a minimum holding period of at least one year. Such minimum period is not actually permitted by the Directive.

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